

TELKONET INC  
Form 10-Q  
November 16, 2009

---

---

U.S. SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2009

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934.

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number 001-31972

TELKONET, INC.

(Exact Name of Registrant as Specified in Its Charter)

Utah  
(State or Other Jurisdiction of Incorporation or  
Organization)

87-0627421  
(I.R.S. Employer Identification No.)

20374 Seneca Meadows Parkway, Germantown,  
MD  
(Address of Principal Executive Offices)

20876  
(Zip Code)

(240) 912-1800  
(Registrant's Telephone Number, Including Area Code)

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

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

Edgar Filing: TELKONET INC - Form 10-Q

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company as defined in Rule 12b-2 of the Exchange Act.

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 96,563,771 shares of Common Stock (\$.001 par value) as of November 14, 2009.

---

---

---

TELKONET, INC.  
FORM 10-Q for the Quarter Ended September 30, 2009

Index

	Page
<b>PART I. FINANCIAL INFORMATION</b>	<b>3</b>
Item 1. Financial Statements (Unaudited)	3
Condensed Consolidated Balance Sheets: September 30, 2009 and December 31, 2008	3
Condensed Consolidated Statements of Operations and Comprehensive Income (Loss): Three And Nine Months Ended September 30, 2009 and 2008	4
Condensed Consolidated Statement of Equity: January 1, 2009 through September 30, 2009	5
Condensed Consolidated Statements of Cash Flows: Nine Months Ended September 30, 2009 and 2008	6
Notes to Unaudited Condensed Consolidated Financial Statements: September 30, 2009	8
Item 2. Management's Discussion and Analysis	24
Item 3. Quantitative and Qualitative Disclosures About Market Risk.	35
Item 4. Controls and Procedures	35
<b>PART II. OTHER INFORMATION</b>	<b>36</b>
Item 1. Legal Proceedings	36
Item 1A. Risk Factors	36
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	37
Item 3. Defaults Upon Senior Securities	37
Item 4. Submission of Matters to a Vote of Security Holders	37
Item 5. Other Information	37
Item 6. Exhibits	38



## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements (Unaudited)

TELKONET, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS

	(Unaudited)	
	September	December
	30,	31,
	2009	2008
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 38,449	\$ 168,492
Accounts receivable, net	687,056	836,336
Inventories	1,286,296	1,733,940
Other current assets	195,204	230,539
Current assets from discontinued operations	-	476,459
Total current assets	2,207,005	3,445,766
Property and equipment, net	290,924	403,593
Other assets:		
Marketable securities	-	397,403
Deferred financing costs, net	287,178	432,136
Goodwill and other intangible assets, net	14,956,212	15,137,469
Other assets	8,890	98,807
Other assets from discontinued operations	-	6,593,169
Total other assets	15,252,280	22,658,984
Total Assets	\$ 17,750,209	\$ 26,508,343
<b>LIABILITIES AND EQUITY</b>		
Current liabilities:		
Accounts payable and accrued liabilities	\$ 3,148,184	\$ 2,561,213
Accrued liabilities and expenses	1,968,910	1,996,044
Line of credit	449,741	574,005
Other current liabilities	141,059	278,033
Current Liabilities from discontinued operations	-	13,450,362
Total current liabilities	5,707,894	18,859,657
Long-term liabilities:		
Convertible debentures, net of debt discounts of \$538,305 and \$825,585, respectively	1,067,718	1,311,065
Derivative liability	1,870,113	2,573,126
Note payable	300,000	-
Deferred lease liability and other	50,791	50,791
Total long-term liabilities	3,288,622	3,934,982

Commitments and contingencies	-	-
Equity		
Preferred stock, par value \$.001 per share; 15,000,000 shares authorized; none issued and outstanding at September 30, 2009 and December 31, 2008	-	-
Common stock, par value \$.001 per share; 155,000,000 shares authorized; 96,563,771 and 87,525,495 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively	96,564	87,526
Additional paid-in-capital	119,296,304	118,197,450
Accumulated deficit	(110,639,175)	(114,801,318)
Accumulated comprehensive loss	-	(32,750)
Total stockholders' equity	8,753,693	3,450,908
Non-controlling interest	-	262,795
Total equity	8,753,693	3,713,703
Total Liabilities and Equity	\$ 17,750,209	\$ 26,508,343

See accompanying notes to the unaudited condensed consolidated financial statements

## TELKONET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)  
(UNAUDITED)

	For The Three Months Ended September 30,		For The Nine Months Ended September 30,	
	2009	2008	2009	2008
Revenues, net:				
Product	\$ 1,445,888	\$ 3,837,728	\$ 5,462,955	\$ 10,821,179
Recurring	991,130	897,482	2,982,384	2,559,728
Total Revenue	2,437,018	4,735,210	8,445,339	13,380,907
Cost of Sales:				
Product	833,926	2,076,776	2,942,748	6,800,627
Recurring	348,321	416,723	957,668	1,274,786
Total Cost of Sales	1,182,247	2,493,499	3,900,416	8,075,413
Gross Profit	1,254,771	2,241,711	4,544,923	5,305,494
Operating Expenses:				
Research and Development	263,672	509,418	761,950	1,667,229
Selling, General and Administrative	1,732,053	2,123,035	5,089,221	7,268,375
Impairment write-down in investment in affiliate	-	-	-	380,000
Stock Based Compensation	65,746	194,483	243,366	704,613
Depreciation and Amortization	86,223	103,056	266,740	318,210
Total Operating Expense	2,147,694	2,929,992	6,361,277	10,338,427
Loss from Operations	(892,923)	(688,281)	(1,816,354)	(5,032,933)
Other Income (Expenses):				
Financing Expense, net	(228,730)	(243,424)	(710,266)	(2,191,431)
Gain (Loss) on Derivative Liability	(650,338)	(576,156)	788,936	(1,594,609)
Impairment of Investment in Marketable Securities	(367,653)	-	(367,653)	-
(Loss) on Sale of Investment	-	-	(29,371)	-
Total Other Income (Expenses)	(1,246,721)	(819,580)	(318,354)	(3,786,040)
Income (Loss) Before Provision for Income Taxes	(2,139,644)	(1,507,861)	(2,134,708)	(8,818,973)
Provision for Income Taxes	-	-	-	-
Income (Loss) from Continuing Operations	\$ (2,139,644)	\$ (1,507,861)	\$ (2,134,708)	\$ (8,818,973)
Discontinued Operations				
Income (Loss) from Discontinued Operations	-	(1,370,896)	(635,735)	(3,412,656)
Gain on Deconsolidation	-	-	6,932,586	-
Net Income (Loss)	\$ (2,139,644)	\$ (2,878,757)	\$ 4,162,143	\$ (12,231,629)
Net income (loss) per share:				
Income (loss) per share from continuing operations - basic	\$ (0.02)	\$ (0.04)	\$ (0.02)	\$ (0.16)

Edgar Filing: TELKONET INC - Form 10-Q

Income (loss) per share from continuing operations - diluted	\$ (0.02)	\$ (0.04)	\$ (0.02)	\$ (0.16)
Income (loss) per share from discontinued operations – basic	\$ 0.00	\$ (0.02)	\$ 0.07	\$ (0.04)
Income (loss) per share from discontinued operations – diluted	\$ 0.00	\$ (0.02)	\$ 0.07	\$ (0.04)
Net income (loss) per share – basic	\$ (0.02)	\$ (0.04)	\$ 0.04	\$ (0.16)
Net income (loss) per share - diluted	\$ (0.02)	\$ (0.04)	\$ 0.04	\$ (0.16)
Weighted Average Common Shares Outstanding - basic	96,220,386	81,422,404	93,787,069	76,880,047
Weighted Average Common Shares Outstanding - diluted	96,220,386	81,422,404	93,787,069	76,880,047
Comprehensive Income (Loss):				
Net Income (Loss)	\$ (2,139,644)	\$ (2,878,757)	\$ 4,162,143	\$ (12,231,629)
Unrecognized Gain (Loss) on Investment	-	(1,218,100)	32,750	(2,776,304)
Comprehensive Income (Loss)	\$ (2,139,644)	\$ (4,096,857)	\$ 4,194,893	\$ (15,007,933)

See accompanying notes to the unaudited condensed consolidated financial statements



TELKONET, INC.  
 CONDENSED CONSOLIDATED STATEMENT OF EQUITY (UNAUDITED)  
 FOR THE PERIOD FROM JANUARY 1, 2009 THROUGH SEPTEMBER 30, 2009

	Preferred Shares	Preferred Stock Amount	Common Shares	Common Stock Amount	Additional Paid in Capital	Accumulated Deficit	Comprehensive Income (Loss)	Noncontrolling Interest	Total
Balance at January 1, 2009			87,525,495	\$ 87,526	\$ 118,197,450	\$ (114,801,318)	\$ (32,750)	\$ 262,795	\$ 3,713,703
Shares issued in exchange for services rendered at approximately \$0.12 per share	-	-	83,333	83	9,917	-	-	-	10,000
Shares issued for warrants exercised at \$0.09 per share	-	-	780,000	780	70,746	-	-	-	71,526
Shares issued in exchange for convertible debentures	-	-	8,174,943	8,175	714,339	-	-	-	722,514
Stock-based compensation expense related to employee stock options	-	-	-	-	233,366	-	-	-	233,366
Stock-based compensation expense related to the re-pricing of investor warrants	-	-	-	-	70,486	-	-	-	70,486
Unrealized Gain on available for sale securities	-	-	-	-	-	-	32,750	-	32,750
Reclass of non-controlling interest	-	-	-	-	-	-	-	(262,795)	(262,795)

Income from discontinued operations	-	-	-	-	-	6,296,851	-	-	6,296,851	
Income from continuing operations	-	-	-	-	-	(2,134,708)	-	-	(2,134,708)	
Balance at September 30, 2009	\$	-	-	96,563,771	\$ 96,564	\$ 119,296,304	\$ (110,639,175)	\$	-	\$ 8,753,693

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

	For the Nine Months Ended September 30,	
	2009	2008
Increase (Decrease) In Cash and Equivalents		
Cash Flows from Operating Activities:		
Net income (loss) attributable to common shareholders	\$ 4,162,143	\$ (12,231,639)
Net (income) loss from discontinued operations	(6,296,851)	3,082,656
Net income (loss) from continuing operations	(2,134,708)	(9,148,983)
Adjustments to reconcile net income (loss) from operations to cash (used in) operating activities:		
Amortization of debt discounts and financing costs	543,161	364,374
Loss on sale of investment	29,371	-
Impairment of investment in marketable securities	367,653	
(Gain) loss on derivative liability	(788,936)	1,594,609
Impairment write-down on fixed assets and goodwill	-	710,000
Stock based compensation	243,366	704,613
Fair value of issuance of warrants and re-pricing (financing expense)	70,486	1,798,662
Depreciation and amortization	266,740	350,163
Increase / decrease in:		
Accounts receivable, trade and other	766,598	455,162
Inventories	447,644	572,088
Prepaid expenses and deposits	117,019	345,520
Deferred revenue	(20,536)	(28,008)
Other Assets	(62,595)	157,654
Accounts payable, net	(90,088)	(803,822)
Accrued expenses, net	172,319	(305,398)
Cash used in continuing operations	(72,506)	(3,233,366)
Cash used in discontinued operations	(287,997)	(861,542)
Net Cash Used In Operating Activities	(360,503)	(4,094,908)
Cash Flows From Investing Activities:		
Purchase of property and equipment	(2,675)	(14,375)
Advances to unconsolidated subsidiary	(305,539)	-
Proceeds from sale of investment	33,129	-
Cash used in continuing operations	(275,085)	(14,375)
Cash used in discontinued operations	(5,979)	(994,344)
Net Cash Used In Investing Activities	(281,064)	(1,008,719)
Cash Flows From Financing Activities:		
Proceeds from issuance of convertible debentures	-	3,500,000
Proceeds from sale of common stock, net of costs and fees	-	1,500,000
Proceeds from issuance of notes payable	300,000	60,000
Proceeds (repayments) from line of credit	(124,264)	475,000

Edgar Filing: TELKONET INC - Form 10-Q

Financing fees	(25,000)	(462,566)
Repayment of notes payable	-	(1,500,000)
Proceeds from the exercise of warrants	71,526	-
Repayment of capital lease and other	(4,714)	(4,625)
Cash provided by continuing operations	217,548	3,567,809
Cash provided by discontinued operations	293,976	56,228
Net Cash Provided By Financing Activities	511,524	3,624,037
Net Decrease In Cash and Equivalents	(130,043)	(1,479,590)
Cash and cash equivalents at the beginning of the period	168,492	1,629,583
Cash and cash equivalents at the end of the period	\$ 38,449	\$ 149,993

TELKONET, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)  
 (UNAUDITED)

	For the Nine Months Ended September 30,	
	2009	2008
<b>Supplemental Disclosures of Cash Flow Information:</b>		
<b>Cash transactions:</b>		
Cash paid during the period for financing expenses	\$ 355,340	\$ 257,403
Income taxes paid	-	-
<b>Non-cash transactions:</b>		
Stock based compensation to employees and consultants in exchange for services	\$ 243,366	\$ 704,613
Fair value of issuance of warrants and re-pricing (financing expense)	70,486	1,798,662
(Gain) loss on derivative liability	(788,936 )	1,594,609
Impairment write-down on goodwill and fixed assets	-	710,000
Amortization of debt discount on convertible debentures and financing costs	543,161	364,374
Accrued interest re classified as convertible debenture principal	191,887	-
Value of common stock issued in exchange for conversion of debenture principal	722,514	710,000

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2009  
(UNAUDITED)

NOTE A-SUMMARY OF ACCOUNTING POLICIES

A summary of the significant accounting policies applied in the preparation of the accompanying consolidated financial statements follows.

Business and Basis of Presentation

Telkonet, Inc., formed in 1999 and incorporated under the laws of the state of Utah, has evolved into a Clean Technology company that develops and manufactures proprietary energy efficiency and SmartGrid networking technology. Prior to January 1, 2007, the Company was primarily engaged in the business of developing, producing and marketing proprietary equipment enabling the transmission of voice and data communications over a building's existing internal electrical wiring.

In January 2006, of the Company acquired 90% of Microwave Satellite Technologies, Inc. (MST), and through this subsidiary, the Company began offering complete sales, installation, and service of VSAT and business television networks, and became a full-service national Internet Service Provider (ISP). In 2009, the Company completed the deconsolidation of MST by reducing its ownership percentage and board membership. Financial statements and accompanying notes included in this report include disclosure of the results of operations for MST, for all periods presented, as discontinued operations.

In March 2007, the Company acquired substantially all of the assets of Smart Systems International (SSI), a leading provider of energy management products and solutions to customers in the United States and Canada.

In March 2007, the Company acquired 100% of the outstanding membership units of EthoStream, LLC, a network solutions integration company that offers installation, sales and service to the hospitality industry. The EthoStream acquisition enables Telkonet to provide installation and support for PLC products and third party applications to customers across North America.

The unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Telkonet Communications, Inc. and EthoStream, LLC. Significant intercompany transactions have been eliminated in consolidation.

Going Concern

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern. The Company has reported a net income available to common shareholders of \$4,162,143 for the nine months ended September 30, 2009. However, the Company has reported operating losses of \$1,816,354, excluding gains on derivative liabilities, impairment of marketable securities and discontinued operations, for the nine months ended September 30, 2009. In addition, the Company has reported an accumulated deficit of \$110,639,175 and a working capital deficit of \$3,500,889 as of September 30, 2009.

The Company believes that anticipated revenues from operations will be insufficient to satisfy its ongoing capital requirements for at least the next 12 months. If the Company's financial resources from operations are insufficient, the Company will require additional financing in order to execute its operating plan and continue as a going concern. The Company cannot predict whether this additional financing will be in the form of equity or debt, or be in another form. The Company may not be able to obtain the necessary additional capital on a timely basis, on acceptable terms, or at all. In any of these events, the Company may be unable to implement its current plans for expansion, repay its debt obligations as they become due, or respond to competitive pressures, any of which circumstances would have a material adverse effect on its business, prospects, financial condition and results of operations.

Management intends to raise capital through asset-based financing and/or the sale of its stock in private placements. Management believes that with this financing, the Company will be able to generate additional revenues that will allow the Company to continue as a going concern. There can be no assurance that the Company will be successful in obtaining additional funding.

TELKONET, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2009  
(UNAUDITED)

### Goodwill and Other Intangibles

Goodwill represents the excess of the cost of businesses acquired over fair value or net identifiable assets at the date of acquisition. Goodwill is subject to a periodic impairment assessment by applying a fair value test based upon a two-step method. The first step of the process compares the fair value of the reporting unit with the carrying value of the reporting unit, including any goodwill. The Company utilizes a discounted cash flow valuation methodology to determine the fair value of the reporting unit. If the fair value of the reporting unit exceeds the carrying amount of the reporting unit, goodwill is deemed not to be impaired in which case the second step in the process is unnecessary. If the carrying amount exceeds fair value, the Company performs the second step to measure the amount of impairment loss. Any impairment loss is measured by comparing the implied fair value of goodwill, calculated per SFAS No. 142, with the carrying amount of goodwill at the reporting unit, with the excess of the carrying amount over the fair value recognized as an impairment loss.

### Fair Value of Financial Instruments

In January 2008, the Company adopted the provisions under FASB for Fair Value Measurements, which define fair value for accounting purposes, establishes a framework for measuring fair value and expands disclosure requirements regarding fair value measurements. The Company's adoption of these provisions did not have a material impact on its consolidated financial statements. Fair value is defined as an exit price, which is the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date. The degree of judgment utilized in measuring the fair value of assets and liabilities generally correlates to the level of pricing observability. Financial assets and liabilities with readily available, actively quoted prices or for which fair value can be measured from actively quoted prices in active markets generally have more pricing observability and require less judgment in measuring fair value. Conversely, financial assets and liabilities that are rarely traded or not quoted have less price observability and are generally measured at fair value using valuation models that require more judgment. These valuation techniques involve some level of management estimation and judgment, the degree of which is dependent on the price transparency of the asset, liability or market and the nature of the asset or liability. The Company has categorized its financial assets and liabilities measured at fair value into a three-level hierarchy in accordance with these provisions.

### Investments

Telkonet maintained investments in two publicly-traded companies for the period ended September 30, 2009. The Company has classified these securities as available for sale. Such securities are carried at fair market value. Unrealized gains and losses on these securities, if any, are reported as accumulated other comprehensive income (loss), which is a separate component of stockholders' equity. Unrealized gains on the sale of one investment resulted in a gain of \$32,750 recorded for the nine months ended September 30, 2009 and unrealized losses of \$2,776,304 were recorded for the nine months ended September 30, 2008. Realized gains and losses and declines in value judged to be other than temporary on securities available for sale, if any, are included in operations. Realized losses of \$397,024 were recognized for the nine months ended September 30, 2009, of which, a \$29,371 loss was recorded in February 2009 for the sale of the Company's investment in Multiband, and a \$367,653 loss was recorded in September 2009 for the write-off of the Company's remaining investment in Geeks on Call America, Inc. There were no realized gains or losses for the nine months ended September 30, 2008.



Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

TELKONET, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2009  
(UNAUDITED)

### Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with FASB's Accounting Standards Codification ("ASC") 605-10, and ASC Topic 13 guidelines that require that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the selling prices of the products delivered and the collectibility of those amounts. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. The Company defers any revenue for which the product has not been delivered or is subject to refund until such time that the Company and the customer jointly determine that the product has been delivered or no refund will be required. The guidelines also address the accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

For equipment under lease, revenue is recognized over the lease term for operating lease and rental contracts. All of the Company's leases are accounted for as operating leases. At the inception of the lease, no lease revenue is recognized and the leased equipment and installation costs are capitalized and appear on the balance sheet as "Equipment Under Operating Leases." The capitalized cost of this equipment is depreciated from two to three years, on a straight-line basis down to the Company's original estimate of the projected value of the equipment at the end of the scheduled lease term. Monthly lease payments are recognized as rental income.

Revenue from sales-type leases for EthoStream products is recognized at the time of lessee acceptance, which follows installation. The Company recognizes revenue from sales-type leases at the net present value of future lease payments. Revenue from operating leases is recognized ratably over the lease period

### Reclassifications

Certain reclassifications have been made in prior year's financial statements to conform to classifications used in the current year.

### Non-controlling Interest

As a result of adopting FASB ASC 810-10 Consolidations – Variable Interest Entities, on January 1, 2009, we present non-controlling interests (previously shown as minority interest) as a component of equity on our Consolidated Balance Sheets and Consolidated Statement of Equity (Deficit). The adoption of this guidance did not have any other material impact on our financial position, results of operations or cash flow.

### New Accounting Pronouncements

Accounting Standards Codification and GAAP Hierarchy — Effective for interim and annual periods ending after September 15, 2009, the Accounting Standards Codification and related disclosure requirements issued by the FASB became the single official source of authoritative, nongovernmental GAAP. The ASC simplifies GAAP, without change, by consolidating the numerous, predecessor accounting standards and requirements into logically organized topics. All other literature not included in the ASC is non-authoritative. We adopted the ASC as of September 30, 2009, which did not have any impact on our results of operations, financial condition or cash flows as it does not

represent new accounting literature or requirements. All references to pre-codified U.S. GAAP have been removed from this Form 10-Q.

Financial Instruments — Effective for interim and annual periods ending after June 15, 2009, GAAP established new disclosure requirements for the fair value of financial instruments in both interim and annual financial statements. Previously, the disclosure was only required annually. We adopted the new requirements as of July 4, 2009, which resulted in no change to our accounting policies, and had no effect on our results of operations, cash flows or financial position, but did result in the addition of interim disclosure of the fair values of our financial instruments.

TELKONET, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2009  
(UNAUDITED)

Consolidation — Effective for interim and annual periods beginning after November 15, 2009, with earlier application prohibited, GAAP amends the current accounting standards for determining which enterprise has a controlling financial interest in a VIE and amends guidance for determining whether an entity is a VIE. The new standards will also add reconsideration events for determining whether an entity is a VIE and will require ongoing reassessment of which entity is determined to be the VIE's primary beneficiary as well as enhanced disclosures about the enterprise's involvement with a VIE. We are currently assessing the future impact these new standards will have on our results of operations, financial position or cash flows.

Transfers and Servicing – Effective for interim and annual periods beginning after November 15, 2009, GAAP eliminates the concept of a qualifying special purpose entity, changes the requirements for derecognizing financial assets and requires additional disclosures. We are currently assessing the future impact these new standards will have on our results of operations, financial position or cash flows.

NOTE B- INTANGIBLE ASSETS AND GOODWILL

Total identifiable intangible assets acquired and their carrying values at December 31, 2008 are:

	Gross Carrying Amount	Accumulated Amortization	Net	Residual Value	Weighted Average Amortization Period (Years)
Amortized Identifiable Intangible Assets:					
Subscriber lists - EthoStream	\$ 2,900,000	\$ (432,986)	\$ 2,467,014	\$ -	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(432,986)	2,467,014	-	9.6
Goodwill - EthoStream	8,796,439	(2,000,000)	6,796,439	-	
Goodwill - SSI	5,874,016	-	5,874,016	-	
Total	\$ 17,570,455	\$ (2,432,985)	\$ 15,137,469	\$ -	

Total identifiable intangible assets acquired and their carrying values at September 30, 2009 are:

	Gross Carrying Amount	Accumulated Amortization	Net	Residual Value	Weighted Average Amortization Period (Years)
Amortized Identifiable Intangible Assets:					
Subscriber lists - EthoStream	\$ 2,900,000	\$ (614,243)	\$ 2,285,757	\$ -	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(614,243)	2,285,757	-	12.0
Goodwill - EthoStream	8,796,439	(2,000,000)	6,796,439	-	
Goodwill - SSI	5,874,016	-	5,874,016	-	
Total	\$ 17,570,455	\$ (2,614,243)	\$ 14,956,212	\$ -	

Total amortization expense charged to operations for the three and nine months ended September 30, 2009 and 2008 was \$60,424 and \$181,257, and \$60,417 and \$120,833, respectively.

TELKONET, INC.  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 SEPTEMBER 30, 2009  
 (UNAUDITED)

NOTE C – ACCOUNTS RECEIVABLE

Components of accounts receivable as of September 30, 2009 and December 31, 2008 are as follows:

	September 30, 2009	December 31, 2008
Accounts receivable (factored)	\$ 1,087,086	\$ 1,961,535
Advances from factor	(342,876)	(1,075,879)
Due from factor	744,210	885,656
Accounts receivable (non-factored)	85,846	127,080
Allowance for doubtful accounts	(143,000)	(176,400)
Total	\$ 687,056	\$ 836,336

In February 2008, the Company entered into a factoring agreement to sell, without recourse, certain receivables to an unrelated third party financial institution in an effort to accelerate cash flow. Under the terms of the factoring agreement the maximum amount of outstanding receivables at any one time is \$2.5 million. Proceeds on the transfer reflect the face value of the account less a discount. The discount is recorded as interest expense in the Consolidated Statement of Operations in the period of the sale. Net funds received reduced accounts receivable outstanding while increasing cash. Fees paid pursuant to this arrangement are included in "Operating expenses" in the Consolidated Statement of Operations and amounted to \$156,582 for the period ended September 30, 2009. The amounts borrowed are collateralized by the outstanding accounts receivable, and are reflected as a reduction to accounts receivable in the accompanying consolidated balance sheets.

NOTE D - INVENTORIES

Components of inventories as of September 30, 2009 and December 31, 2008 are as follows:

	September 30, 2009	December 31, 2008
Raw Materials	\$737,752	\$843,978
Finished Goods	748,544	1,089,962
Reserve for Obsolescence	(200,000)	(200,000 )
Total	\$1,286,296	\$1,733,940

TELKONET, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2009  
(UNAUDITED)

NOTE E - PROPERTY AND EQUIPMENT

The Company's property and equipment at September 30, 2009 and December 31, 2008 consists of the following:

	September 30, 2009	December 31, 2008
Telecommunications and related equipment	\$ 117,637	\$ 117,493
Development Test Equipment	153,484	153,484
Computer Software	160,894	160,894
Leasehold Improvements	228,017	248,778
Office Equipment	371,251	377,851
Office Fixtures and Furniture	249,604	265,315
Total	1,280,887	1,328,818
Accumulated Depreciation	(989,966)	(925,225)
	\$ 290,924	\$ 403,593

Depreciation expense included as a charge to income was \$25,803 and \$90,364 and \$54,120 and \$168,911 for the three and nine months ended September 30, 2009 and 2008, respectively.

NOTE F – MARKETABLE SECURITIES

Multiband Corporation

In connection with a payment of \$75,000 of accounts receivable, the Company received 30,000 shares of common stock of Multiband Corporation, a Minnesota-based communication services provider to multiple dwelling units. The Company classifies this security as available for sale, and it is carried at fair market value. The Company sold its remaining investment in Multiband and recorded a loss of \$29,371 in January 2009.

Geeks on Call America, Inc

As of September 30, 2009, the Company maintained an investment in a publicly traded company which was approximately 18% of the outstanding shares of common stock of Geeks on Call Holdings, Inc. ("GOCA"), a provider of on-site computer services to residential and commercial customers. As of December 31, 2008, the Company determined that a significant portion of this investment was permanently impaired and wrote-off \$4,098,514. Management has determined that the entire investment in GOCA is impaired and the remaining value of \$367,653 has been written off during the period ended September 30, 2009.

TELKONET, INC.  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 SEPTEMBER 30, 2009  
 (UNAUDITED)

NOTE G – LINE OF CREDIT

In September 2008, the Company entered into a two-year line of credit facility with a third party financial institution. The line of credit has an aggregate principal amount of \$1,000,000 and is secured by the Company's inventory. The outstanding principal balance bears interest at the greater of (i) the Wall Street Journal Prime Rate plus nine (9%) percent per annum, adjusted on the date of any change in such prime or base rate, or (ii) sixteen percent (16%). Interest, computed on a 365/360 simple interest basis, and fees on the credit facility are payable monthly in arrears on the last day of each month and continuing on the last day of each month until the maturity date. The Company may prepay amounts outstanding under the credit facility in whole or in part at any time. In the event of such prepayment, the lender will be entitled to receive a prepayment fee of four percent (4.0%) of the highest aggregate loan commitment amount if prepayment occurs before the end of the first year and three percent (3.0%) if prepayment occurs thereafter. The outstanding borrowing under the agreement at September 30, 2009 was \$449,741. The Company has incurred interest expense of \$103,881 related to the line of credit for the nine months ended September 30, 2009. The Prime Rate was 3.25% at September 30, 2009.

On November 11, 2009, the Company received a notice of waiver of the "minimum cash flow to debt service ratio" and the "tangible net worth" requirements under the line of credit facility, as such terms are defined in items D(10)a and D(10)b, respectively, of the line of credit agreement. The waiver is in effect as of September 30, 2009 and continues for the 90 day period thereafter.

NOTE H - SENIOR CONVERTIBLE DEBENTURES

Senior Convertible Debenture

A summary of convertible debentures payable at September 30, 2009 and December 31, 2008 is as follows:

	September 30, 2009	December 31, 2008
Senior Convertible Debentures, accrue interest at 13% per annum and mature on May 29, 2011	\$ 1,606,023	\$ 2,136,650
Debt Discount - beneficial conversion feature, net of accumulated amortization of \$514,381 and \$295,508 at September 30, 2009 and December 31, 2008, respectively.	(292,508)	(425,458)
Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of \$432,243 and \$277,913 at September 30, 2009 and December 31, 2008, respectively.	(245,797)	(400,127)
<b>Total</b>	<b>\$ 1,067,718</b>	<b>\$ 1,311,065</b>
Less: current portion	-	-
	<b>\$ 1,067,718</b>	<b>\$ 1,311,065</b>

As of September 30, 2009, the Company has \$1,606,023 outstanding in convertible debentures. During the nine months ended September 30, 2009, \$722,514 of convertible debentures was converted into 8,174,943 shares of common stock.



The Company amortized the beneficial conversion feature and the value of the attached warrants, and recorded non-cash interest expense in the amount of \$218,873 and \$154,330, respectively, and \$146,251 and \$137,545, respectively, for the nine months ended September 30, 2009, and 2008.

On February 20, 2009, the Company and YA Global entered into an Agreement of Clarification pursuant to which the parties agreed that interest accrued as of December 31, 2008, in the amount of \$191,887 shall be added to the principal amount outstanding under the Debentures and that each Debenture be amended to reflect the applicable increase in principal amount. In connection with this increase in the principal value of the debenture, the Company has recognized an additional \$85,923 of debt discount attributed to the beneficial conversion feature of the debenture for the period ended September 30, 2009.

TELKONET, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2009  
(UNAUDITED)

On May 28, 2009, the Company's shareholders voted against a proposal to remove the Exchange Cap, allowing YA Global to potentially acquiring in excess of 19.99% of the outstanding shares of the Company's common stock, as of May 30, 2008, upon conversion of debentures and/or the exercise of warrants, pursuant to NYSE Amex LLC regulations. In the Agreement of Clarification, the Company agreed to seek approval of the share issuance at the 2009 annual meeting of stockholders, which was held on May 28, 2009. On May 12, 2009, YA Global met the Exchange Cap for the conversion of its debentures, and cannot receive additional shares of the Company's common stock for the conversion of debentures or exercise of warrants, under NYSE Amex rules.

At September 30, 2009, the Senior Convertible Debenture had an estimated fair value of \$1.1 million.

#### Business Loan

On September 11, 2009, the Company entered into a Loan Agreement in the aggregate principal amount of \$300,000 with the Wisconsin Department of Commerce (the "Department"). The outstanding principal balance bears interest at the annual rate of two (2.00) percent. Payment of interest and principal is to be made in the following manner: (a) payment of any and all interest that accrues from the date of disbursement commences on January 1, 2010 and continues on the first day of each consecutive month thereafter through and including December 31, 2010; (b) commencing on January 1, 2011 and continuing on the first day of each consecutive month thereafter through and including November 1, 2016, the Company shall pay equal monthly installments of \$4,426 each; followed by a final installment on December 1, 2016 which shall include all remaining principal, accrued interest and other amounts owed by the Company to the Department under the Loan Agreement. The Company may prepay amounts outstanding under the credit facility in whole or in part at any time without penalty. The credit facility is secured by the Company's assets and the proceeds from this loan will be used for the working capital requirements of the Company. The outstanding borrowing under the agreement at September 30, 2009 was \$300,000.

Aggregate maturities of long-term debt as of September 30, 2009 are as follows:

For the twelve months ended	Amount
December 31, 2009	\$ -
2010	-
2011	1,606,023
2012 and thereafter	300,000
	\$ 1,906,023

#### NOTE I - CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock, with a par value of \$.001 per share. As of September 30, 2009 and December 31, 2008, the Company has no preferred stock issued and outstanding. The Company has authorized 155,000,000 shares of common stock, with a par value of \$.001 per share. As of September 30, 2009 and December 31, 2008, the Company has 96,563,771 and 87,525,495, respectively, shares of common stock

issued and outstanding.

During the nine months ended September 30, 2009, the Company issued 83,333 shares of common stock to consultants for services performed and services accrued in fiscal 2008. These shares were valued at \$10,000, which approximated the fair value of the shares when they were issued.

During the nine months ended September 30, 2009, the Company issued 780,000 shares of common stock at approximately \$0.09 per share to warrant holders in exchange for the exercise of their stock purchase warrants.

During the nine months ended September 30, 2009, the Company issued 8,174,943 shares of common stock at approximately \$0.09 per share to its senior convertible debenture holders in exchange for \$722,514 of debentures.

TELKONET, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2009  
(UNAUDITED)

## NOTE J - STOCK OPTIONS AND WARRANTS

## Employee Stock Options

The following table summarizes the changes in options outstanding and the related prices for the shares of the Company's common stock issued to employees of the Company under a non-qualified employee stock option plan.

Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price	
1.00 - \$ \$1.99	4,417,133	3.93	\$ 1.02	4,273,550	\$ 1.01	
2.00 - \$ \$2.99	997,500	5.48	\$ 2.52	957,250	\$ 2.51	
3.00 - \$ \$3.99	536,250	6.08	\$ 3.23	413,500	\$ 3.28	
4.00 - \$ \$4.99	70,000	5.83	\$ 4.33	58,500	\$ 4.33	
5.00 - \$ \$5.99	100,000	5.57	\$ 5.17	88,000	\$ 5.16	
	6,120,883	4.42	\$ 1.56	5,790,800	\$ 1.52	

Transactions involving stock options issued to employees are summarized as follows:

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2008	8,105,429	\$ 1.98
Granted	185,000	1.00
Exercised	-	-
Cancelled or expired	(1,296,500)	2.71
Outstanding at December 31, 2008	6,993,929	\$ 1.82
Granted	320,000	1.00
Exercised	-	-
Cancelled or expired	(1,193,046)	2.91
Outstanding at September 30, 2009	6,120,883	\$ 1.56

TELKONET, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2009  
(UNAUDITED)

The weighted-average fair value of stock options granted to employees during the period ended September 30, 2009 and 2008 and the weighted-average significant assumptions used to determine those fair values, using a Black-Scholes option pricing model are as follows:

	September 30, 2009	September 30, 2008
Significant assumptions (weighted-average):		
Risk-free interest rate at grant date	3.5%	3.0%
Expected stock price volatility	81%	74%
Expected dividend payout	-	-
Expected option life (in years)	5.0	5.0
Expected forfeiture rate	12%	12%
Fair value per share of options granted	\$ 0.30	\$ 0.62

The expected life of awards granted represents the period of time that they are expected to be outstanding. We determine the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules, exercise patterns and pre-vesting and post-vesting forfeitures. We estimate the volatility of our common stock based on the calculated historical volatility of our own common stock using the trailing 60 months of share price data prior to the date of the award. We base the risk-free interest rate used in the Black-Scholes-Merton option valuation model on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term equal to the expected life of the award. We have not paid any cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero in the Black-Scholes-Merton option valuation model. We use historical data to estimate pre-vesting option forfeitures and record share-based compensation for those awards that are expected to vest. In accordance with Share Based Payments, we adjust share-based compensation for changes to the estimate of expected equity award forfeitures based on actual forfeiture experience.

There were no options exercised during the period ended September 30, 2009 or 2008.

The total fair value of shares vested during the period ended September 30, 2009 and 2008 was \$233,366 and \$623,113, respectively.

Total stock-based compensation expense recognized in the consolidated statement of earnings for the three and nine months ended September 30, 2009 and 2008 was \$65,746 and \$243,366, and \$194,483 and \$704,613, respectively, net of tax effect. Additionally, the aggregate intrinsic value of options outstanding and unvested as of September 30, 2009 is \$0.

#### Non-Employee Stock Options

The following table summarizes the changes in options outstanding and the related prices for the shares of the Company's common stock issued to the Company consultants. These options were granted in lieu of cash compensation for services performed.

Options Outstanding

Options Exercisable

Edgar Filing: TELKONET INC - Form 10-Q

Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 1.00	740,000	2.84	\$ 1.00	740,000	\$ 1.00

17

---

TELKONET, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2009  
(UNAUDITED)

Transactions involving options issued to non-employees are summarized as follows:

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2008	1,815,937	\$ 1.00
Granted	-	-
Exercised	-	-
Canceled or expired	-	-
Outstanding at December 31, 2008	1,815,937	\$ 1.00
Granted	-	-
Exercised	-	-
Canceled or expired	(1,075,937)	1.00
Outstanding at September 30, 2009	740,000	\$ 1.00

There were no non-employee stock options vested during the period ended September 30, 2009 and 2008, respectively.

#### Warrants

The following table summarizes the changes in warrants outstanding and the related prices for the shares of the Company's common stock issued to non-employees of the Company. These warrants were granted in lieu of cash compensation for services performed or financing expenses and in connection with placement of convertible debentures.

Warrants Outstanding			Warrants Exercisable		
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighed Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 0.58	76,639	2.59	\$ 0.58	76,639	\$ 0.58
\$ 0.60	800,000	3.85	\$ 0.60	800,000	\$ 0.60
\$ 0.61	2,500,000	3.92	\$ 0.61	2,500,000	\$ 0.61
\$ 2.59	862,452	2.12	\$ 2.59	862,452	\$ 2.59
\$ 3.98	3,078,864	2.29	\$ 3.98	3,078,864	\$ 3.98
\$ 4.17	359,712	3.06	\$ 4.17	359,712	\$ 4.17
	7,677,667	2.97	\$ 2.35	7,677,667	\$ 2.19

TELKONET, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2009  
(UNAUDITED)

Transactions involving warrants are summarized as follows:

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2008	7,673,627	\$ 4.15
Issued	4,164,140	1.31
Exercised	(3,380,000)	0.70*
Canceled or expired	-	-
Outstanding at December 31, 2008	8,457,767	\$ 2.19
Issued	-	-
Exercised	(780,000)	0.09
Canceled or expired	-	-
Outstanding at September 30, 2009	7,677,667	\$ 2.35

\*The warrants were issued to Enable Capital and originally priced at \$4.17 per share. In February 2008, these warrants were re-priced to \$0.6978258 per share and the holders exercised the warrants on a cashless basis and received 1,000,000 shares

The Company did not issue any warrants during the period ended September 30, 2009. During the period ended September 30, 2008, the Company granted 645,632 warrants to Convertible Senior Notes holders, 2,100,000 to a Convertible Debenture holder and 800,000 to a Note holder. The Company did not issue any compensatory warrants during the period ended September 30, 2009 and 2008.

The purchase price of the warrants issued to Convertible Senior Note holders was adjusted from \$4.70 to \$4.39 per share and approximately 79,000 additional warrants were issued during the period ended September 30, 2008 in accordance with the anti-dilution protection provision of the Convertible Senior Notes Payable Agreement (the "Agreement") dated October 27, 2005, upon the occurrence of certain events as defined in the Agreement.

In February 2008, the Company amended certain stock purchase warrants held by private placement investors to reduce the exercise price under such warrants from \$4.17 per share to \$0.6978258 per share. The warrants entitled the holders to purchase an aggregate of up to 3,380,000 shares of Telkonet's common stock. Subsequently, these private placement investors exercised all of their warrants on a cashless basis using the five day volume average weighted price (VWAP) as of January 31, 2008 of \$0.99 resulting in the issuance of 1,000,000 shares of Company common stock. The Company has accounted for the amended warrants issued, valued at \$1,224,236, as other expense using the Black-Scholes pricing model and the following assumptions: contractual term of 5 years, an average risk-free interest rate of 3.5% a dividend yield of 0% and volatility of 70%. In addition, during the period ended September 30, 2008, the Company recorded non-cash expenses of \$574,426 for issuing additional warrants and the re-pricing of outstanding warrants in accordance with the anti-dilution provision of the warrant agreements.

In July 2009, the Company amended certain stock purchase warrants held by private placement investors to reduce the exercise price under such warrants from \$0.60 per share to approximately \$0.09 per share. The warrants entitled the holders to purchase an aggregate of up to 780,000 shares of the Company's common stock. Subsequently, these



private placement investors exercised all of their warrants, and the Company has accounted for the amended warrants issued, valued at \$70,486, as financing expense using the Black-Scholes pricing model and the following assumptions: contractual term of 5 years, an average risk-free interest rate of 1.6% a dividend yield of 0% and volatility of 103%.

TELKONET, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2009  
(UNAUDITED)

NOTE K - COMMITMENTS AND CONTINGENCIES

Employment and Consulting Agreements

On August 1, 2007, the Company entered into an agreement with Barry Honig, President of GRQ Consultants, Inc. ("GRQ"). Telkonet has agreed to pay Mr. Honig 50,000 shares of common stock per month for six (6) months, to provide the Company with transaction advisory services. As of December 31, 2007, GRQ held a Senior Promissory Note issued by Telkonet on July 24, 2007, in the principal amount of \$1,500,000 (Note J). On February 8, 2008, this note was repaid in full including \$49,750 in accrued but unpaid interest from the issuance date through the date of repayment.

Litigation

The Company is subject to legal proceedings and claims which arise in the ordinary course of its business. Although occasional adverse decisions or settlements may occur, the Company believes that the final disposition of such matters should not have a material adverse effect on its financial position, results of operations or liquidity.

Senior Convertible Noteholder Claim

The August 14, 2006 Settlement Agreement with the Senior Convertible Debenture Noteholders provided that the number of shares issued to the Noteholders shall be adjusted based upon the arithmetic average of the weighted average price of the Company's common stock on the American Stock Exchange for the twenty trading days immediately following the settlement date. The Company has concluded that, based upon the weighted average of the Company's common stock between August 16, 2006 and September 13, 2006, the Company is entitled to a refund from the two Noteholders. One of the Noteholders has informed the Company that it does not believe such a refund is required. As a result, the Company has declined to deliver to the Noteholders certain stock purchase warrants issued to them pursuant to the Settlement Agreement pending resolution of this disagreement. The Noteholder has alleged that the Company has failed to satisfy its obligations under the Settlement Agreement by failing to deliver the warrants. In addition, the Noteholder maintains that the Company has breached certain provisions of the Registration Rights Agreement and, as a result of such breach, such Noteholder claims that it is entitled to receive liquidated damages from the Company. In the Company's opinion, the ultimate disposition of these matters will not have a material adverse effect on the Company's results of operations or financial position.

Purchase Price Contingency

In conjunction with the acquisition of MST on January 31, 2006, the stock portion of the purchase price was price protected for the benefit of the former owner of MST. In the event the Company's common stock price is below \$4.50 per share upon the achievement of thirty three hundred (3,300) subscribers during the three (3) year period following the closing (as extended) a pro rata adjustment in the number of shares will be required to support the aggregate consideration of \$5.4 million. The issuance of additional shares or distribution of other consideration upon resolution of the contingency based on the Company's common stock prices will not affect the cost of the acquisition. When the contingency is resolved or settled, and additional consideration is distributable, the Company will record the current fair value of the additional consideration and the amount previously recorded for the common stock issued will be simultaneously reduced to the lower current value of the Company's common stock. In addition, the Company agreed to fully fund the MST three year business plan, established on January 31, 2006. The parties originally agreed, in the

event, for any reason, the Company materially fails to satisfy its funding obligations under the acquisition agreement, that the former owners of MST shall be entitled to the release of any and all consideration held in reserve. However the parties deleted this provision in a May, 2008 agreement wherein the Company made a minimum commitment of \$2.3 million to fund MST's business plan in accordance with Section 11.1 of the Stock Purchase Agreement between Telkonet and Frank T. Matarazzo. In addition, the adjustment date for the achievement of MST's 3,300 subscribers was extended an additional six months from January 31, 2009 to July 31, 2009. In April 2008 the Company issued from escrow 200,000 shares of the reserve shares and advanced 400,000 of such shares in June 2008 in exchange for Mr. Matarazzo's agreement to a debt covenant restricting the use of proceeds in the Company's debenture financing with YA Global Investments LP.

TELKONET, INC.  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 SEPTEMBER 30, 2009  
 (UNAUDITED)

NOTE L- BUSINESS CONCENTRATION

Revenue from one major customer approximated \$839,000 or 10% of total revenues for the period ended September 30, 2009. Revenue from three (3) major customers approximated \$6,782,000 or 42% of total revenues for the period ended September 30, 2008. Total accounts receivable of \$118,407, or 9% of total accounts receivable, were due from these customers as of September 30, 2009. Total accounts receivable of \$674,800, or 36% of total accounts receivable, was due from these customers as of September 30, 2008.

Purchases from one major supplier approximated \$856,000, or 61% of purchases during the period ended September 30, 2009, and \$2,014,380, or 47% of purchases, for the period ended September 30, 2008, respectively. Total accounts payable of approximately \$76,740, or 2% of total accounts payable, was due to this supplier as of September 30, 2009, and \$145,769, or 3% of total accounts payable, was due to this supplier as of September 30, 2008.

NOTE M- FAIR VALUE MEASUREMENTS

The financial assets of the Company measured at fair value on a recurring basis are cash equivalents, and long-term marketable securities. The Company's cash equivalents and long term marketable securities are generally classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The Company's long-term investments are classified within Level 3 of the fair value hierarchy because they are valued using unobservable inputs, due to the fact that observable inputs are not available, or situations in which there is little, if any, market activity for the asset or liability at the measurement date. The Company's derivative liabilities are classified within Level 2 of the fair value hierarchy because they are valued using inputs which are not actively observable, either directly or indirectly.

- Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2: Quoted prices in markets that are not active, or inputs which are observable, either directly or indirectly, for substantially the full term of the asset or liability; or
- Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and are unobservable.

The following table sets forth the Company's financial instruments as of September 30, 2009 which are measured at fair value on a recurring basis by level within the fair value hierarchy. Financial instruments are classified based on the lowest level of input that is significant to the fair value measurement, (in thousands):

(in thousands)	Level 1	Level 2	Level 3	Assets at fair value
Cash and cash equivalents	\$ 38	\$ -	\$ -	\$ 38
Long-term investments	-	-	8	8
Total	\$ 38	\$ -	\$ 8	\$ 46
Derivative liabilities	-	1,870	-	1,870

Edgar Filing: TELKONET INC - Form 10-Q

Long-term debt		300		-		1,068		1,368
Total		\$ 389	\$	1,870	\$	1,068	\$	3,238

21

---

TELKONET, INC.  
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
 SEPTEMBER 30, 2009  
 (UNAUDITED)

NOTE N – DISCONTINUED OPERATIONS

On January 31, 2006, the Company acquired a 90% interest in Microwave Satellite Technologies, Inc. (“MST”) in exchange for \$1.8 million in cash and 1.6 million unregistered shares of the Company’s common stock. In May 2007, MST merged with MSTI Holdings Inc. (“MSTI”) (formerly Fitness Xpress-Software Inc.) and as a result of the merger, the Company’s common stock in MST was exchanged for 63% of the outstanding shares of common stock of MSTI Holdings Inc. The Company has historically consolidated its investment in MSTI as a consolidated majority-owned subsidiary.

On February 26, 2009, the Company executed a Stock Purchase Agreement pursuant to which the Company sold 2.8 million shares of MSTI common stock (the “MSTI Shares”) for an aggregate purchase price of \$10,000. As a result of this transaction, the Company beneficially owns 49% of the issued and outstanding shares of MSTI common stock.

On April 22, 2009, Warren V. Musser and Thomas C. Lynch, members of the Company’s Board of Directors, submitted their resignations as directors of MSTI. As a result of these resignations, and the decrease in beneficial ownership resulting from the transaction described above, the Company is no longer required to consolidate MSTI as a majority- owned subsidiary and the Company’s investment in MSTI will now be accounted for under the cost method.

On June 26, 2009, MSTI entered into an Agreement and Consent to Acceptance of Collateral (“Agreement”) with its senior secured lenders, Alpha Capital Anstalt, Gemini Master Fund, Ltd., Whalehaven Capital Fund Limited and Brio Capital L.P. (“Secured Lenders”). The Secured Lenders were the senior secured creditors of MSTI with regard to obligations in the total principal amount of \$1,893,295 (together, the “Secured Lender Obligations”).

Under the Agreement: (a) MSTI (i) agreed and consented to the transfer to MST Acquisition Group LLC (the “Designee”), for the benefit of the Secured Lenders, of all of the assets of MSTI (the “Pledged Collateral”) in full satisfaction of the Secured Lender Obligations, and (ii) waived and released (x) all right, title and interest it has or might have in or to the Pledged Collateral, including any right to redemption, and (y) any claim for a surplus; and (b) the Secured Lenders agreed to accept the Pledged Collateral in full satisfaction of the Secured Lender Obligations and waived and released MSTI from any further obligations with respect to the Secured Lender Obligations.

Net income (loss) from discontinued operations on the consolidated statement of operations for the nine month period ended September 30, 2009 includes the gain on deconsolidation of \$6,932,586, offset by MSTI's net losses of \$(635,735) for the period January 1, 2009 through April 30, 2009, the date of deconsolidation. The market value of the MSTI common shares owned by the Company as of September 30, 2009 was deemed permanently impaired by management and as a result the Company has fully written off its investment in MSTI and has not included any value for MSTI in the balance sheet as of September 30, 2009.

	Nine months ended September 30, 2009
Fair value of MSTI investment as of September 30, 2009; 15,543,000 shares at \$0.00 per share	\$ -
Cost basis of MSTI investment at September 30, 2009, including intercompany loans and receivables	(12,192,281)

Edgar Filing: TELKONET INC - Form 10-Q

Recovery of MSTI cumulative net losses included in consolidated operating results	19,124,867
Gain on deconsolidation	6,932,586
MSTI's net loss for the nine months ended September 30, 2009	(635,735)
Net gain from discontinued operations	\$ 6,296,851

22

---

TELKONET, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 2009  
(UNAUDITED)

NOTE O – SUBSEQUENT EVENTS

In accordance with FASB ASC 855 "Subsequent Events", the Company has evaluated subsequent events through the date of the filing (November 16, 2009)

NYSE Amex Delisting Notice

On November 3, 2009, Telkonet, Inc. received notice from NYSE Amex, LLC (the "Exchange") that a Listing Qualifications Panel of the Exchange's Committee on Securities (the "Panel") had affirmed the Exchange's Listing Qualifications Department staff's determination to delist the Company's common stock from the Exchange. The Exchange will file a delisting application with the Securities and Exchange Commission ("SEC") to strike the Company's common stock from listing and registration on the Exchange, when and if authorized by the SEC. The delisting of Company's common stock will be effective 10 days after the Exchange files a Form 25 with the SEC. The Company does not intend to appeal, or request a review of, the Panel's decision, and thus its common stock is expected to be delisted from the Exchange. The Exchange suspended trading in the Company's stock effective at the open of business on November 13, 2009 at which time our common stock began trading on the Over-the-Counter market's Pink Sheets under the symbol "TKOI.PK"

The Company will be in default of the convertible debentures if its common stock is not quoted for listing on one of: (a) the American Stock Exchange, (b) New York Stock Exchange, (c) the Nasdaq Global Market, (d) the Nasdaq Capital Market, or (e) the OTC Bulletin Board ("OTCBB") within five (5) Trading Days of the stock's delisting. The Company is seeking to obtain a listing on the OTCBB however there can be no guarantee that the Company will be successful in obtaining a listing on the OTCBB or that it will be able to obtain such a listing within five days of the common stock's delisting from the Exchange.

Private Placement

On November 16, 2009, the Company entered into definitive agreements in connection with a Regulation D private placement of 215 shares of the Company's Series A Convertible Redeemable Preferred Stock, par value \$0.001 per share ("Series A"), and warrants ("Warrants") to purchase an aggregate of 1,628,800 shares of the Company's common stock, par value \$0.001 per share (the "Common Stock"). The Series A shares were sold at a price per share of \$5,000 and the Warrants have an exercise price of \$0.33, which is equal to the volume-weighted average price of a share of Common Stock measured over the 30-day period immediately preceding November 12, 2009. The Company expects to complete the private placement transaction within the next several days and expects to receive \$1,075,000 from the sale of these Series A shares and Warrants. A portion of the proceeds to be received by the Company will come from certain members of Company management in connection with the conversion of a portion of outstanding indebtedness of the Company owed to such members of management. The Company intends to use the net proceeds from the sale of the Series A shares and the Warrants for general working capital needs and may use the proceeds in the short term to repay certain outstanding indebtedness, and to pay expenses of the offering as well as other general corporate capital purposes.

Under the terms of the private placement transaction, each Series A share is convertible into approximately 13,774 shares of Common Stock at a conversion price of \$0.363 per share, which is equal to 110% of the volume-weighted average price of a share of Common Stock measured over the 30-day period immediately preceding November 12,



2009. Except as specifically provided or as otherwise required by law, the Series A shares will vote together with the Common Stock shares on an as-if-converted basis and not as a separate class. Each Series A share shall have a number of votes equal to the number of shares of Common Stock then issuable upon conversion of such shares of the Series A.

Additionally, the Company agreed with the purchasers to file a registration statement covering the resale of the shares of common stock to be acquired by the purchasers upon conversion of their Series A shares following the conclusion of a rights offering to be filed with the SEC.

#### Board of Directors

Effective November 13, 2009, Dr. Thomas M. Hall submitted his resignation as a director of the Company.

The Company's Board of Directors elected Anthony J. Paoni as Chairman of the Board to take the position previously held by Warren V. Musser effective as of November 16, 2009.

In connection with the closing of the private placement transaction, Seth D. Blumenfeld will be resigning from the Board and Jason L. Tienor, the Company's President and Chief Executive Officer, will fill the vacancy created by the resignation of Seth D. Blumenfeld.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of the Company's financial condition and results of operations should be read in conjunction with the accompanying financial statements and related notes thereto for the quarter ended September 30, 2009 and 2008, as well as the Company's consolidated financial statements and related notes thereto and management's discussion and analysis of financial condition and results of operations in the Company's Form 10-K for the year ended December 31, 2008 filed on April 1, 2009.

### Business

Telkonet, Inc., formed in 1999 and incorporated under the laws of the state of Utah, is a "clean technology" company that develops and manufactures proprietary energy efficiency and smart grid networking technology. The Company's patented Recovery Time™ energy management technology and Series 5™ power grid networking technology are innovative clean technology products that have helped position the Company as a leading clean technology provider.

The Telkonet SmartEnergy™ (TSE) and Networked Telkonet SmartEnergy™ (NTSE) platforms incorporate Recovery Time™, an energy management technology that continuously monitors climate conditions to automatically adjust a room's temperature to account for the presence or absence of an occupant in an effort to save energy while at the same time ensuring occupant comfort. This technology is particularly attractive to our customers in the hospitality area and owners of multi-dwelling units who are continually seeking ways to reduce costs without impacting customer satisfaction. By reducing energy usage automatically when a space is not being utilized, our customers can realize a significant cost savings without diminishing occupant comfort.

Telkonet's wholly-owned subsidiary, EthoStream, LLC, operates one of the largest hospitality high-speed Internet access (HSIA) networks in the United States. Although this business is successful in its own right, its significant customer base in the hospitality industry (i.e. approximately 2,500 properties that represent over 200,000 rooms) has created an opportunity for Telkonet to market its energy efficiency solutions more successfully. It also provides a marketing opportunity for the Company's more traditional HSIA offerings, including the Telkonet iWire System. The iWire System offers a fast and cost effective way to deliver commercial high-speed broadband access from an IP "platform" using a building's existing electrical infrastructure to convert virtually every electrical outlet into a high-speed data port without the installation of additional wiring or major disruption of business activity. EthoStream represents a significant portion of Telkonet's hospitality growth and market share.

Telkonet's Series 5 system uses powerline communications technology (PLC) to transform a site's existing internal electrical infrastructure into an IP network backbone. With its powerful 200 Mbps chip, the system offers a new competitive alternative in grid communications, enabling local area network (LAN) infrastructure for command and control, monitoring and grid management, transforming a traditional power management system into a "smart grid" that delivers electricity in a manner that saves energy, reduces cost and increases reliability. The Company's PLC platform provides a compelling solution for substation automation, power generation, renewable facilities, manufacturing, and research environments, by providing a rapidly-deployed, low cost alternative to structured cable or fiber. By leveraging the existing electrical wiring within a facility to transport data, Telkonet's PLC solutions enable facilities to deploy sensing and control systems to locations without the need for new network wiring, and without the security risks entailed with wireless.

On April 22, 2009, the Company completed the deconsolidation of MSTI Holdings, Inc. (MSTI). To effect the deconsolidation of MSTI, the Company was required to reduce its ownership percentage and board membership. On February 26, 2009, the Company executed a Stock Purchase Agreement pursuant to which the Company sold 2.8 million shares of MSTI common stock and following this transaction, the Company beneficially owns 49% of the issued and outstanding shares of MSTI common stock. On April 22, 2009, Warren V. Musser and Thomas C. Lynch, members of the Company's Board of Directors, submitted their resignations as directors of MSTI. As a result, the

majority of MSTI's board of directors is no longer controlled by the Company. As a result of the deconsolidation, the interim financial statements have been revised to present the previously consolidated operations as discontinued operations.

The Company's headquarters is located at 20374 Seneca Meadows Parkway in Germantown, Maryland 20876. Telkonet's reports that are filed pursuant to the Securities Exchange Act of 1934 are posted on the Company's website: [www.telkonet.com](http://www.telkonet.com).

The Company classifies revenue and cost of sales into two categories: product and recurring. Product revenue is defined as products and installation services for the Company's broadband networks and energy management products. Recurring revenue is primarily monthly subscription revenue for support and network maintenance contracts for our broadband network platforms. Product and labor costs directly related to sales are allocated to cost of sales in the period in which they are provided. For management reporting purposes, all other expenses are classified as operating expenses, and are recorded as such in the consolidated statement of operations.

## Forward Looking Statements

This report may contain “forward-looking statements,” which represent the Company’s expectations or beliefs, including, but not limited to, statements concerning industry performance and the Company’s results, operations, performance, financial condition, plans, growth and strategies, which include, without limitation, statements preceded or followed by or that include the words “may,” “will,” “expect,” “anticipate,” “intend,” “could,” “estimate,” or “continue” or the negative variations thereof or comparable terminology. Any statements contained in this report or the information incorporated by reference that are not statements of historical fact may be deemed to be forward-looking statements within the meaning of Section 27(A) of the Securities Act of 1933 and Section 21(F) of the Securities Exchange Act of 1934. For such statements, the Company claims the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. These statements by their nature involve substantial risks and uncertainties, some of which are beyond the Company’s control, and actual results may differ materially depending on a variety of important factors, including those risk factors discussed under “Risk Factors”, many of which are also beyond the Company’s control. You should not place undue reliance on these forward-looking statements, which speak only as of the date of this report. The Company does not undertake any obligation to update or release any revisions to these forward-looking statements to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events, except to the extent such updates and/or revisions are required by applicable law.

## Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. On an ongoing basis, we evaluate significant estimates used in preparing our financial statements including those related to revenue recognition, guarantees and product warranties, stock based compensation and business combinations. We base our estimates on historical experience, underlying run rates and various other assumptions that we believe to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results could differ from these estimates. The following are critical judgments, assumptions, and estimates used in the preparation of the consolidated financial statements.

### Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with FASB’s Accounting Standards Codification (“ASC”) 605-10, and ASC Topic 13 guidelines that require that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on management’s judgments regarding the fixed nature of the selling prices of the products delivered and the collectibility of those amounts. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. The Company defers any revenue for which the product has not been delivered or is subject to refund until such time that the Company and the customer jointly determine that the product has been delivered or no refund will be required. The guidelines also address the accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

For equipment under lease, revenue is recognized over the lease term for operating lease and rental contracts. All of the Company’s leases are accounted for as operating leases. At the inception of the lease, no lease revenue is recognized and the leased equipment and installation costs are capitalized and appear on the balance sheet as

“Equipment Under Operating Leases.” The capitalized cost of this equipment is depreciated from two to three years, on a straight-line basis down to the Company’s original estimate of the projected value of the equipment at the end of the scheduled lease term. Monthly lease payments are recognized as rental income.

Revenue from sales-type leases for EthoStream products is recognized at the time of lessee acceptance, which follows installation. The Company recognizes revenue from sales-type leases at the net present value of future lease payments. Revenue from operating leases is recognized ratably over the lease period

## Fair Value of Financial Instruments

In January 2008, the Company adopted the provisions under FASB for Fair Value Measurements, which define fair value for accounting purposes, establishes a framework for measuring fair value and expands disclosure requirements regarding fair value measurements. The Company's adoption of these provisions did not have a material impact on its consolidated financial statements. Fair value is defined as an exit price, which is the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date. The degree of judgment utilized in measuring the fair value of assets and liabilities generally correlates to the level of pricing observability. Financial assets and liabilities with readily available, actively quoted prices or for which fair value can be measured from actively quoted prices in active markets generally have more pricing observability and require less judgment in measuring fair value. Conversely, financial assets and liabilities that are rarely traded or not quoted have less price observability and are generally measured at fair value using valuation models that require more judgment. These valuation techniques involve some level of management estimation and judgment, the degree of which is dependent on the price transparency of the asset, liability or market and the nature of the asset or liability. The Company has categorized its financial assets and liabilities measured at fair value into a three-level hierarchy in accordance with these provisions.

## New Accounting Pronouncements

For information regarding recent accounting pronouncements and their effect on the Company, see "Recent Accounting Pronouncements" in Note A of the Notes to Unaudited Condensed Consolidated Financial Statements contained herein.

## Revenues

The table below outlines product versus recurring revenues for comparable periods:

	September 30, 2009		Three Months Ended September 30, 2008		Variance	
Product	\$ 1,445,888	59%	\$ 3,837,728	81%	\$ (2,391,840)	-62%
Recurring	991,130	41%	897,482	19%	93,648	10%
Total	\$ 2,437,018	100%	\$ 4,735,210	100%	\$ (2,298,192)	-49%

	September 30, 2009		Nine months Ended September 30, 2008		Variance	
Product	\$ 5,462,955	65%	\$ 10,821,179	81%	\$ (5,358,224)	-50%
Recurring	2,982,384	35%	2,559,728			