

TELKONET INC  
Form 10-Q  
November 14, 2012

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, 2012

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 Issuer as specified in its charter)

Utah  
(State or Other Jurisdiction of Incorporation or Organization)

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

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10200 Innovation Drive, Suite 300, Milwaukee, WI  
(Address of Principal Executive Offices)

53226  
(Zip Code)

(414) 223-0473

(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 Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(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: 108,103,001 shares of Common Stock (\$.001 par value) as of November 7, 2012.

**TELKONET, INC.**

**FORM 10-Q for the Quarter Ended September 30, 2012**

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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****TELKONET, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS**

	<b>(Unaudited) September 30, 2012</b>	<b>December 31, 2011</b>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 1,067,207	\$ 961,091
Restricted cash on deposit	91,000	91,000
Accounts receivable, net	1,921,025	1,306,011
Inventories	769,946	322,210
Prepaid expenses	181,692	157,665
Total current assets	4,030,870	2,837,977
<b>Property and equipment, net</b>	<b>33,986</b>	<b>11,953</b>
<b>Other assets:</b>		
Goodwill	8,570,446	8,570,446
Intangible assets, net	1,560,717	1,741,977
Deposits	34,238	34,238
Total other assets	10,165,401	10,346,661
<b>Total Assets</b>	<b>\$ 14,230,257</b>	<b>\$ 13,196,591</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 1,459,667	\$ 1,248,386
Notes payable – current	49,238	111,405
Accrued liabilities and expenses	2,260,248	2,176,208
Deferred revenues	171,535	55,529
Customer deposits	141,358	21,364
Total current liabilities	4,082,046	3,612,892
<b>Long-term liabilities:</b>		
Deferred lease liability	131,926	118,636
Notes payable – long term	851,519	853,795
Total long-term liabilities	983,445	972,431
<b>Redeemable preferred stock:</b>		

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15,000,000 shares authorized, par value \$.001 per share		
Series A; 215 shares authorized, 185 shares outstanding at September 30, 2012 and December 31, 2011, preference in liquidation of \$1,157,416 as of September 30, 2012	1,005,669	892,995
Series B; 538 shares authorized, 493 shares outstanding at September 30, 2012 and December 31, 2011, preference in liquidation of \$2,835,103 as of September 30, 2012	2,085,534	1,474,956
Total redeemable preferred stock	3,091,203	2,367,951
<b>Commitments and contingencies</b>	–	–
<b>Stockholders' Equity</b>		
Common stock, par value \$.001 per share; 190,000,000 shares authorized; 108,103,001 and 104,349,507 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively	108,105	104,352
Additional paid-in-capital	124,368,084	124,483,161
Accumulated deficit	(118,402,626)	(118,344,196)
Total stockholders' equity	6,073,563	6,243,317
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 14,230,257</b>	<b>\$ 13,196,591</b>

See accompanying notes to the condensed consolidated financial statements

**TELKONET, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS****(UNAUDITED)**

	<b>For The Three Months Ended September 30,</b>		<b>For The Nine Months Ended September 30,</b>	
	2012	2011	2012	2011
Revenues, net:				
Product	\$2,161,753	\$1,632,160	\$5,481,365	\$4,760,120
Recurring	1,127,025	1,162,559	3,197,925	3,445,234
Total Net Revenue	3,288,778	2,794,719	8,679,290	8,205,354
Cost of Sales:				
Product	1,166,848	1,002,816	2,969,512	2,728,980
Recurring	292,264	294,846	858,988	849,962
Total Cost of Sales	1,459,112	1,297,662	3,828,500	3,578,942
Gross Profit	1,829,666	1,497,057	4,850,790	4,626,412
Operating Expenses:				
Research and development	251,089	197,674	732,154	588,908
Selling, general and administrative	1,009,814	1,194,156	3,937,522	3,488,802
Depreciation and amortization	63,265	72,463	197,341	202,809
Total Operating Expenses	1,324,168	1,464,293	4,867,017	4,280,519
Income (Loss) from Operations	505,498	32,764	(16,227 )	345,893
Other Income (Expenses):				
Interest (expense) income, net	7,712	(23,428 )	(57,611 )	(237,402 )
Gain on derivative liability	–	–	–	172,476
Gain on disposal of property and equipment	–	–	–	829,296
Gain on sale of product line	–	–	15,408	2,165
Total Other Income (Expense)	7,712	(23,428 )	(42,203 )	766,535
Income (Loss) Before Provision for Income Taxes	513,210	9,336	(58,430 )	1,112,428
Provision for Income Taxes	–	–	–	–
Net Income (Loss)	513,210	9,336	(58,430 )	1,112,428
Accretion of preferred dividends and discount	(308,386 )	(194,324 )	(723,252 )	(508,191 )
Net income (loss) attributable to common stockholders	\$204,824	\$(184,988 )	\$(781,682 )	\$604,237

Net income (loss) per common share:

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Income (loss) per common share— basic	\$0.00	\$0.00	\$0.00	\$0.01
Income (loss) per common share - diluted	\$0.00	\$0.00	\$0.00	\$0.01
Weighted Average Common Shares Outstanding – basic	106,153,192	102,970,585	105,011,687	102,033,143
Weighted Average Common Shares Outstanding - diluted	107,611,189	104,399,613	106,469,685	103,462,171

See accompanying notes to the condensed consolidated financial statements



**TELKONET, INC.****CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)****FOR THE NINE MONTHS FROM JANUARY 1, 2012 THROUGH SEPTEMBER 30, 2012**

	Common Shares	Common Stock Amount	Additional Paid in Capital	Accumulated Deficit	Total Stockholders' Equity
Balance at January 1, 2012	104,349,507	\$104,352	\$124,483,161	\$(118,344,196)	\$6,243,317
Shares issued to directors and management at approximately \$0.16 per share	638,104	637	101,363	–	102,000
Stock-based compensation expense related to employee stock options	–	–	104,928	–	104,928
Shares issued to preferred share holders for warrants exercised at \$0.13 per share	3,115,390	3,116	401,884		405,000
Accretion of redeemable preferred stock discount	–	–	(519,578)	–	(519,578)
Accretion of redeemable preferred stock dividends	–	–	(203,674)	–	(203,674)
Net loss				(58,430)	(58,430)
Balance at September 30, 2012	108,103,001	\$108,105	\$124,368,084	\$(118,402,626)	\$6,073,563

See accompanying notes to the condensed consolidated financial statements

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

	For the Nine Months Ended September 30,	
	2012	2011
<b>Cash Flows from Operating Activities:</b>		
Net (loss) income	\$(58,430 )	\$1,112,428
Adjustments to reconcile net (loss) income from operations to net cash used in operating activities:		
Amortization of debt discounts and financing costs	–	191,357
Gain on sale of product line	(15,408 )	(829,296 )
Gain on derivative liability	–	(172,476 )
Gain on disposal of property and equipment	–	(2,165 )
Stock based compensation expense	206,928	132,642
Depreciation of property & equipment	16,081	21,549
Amortization of intangible assets	181,260	181,260
Provision for doubtful accounts	(14,525 )	(68,321 )
Increase / decrease in:		
Accounts receivable	(600,489 )	62,960
Inventories	(447,736 )	(241,123 )
Prepaid expenses	(24,027 )	25,330
Accounts payable	211,281	(797,061 )
Accrued liabilities & expenses	84,040	204,741
Deferred revenue	116,006	(10,614 )
Customer deposits	119,994	(80,556 )
Deferred lease liability	13,290	26,060
<b>Net Cash Used In Operating Activities</b>	<b>(211,735 )</b>	<b>(243,285 )</b>
Cash Flows From Investing Activities:		
Purchases of property and equipment	(38,114 )	–
Proceeds from disposal of property and equipment	–	6,645
Proceeds from sale of product line	–	1,000,000
Deposit of restricted cash	–	(91,000 )
<b>Net Cash (Used In) Provided By Investing Activities</b>	<b>(38,114 )</b>	<b>915,645</b>
Cash Flows From Financing Activities:		
Proceeds from issuance of note payable	–	700,000
Payments on note payable	(49,035 )	(60,243 )
Payments on note payable – related party	–	(25,114 )
Proceeds from issuance of redeemable preferred stock	–	1,355,000
Proceeds from exercised warrants	405,000	–
Repayment of convertible debentures	–	(1,606,023)

<b>Net Cash Provided by Financing Activities</b>	355,965	363,620
Net increase in cash and cash equivalents	106,116	1,035,980
Cash and cash equivalents at the beginning of the period	961,091	136,030
<b>Cash and cash equivalents at the end of the period</b>	<b>\$1,067,207</b>	<b>\$1,172,010</b>

See accompanying notes to the condensed consolidated financial statements

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

	<b>For the Nine Months Ended September 30,</b>	
	2012	2011
Supplemental Disclosures of Cash Flow Information:		
Cash transactions:		
Cash paid during the period for interest expense	\$4,889	\$180,162
Non-cash transactions:		
Issuance of note payable in conjunction with warrant cancellation	\$—	\$50,000
Beneficial conversion feature of redeemable convertible preferred stock	—	427,895
Value of warrants issued with redeemable convertible preferred stock	—	427,895
Accretion of discount on redeemable preferred stock	519,578	316,908
Accretion of dividends on redeemable preferred stock	203,674	191,283
Retirement of derivative liability related to warrant obligation	—	1,729,299
Conversion of preferred stock to common stock	—	375,000

See accompanying notes to the condensed consolidated financial statements

**TELKONET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2012**

**(UNAUDITED)**

**NOTE A – SUMMARY OF ACCOUNTING POLICIES**

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

**General**

The accompanying unaudited condensed consolidated financial statements of Telkonet, Inc. (the “Company”) have been prepared in accordance with Rule S-X of the Securities and Exchange Commission (the “SEC”) and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. However, the results from operations for the three and nine months ended September 30, 2012, are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated December 31, 2011 financial statements and footnotes thereto included in the Company's Form 10-K filed with the SEC.

**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, manufactures and sells 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 internal electrical wiring.

In March 2007, the Company acquired substantially all of the assets of Smart Systems International (“SSI”), a 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 enabled Telkonet to provide installation and support for PLC products and third party applications to customers across North America.

In March 2011, the Company sold all its Series 5 PLC power line carrier product line and related assets to Wisconsin-based Dynamic Ratings, Inc. under an Asset Purchase Agreement.

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

### **Going Concern**

The accompanying 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 net loss of \$58,430 for the nine month period ended September 30, 2012, accumulated deficit of \$118,402,626 and total current liabilities in excess of current assets of \$51,176 as of September 30, 2012.

We continue to experience net operating losses and deficits in cash flows from operations. Our ability to continue as a going concern is subject to our ability to generate a profit and/or obtain necessary funding from outside sources, including proceeds from the issuance of debt or equity securities or assets, or obtaining loans from financial institutions, where possible. Our continued net operating losses and the uncertainty regarding contingent liabilities cast doubt on our ability to meet such goals and the Company cannot make any representations for the remainder of fiscal 2012 and beyond. The accompanying condensed consolidated financial statements do not include any adjustments that might result from the outcome of these uncertainties.

If the Company’s financial resources from operations are insufficient, the Company will require additional funding 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 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.



**TELKONET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2012**

**(UNAUDITED)**

Management intends to review the options for raising capital including, but not limited to, asset-based financing, private placements, and/or disposition of assets. 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.

**Fair Value of Financial Instruments**

The Company accounts for the fair value of financial instruments in accordance with Accounting Standards Codification (ASC) 820, which defines fair value for accounting purposes, established a framework for measuring fair value and expanded disclosure requirements regarding fair value measurements. 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. We have categorized our financial assets and liabilities that are recurring, at fair value into a three-level hierarchy in accordance with these provisions.

The following method and assumptions were used to estimate the fair value of each class of financial instruments:

*“Accounts receivable, accounts payable and current portion of long-term debt.”* The carrying amount of these items approximate fair value.

**Restricted Cash on Deposit**



During the third quarter of 2011, the Company was awarded a contract that contained a bonding requirement. The Company satisfied this requirement with cash collateral supported by an irrevocable standby letter of credit in the amount of \$91,000 which expires November 26, 2012. The amount is presented as restricted cash on deposit on the condensed consolidated balance sheets.

### **Goodwill and Other Intangibles**

In accordance with the accounting guidance on goodwill and other intangible assets, we perform an annual impairment test of goodwill at our reporting unit level and other intangible assets at our unit of account level, or more frequently if events or circumstances change that would more likely than not reduce the fair value of our reporting units below their carrying value. Amortization is recorded for other intangible assets with determinable lives using the straight line method over the 12 year estimated useful life. 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. We utilize a discounted cash flow valuation methodology to determine the fair value of the reporting unit. This approach is developed from management's forecasted cash flow data. If the fair value of the reporting unit exceeds the carrying amount of the reporting unit, goodwill is deemed not to be impaired. If the carrying amount exceeds fair value, we calculate an impairment loss. Any impairment loss is measured by comparing the implied fair value of goodwill to 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.

### **Long-Lived Assets**

We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable in accordance with ASC 360-10. Recoverability is measured by comparison of the carrying amount to the future net cash flows which the assets are expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the projected future cash flows arising from the asset determined by management to be commensurate with the risk inherent to our current business model.

**TELKONET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2012**

**(UNAUDITED)**

**Income (Loss) per Common Share**

The Company computes income (loss) per share under ASC 260-10, Earnings Per Share. Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of shares outstanding of common stock. Diluted income (loss) per share is computed using the weighted average number of common and common stock equivalent shares outstanding during the period. There is no effect on diluted income (loss) per share since the majority of common stock equivalents are anti-dilutive. Dilutive common stock equivalents consist of shares issuable upon the exercise of the Company's outstanding stock options and warrants.

**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.

**Income Taxes**

The Company accounts for income taxes in accordance with ASC 740-10 "Income Taxes." Under this method, deferred income taxes (when required) are provided based on the difference between the financial reporting and income tax basis of assets and liabilities and net operating losses at the statutory rates enacted for future periods. The Company has a policy of establishing a valuation allowance when it is more likely than not that the Company will not realize the benefits of its deferred income tax assets in the future.

The Company adopted ASC 740-10-25, which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. ASC 740-10-25 also provides guidance on derecognition, classification, treatment of interest and penalties, and disclosure of such positions.

The Company also accounts for the uncertainty in income taxes related to the recognition and measurement of a tax position taken or expected to be taken in an income tax return. The Company follows the applicable pronouncement guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition related to the uncertainty in these income tax positions.

### **Revenue Recognition**

For revenue from product sales, we recognize revenue in accordance with 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) collectability 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 collectability 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. We defer any revenue for which the product has not been delivered or is subject to refund until such time that we 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.

We provide call center support services to properties installed by us and also to properties installed by other providers. In addition, we provide the property with the portal to access the Internet. We receive monthly service fees from such properties for our services and Internet access. We recognize the service fee ratably over the term of the contract. The prices for these services are fixed and determinable prior to delivery of the service. The fair value of these services is known due to objective and reliable evidence from contracts and standalone sales. We report such revenues as recurring revenues.

Total revenues do not include sales tax as we consider ourselves a pass through conduit for collection and remittance of sales tax.

**TELKONET, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****SEPTEMBER 30, 2012****(UNAUDITED)****Guarantees and Product Warranties**

The Company records a liability for potential warranty claims in cost of sales at the time of sale. The amount of the liability is based on the trend in the historical ratio of claims to sales, the historical length of time between the sale and resulting warranty claim, new product introductions and other factors. The products sold are generally covered by a warranty for a period of one year. In the event the Company determines that its current or future product repair and replacement costs exceed its estimates, an adjustment to these reserves would be charged to earnings in the period such determination is made. For the period ended September 30, 2012 and year ended December 31, 2011, the Company experienced returns of approximately 2% to 8% material cost of sales. For the period ended September 30, 2012 and the year ended December 31, 2011, the Company recorded warranty liabilities in the amount of \$62,642 and \$104,423, respectively, using this experience factor range.

Product warranties for the periods ended September 30, 2012 and December 31, 2011 is as follows:

	September 30, 2012	December 31, 2011
Beginning balance	\$ 104,423	\$ 100,293
Warranty claims incurred	(59,203 )	(101,505)
Provision charged to expense	17,422	105,635
Ending balance	\$ 62,642	\$ 104,423

**Stock-Based Compensation**

We account for our stock based awards in accordance with ASC 718-10, Compensation, which requires a fair value measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors, including employee stock options and restricted stock awards. We estimate the fair value of stock options granted using the Black-Scholes valuation model. This model requires us to make estimates and assumptions including, among other things, estimates regarding the length of time an employee will hold vested stock options before exercising them, the estimated volatility of our common stock price and the number of options that will be

forfeited prior to vesting. The fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. Changes in these estimates and assumptions can materially affect the determination of the fair value of stock-based compensation and consequently, the related amount recognized in our consolidated statements of operations.

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. For 2012 and prior years, expected stock price volatility is based on the historical volatility of the Company's stock for the related vesting periods.

Stock-based compensation expense in connection with options granted to employees for the three and nine months ended September 30, 2012 and 2011 was \$1,259 and \$5,655, and \$104,928 and \$44,720, respectively.

#### **Deferred Lease Liability**

Rent expense is recorded on a straight-line basis over the term of the lease. Rent escalations and rent abatement periods during the term of the lease create a deferred lease liability which represents the excess of cumulative rent expense recorded to date over the actual rent paid to date.

#### **Lease Abandonment**

On July 15, 2011, the Company executed a sublease agreement for approximately 12,000 square feet of commercial office space in Germantown, Maryland. Because we no longer have access to this subleased space, we recorded a charge of \$59,937 in accrued liabilities and expenses related to this abandonment during 2011. On June 27, 2012 the subtenant exercised the option to extend the expiration of the term of the sublease from January 31, 2013 to December 31, 2015 and we recorded an additional charge of \$132,174 during the three months ended June 30, 2012. The remaining liability at September 30, 2012 is \$146,103.

**TELKONET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2012**

**(UNAUDITED)**

**NOTE B – NEW ACCOUNTING PRONOUNCEMENTS**

In May 2011, the Financial Accounting Standards Board (“FASB”) issued FASB ASU No. 2011-04, “Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs,” which is now codified under FASB ASC Topic 820, “Fair Value Measurement.” This new guidance provides common requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. generally accepted accounting principles (“GAAP”) and International Financial Reporting Standards (“IFRSs”). Certain fair value measurement principles were clarified or amended in this ASU, such as the application of the highest and best use and valuation premise concepts. New and revised disclosure requirements include: quantitative information about significant unobservable inputs used for all Level 3 fair value measurements and a description of the valuation processes in place, as well as a qualitative discussion about the sensitivity of recurring Level 3 fair value measurements; public companies will need to disclose any transfers between Level 1 and Level 2 fair value measurements on a gross basis, including the reason(s) for those transfers; a requirement regarding disclosure on the highest and best use of a nonfinancial asset; and a requirement that all fair value measurements be categorized in the fair value hierarchy with disclosure of that categorization. FASB ASU No. 2011-04 was effective during the nine month period ended September 30, 2012. The adoption of this ASU did not have an impact on our condensed consolidated statements.

In September 2011, the FASB issued FASB ASU No. 2011-08, “Testing Goodwill for Impairment,” which is now codified under FASB ASC Topic 350, “Intangibles — Goodwill and Other.” This new guidance allows an entity to first assess qualitative factors to evaluate if the existence of events or circumstances leads to a determination it is necessary to perform the current two-step test. After assessing the totality of events or circumstances, if it is determined it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. Otherwise, the entity is required to perform Step 1 of the impairment test. An entity has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to Step 1 of the two-step impairment test, and then resume performing the qualitative assessment in any subsequent period. Reporting units with zero or negative carrying amounts continue to be required to perform a qualitative assessment in place of Step 1 of the impairment test. The new guidance includes examples of events and circumstances an entity should consider in its evaluation of whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount, such as macroeconomic conditions; industry and market considerations; cost factors; overall financial performance; and other relevant entity-specific events. The examples of events and circumstances included in this ASU supersede the previous examples entities should have considered. FASB ASU No. 2011-08 is effective for our annual and interim goodwill impairment tests performed during the year ending December 31, 2012. We did not perform any impairment tests during the nine month period ended September 30, 2012 and will be considering the impact of this ASU on our condensed consolidated statements going forward.

In July 2012, the FASB issued ASU No. 2012-02, "Testing Indefinite-Lived Intangible Assets for Impairment". The revised standard is intended to reduce the cost and complexity of testing indefinite-lived intangible assets other than goodwill for impairment. It allows companies to perform a "qualitative" assessment to determine whether further impairment testing of indefinite-lived intangible assets is necessary, similar in approach to the goodwill impairment test. The revised standard allows an entity the option to first assess qualitatively whether it is more likely than not (that is, a likelihood of more than 50 percent) that an indefinite-lived intangible asset is impaired, thus necessitating that it perform the quantitative impairment test.<sup>1</sup> An entity is not required to calculate the fair value of an indefinite-lived intangible asset and perform the quantitative impairment test unless the entity determines that it is more likely than not that the asset is impaired. An entity choosing to perform the qualitative assessment would need to identify and consider those events and circumstances that, individually or in the aggregate, most significantly affect an indefinite-lived intangible asset's fair value. The revised standard provides examples of events and circumstances that should be considered, including deterioration in the entity's operating environment, entity-specific events, such as a change in management, and overall financial performance, such as negative or declining cash flows. An entity also should consider any positive and mitigating events and circumstances, as well as whether there have been changes to the carrying amount of the indefinite-lived intangible asset. An entity can choose to perform the qualitative assessment on none, some, or all of its indefinite-lived intangible assets. Moreover, an entity can bypass the qualitative assessment and perform the quantitative impairment test for any indefinite-lived intangible in any period. The revised standard is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. However, an entity can choose to early adopt the revised guidance even if its annual test date is before the issuance of the revised standard, provided that the entity has not yet performed its 2012 annual impairment test or issued its financial statements. For example, a calendar year-end entity with a third quarter annual test date may apply the revised standard to its 2012 annual impairment test.

## TELKONET, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2012

(UNAUDITED)

## NOTE C – INTANGIBLE ASSETS AND GOODWILL

Total identifiable intangible assets acquired and their carrying values at September 30, 2012 are:

	<b>Cost</b>	<b>Accumulated Amortization</b>	<b>Carrying Value</b>	<b>Weighted Average Amortization Period (Years)</b>
Amortized Identifiable Intangible Assets:				
Subscriber lists – EthoStream	\$2,900,000	\$(1,339,283 )	\$1,560,717	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(1,339,283 )	1,560,717	
Goodwill – EthoStream	5,796,430	-	5,796,430	
Goodwill – SSI	2,774,016	-	2,774,016	
Total Goodwill	8,570,446	-	8,570,446	
Total	\$11,470,446	\$(1,339,283 )	\$10,131,163	

Total identifiable intangible assets acquired and their carrying values at December 31, 2011 are:

	<b>Cost</b>	<b>Accumulated Amortization</b>	<b>Impairment</b>	<b>Carrying Value</b>	<b>Weighted Average Amortization Period (Years)</b>
Amortized Identifiable Intangible Assets:					
Subscriber lists – EthoStream	\$2,900,000	\$(1,158,023 )	\$-	\$1,741,977	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(1,158,023 )	-	1,741,977	
Goodwill – EthoStream	5,796,430	-	-	5,796,430	



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Goodwill – SSI	5,874,016	-	(3,100,000 )	2,774,016
Total Goodwill	11,670,446	-	(3,100,000 )	8,570,446
Total	\$14,570,446	\$(1,158,023 )	\$(3,100,000 )	\$10,312,423

Total amortization expense charged to operations for each of the three and nine months ended September 30, 2012 and 2011 was \$60,420 and \$181,260, respectively.

Estimated amortization expense as of September 30, 2012 is as follows:

Remainder of 2012	\$60,420
2013	241,680
2014	241,680
2015	241,680
2016	241,680
2017	241,680
2018 and after	291,897
Total	\$1,560,717

The Company does not amortize goodwill. The Company recorded goodwill in the amount of \$14,670,446 as a result of the acquisitions of EthoStream and SSI during the year ended December 31, 2007. The Company evaluates goodwill for impairment based on the fair value of the operating business units to which this goodwill relates at least once a year. We utilize a discounted cash flow valuation methodology to determine the fair value of the reporting unit.

**TELKONET, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****SEPTEMBER 30, 2012****(UNAUDITED)**

At December 31, 2011, the Company determined that a portion of the value SSI's goodwill was impaired based upon management's assessment of operating results and forecasted discounted cash flow and wrote off \$3,100,000 based on that determination. Since acquisition, the Company has written off \$3,000,000 and \$3,100,000 of goodwill for Ethostream and SSI, respectively.

**NOTE D – ACCOUNTS RECEIVABLE**

Components of accounts receivable as of September 30, 2012 and December 31, 2011 are as follows:

	September 30,	December 31,
	2012	2011
Accounts receivable	\$ 1,982,431	\$ 1,421,411
Allowance for doubtful accounts	(61,406 )	(115,400 )
Accounts receivable, net	\$ 1,921,025	\$ 1,306,011

**NOTE E – INVENTORY**

Components of inventories as of September 30, 2012 and December 31, 2011 are as follows:

	September 30,	December 31,
	2012	2011
Merchandise purchased for resale	\$ 901,846	\$ 387,210
Reserve for obsolescence	(131,900)	(65,000 )

Inventory, net                                 \$769,946     \$322,210

## NOTE F – ACCRUED LIABILITIES AND EXPENSES

Accrued liabilities and expenses at September 30, 2012 and December 31, 2011 are as follows:

	September 30,	December 31,
	2012	2011
Accrued liabilities and expenses	\$669,066	\$684,823
Accrued payroll and payroll taxes	304,289	285,048
Accrued sales taxes, penalties, and interest	1,158,428	1,068,314
Accrued interest	65,823	33,600
Warranty	62,642	104,423
Total	\$2,260,248	\$2,176,208

## NOTE G – LONG TERM DEBT

### 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 2%. 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 commenced on January 1, 2010 and continued 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 Loan Agreement is secured by substantially all of the Company’s assets and the proceeds from this loan were used for the working capital requirements of the Company. The Loan Agreement contains covenants which require, among other things, that the Company shall keep and maintain 75 existing full-time positions and create and fill 35 additional full-time positions in Milwaukee, Wisconsin by December 31, 2012. Under the terms of the Loan Agreement, for each new full time position not kept, created or maintained, the Company would be required to pay a penalty consisting of an incremental increase in the interest rate not to exceed 4%. In May of 2012, the Company notified the Department that due to the economic climate, it is unlikely that the 35 new full time position covenant will be met by December 31, 2012. On June 18, 2012, the Department agreed to waive all penalties associated with the covenant and keep the loan interest rate fixed at 2%. The outstanding borrowings under the agreement as of September 30, 2012 and December 31, 2011 were \$216,165 and \$252,454, respectively.



**TELKONET, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****SEPTEMBER 30, 2012****(UNAUDITED)****Promissory Note #1**

On March 4, 2011, the Company sold all its Series 5 PLC product line assets to Wisconsin-based Dynamic Ratings, Inc. ("Purchaser") under an Asset Purchase Agreement ("APA"). Per the APA, the Company signed an unsecured Promissory Note ("Note #1") due to Purchaser in the aggregate principal amount of \$700,000. The outstanding principal balance bears interest at the annual rate of 6% and is due on March 31, 2014. Note #1 may be prepaid in whole or in part, without penalty at any time. Note #1 contains certain earn-out provisions that encompass both the Company's and Purchaser's revenue volumes. Amounts earned under the earn-out provisions shall be applied against Note #1 on June 30, 2012 and June 30, 2013. Provided these provisions are met, the Company could potentially retire Note #1 prior to its expiration date. As of June 30, 2012, the non cash reduction of principal calculated under these provisions and applied to the note was \$15,408. Payments not made when due, by maturity acceleration or otherwise, shall bear interest at the rate of 12% per annum from the date due until fully paid. The outstanding principal balance of this note as of September 30, 2012 and December 31, 2011 was \$684,592 and \$700,000, respectively.

**Promissory Note #2**

From the sale of its Series 5 PLC product line assets, the Company used the proceeds received to retire substantially all of its obligations under its \$1.6 million senior convertible debenture due May 29, 2011 and to cancel the related warrants covering 11.7 million shares of the Company's common stock. In exchange for the early retirement of debt and cancellation of warrants, the Company provided the third party with an unsecured one-year promissory note ("Note #2") for \$50,000. The outstanding principal balance bore interest at the annual rate of 5.25% and was due on March 4, 2012. This note was paid in full prior to March 31, 2012.

Aggregate maturities of long-term debt as of September 30, 2012 are as follows:

For the years ending December 31,	Amount
2012 (Remainder of)	\$ 12,218
2013	49,485
2014	735,076
2015	51,503

2016	52,475
Total	900,757
Less: Current portion	(49,238 )
Total Long term portion	\$851,519

## NOTE H – REDEEMABLE PREFERRED STOCK

### Series A

The Company has designated 215 shares of preferred stock as Series A Preferred Stock (“Series A”). Each share of Series A is convertible, at the option of the holder thereof, at any time, into shares of our Common Stock at an initial conversion price of \$0.363 per share. In the event of a change of control (as defined in the purchase agreement with respect to the Series A), or at the holder’s option, on November 19, 2014 and for a period of 180 days thereafter, provided that at least 50% of the shares of Series A issued on the Series A Original Issue Date remain outstanding as of November 19, 2014, and the holders of at least a majority of the then outstanding shares of Series A provide written notice requesting redemption of all shares of Series A, we are required to redeem the Series A for the purchase price plus any accrued but unpaid dividends. The Series A accrues dividends at an annual rate of 8% of the original purchase price, payable only when, as, and if declared by the Board of Directors of Telkonet.

On November 16, 2009, the Company sold 215 shares of Series A with attached warrants to purchase an aggregate of 1,628,800 shares of the Company’s common stock at \$0.33 per share. The Series A shares were sold at a price per share of \$5,000 and each Series A share is convertible into approximately 13,774 shares of common stock at a conversion price of \$0.363 per share. The Company received \$1,075,000 from the sale of the Series A shares. Since the Series A may ultimately be redeemable at the option of the holder, the carrying value of the preferred stock, net of discount and accumulated dividends, has been classified as redeemable preferred stock on the condensed consolidated balance sheets.

**TELKONET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2012**

**(UNAUDITED)**

In accordance with ASC 470 Topic "*Debt*", a portion of the proceeds were allocated to the warrants based on their relative fair value, which totaled \$287,106 using the Black Scholes option pricing model. Further, the Company attributed a beneficial conversion feature of \$70,922 to the Series A preferred shares based upon the difference between the effective conversion price of those shares and the closing price of the Company's common stock on the date of issuance. The assumptions used in the Black-Scholes model are as follows: (1) dividend yield of 0%; (2) expected volatility of 123%, (3) weighted average risk-free interest rate of 2.2%, (4) expected life of 5 years, and (5) estimated fair value of Telkonet common stock of \$0.24 per share. The expected term of the warrants represents the estimated period of time until exercise and is based on historical experience of similar awards and giving consideration to the contractual terms. The amounts attributable to the warrants and beneficial conversion feature, aggregating \$358,028, have been recorded as a discount and deducted from the face value of the preferred stock. The discount is being amortized over the period from issuance to November 19, 2014 (the initial redemption date) as a charge to additional paid-in capital (since there is a deficit in retained earnings).

The charge to additional paid in capital for amortization of Series A discount and costs for the three and nine months ended September 30, 2012 and 2011 was \$17,508 and \$17,901 and \$57,106 and \$53,703, respectively.

For the three and nine months ended September 30, 2012 and 2011, we have accrued dividends in the amount of \$18,660 and \$19,832 and \$55,568 and \$62,256, respectively, and have cumulative accrued dividends of \$232,416 and \$158,188, respectively. The accrued dividends have been charged to additional paid-in capital (since there is a deficit in retained earnings) and the net unpaid accrued dividends have been added to the carrying value of the Series A shares.

**Series B**

The Company has designated 538 shares of preferred stock as Series B Preferred Stock ("Series B"). Each share of Series B is convertible, at the option of the holder thereof, at any time, into shares of our Common Stock at an initial conversion price of \$0.13 per share. In the event of a change of control (as defined in the purchase agreement with respect to the Series B), or at the holder's option, on August 4, 2015 and for a period of 180 days thereafter, provided that at least 50% of the shares of Series B issued on the Series B Original Issue Date remain outstanding as of August 4, 2015, and the holders of at least a majority of the then outstanding shares of Series B provide written notice requesting redemption of all shares of Series B, we are required to redeem the Series B for the purchase price plus any accrued but unpaid dividends. The Series B accrues dividends at an annual rate of 8% of the original purchase price,

payable only when, as, and if declared by our Board of Directors.

On August 4, 2010, the Company sold 267 shares of Series B with attached warrants to purchase an aggregate of 5,134,626 shares of the Company's common stock at \$0.13 per share. The Series B shares were sold at a price per share of \$5,000 and each Series B share is convertible into approximately 38,461 shares of common stock at a conversion price of \$0.13 per share. The Company received \$1,335,000 from the sale of the Series B shares. Since the Series B may ultimately be redeemable at the option of the holder, the carrying value of the preferred stock, net of discount and accumulated dividends, has been classified as redeemable preferred stock on the condensed balance sheets.

In accordance with ASC 470 Topic "*Debt*", a portion of the proceeds was allocated to the warrants based on their relative fair value, which totaled \$394,350 using the Black-Scholes option pricing model. Further, the Company attributed a beneficial conversion feature of \$394,350 to the Series B preferred shares based upon the difference between the effective conversion price of those shares and the closing price of the Company's common stock on the date of issuance. The assumptions used in the Black-Scholes model are as follows: (1) dividend yield of 0%; (2) expected volatility of 123%, (3) weighted average risk-free interest rate of 1.76%, (4) expected life of approximately 4 years, and (5) estimated fair value of Telkonet common stock of \$0.109 per share. The expected term of the warrants represents the estimated period of time until exercise and is based on historical experience of similar awards and giving consideration to the contractual terms. The amounts attributable to the warrants and beneficial conversion feature, aggregating \$788,700, have been recorded as a discount and deducted from the face value of the preferred stock. The discount is being amortized over the period from issuance to November 19, 2014 (the initial redemption date) as a charge to additional paid-in capital (since there is a deficit in retained earnings).

On April 8, 2011, the Company sold 271 additional shares of Series B with attached warrants to purchase an aggregate of 5,211,542 shares of the Company's common stock at \$0.13 per share. The Series B shares were sold at a price per share of \$5,000 and each Series B share is convertible into approximately 38,461 shares of common stock at a conversion price of \$0.13 per share. The Company received \$1,355,000 from the sale of the Series B shares. Since the Series B shares may ultimately be redeemable at the option of the holder, the carrying value of the Series B shares, net of discount and accumulated dividends, has been classified as redeemable preferred stock on the condensed balance sheets.



**TELKONET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2012**

**(UNAUDITED)**

In accordance with ASC 470 Topic “*Debt*”, a portion of the proceeds was allocated to the warrants based on their relative fair value, which totaled \$427,895 using the Black-Scholes option pricing model. Further, the Company attributed a beneficial conversion feature of \$427,895 to the Series B shares based upon the difference between the effective conversion price of those shares and the closing price of the Company’s common stock on the date of issuance. The assumptions used in the Black-Scholes model are as follows: (1) dividend yield of 0%; (2) expected volatility of 129%, (3) weighted average risk-free interest rate of 0.26%, (4) expected life of approximately 3.5 years, and (5) estimated fair value of Telkonet common stock of \$0.12 per share. The expected term of the warrants represents the estimated period of time until exercise and is based on historical experience of similar awards and giving consideration to the contractual terms. The amounts attributable to the warrants and beneficial conversion feature, aggregating \$855,790, have been recorded as a discount and deducted from the face value of the Series B shares. The discount is being amortized over the period from issuance to November 19, 2014 (the initial redemption date) as a charge to additional paid-in capital (since there is a deficit in retained earnings).

The charge to additional paid in capital for amortization of Series B discount and costs for the three months and nine months ended September 30, 2012 and 2011 was \$222,488 and \$105,210 and \$462,472 and \$263,205, respectively.

For the three and nine months ended September 30, 2012 and 2011, we have accrued dividends for Series B in the amount of \$49,730 and \$51,381 and \$148,106 and \$129,027, respectively, and have cumulative accrued dividends of \$370,103 and \$172,064 as of September 30, 2012 and 2011, respectively. The accrued dividends have been charged to additional paid-in capital (since there is a deficit in retained earnings) and the net unpaid accrued dividends been added to the carrying value of the preferred stock.

Preferred stock carries certain preference rights as detailed in the Company’s Amended Articles of Incorporation related to both the payment of dividends and as to payments upon liquidation in preference to any other class or series of capital stock of the Company. Liquidation preference of the preferred stock is based on the following order: first, Series B with a preference value of \$2,835,103 and second, Series A with a preference value of \$1,157,416. With respect to dividends, both series of preferred stock are equal in their preference over common stock.

**NOTE I – CAPITAL STOCK**

The Company has authorized 15,000,000 shares of preferred stock (designated and undesignated), with a par value of \$.001 per share. As of September 30, 2012 and December 31, 2011, the Company has 215 and 538 shares of preferred stock designated and 185 and 493 shares outstanding, designated Series A and B preferred stock, respectively.

The Company has authorized 190,000,000 shares of common stock with a par value of \$.001 per share. As of September 30, 2012 and December 31, 2011 the company has 108,103,001 and 104,349,507 shares issued and outstanding.

During the nine months ended September 30, 2012, the Company issued 638,104 shares of common stock to directors and management for services performed through September 30, 2012. These shares were valued at \$102,000, which approximated the fair value of the shares when they were issued.

During the nine months ended September 30, 2011, the Company issued 584,455 shares of common stock to directors and management for services performed through September 30, 2011. These shares were valued at \$85,999, which approximated the fair value of the shares when they were issued. In addition, 177,083 shares were issued to a current member of the Company's Board of Directors for consulting fees incurred prior to, but not paid until after, his election to Board of Directors. These shares were valued at \$25,000.

During the quarter ended September 30, 2012, 3,115,390 of Series B preferred stock attached warrants were exercised to an equal number of common shares at an exercise price of \$0.13 per share. The total proceeds received from these exercised warrants was \$405,000.

## **NOTE J – STOCK OPTIONS AND WARRANTS**

### **Employee Stock Options**

The Company maintains two stock option plans. The first plan was initiated in the year 2000 and was established as a long term incentive plan for employees and consultants, including board of director members. The second plan was established in 2010 also as an incentive plan for officers, employees, non employee directors, prospective employees and other key persons. It is anticipated that providing such persons with a direct stake in the Company's welfare will assure a better alignment of their interests with those of the Company and its stockholders.

**TELKONET, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****SEPTEMBER 30, 2012****(UNAUDITED)**

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. No new grants may be made under the 2000 stock option plan, which expired April 23, 2012.

Options Outstanding		Options Exercisable			
Exercise Prices	Number	Weighted Average Remaining	Weighted Average Exercise	Number	Weighted Average Exercise
	Outstanding	Contractual Life  (Years)	Price	Exercisable	Price
\$ 0.01-0.20	790,642	8.52	\$ 0.18	786,781	\$ .18
\$ 1.00-3.00	95,000	2.90	2.22	95,000	2.22
\$ 3.01-5.99	95,000	3.15	4.05	95,000	4.05
	980,642	7.46	\$ 0.75	976,781	\$ 0.75

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

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2011	2,548,800	\$ 1.57
Granted	-	-
Exercised	-	-
Cancelled or expired	(1,863,800)	1.10
Outstanding at December 31, 2011	685,000	\$ 1.45
Granted	615,642	0.19
Exercised	-	-
Cancelled or expired	(320,000 )	1.16
Outstanding at September 30, 2012	980,642	\$ 0.75

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 24 months of share price data prior to the date of the award. We base the risk-free interest rate used in the Black-Scholes 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 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 ASC 718-10, we adjust share-based compensation for changes to the estimate of expected equity award forfeitures based on actual forfeiture experience.

There were 615,642 and 0 options granted and no options exercised during the nine months ended September 30, 2012 and 2011. Total stock-based compensation expense in connection with options granted to employees recognized in the condensed consolidated statements of operations for the three months ended September 30, 2012 and 2011 was \$1,259 and \$5,655 respectively, and for the nine months ended September 30, 2012 and 2011 was \$104,928 and \$21,643, respectively.

**TELKONET, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****SEPTEMBER 30, 2012****(UNAUDITED)****Non-Employee Stock Options**

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

	Number of Shares	Weighted Average Price  Per Share
Outstanding at January 1, 2011	425,000	\$ 1.00
Granted	-	-
Exercised	-	-
Canceled or expired	-	-
Outstanding at December 31, 2011	425,000	\$ 1.00
Granted	-	-
Exercised	-	-
Canceled or expired	(425,000)	1.00
Outstanding at September 30, 2012	-	\$ -

There were no non-employee stock options exercised during the nine month periods ended September 30, 2012 and 2011.

**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 the issuance of Series A and B redeemable preferred stock.

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Exercise Prices	Warrants Outstanding			Warrants Exercisable	
	Number	Weighted	Weighted	Number	Weighted
		Average			
Outstanding	Remaining	Contractual	Exercise	Exercisable	Exercise
		Life	Price		Price
		(Years)			
\$ 0.13	7,230,778	3.37	\$ 0.13	7,230,778	\$ 0.13
0.33	1,628,800	2.13	0.33	1,628,800	0.33
0.60	800,000	.59	0.60	800,000	0.60
3.01	960,782	1.75	3.01	960,782	3.01
	10,620,360	2.82	\$ .46	10,620,360	\$ .46

Transactions involving warrants are summarized as follows:

	Number of	Weighted
	Shares	Average
		Price Per
		Share
Outstanding at January 1, 2011	22,104,742	\$ 0.51
Issued	5,336,816	0.20
Canceled or expired	(12,729,694)	0.34
Outstanding at December 31, 2011	14,711,864	0.50
Issued	-	-
Exercised	(3,115,390)	0.13
Canceled or expired	(976,114)	1.04
Outstanding at September 30, 2012	10,620,360	\$ .46

The Company did not issue any warrants during the nine month period ended September 30, 2012.

On April 8, 2011, the Company issued 271 shares of Series B Preferred Stock ("Series B") with attached warrants to purchase 5,211,542 shares of the Company's common stock at \$0.13 per share. The Company issued 125,274 warrants during the nine months ended September 30, 2011. These warrants were issued pursuant to anti-dilution provisions in existing warrant agreements that were triggered by the completion of the Series B preferred stock private placement.

**TELKONET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2012**

**(UNAUDITED)**

During the quarter ended September 30, 2012, a total of 3,115,390 Series B warrants were exercised at an exercise price of \$0.13 per share.

**NOTE K – RELATED PARTIES**

From time to time the Company may receive advances from certain of its officers in the form of salary deferment and cash advances, to meet short term working capital needs. These advances may not have formal repayment terms or arrangements. There were no such deferments or advances outstanding as of September 30, 2012 and December 31, 2011.

**NOTE L – COMMITMENTS AND CONTINGENCIES**

**Office Lease Obligations**

The Company presently leases approximately 14,000 square feet of office space in Milwaukee, Wisconsin for its corporate headquarters. The Milwaukee lease expires in March 2020.

The Company presently leases 16,416 square feet of commercial office space in Germantown, Maryland. The lease commitments expire in December 2015. On July 15, 2011, Telkonet executed a sublease agreement for 11,626 square feet of the office space in Germantown, Maryland. The subtenant received one month rent abatement and has the option to extend the sublease from January 31, 2013 to December 31, 2015. On June 27, 2012 the subtenant exercised the option to extend the expiration of the term of the sublease from January 31, 2013 to December 31, 2015.

Commitments for minimum rentals under non cancelable leases at September 30, 2012 are as follows:

2012 (Remainder of)	\$98,223
2013	402,948
2014	414,263
2015	426,399
2016	169,156
2017	174,098
2018 and thereafter	410,179
Total	\$2,095,266

Expected rent payments to be received under sublease agreement at September 30, 2012 are as follows:

2012 (Remainder of)	\$32,331
2013	130,942
2014	134,872
2015	138,919
Total	\$437,064

Rental expenses charged to operations for the three and nine months ended September 30, 2012 and 2011 are \$145,605 and \$187,111 and \$407,564 and \$547,891, respectively. Rental income received for the three and nine months ended September 30, 2012 was \$32,180 and \$94,958, respectively.

### **Employment Agreements**

The Company has employment agreements with certain of its key employees which include non-disclosure and confidentiality provisions for protection of the Company's proprietary information.

Jason L. Tienor, President and Chief Executive Officer, is employed pursuant to an employment agreement dated May 1, 2012. Mr. Tienor's employment agreement is for a term expiring on May 1, 2014, is renewable at the agreement of the parties and provides for a base salary of \$200,000 per year.

Jeffrey J. Sobieski, Chief Technology Officer, is employed pursuant to an employment agreement, dated May 1, 2012. Mr. Sobieski's employment agreement is for a term expiring on May 1, 2014, is renewable at the agreement of the parties and provides for a base salary of \$190,000 per year.



**TELKONET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2012**

**(UNAUDITED)**

Richard E. Mushrush, Chief Financial Officer, is employed pursuant to an employment agreement, dated May 1, 2012. Mr. Mushrush's employment agreement is for a term expiring on May 1, 2013, is renewable at the agreement of the parties and provides for a base salary of \$110,000 per year.

Gerrit J. Reinders, Executive Vice President-Global Sales and Marketing, is employed pursuant to an employment agreement, dated May 1, 2012. Mr. Reinder's employment agreement is for a term expiring on May 1, 2013, is renewable at the agreement of the parties and provides for a base salary of \$150,000 per year.

Matthew P. Koch, Chief Operating Officer, is employed pursuant to an employment agreement, dated May 1, 2012. Mr. Koch's employment agreement is for a term expiring on May 1, 2013, is renewable at the agreement of the parties and provides for a base salary of \$130,000 per year.

**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.

**Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc.**

On July 1, 2008, Linksmart Wireless Technology, LLC, or Linksmart, filed a civil lawsuit in the Eastern District of Texas against EthoStream, LLC, our wholly-owned subsidiary and 22 other defendants (*Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc., et al*, U.S. District Court, for the Eastern District of Texas, Marshall Division, No. 2:08-cv-00264). This lawsuit alleges that the defendants' services infringe a wireless network security patent held by Linksmart. Linksmart seeks a permanent injunction enjoining the defendants from infringing, inducing the infringement of, or contributing to the infringement of its patent, an award of damages and attorney's fees.

Defendant Ramada Worldwide, Inc. provided us with notice of the suit and demanded that we defend and indemnify it pursuant to a vendor direct supplier agreement between EthoStream and WWC Supplier Services, Inc., a Ramada affiliate (wherein we agreed to indemnify, defend and hold only EthoStream supported Ramada properties harmless from and against claims of infringement). After a review of that agreement, it was determined that EthoStream owes the duty to defend and indemnify with respect to services provided by Telkonet to Ramada and it has assumed Ramada's defense.

The parties in the lawsuit agreed to and the Court ordered a stay of the litigation pending the conclusion of a reexamination proceeding in the U.S. Patent and Trademark Office relating to the patent involved in the lawsuit. The case was reopened in early 2012 based on the expectation that a reexamination certificate would be issued by the Patent Office. The reexamination certificate has been issued. After the case resumed, the parties agreed to a "transfer" of the case from the Eastern District of Texas to the Central District of California. To accomplish the "transfer," with the agreement of the parties, the Texas case was dismissed and a new action was filed in California on April 5, 2012. (*Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc., et al*, U.S. District Court, for the Central District of California, Southern Division, No. SACV 12-522-JST). The parties have answered the complaint filed in the new action and the court has set the litigation calendar with trial set for June 2014.

*Robert P. Crabb v Telkonet Inc.*

On November 9, 2010, a former executive, Robert P. Crabb, served Telkonet, Inc. and Telkonet Communications, Inc. ("Telkonet") with a Complaint in the Circuit Court for Montgomery County, MD alleging (1) violation of Maryland's Wage Payment and Collection Act (2) Breach of Contract and (3) Promissory Estoppel/Detrimental Reliance. The claims in his Complaint arose out of his retirement in September 2007. In terms of relief, Mr. Crabb sought "severance compensation" in the amount of \$156,000, treble damages, interest, and attorneys' fees. This lawsuit was resolved as part of a voluntary settlement prior to the scheduled four day jury trial beginning on December 12, 2011. On January 25, 2012, the Court entered the parties' joint Stipulation of Dismissal.

In the case of *Robert P. Crabb v Telkonet, Inc.*, the parties executed a settlement agreement and general release on January 20, 2012 for \$127,000. Terms of the agreement called for Telkonet to make an initial payment of \$27,000 on January 27, 2012, and Telkonet made additional payments on March 1 and June 1, 2012. The remaining balance was paid on September 1, 2012.

**TELKONET, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2012**

**(UNAUDITED)**

*Stephen L. Sadle v. Telkonet, Inc*

On April 15, 2011, a former executive, Stephen L. Sadle, served Telkonet, Inc. and Telkonet Communications, Inc. ("Telkonet") with a Complaint in the Circuit Court for Montgomery County, MD alleging (1) Breach of Contract, (2) Promissory Estoppel/Detrimental Reliance and (3) violation of Maryland's Wage Payment and Collection Act. The three claims in his Complaint each arose out of his departure in 2007. In terms of relief, Mr. Sadle sought "severance compensation" in the amount of \$195,000, treble damages, interest, and attorneys' fees. This lawsuit was resolved as part of a voluntary settlement prior to the scheduled jury trial beginning on May 14, 2012. On July 26, 2012, the Parties filed a Joint Stipulation of Dismissal with prejudice.

In the case of *Stephen L. Sadle v Telkonet, Inc.*, the parties executed a settlement agreement and general release on July 2, 2012 for \$100,000. Terms of the agreement called for Telkonet to make an initial payment of \$30,000 on June 1, 2012 and Telkonet made an additional scheduled payment on September 1, 2012. The remaining balance is to be paid in three equal installments on or before December 1, 2012 and March 1, 2013. If Telkonet fails to make any of the above-specified payments within ten days of the specified date, Telkonet will be deemed in default. In the event of such a default, Mr. Sadle may, at his option, demand the entire balance due (and unpaid) and will be entitled to 6% interest on \$155,000 from May 1, 2008.

**Sales Tax**

The Company engaged a sales tax consultant to assist in determining the extent of its potential sales tax exposure. Based upon this analysis, management determined the Company had probable exposure for certain unpaid obligations, including interest and penalty, of approximately \$1,100,000 including and prior to the year ended December 31, 2011. The Company has approximately \$1,158,000 accrued as of September 30, 2012. The Company intends to manage the liability by (1) confirming if customers self-assessed and remitted tax to the applicable state(s) absent from our transactions (2) confirming if customers were subjected to a state audit and if so did it result in the customer paying tax absent from our transaction (3) invoicing customers for the back taxes and (4) establishing voluntary disclosure agreements with the applicable states, which establishes a maximum look-back period and payment arrangements. However, if the aforementioned methods prove unsuccessful and the Company is examined or challenged by taxing authorities, there exists possible exposure of an additional \$620,000, not including any applicable interest and penalties.

The following table sets forth the change in the sales tax accrual as of September 30, 2012 and December 31, 2011:

	September 30, 2012	December 31, 2011
Balance, beginning of year	\$1,068,314	\$776,671
Collections	217,350	162,975
Provisions	(132,126 )	75,979
Interest and penalties	20,574	89,020
Payments	(15,684 )	(36,331 )
Balance at end of period	\$1,158,428	\$1,068,314

#### **NOTE M – BUSINESS CONCENTRATION**

For the nine months ended September 30, 2012 and 2011, no single customer represented 10% or more of total net revenues.

Purchases from two major suppliers approximated \$1,624,639, or 71%, of purchases, and \$1,284,352, or 71%, of purchases, for the nine months ended September 30, 2012 and 2011, respectively. Total due to these suppliers, net of deposits, was approximately \$152,099 as of September 30, 2012, and \$99,084, as of September 30, 2011.

#### **NOTE N – 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. When applicable, the Company's 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 and convertible debentures are classified within Level 3 of the fair value hierarchy because they are valued using inputs which are not actively observable, either directly or indirectly.

**TELKONET, INC.****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS****SEPTEMBER 30, 2012****(UNAUDITED)**

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 table below sets forth a summary of changes in the fair value of the Company's Level 3 financial liabilities (derivative liability) for the nine months ended September 30, 2011.

	2011
Balance at beginning of year	\$1,901,775
Repayment of debt and warrants related to derivative liability	(1,158,730)
Change in fair value of derivative liability	(172,476)
Retirement of derivative liability related to warrant obligation	(570,569)
Balance at end of period	\$-

The following table sets forth certain Company assets as of December 31, 2011 which are measured at fair value on a non-recurring basis by level within the fair value hierarchy. These are classified based on the lowest level of input that is significant to the fair value measurement:

	Level 1	Level 2	Level 3	Total
Goodwill-SSI	\$ -	\$ -	\$2,774,016	\$2,774,016
Total	\$ -	\$ -	\$2,774,016	\$2,774,016

The table below sets forth a summary of changes in the fair value of the Company's Level 3 assets (Goodwill-SSI) measured on a non-recurring basis as of December 31, 2011.

	2011
Balance at beginning of year	\$5,874,016
Impairment of carried value	(3,100,000)
Balance at December 31, 2011	\$2,774,016

## **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 condensed consolidated financial statements and related notes thereto for the quarter ended September 30, 2012, 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, 2011, filed April 23, 2012.

### **Business**

Telkonet, Inc., formed in 1999 and incorporated under the laws of the state of Utah, is a Clean Technology company that designs, develops and markets proprietary energy efficiency and smart grid networking products and services. Our SmartEnergy, EcoSmart and Series 5 SmartGrid networking technologies enable us to provide innovative clean technology solutions and have helped position Telkonet as a leading Clean Technology provider.

Our Telkonet SmartEnergy, Networked Telkonet SmartEnergy and EcoSmart energy efficiency products incorporate our patented Recovery Time™ technology, providing continuous monitoring of climate and environmental conditions to dynamically adjust a room's temperature, accounting for the occupancy of the room. Our SmartEnergy and EcoSmart platforms maximize energy savings while at the same time ensuring occupant comfort and extending equipment life expectancy. This technology is particularly attractive to customers in the hospitality industry, as well as the education, healthcare and government/military markets, who are continually seeking ways to reduce costs and meet federal and state mandates without impacting building occupant comfort. By reducing energy consumption automatically when a space is unoccupied, our customers can realize significant cost savings without diminishing occupant comfort. This technology may also be integrated with property management systems and building automation systems and used in load shedding initiatives. This feature provides management companies and utilities enhanced opportunity for cost savings, environmental awareness and energy management. Telkonet's energy management systems are lowering heating, ventilation and air conditioning, or HVAC, costs in hundreds of thousands of rooms worldwide and qualify for state and federal energy efficiency and rebate programs.

The Series 5 SmartGrid networking technology allows commercial, industrial and consumer users to connect computers to a communications network using the existing low voltage electrical grid. The Series 5 SmartGrid networking technology uses powerline communications, or PLC, technology to transform existing electrical infrastructure into a communications backbone. Operating at 200 Mbps, the PLC platform offers a secure alternative in grid communications, transforming a traditional electrical distribution system into a "smart grid" that delivers electricity in a manner that can save energy, reduce cost and increase reliability.

On March 4, 2011, the Company sold its Series 5 Power Line Carrier product line and related business assets to Dynamic Ratings ("Dynamic Ratings"). The sales price was \$1,000,000 in cash. In connection with the sale, Dynamic

Ratings lent the Company an additional \$700,000 in the form of a 6% promissory note dated March 4, 2011. Concurrent with the sale, the Company entered into a Distributorship Agreement and a Consulting Agreement with Dynamic Ratings. Under the Distributorship Agreement, the Company was designated as a distributor of the Series 5 product to the non-utility sector and will receive preferred pricing for purchases of Series 5 product. Under the Consulting Agreement, the Company agreed to provide Dynamic Ratings with ongoing transition assistance and consulting services for the Series 5 product. The Distributorship Agreement and the Consulting Agreement have initial terms that expire on March 31, 2014 and March 31, 2013, respectively. Any sales incentives and consulting compensation amounts payable to the Company under the Distributorship Agreement and the Consulting Agreement will be applied to the balance of the promissory note.

Telkonet's EthoStream Hospitality Network is now one of the largest high speed internet access (HSIA) solution providers in the world, with a customer base of more than 2,300 properties representing approximately 233,000 hotel rooms. This network provides Telkonet with the opportunity to market our energy efficiency solutions. The EthoStream Hospitality Network is backed by a 24/7 U.S.-based in-house support center that uses integrated, web-based management tools enabling proactive customer support. We utilize direct and indirect sales channels in all areas of our business. With a growing Value-Added Reseller (VAR) network, we continue to broaden our reach throughout the industry. Utilizing key integrators and strategic partners, we've been able to increase penetration in each of our targeted markets. The impact of this effort is a growing percentage of Telkonet's business is driven by our indirect sales channels.

Our direct sales efforts target the hospitality, education, commercial, utility and government/military markets. Taking advantage of legislation, including the Energy Independence and Security Act of 2007, or EISA, the Energy Policy Act of 2005, and the American Recovery and Reinvestment Act we've focused our sales efforts in areas with available public funding and incentives, such as rebate programs offered by utilities for efficiency upgrades. Through our proprietary platform, technology and partnerships with energy efficiency providers, we intend to position our Company as a leading provider of energy management solutions.



### **Forward Looking Statements**

In accordance with the Private Securities Litigation Reform Act of 1995, we can obtain a “safe-harbor” for forward-looking statements by identifying those statements and by accompanying those statements with cautionary statements which identify factors that could cause actual results to differ materially from those in the forward-looking statements. Accordingly, the following “Management’s Discussion and Analysis of Financial Condition and Results of Operations” may contain certain forward-looking statements regarding strategic growth initiatives, growth opportunities and management’s expectations regarding orders and financial results for the remainder of 2012 and future periods. These forward-looking statements are based on current expectations and current assumptions which management believes are reasonable. However, these statements involve risks and uncertainties that could cause actual results to differ materially from any future results encompassed within the forward-looking statements. Factors that could cause or contribute to such differences include those risks affecting the Company’s business as described in the Company’s filings with the SEC, including the current reports on Form 8-K, which factors are incorporated herein by reference. The Company expressly disclaims a duty to provide updates to forward-looking statements, whether as a result of new information, future events or other occurrences.

### **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 condensed consolidated financial statements and accompanying notes. On an ongoing basis, we evaluate significant estimates used in preparing our condensed consolidated financial statements including those related to revenue recognition, fair value of financial instruments, guarantees and product warranties, sales tax obligations, stock based compensation, potential impairment of goodwill and other long lived assets 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, we recognize revenue in accordance with 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) collectability 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 collectability 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. We defer any revenue for which the product has not been delivered or is subject to refund until such time that we 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.

We provide call center support services to properties installed by us and also to properties installed by other providers. In addition, we provide the property with the portal to access the Internet. We receive monthly service fees from such properties for our services and Internet access. We recognize the service fee ratably over the term of the contract. The prices for these services are fixed and determinable prior to delivery of the service. The fair value of these services is known due to objective and reliable evidence from contracts and standalone sales. We report such revenues as recurring revenues.

Total revenues do not include sales tax as we consider ourselves a pass through conduit for collection and remitting sales tax.

### **Fair Value of Financial Instruments**

The Company accounts for the fair value of financial instruments in accordance with ASC 820, which defines fair value for accounting purposes, established a framework for measuring fair value and expand disclosure requirements regarding fair value measurements. 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. We have categorized our financial assets and liabilities that are recurring, 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 “New Accounting Pronouncements” in Note B of the Notes to Unaudited Condensed Consolidated Financial Statements contained herein.

**Revenues**

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

	Three Months Ended				Variance	
	September 30, 2012	September 30, 2011				
Product	\$2,161,753	66%	\$1,632,160	58%	\$529,593	32%
Recurring	1,127,025	34%	1,162,559	42%	(35,534)	-3%
Total	\$3,288,778	100%	\$2,794,719	100%	\$494,059	18%

	Nine Months Ended				Variance	
	September 30, 2012	September 30, 2011				
Product	\$5,481,365	63%	\$4,760,120	58%	\$721,245	15%
Recurring	3,197,925	37%	3,445,234	42%	(247,309)	-7%
Total	\$8,679,290	100%	\$8,205,354	100%	\$473,936	6%

***Product Revenue***

Product revenue principally arises from the sale and installation of SmartEnergy, SmartGrid and High Speed Internet Access equipment. These include TSE, Telkonet Series 5, Telkonet iWire, and wireless networking products. We market and sell to the hospitality, education, healthcare and government/military markets. The Telkonet Series 5 and the Telkonet iWire products consist of the Telkonet Gateways, Telkonet Extenders, the patented Telkonet Coupler, and Telkonet iBridges. The SmartEnergy product suite consists of thermostats, sensors, controllers, wireless networking products and a control platform. The HSIA product suite consists of gateway servers, switches and access points.

For the three and nine months ended September 30, 2012, product revenue increased by 32% and 15% respectively, when compared to the prior year periods. Product revenue in 2012 includes approximately \$3.4 million attributed to the sale and installation of energy management products, and approximately \$2.1 million for the sale and installation

of HSIA products. The increase in product revenue can be attributed to management's commitment of resources to sales and marketing expense and personnel.

### ***Recurring Revenue***

Recurring revenue is primarily attributed to recurring services. The Company recognizes revenue ratably over the service month for monthly support revenues and defers revenue for annual support services over the term of the service period. The recurring revenue consists primarily of HSIA support services and advertising revenue. Advertising revenue is based on impression-based statistics for a given period from customer site visits to the Company's login portal page under the terms of advertising agreements entered into with third-parties. A component of our recurring revenue is derived from fees, less pay back costs, associated with approximately 1% of our hospitality customers who do not internally manage guest-related, internet transactions.

Recurring revenue includes approximately 2,300 hotels in our broadband network portfolio. We currently support approximately 233,000 HSIA rooms. For the three and nine months ended September 30, 2012, recurring revenue decreased by 3% and 7%, respectively, when compared to the prior year periods.

**Cost of Sales**

	Three Months Ended					
	September 30, 2012		September 30, 2011		Variance	
Product	\$1,166,848	52%	\$1,002,816	61%	\$164,032	16%
Recurring	292,264	26%	294,846	25%	(2,582 )	-1%
Total	\$1,459,112	43%	\$1,297,662	46%	\$161,450	12%

	Nine Months Ended					
	September 30, 2012		September 30, 2011		Variance	
Product	\$2,969,512	53%	\$2,728,980	57%	\$240,532	9%
Recurring	858,988	27%	849,962	25%	9,026	1%
Total	\$3,828,500	44%	\$3,578,942	44%	\$249,558	7%

***Product Costs***

Costs of product sales include equipment and installation labor related to the sale of SmartGrid and broadband networking equipment, including EcoSmart technology, Telkonet Series 5 and Telkonet iWire. For the three and nine months ended September 30, 2012, product costs as a percentage of sales increased by 16% and 9%, respectively, when compared to the prior year periods. The increase was attributed to the increase in product sales.

***Recurring Costs***

Recurring costs are comprised of labor and telecommunication services for our Customer Service department. For the three months ended September 30, 2012, recurring costs decreased by 1% when compared to the prior year period. The decrease is attributed to the decrease in recurring sales. For the nine months ended September 30, 2012, recurring costs increased by 1% when compared to the prior year period. The increase was primarily due to additional customer support staff and related expenses incurred during the nine month period ended September 30, 2012.

**Gross Profit**

	Three Months Ended					
	September 30, 2012		September 30, 2011		Variance	
Product	\$994,905	46%	\$629,344	39%	\$365,561	58%

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Recurring	834,761	74%	867,713	75%	(32,952 )	-4%
Total	\$1,829,666	56%	\$1,497,057	54%	\$332,609	22%

	Nine Months Ended				Variance	
	September 30,		September 30,			
	2012		2011			
Product	\$2,511,853	46%	\$2,031,140	43%	\$480,713	24%
Recurring	2,338,937	73%	2,595,272	75%	(256,335)	-10%
Total	\$4,850,790	56%	\$4,626,412	56%	\$224,378	5%

***Product Gross Profit***

The gross profit on product revenue for the three and nine months ended September 30, 2012 increased by 58% and by 24%, respectively, when compared to the prior year periods. The variances were a result of increased product sales and installations on energy management and HSIA sales.

***Recurring Gross Profit***

Our gross profit associated with recurring revenue decreased by 4% and 10%, respectively, for the three and nine months ended September 30, 2012. The decrease was mainly due to a decrease in advertising revenue which yields higher gross profit margins.

**Operating Expenses**

Three Months Ended September 30,		
2012	2011	Variance

Total	\$1,324,168	\$1,464,293	\$(140,125)	-10%
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Nine Months Ended September 30,		
2012	2011	Variance

Total	\$4,867,017	\$4,280,519	\$586,498	14%
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During the three months ended September 30, 2012, operating expenses decreased by 10% when compared to the prior year periods. Management confirmed that a customer had self assessed sales and use tax included in the sales tax liability calculation discussed in Note L. The recalculation resulted in a reduction to the Company's liability by approximately \$132,000 and a reduction of interest due on that liability of approximately \$19,000. During the nine months ended September 30, 2012 operating expense increased by 14%. The increase was the result of additional professional fees, a \$132,174 charged to rent from the lease abandonment referenced in Note A during the period ended June 30, 2012, additional sales and marketing staff and related expenses.

**Research and Development**

Three Months Ended September 30,		
2012	2011	Variance

Total	\$251,089	\$197,674	\$53,415	27%
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Nine Months Ended September 30,		
2012	2011	Variance

Total	\$732,154	\$588,908	\$143,246	24%
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Our research and development costs related to both present and future products are expensed in the period incurred. Current research and development costs are associated with product development and integration. During the three and nine months ended September 30, 2012, research and development costs increased 27% and 24% when compared to the prior year periods. The increase is due to additional expenditures for test equipment and consulting.

**Selling, General and Administrative Expenses**

Three Months Ended September 30,		
2012	2011	Variance

Total	\$1,009,814	\$1,194,156	\$(184,342)	-15%
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Nine Months Ended September 30,		
2012	2011	Variance

Total	\$3,937,522	\$3,488,802	\$448,720	13%
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During the three months ended September 30, 2012, selling, general and administrative expenses decreased over the comparable prior year period by 15%. The decrease is primarily the result of a reduction in the sales and use tax liability and interest due on that balance. For the nine months ended September 30, 2012, general and administrative expenses increased by 13% over the comparable prior year period. The variance is a result of an increase in professional fees, a \$132,174 charge to rent from the lease abandonment discussed in Note A, additional sales and marketing staff compensation and related expenses.

**Liquidity and Capital Resources**

We have financed our operations since inception primarily through private and public offerings of our equity securities, the issuance of various debt instruments and asset based lending.



### ***Working Capital***

Our working capital deficit decreased by \$723,739 during the nine months ended September 30, 2012 from a working capital deficit (current liabilities in excess of current assets) of \$774,915 at December 31, 2011 to a working capital deficit of \$51,176 at September 30, 2012.

### ***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 2%. 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 commenced on January 1, 2010 and continued 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 Loan Agreement is secured by substantially all of the Company's assets and the proceeds from this loan were used for the working capital requirements of the Company. The Loan Agreement contains covenants which require, among other things, that the Company shall keep and maintain 75 existing full-time positions and create and fill 35 additional full-time positions in Milwaukee, Wisconsin by December 31, 2012. Under the terms of the Loan Agreement, for each new full time position not kept, created or maintained, the Company would be required to pay a penalty consisting of an incremental increase in the interest rate not to exceed 4%. In May of 2012, the Company notified the Department that due to the economic climate, it is unlikely that the 35 new full time position covenant will be met by December 31, 2012. On June 18, 2012, the Department agreed to waive all penalties associated with the covenant and keep the loan interest rate fixed at 2%. The outstanding borrowings under the agreement as of September 30, 2012 and December 31, 2011 were \$216,165 and \$252,454, respectively.

### ***Promissory Note #1***

On March 4, 2011, the Company sold all its Series 5 PLC product line assets to Wisconsin-based Dynamic Ratings, Inc. ("Purchaser") under an Asset Purchase Agreement ("APA"). Per the APA, the Company signed an unsecured Promissory Note ("Note #1") due to Purchaser in the aggregate principal amount of \$700,000. The outstanding principal balance bears interest at the annual rate of 6% and is due on March 31, 2014. Note #1 may be prepaid in whole or in part, without penalty at any time. Note #1 contains certain earn-out provisions that encompass both the Company's and Purchaser's revenue volumes. Amounts earned under the earn-out provisions shall be applied against Note #1 on June 30, 2012 and June 30, 2013. Provided these provisions are met, the Company could potentially retire Note #1 prior to its expiration date. As of June 30, 2012, the non cash reduction of principal calculated under these provisions and applied to the note was \$15,408. Payments not made when due, by maturity acceleration or otherwise, shall bear

interest at the rate of 12% per annum from the date due until fully paid. The outstanding principal balance of this note as of September 30, 2012 and December 31, 2011 was \$684,592 and \$700,000, respectively.

***Promissory Note #2***

From the sale of its Series 5 PLC product line assets, the Company used the proceeds received to retire substantially all of its obligations under its \$1.6 million senior convertible debenture due May 29, 2011 and to cancel the related warrants covering 11.7 million shares of the Company's common stock. In exchange for the early retirement of debt and cancellation of warrants, the Company provided the third party with an unsecured one-year promissory note ("Note #2") for \$50,000. The outstanding principal balance bore interest at the annual rate of 5.25% and was due on March 4, 2012. This note was paid in full prior to March 31, 2012.

***Cash Flow Analysis***

Cash used in continuing operations was \$211,735 and \$243,285 during the nine months ended September 30, 2012 and 2011, respectively. As of September 30, 2012, our primary capital needs included business strategy execution, inventory procurement and managing current liabilities.

Cash used in investing activities from continuing operations was \$38,114 during the nine month period ended September 30, 2012 and cash provided by investing activities was \$915,645 during the nine month period ended September 30, 2011. On March 4, 2011, the Company sold its Series 5 Power Line Carrier product line and related business assets for \$1,000,000 in cash.

Cash provided by financing activities was \$355,965 and \$363,620 during the nine month periods ended September 30, 2012 and 2011, respectively. During the nine month period ended September 30, 2012, 3,115,390 of Series B preferred stock attached warrants were exercised to an equal number of common shares at an exercise price of \$0.13 per share. The total proceeds received from these exercised warrants was \$405,000. During the nine month period ended September 30, 2011, the Company sold its Series 5 Power Line Carrier product line and related business assets for \$1,000,000 in cash. In connection with the sale, the purchaser lent the Company \$700,000 in the form of a 6% promissory note dated March 4, 2011. The Company also issued Series B redeemable preferred stock during the first six months of 2011. Proceeds from the issuance were \$1,355,000. The Company used the proceeds received to retire substantially all of its obligations under its \$1.6 million senior convertible debenture due May 29, 2011.

Our independent registered public accountants report on our consolidated financial statements for the year ended December 31, 2011 includes an explanatory paragraph relating to our ability to continue as a going concern. We have incurred operating losses in the past years and we are dependent upon our ability to develop profitable operations and/or obtain necessary funding from outside sources, including by the sale of our securities, or obtaining loans from financial institutions, where possible. These factors, among others, raise doubt about our ability to continue as a going concern and may also affect our ability to obtain financing in the future.

Management expects that global economic conditions will continue to present a challenging operating environment through 2012; therefore working capital management will continue to be a high priority for the remainder of 2012.

The Company intends to manage the approximately \$1,158,000 of accrued sales tax liability by (1) confirming if customers self-assessed and remitted tax to the applicable state(s) absent from our transactions (2) confirming if customers were subjected to a state audit and if so did it result in the customer paying tax absent from our transaction (3) invoicing customers for the back taxes and (4) establishing voluntary disclosure agreements with the applicable states, which establishes a maximum look-back period and payment arrangements. However, if the aforementioned methods prove unsuccessful and the Company is examined or challenged by taxing authorities, there exists possible exposure of an additional \$620,000, not including any applicable interest and penalties.

Additional financing may be required in order to meet our current and projected cash flow requirements from operations. We cannot predict whether this new financing, if it is required, will be in the form of equity or debt. We may not be able to obtain the necessary additional capital on a timely basis, on acceptable terms, or at all. Additional investments are being sought, but we cannot guarantee that we will be able to obtain such investments. Financing transactions may include the issuance of equity or debt securities, obtaining credit facilities, or other financing mechanisms. However, the trading price of our common stock and the continued economic instability could make it more difficult to obtain financing through the issuance of equity or debt securities. Even if we are able to raise the funds required, it is possible that we could incur unexpected costs and expenses, fail to collect significant amounts owed to us, or experience unexpected cash requirements that would force us to seek alternative financing. Further, if we issue additional equity or debt securities, stockholders may experience additional dilution or the new equity securities may have rights, preferences or privileges senior to those of existing holders of our common stock. If additional financing is not available or is not available on acceptable terms, we will have to curtail our operations.

**Off-Balance sheet Arrangements**

The Company has no off-balance sheet arrangements other than its facility leases.

**Acquisition or Disposition of Property and Equipment**

During the nine months ended September 30, 2012, the Company spent \$38,114 of expenditures for equipment. The Company does not anticipate any significant purchases of property or equipment during the next twelve months, other than computer equipment and peripherals to be used in the Company's day-to-day operations.

We presently lease two commercial office spaces in Germantown, Maryland totaling, in the aggregate, 16,400 square feet. Both leases expire in December 2015. On July 15, 2011, Telkonet executed a sublease agreement for 11,626 square feet of its space located in Germantown, Maryland. On June 27, 2012 the subtenant exercised its option to extend the expiration of the term of the sublease from January 31, 2013 to December 31, 2015.

**Item 4. Controls and Procedures.**

As of September 30, 2012, the Company performed an evaluation, under the supervision and with the participation of management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures. Due to the lack of a segregation of duties and failure to implement accounting controls, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were ineffective as of the end of the period covered by this report.

During the three months ended September 30, 2012, there were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.



## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings.

#### 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.

#### *Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc.*

On July 1, 2008, Linksmart Wireless Technology, LLC, or Linksmart, filed a civil lawsuit in the Eastern District of Texas against EthoStream, LLC, our wholly-owned subsidiary and 22 other defendants (*Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc., et al*, U.S. District Court, for the Eastern District of Texas, Marshall Division, No. 2:08-cv-00264). This lawsuit alleges that the defendants' services infringe a wireless network security patent held by Linksmart. Linksmart seeks a permanent injunction enjoining the defendants from infringing, inducing the infringement of, or contributing to the infringement of its patent, an award of damages and attorney's fees.

Defendant Ramada Worldwide, Inc. provided us with notice of the suit and demanded that we defend and indemnify it pursuant to a vendor direct supplier agreement between EthoStream and WWC Supplier Services, Inc., a Ramada affiliate (wherein we agreed to indemnify, defend and hold only Ethostream supported Ramada properties harmless from and against claims of infringement). After a review of that agreement, it was determined that EthoStream owes the duty to defend and indemnify with respect to services provided by Telkonet to Ramada and it has assumed Ramada's defense.

The parties in the lawsuit agreed to and the Court ordered a stay of the litigation pending the conclusion of a reexamination proceeding in the U.S. Patent and Trademark Office relating to the patent involved in the lawsuit. The case was reopened in early 2012 based on the expectation that a reexamination certificate would be issued by the Patent Office. The reexamination certificate has been issued. After the case resumed, the parties agreed to a "transfer" of the case from the Eastern District of Texas to the Central District of California. To accomplish the "transfer," with the agreement of the parties, the Texas case was dismissed and a new action was filed in California on April 5, 2012. (*Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc., et al*, U.S. District Court, for the Central District of California, Southern Division, No. SACV 12-522-JST). The parties have answered the complaint filed in the new

action and the court has set the litigation calendar with trial set for June 2014.

*Stephen L. Sadle v. Telkonet, Inc*

On April 15, 2011, a former executive, Stephen L. Sadle, served Telkonet, Inc. and Telkonet Communications, Inc. ("Telkonet") with a Complaint in the Circuit Court for Montgomery County, MD alleging (1) Breach of Contract, (2) Promissory Estoppel/Detrimental Reliance and (3) violation of Maryland's Wage Payment and Collection Act. The three claims in his Complaint each arose out of his departure in 2007. In terms of relief, Mr. Sadle sought "severance compensation" in the amount of \$195,000, treble damages, interest, and attorneys' fees. This lawsuit was resolved as part of a voluntary settlement prior to the scheduled jury trial beginning on May 14, 2012. On July 26, 2012, the Parties filed a Joint Stipulation of Dismissal with prejudice.

In the case of *Stephen L. Sadle v Telkonet, Inc.*, the parties executed a settlement agreement and general release on July 2, 2012 for \$100,000. Terms of the agreement called for Telkonet to make an initial payment of \$30,000 on June 1, 2012 and Telkonet made an additional scheduled payment on September 1, 2012. The remaining balance is to be paid in three equal installments on or before December 1, 2012 and March 1, 2013. If Telkonet fails to make any of the above-specified payments within ten days of the specified date, Telkonet will be deemed in default. In the event of such a default, Mr. Sadle may, at his option, demand the entire balance due (and unpaid) and will be entitled to 6% interest on \$155,000 from May 1, 2008.

**Item 1A. Risk Factors.**

There have been no material changes to risk factors previously disclosed in our 2011 Annual Report in response to Item 1A of Form 10-K.



**Item 6. Exhibits.**

Exhibit Number	Description Of Document
31.1	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Jason L. Tienor
31.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Richard E. Mushrush
32.1	Certification of Jason L. Tienor pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Richard E. Mushrush pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Schema Document
101.CAL	XBRL Calculation Linkbase Document
101.DEF	XBRL Definition Linkbase Document
101.LAB	XBRL Label Linkbase Document
101.PRE	XBRL Presentation Linkbase Document

**SIGNATURES**

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

Telkonet, Inc.

Registrant

Date: November 14, 2012 By: /s/ Jason L. Tienor  
Jason L. Tienor

Chief Executive Officer

(principal executive officer)

Date: November 14, 2012 By: /s/ Richard E. Mushrush  
Richard E. Mushrush

Chief Financial Officer

(principal financial officer)

