

TELKONET INC
Form 10-Q
November 10, 2008

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

OR

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

For the transition period from _____ to _____.

For the period ended September 30, 2008

Commission file number 001-31972

TELKONET, INC.

(Exact name of Issuer as specified in its charter)

Utah 87-0627421
(State of (IRS Employer
Incorporation) Identification
 No.)

20374 Seneca Meadows Parkway, Germantown, MD 20876
(Address of Principal Executive Offices)

(240) 912-1800
Issuer's Telephone Number

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 x No o

Indicate by check mark whether the registrant is a large accelerated filer, and accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act, (check one).

Large Accelerated Filer o Accelerated Filer x Non-Accelerated Filer o

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

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 86,742,162 shares of Common Stock (\$.001 par value) as of November 1, 2008.

TELKONET, INC.

FORM 10-Q for the Quarter Ended September 30, 2008

Index

| | Page |
|--|------|
| PART I. FINANCIAL INFORMATION | 2 |
| Item 1. Financial Statements (Unaudited) | 2 |
| Condensed Consolidated Balance Sheets: September 30, 2008 and December 31, 2007 | 2 |
| Condensed Consolidated Statements of Operations and Comprehensive Loss: Three and Nine Months Ended September 30, 2008 and 2007 | 3 |
| Condensed Consolidated Statement of Stockholders' Equity January 1, 2008 through September 30, 2008 | 4 |
| Condensed Consolidated Statements of Cash Flows: Nine Months Ended September 30, 2008 and 2007 | 5 |
| Notes to Unaudited Condensed Consolidated Financial Statements: September 30, 2008 | 7 |
| Item 2. Management's Discussion and Analysis | 29 |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk. | 40 |
| Item 4. Controls and Procedures | 40 |
| PART II. OTHER INFORMATION | 41 |
| Item 1. Legal Proceedings | 41 |
| Item 1A. Risk Factors | 41 |
| Item 2. Unregistered Sales of Equity Securities and Use of Proceeds | 42 |
| Item 3. Defaults Upon Senior Securities | 42 |
| Item 4. Submission of Matters to a Vote of Security Holders | 42 |
| Item 5. Other Information | 43 |
| Item 6. Exhibits | 43 |

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

TELKONET, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

| | September 30, 2008 (unaudited) | December 31, 2007 |
|--|--------------------------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 149,993 | \$ 1,629,583 |
| Accounts receivable, net of allowance for doubtful accounts of \$210,137 and \$111,957 at September 30, 2008 and December 31, 2007, respectively | 787,796 | 2,134,978 |
| Due from receivable factoring | 872,719 | - |
| Investment in sales type leases | 4,040 | 16,501 |
| Inventories | 2,005,996 | 2,578,084 |
| Prepaid expenses and deposits | 564,934 | 645,022 |
| Total current assets | 4,385,478 | 7,004,168 |
| Property and equipment, at cost: | | |
| Furniture and equipment | 1,580,087 | 1,660,493 |
| Less: accumulated depreciation | 914,183 | 809,915 |
| Total property and equipment, net | 665,904 | 850,578 |
| Equipment under operating leases, at cost: | | |
| Telecommunications and related equipment, at cost | 117,493 | 313,941 |
| Less: accumulated depreciation | 92,698 | 243,894 |
| Total equipment under operating leases, net | 24,795 | 70,047 |
| Cable and related equipment: | | |
| Telecommunications and related equipment, at cost | 6,520,047 | 5,764,645 |
| Less: accumulated depreciation | 2,087,869 | 1,537,862 |
| Total cable and related equipment, net | 4,432,178 | 4,226,783 |
| Other assets: | | |
| Long-term investments | 62,803 | 62,803 |
| Marketable securities | 1,764,863 | 4,541,167 |
| Intangible assets, net of accumulated amortization of \$1,492,969 and \$895,085 at September 30, 2008 and December 31, 2007, respectively | 5,851,145 | 6,449,029 |
| Financing costs, net of accumulated amortization of \$423,636 and \$168,353 at September 30, 2008 and December 31, 2007, respectively | 892,178 | 697,461 |
| Goodwill | 14,670,455 | 14,670,455 |
| Deposits and other | 113,676 | 168,854 |
| Total other assets | 23,355,120 | 26,589,769 |
| Total Assets | \$ 32,863,475 | \$ 38,741,345 |

| | | |
|--|----------------------|----------------------|
| Current liabilities: | | |
| Accounts payable | \$ 4,797,855 | \$ 5,700,397 |
| Accrued liabilities | 2,931,760 | 1,653,782 |
| Capital lease payable – current | 36,663 | - |
| Related party advances | 348,918 | 291,000 |
| Senior note payable, net of debt discounts | - | 1,470,820 |
| Registration rights liability | - | 500,000 |
| Deferred revenue | 294,201 | 250,613 |
| Working capital line of credit | 475,000 | - |
| Other | 221,677 | 128,222 |
| Total current liabilities | 9,106,074 | 9,994,832 |
| Long-term liabilities: | | |
| Convertible debentures, net of debt discounts | 6,251,716 | 4,432,342 |
| Capital lease payable – non current | 176,011 | - |
| Derivative liability | 2,993,615 | - |
| Deferred lease liability and other | 55,611 | 67,112 |
| Total long-term liabilities | 9,476,953 | 4,499,454 |
| Commitments and contingencies | - | - |
| Minority interest | 2,668,058 | 2,978,918 |
| Stockholders' equity | | |
| Preferred stock, par value \$.001 per share; 15,000,000 shares authorized; none issued and outstanding at September 30, 2008 and December 31, 2007 | - | - |
| Common stock, par value \$.001 per share; 130,000,000 shares authorized; 82,380,634 and 70,826,544 shares issued and outstanding at September 30, 2008 and December 31, 2007, respectively | 82,381 | 70,827 |
| Additional paid-in-capital | 117,353,721 | 112,013,093 |
| Accumulated deficit | (103,047,408) | (90,815,779) |
| Accumulated comprehensive loss | (2,776,304) | - |
| Stockholders' equity | 11,612,390 | 21,268,141 |
| Total Liabilities and Stockholders' Equity | \$ 32,863,475 | \$ 38,741,345 |

See accompanying footnotes to the unaudited condensed consolidated financial information

TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(UNAUDITED)

| | For The Three Months Ended September 30, | | For The Nine Months Ended September 30, | |
|---|---|--------------------|--|---------------------|
| | 2008 | 2007 | 2008 | 2007 |
| Revenues, net: | | | | |
| Product | \$ 3,964,419 | \$ 3,005,144 | \$ 11,333,574 | \$ 6,269,079 |
| Rental | 1,763,396 | 1,583,633 | 4,977,799 | 3,232,574 |
| Total Revenue | 5,727,815 | 4,588,777 | 16,311,373 | 9,501,653 |
| Cost of Sales: | | | | |
| Product | 2,165,379 | 2,139,034 | 7,124,696 | 4,503,983 |
| Rental | 1,355,985 | 1,229,985 | 3,975,648 | 3,177,386 |
| Total Cost of Sales | 3,521,364 | 3,369,019 | 11,100,344 | 7,681,369 |
| Gross Profit | 2,206,451 | 1,219,758 | 5,211,029 | 1,820,284 |
| Costs and Expenses: | | | | |
| Research and Development | 509,418 | 646,848 | 1,667,229 | 1,736,656 |
| Selling, General and Administrative | 3,111,570 | 4,553,161 | 10,317,209 | 13,057,979 |
| Impairment Write-Down in Investment in Affiliate | - | - | 380,000 | - |
| Impairment Write-Down in Long Lived Assets of Subsidiary | 330,000 | - | 330,000 | - |
| Non-Employee Stock Based Compensation | - | 400,220 | 81,500 | 400,220 |
| Employee Stock Based Compensation | 194,483 | 294,859 | 623,113 | 941,900 |
| Employee Stock Based Compensation of Subsidiary | 128,507 | 130,941 | 395,904 | 173,967 |
| Depreciation and Amortization | 251,587 | 275,611 | 764,157 | 638,131 |
| Total Operating Expense | 4,525,565 | 6,301,640 | 14,559,112 | 16,948,853 |
| Loss from Operations | (2,319,114) | (5,081,882) | (9,348,083) | (15,128,569) |
| Other Income (Expenses): | | | | |
| Interest Income | 405 | 37,883 | 28,946 | 110,343 |
| Financing Expense | (789,021) | (328,611) | (2,494,888) | (529,168) |
| Gain (Loss) on Derivative Liability | (576,156) | - | (1,594,609) | - |
| Registration rights liquidated damages of subsidiary | - | (500,000) | 500,000 | (500,000) |
| Other income | - | - | 270,950 | - |
| Other expense | - | - | (1,598,203) | - |
| Total Other Income (Expenses) | (1,364,772) | (790,728) | (4,887,804) | (918,825) |
| Loss Before Provision for Income Taxes | (3,683,886) | (5,872,610) | (14,235,887) | (16,047,394) |
| Provision for Income Taxes | - | - | - | - |
| Loss Before Minority Interest | (3,683,886) | (5,872,610) | (14,235,887) | (16,047,394) |

Edgar Filing: TELKONET INC - Form 10-Q

| | | | | |
|---|----------------|----------------|-----------------|-----------------|
| Minority Interest | 805,129 | 916,980 | 2,004,258 | 1,105,420 |
| Net Loss | \$ (2,878,757) | \$ (4,955,630) | \$ (12,231,629) | \$ (14,941,974) |
| Loss per common share (basic and assuming dilution) | \$ (0.04) | \$ (0.07) | \$ (0.16) | \$ (0.23) |
| Weighted average common shares outstanding | 81,422,404 | 67,520,571 | 76,880,047 | 64,324,325 |
| Comprehensive Loss: | | | | |
| Net Loss | \$ (2,878,757) | \$ (4,955,630) | \$ (12,231,629) | \$ (14,941,974) |
| Unrecognized loss on investment | (1,218,100) | - | (2,776,304) | - |
| Comprehensive Loss | \$ (4,096,857) | \$ (4,955,630) | \$ (15,007,933) | \$ (14,941,974) |

See accompanying footnotes to the unaudited condensed consolidated financial information

TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)
FOR THE PERIOD FROM JANUARY 1, 2008 THROUGH SEPTEMBER 30, 2008

| | Preferred Preferred Shares | Stock Amount | Common Shares | Common Stock Amount | Additional Paid in Capital | Accumulated Deficit | Comprehensive Income (Loss) | Total |
|--|----------------------------------|-----------------|------------------|---------------------------|----------------------------------|------------------------|-----------------------------------|---------------|
| Balance at January 1, 2008 | - | - | 70,826,544 | \$ 70,827 | \$ 112,013,093 | \$ (90,815,779) | \$ - | \$ 21,268,141 |
| Shares issued in exchange for services rendered at approximately \$1.09 per share | - | - | 312,911 | 313 | 340,094 | - | - | 340,407 |
| Shares issued for cashless warrants exercised | - | - | 1,000,000 | 1,000 | (1,000) | - | - | - |
| Shares issued in connection with Private Placement | - | - | 2,500,000 | 2,500 | 1,497,500 | - | - | 1,500,000 |
| Adjustment shares issued for investment in affiliate | - | - | 3,046,425 | 3,046 | (3,046) | - | - | - |
| Adjustment shares issued for purchase of subsidiary | - | - | 1,882,225 | 1,882 | (1,882) | - | - | - |
| Shares issued from escrow contingency in purchase of subsidiary | - | - | 600,000 | 600 | 379,400 | - | - | 380,000 |
| Shares issued in exchange for convertible debentures | - | - | 2,212,529 | 2,213 | 707,787 | - | - | 710,000 |

| | | | | | | | | |
|---|---|---|------------|-----------|----------------|------------------|----------------|---------------|
| Value of additional warrants issued in conjunction with anti-dilution provision | - | - | - | - | 200,459 | - | - | 200,459 |
| Stock-based compensation expense related to the re-pricing of investor warrants | - | - | - | - | 1,598,203 | - | - | 1,598,203 |
| Stock-based compensation expense related to employee stock options | - | - | - | - | 623,113 | - | - | 623,113 |
| Holding loss on available for sale securities | - | - | - | - | - | - | (2,776,304) | (2,776,304) |
| Net Loss | - | - | - | - | - | (12,231,629) | - | (12,231,629) |
| Balance at September 30, 2008 | - | - | 82,380,634 | \$ 82,381 | \$ 117,353,721 | \$ (103,047,408) | \$ (2,776,304) | \$ 11,612,390 |

See accompanying footnotes to the unaudited condensed consolidated financial information

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

| | For The Nine Months Ended September 30, | |
|---|--|---------------------|
| | 2008 | 2007 |
| Cash Flows from Operating Activities: | | |
| Net loss from operating activities | \$ (12,231,629) | \$ (14,941,974) |
| Adjustments to reconcile net loss from operations to cash used in operating activities | | |
| Minority interest | (2,004,258) | (1,105,420) |
| Registration rights liquidated damages | (500,000) | 500,000 |
| Write-off of fixed assets in conjunction with loss on sublease | - | 64,608 |
| Amortization of financing costs | 267,849 | 101,663 |
| Amortization of debt discount and warrant on convertible debentures | 534,464 | 175,450 |
| Loss on derivative liability | 1,594,609 | - |
| Impairment write-down on long lived assets of subsidiary | 330,000 | - |
| Impairment write-down on goodwill | 380,000 | - |
| Value of warrant repricing and additional warrants issued | 2,973,742 | 319,495 |
| Stock based compensation to employees and consultants in exchange for services rendered | 1,100,517 | 1,424,209 |
| Depreciation and Amortization, including depreciation of equipment under operating leases and cable and related equipment | 1,459,861 | 1,181,149 |
| Increase / decrease in: | | |
| Accounts receivable | 1,330,521 | (1,573,744) |
| Due from receivable factoring | (872,719) | - |
| Inventory | 572,088 | 474,432 |
| Prepaid expenses and deposits | 306,978 | (713,831) |
| Customer deposits and other current liability | 91,373 | 129,368 |
| Accounts payable and accrued expenses | 478,345 | 1,480,144 |
| Deferred revenue | 35,152 | (115,927) |
| Other | 58,199 | 9,114 |
| Net Cash (Used in) Operating Activities | (4,094,908) | (12,591,264) |
| Cash Flows from Investing Activities: | | |
| Costs of equipment under operating leases and cable and related equipment | (999,718) | (1,162,832) |
| Investment in subsidiaries | - | (5,070,557) |
| Purchase of property and equipment, net | (9,001) | (266,280) |
| Net Cash (Used in) Investing Activities | (1,008,719) | (6,499,669) |
| Cash Flows from Financing Activities: | | |
| Proceeds from issuance of convertible debentures, net of costs and fees | 3,112,434 | 5,303,238 |
| Proceeds from the issuance of a senior note payable | - | 1,500,000 |
| Proceeds from sale of common stock, net of costs | 1,500,000 | 9,610,000 |
| Proceeds from subsidiary's sale of common stock, net of costs | - | 2,694,020 |
| Proceeds from exercise of stock options and warrants | - | 124,460 |
| Proceeds from related party advances, net | 60,000 | - |
| Proceeds from line of credit | 475,000 | - |

Edgar Filing: TELKONET INC - Form 10-Q

| | | |
|--|-------------|--------------|
| Repayment of capital lease and other | (23,397) | - |
| Repayment of senior note | (1,500,000) | - |
| Repayment of subsidiary loans | - | (202,236) |
| Net Cash Provided by Financing Activities | 3,624,037 | 19,029,482 |
| Net Increase (Decrease) in Cash and Cash Equivalents | (1,479,590) | (61,451) |
| Cash and cash equivalents at the beginning of the period | 1,629,583 | 1,644,037 |
| Cash and cash equivalents at the end of the period | \$ 149,993 | \$ 1,582,586 |

See accompanying footnotes to the unaudited condensed consolidated financial information

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

| | For The Nine Months Ended September 30, | |
|---|--|----------------|
| | 2008 | 2007 |
| Supplemental Disclosures of Cash Flow Information | | |
| Cash paid during the period for financing expenses | \$ 257,403 | \$ 3,995 |
| Income taxes paid | - | - |
| Non-cash transactions: | | |
| Issuance of shares for purchase of subsidiary | - | 17,286,097 |
| Amortization of debt discount and warrant on convertible debentures | 534,464 | - |
| Loss on derivative liability | 1,594,604 | - |
| Impairment write-down on long lived assets of subsidiary | 330,000 | - |
| Impairment write-down on goodwill | 380,000 | - |
| Value of warrant repricing and additional warrants issued | 2,973,742 | 319,495 |
| Stock based compensation to employees and consultants in exchange for services rendered | 1,100,517 | 1,424,209 |
| Value of stock based payment for services | 258,907 | - |
| Registration rights liquidated damages of subsidiary | (500,000) | 500,000 |
| Capital lease advances | 226,185 | - |
| Acquisition of subsidiary (Note B): | | |
| Assets acquired | \$ - | \$ 3,052,880 |
| Subscriber lists | - | 4,781,893 |
| Goodwill | - | 15,096,922 |
| Liabilities assumed | - | (1,356,415) |
| Common stock issued | - | (17,286,097) |
| Direct acquisition costs | - | (394,183) |
| Cash paid for acquisition | \$ - | \$ (3,895,000) |

See accompanying footnotes to the unaudited condensed consolidated financial information

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2008
(UNAUDITED)

NOTE A-SUMMARY OF ACCOUNTING POLICIES

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

Business and Basis of Presentation

Telkonet, Inc. (the "Company"), formed in 1999 and incorporated under the laws of the State of Utah, is a leading provider of innovative, centrally managed solutions for integrated energy management, networking, building automation and proactive support services. 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 electric utility lines.

In January 2006, following the acquisition of Microwave Satellite Technologies (MST) (Note B), the Company began offering complete sales, installation, and service of VSAT and business television networks, and became a full-service national Internet Service Provider (ISP). The MST solution offers a complete "Quad-play" solution to subscribers of multichannel video programming, VoIP telephony, NuVision Broadband Internet access and wireless fidelity ("Wi-Fi") access, to commercial multi-dwelling units and hotels.

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

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

In May 2007, Microwave Acquisition Corp., a newly formed, wholly-owned subsidiary of MSTI Holdings Inc. (formerly Fitness Xpress-Software Inc.) merged with MST. As a result of the merger, the Company's common stock in MST was exchanged for shares of common stock of MSTI Holdings Inc. Immediately following the merger, MSTI Holdings Inc. completed a private placement of its common stock for aggregate gross proceeds of \$3,078,716 and sold senior convertible debentures in the aggregate principal amount of \$6,050,000 (plus an 8% original issue discount added to such principal amount). As a result of these transactions, the Company's 90% interest in MST became a 63% interest in MSTI Holdings Inc.

In July 2007, MST, the wholly-owned subsidiary of the Company's majority owned subsidiary MSTI Holdings Inc., acquired substantially all of the assets of Newport Telecommunications Co., a New Jersey general partnership. Pursuant to the terms of the acquisition, the total consideration paid was \$2,550,000, consisting of unregistered shares of the Company's common stock, equal to \$1,530,000, and (ii) \$1,020,000 in cash.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Telkonet Communications, Inc. and Ethostream and 63%-owned subsidiary MSTI Holdings Inc. (reported as the

Company's MST segment). Significant intercompany transactions have been eliminated in consolidation.

Investments in entities over which the Company has significant influence, typically those entities that are 20 to 50 percent owned by the Company, are accounted for using the equity method of accounting, whereby the investment is carried at cost of acquisition, plus the Company's equity in undistributed earnings or losses since acquisition.

Going Concern

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern. However, the Company has reported a net loss of \$12,231,629 for the nine months ended September 30, 2008, accumulated deficit of \$103,047,408 and a working capital deficit of \$4,720,596 as of September 30, 2008.

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

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

Concentrations of Credit Risk

Financial instruments and related items, which potentially subject the Company to concentrations of credit risk, consist primarily of cash and cash equivalents. The Company places its cash and temporary cash investments with credit quality institutions. At times, such investments may be in excess of the FDIC insurance limit. The allowance for doubtful accounts was \$210,137 and \$111,957 at September 30, 2008 and December 31, 2007, respectively.

Investments

Telkonet maintained investments in two publicly-traded companies for the nine months ended September 30, 2008. The Company has classified these securities as available for sale. Such securities are carried at fair market value. Unrealized gains and losses on these securities, if any, are reported as accumulated other comprehensive income (loss), which is a separate component of stockholders' equity. Unrealized losses of \$2,776,304 were recorded for the nine months ended September 30, 2008 and there were no unrealized gains or losses for the nine months ended September 30, 2007. Realized gains and losses and declines in value judged to be other than temporary on securities available for sale, if any, are included in operations. There were no realized gains or losses for the nine months ended September 30, 2008 and 2007, respectively.

Liquidity

As shown in the accompanying consolidated financial statements, the Company incurred net losses of \$12,231,629 and \$14,941,974 for the nine months ended September 30, 2008 and 2007, respectively. The Company's current liabilities, on a consolidated basis, exceeded its current assets by \$4,720,596 as of September 30, 2008.

Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with Staff Accounting Bulletin No. 104, Revenue Recognition ("SAB104"), which superseded Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements ("SAB101"). SAB 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the selling prices of the products delivered and the collectibility of those amounts. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. The Company defers any revenue for which the product has not been delivered or is subject to refund until such time that the Company and the customer jointly determine that the product has been delivered or no refund will be required. SAB 104 incorporates Emerging Issues Task Force 00-21 ("EITF 00-21"), Multiple-Deliverable Revenue Arrangements. EITF 00-21 addresses accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

For equipment under lease, revenue is recognized over the lease term for operating lease and rental contracts. All of the Company's leases are accounted for as operating leases. At the inception of the lease, no lease revenue is

recognized and the leased equipment and installation costs are capitalized and appear on the balance sheet as "Equipment Under Operating Leases." The capitalized cost of this equipment is depreciated from two to three years, on a straight-line basis down to the Company's original estimate of the projected value of the equipment at the end of the scheduled lease term. Monthly lease payments are recognized as rental income.

MST accounts for the revenue, costs and expense related to residential cable services as the related services are performed in accordance with SFAS No. 51, Financial Reporting by Cable Television Companies. Installation revenue for residential cable services is recognized to the extent of direct selling costs incurred. Direct selling costs have exceeded installation revenue in all reported periods. Generally, credit risk is managed by disconnecting services to customers who are delinquent. The capitalized cost of this equipment is depreciated from three to ten years, on a straight-line basis down to the Company's original estimate of the projected value of the equipment at the end of the scheduled lease term and appears on the Balance Sheet in "Cable and Related Equipment."

Management identifies a delinquent customer based upon the delinquent payment status of an outstanding invoice, generally greater than 30 days past due. The delinquent account designation does not trigger an accounting transaction until such time the account is deemed uncollectible. The allowance for doubtful accounts is determined by examining the reserve history and any outstanding invoices that are over 30 days past due as of the end of the reporting period. Accounts are deemed uncollectible on a case-by-case basis, at management's discretion based upon an examination of the communication with the delinquent customer and payment history. Typically, accounts are only escalated to "uncollectible" status after multiple attempts have been made to communicate with the customer.

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

Guarantees and Product Warranties

FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"), requires that upon issuance of a guarantee, the guarantor must disclose and recognize a liability for the fair value of the obligation it assumes under that guarantee.

The Company's guarantees were issued subject to the recognition and disclosure requirements of FIN 45 as of September 30, 2008 and December 31, 2007. The Company records a liability for potential warranty claims. 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. During the nine months ended September 30, 2008 and the year ended December 31, 2007, the Company experienced approximately three percent of units returned. As of September 30, 2008 and December 31, 2007, the Company recorded warranty liabilities in the amount of \$130,883 and \$102,534, respectively, using this experience factor.

Reclassifications

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

Registration Payment Arrangements

The Company accounts for registration payment arrangements under Financial Accounting Standards board (FASB) Staff Position EITF 00-19-2, "Accounting for Registration Payment Arrangements" (FSP EITF 00-19-2). FSP EITF 00-19-2 specifies that the contingent obligation to make future payments under a registration payment arrangement should be separately recognized and measured in accordance with SFAS No. 5, Accounting for Contingencies. FSP EITF 00-19-2 was issued in December 2006. As of December 31, 2007, the Company had accrued an estimated penalty (see Note E).

On February 11, 2008, the investors in MSTI Holdings Inc. executed a letter agreement with MSTI Holdings, Inc. waiving their rights to receive liquidated damages under the registration rights agreement, in exchange for a reduction in their warrant exercise price from \$1.00 to \$0.65. Therefore the Company has reversed the accrued expense for the potential liquidated damages during the nine months ended September 30, 2008.

Derivative Financial Instruments

The Company's derivative financial instruments consist of embedded derivatives related to the Convertible Debentures entered into in May 2008. These embedded derivatives include certain conversion features, variable interest features, call options and default provisions. The accounting treatment of derivative financial instruments requires that the Company record the derivatives and related warrants at their fair values as of the inception date of the Note Agreement (estimated at \$1,399,006) and at fair value as of each subsequent balance sheet date. In addition, under the provisions of EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock," as a result of entering into the Notes, the Company is required to classify all other non-employee stock options and warrants as derivative liabilities and mark them to market at each reporting date. The fair value of such options and warrants that were reclassified as liabilities from additional paid-in capital in the period ended September 30, 2008 totaled \$2,993,615.

The Company uses the Black-Scholes Pricing Model to determine fair values of its derivatives. Valuations derived from this model are subject to ongoing internal and external verification and review. The model uses market-sourced inputs such as interest rates, exchange rates and option volatilities. Selection of these inputs involves management's judgment and may impact net income. The fair value of the derivative liabilities are subject to the changes in the trading value of the Company's common stock. As a result, the Company's financial statements may fluctuate from quarter-to-quarter based on factors, such as the price of the Company's stock at the balance sheet date, the amount of shares converted by note holders and/or exercised by warrant holders. Any change in fair value will be recorded as non-operating, non-cash income or expense at each reporting date. If the fair value of the derivatives is higher at the subsequent balance sheet date, the Company will record a non-operating, non-cash charge. If the fair value of the derivatives is lower at the subsequent balance sheet date, the Company will record non-operating, non-cash income. Conversion-related derivatives were valued using the Black-Scholes Option Pricing Model with the following assumptions: dividend yield of 0%; annual volatility of 78% to 82%; and risk free interest rate of 2.70% to 3.14%. The derivatives are classified as long-term liabilities.

New Accounting Pronouncements

In March 2008, the Financial Accounting Standards Board (FASB) issued Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 requires companies to provide enhanced disclosures regarding derivative instruments and hedging activities and requires companies to better convey the purpose of derivative use in terms of the risks they intend to manage. Disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect a company's financial position, financial performance, and cash flows are required. This Statement retains the same scope as SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and is effective for fiscal years and interim periods beginning after November 15, 2008. We do not expect the adoption of SFAS No. 161 to have a material impact, if any, on our consolidated financial statements.

In February 2008, the FASB issued a FASB Staff Position (FSP) on Accounting for Transfers of Financial Assets and Repurchase Financing Transactions (FSP FAS 140-3). This FSP addresses the issue of whether the transfer of financial assets and the repurchase financing transactions should be viewed as two separate transactions or as one linked transaction. The FSP includes a rebuttable presumption that the two transactions are linked unless the presumption can be overcome by meeting certain criteria. The FSP will be effective for fiscal years beginning after November 15, 2008 and will apply only to original transfers made after that date; early adoption will not be allowed. We do not expect the adoption of FSP FAS 140-3 to have a material impact, if any, on our consolidated financial statements.

NOTE B - ACQUISITION OF SUBSIDIARY

Acquisition of Microwave Satellite Technologies, Inc.

On January 31, 2006, the Company acquired a 90% interest in MST from Frank Matarazzo, the sole stockholder of MST, in exchange for \$1.8 million in cash and 1.6 million unregistered shares of the Company's common stock for an aggregate purchase price of \$9,000,000. The purchase price of \$9,000,000 was increased by \$117,822 for direct costs related to the acquisition. These direct costs included legal, accounting and other professional fees. The cash portion of the purchase price was paid in two installments, \$900,000 at closing and \$900,000 in February 2007. The stock portion is payable from shares held in escrow, 400,000 shares at closing and the remaining 1,200,000 "purchase price contingency" shares issued based on the achievement of 3,300 subscribers (as defined in Section 2.3 of the purchase agreement) over a three year period. In the year ended December 31, 2006, the Company issued 200,000 shares of the purchase price contingency valued at \$900,000 as an adjustment to goodwill.

Additionally, in April 2008, the Company released from escrow 200,000 shares of the purchase price contingency. In June 2008, the Company released from escrow an additional 400,000 shares in exchange for Mr. Matarazzo's agreement to a debt covenant contained in the transaction documents executed in connection with the debenture financing with YA Global Investments LP which prohibits the use of the proceeds obtained in the debt financing to fund MST.

On May 24, 2007, MST completed a merger transaction pursuant to which it became a wholly-owned subsidiary of MSTI Holdings, Inc. (formerly Fitness Xpress, Inc.), an inactive publicly registered shell corporation with no significant assets or operations. As a result of the merger, there was a change in control of the public shell corporation. In accordance with SFAS No. 141, MST was the acquiring entity. While the transaction is accounted for using the purchase method of accounting, in substance the transaction represented a recapitalization of MST's capital structure. For accounting purposes, the Company accounted for the transaction as a reverse acquisition and MST is the surviving

entity. MST did not recognize goodwill or any intangible assets in connection with the transaction. In connection with the acquisition, the Company's 90% interest in MST was converted to a 63% interest in MSTI Holdings, Inc.

The purchase price contingency shares are price protected for the benefit of the former owner of MST. In the event the Company's common stock price is below \$4.50 per share upon issuance of the shares from escrow, a pro rata adjustment in the number of shares will be required to support the aggregate consideration of \$5.4 million. The price protection provision provides a cash benefit to the former owner of MST if the as-defined market price of the Company's common stock is less than \$4.50 per share at the time of issuance from the escrow. The issuance of additional shares or distribution of other consideration upon resolution of the contingency based on the Company's common stock prices will not affect the cost of the acquisition. When the contingency is resolved or settled, and additional consideration is distributable, the Company will record the current fair value of the additional consideration and the amount previously recorded for the common stock issued will be simultaneously reduced to the lower current value of the Company's common stock.

MST is a communications technology company that offers complete sales, installation, and service of Very Small Aperture Terminal (VSAT) and business television networks, and is a full-service national Internet Service Provider (ISP). Management believes that the MST acquisition will enable Telkonet to provide a complete “Quad-play” solution to subscribers of multichannel video programming, VoIP telephony, NuVision Broadband Internet access and wireless fidelity (“Wi-Fi”) access, to commercial multi-dwelling units and hotels.

The acquisition of MST was accounted for using the purchase method in accordance with SFAS 141, “Business Combinations.” The value of the Company’s common stock issued as a part of the acquisition was determined based on the average price of the Company's common stock for several days before and after the acquisition of MST. The results of operations for MST have been included in the Consolidated Statements of Operations since the date of acquisition. The components of the purchase price were as follows:

| | As Reported | Including Purchase Price Contingency (*) |
|-------------------------------|----------------|--|
| Common stock | \$ 2,700,000 | \$ 7,200,000 |
| Cash (including note payable) | 1,800,000 | 1,800,000 |
| Direct acquisition costs | 117,822 | 117,822 |
| Purchase price | 4,617,822 | 9,117,822 |
| Minority interest | 19,569 | 19,569 |
| Total | \$ 4,637,391 | \$ 9,137,391 |

In accordance with Financial Accounting Standard (SFAS) No. 141, Business Combinations, the total purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. The fair value of the assets acquired was based on management’s best estimates. The purchase price was allocated to the fair value of assets acquired and liabilities assumed as follows:

| | As Reported | Including Purchase Price Contingency (*) |
|-------------------------------|--------------|--|
| Cash and other current assets | \$ 346,548 | \$ 346,548 |
| Equipment and other assets | 1,310,125 | 1,310,125 |
| Subscriber lists | 2,463,927 | 2,463,927 |
| Goodwill | 1,977,767 | 6,477,767 |
| Subtotal | 6,098,367 | 10,598,367 |
| Current liabilities | 1,460,976 | 1,460,976 |
| Total | \$ 4,637,391 | \$ 9,137,391 |

(*) At the date of the acquisition, the effect of the “purchase price contingency” shares valued at approximately \$5.4 million had not been recorded in accordance with FAS 141. In the second quarter of 2006, the Company issued 200,000 shares of the purchase price contingency valued at \$900,000 as an adjustment to goodwill. The remaining shares, when issued, will reflect an adjustment to goodwill and other intangibles.

Goodwill and other intangible assets represent the excess of the purchase price over the fair value of the net tangible assets acquired. The Company used a discounted cash flow model to determine the value of the intangible assets and to allocate the excess purchase price to the intangible assets and goodwill as appropriate. In this model, expected cash flows from subscribers were discounted to their present value at a rate of return of 20% (incorporating the risk-free rate, expected inflation, and related business risks) over a period of eight years. Expected costs such as income taxes and cost of sales were deducted from expected revenues to arrive at after tax cash flows. In accordance with SFAS 142, goodwill is not amortized and will be tested for impairment at least annually. The subscriber list was valued at \$2,463,927 with an estimated useful life of eight years.

The acquisition of MST resulted in the valuation of MST's subscriber lists as intangible assets. The MST subscriber list was determined to have an eight-year life. This intangible was amortized using that life, and amortization from the date of the acquisition through December 31, 2007, was taken as a charge against income in the consolidated statement of operations. In accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the intangible asset subject to amortization was reviewed for impairment at December 31, 2007.

Goodwill of \$1,977,768, excluding the remaining purchase price contingency, represented the excess of the purchase price over the fair value of the net tangible and intangible assets acquired. In accordance with SFAS 142, goodwill is not amortized and will be tested for impairment at least annually. At December 31, 2007, the Company performed an impairment test on the goodwill. Based upon management's assessment of operating results and forecasted discounted cash flow, the carrying value of goodwill was determined to be impaired and therefore the entire value of \$1,977,768 was written off during the year ended December 31, 2007. For the nine months ended September 30, 2008, the Company has estimated \$380,000 impairment of the carrying value of goodwill issued upon the release of the purchase price contingency escrow.

Acquisition of Smart Systems International, Inc.

On March 9, 2007, the Company acquired substantially all of the assets of Smart Systems International (SSI), a leading provider of energy management products and solutions to customers in the United States and Canada for cash and Company common stock having an aggregate value of \$6,875,000. The purchase price was comprised of \$875,000 in cash and 2,227,273 shares of the Company's common stock. The Company was obligated to register the stock portion of the purchase price on or before May 15, 2007 and on March 14, 2008 this registration statement was declared effective. Additionally, 1,090,909 of these shares were held in an escrow account for a period of one year following the closing from which certain potential indemnification obligations under the purchase agreement could be satisfied. The aggregate number of shares held in escrow was subject to adjustment upward or downward depending upon the trading price of the Company's common stock during the one year period following the closing date. On March 12, 2008, the Company released these shares from escrow and issued an additional 1,882,225 shares on June 12, 2008 pursuant to the adjustment provision in the SSI asset purchase agreement.

The acquisition of SSI was accounted for using the purchase method in accordance with SFAS 141, "Business Combinations." The value of the Company's common stock issued as a part of the acquisition was determined based on the most recent price of the Company's common stock on the day immediately preceding the acquisition date. The results of operations for SSI have been included in the Consolidated Statements of Operations since the date of acquisition. The components of the purchase price were as follows:

| | As Reported |
|--------------------------|----------------|
| Common stock | \$ 6,000,000 |
| Cash | 875,000 |
| Direct acquisition costs | 131,543 |
| Total Purchase Price | \$ 7,006,543 |

In accordance with Financial Accounting Standard (SFAS) No. 141, Business Combinations, the total purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. The fair value of the assets acquired was based on management's best estimates. The purchase price was allocated to the fair value of assets acquired and liabilities assumed as follows:

| | |
|--|--------------|
| Current assets | \$ 1,646,054 |
| Property, plant and equipment | 36,020 |
| Other assets | 8,237 |
| Goodwill | 5,874,016 |
| Total assets acquired | 7,564,327 |
| Accounts payable and accrued liabilities | (557,784) |

Edgar Filing: TELKONET INC - Form 10-Q

| | |
|---------------------------|--------------|
| Total liabilities assumed | (557,784) |
| Net assets acquired | \$ 7,006,543 |

Goodwill represents the excess of the purchase price over the fair value of the net tangible assets acquired. In accordance with SFAS 142, goodwill is not amortized and will be tested for impairment at least annually. We completed our annual impairment testing during the fourth quarter of 2007, and determined that there was no impairment to the carrying value of goodwill.

Acquisition of Ethostream LLC

On March 15, 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 will enable Telkonet to provide installation and support for PLC products and third party applications to customers across North America. The purchase price of \$11,756,097 was comprised of \$2.0 million in cash and 3,459,609 shares of the Company's common stock. The entire stock portion of the purchase price was deposited into escrow upon closing to satisfy certain potential indemnification obligations of the sellers under the purchase agreement. The shares held in escrow are distributable over the three years following the closing. As of November 10, 2008, 876,804 shares remain in escrow pursuant to the purchase agreement.

The acquisition of Ethostream was accounted for using the purchase method in accordance with SFAS 141, "Business Combinations." The value of the Company's common stock issued as a part of the acquisition was determined based on the most recent price of the Company's common stock prior to the acquisition date. The results of operations for Ethostream have been included in the Consolidated Statements of Operations since the date of acquisition. The components of the purchase price were as follows:

| | As Reported |
|--------------------------|---------------|
| Common stock | \$ 9,756,097 |
| Cash | 2,000,000 |
| Direct acquisition costs | 164,346 |
| Total Purchase Price | \$ 11,920,443 |

In accordance with Financial Accounting Standard (SFAS) No. 141, Business Combinations, the total purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. The fair value of the assets acquired was based on management's best estimates. The purchase price was allocated to the fair value of assets acquired and liabilities assumed as follows:

| | |
|--|---------------|
| Current assets | \$ 949,308 |
| Property, plant and equipment | 51,724 |
| Other assets | 21,602 |
| Subscriber lists | 2,900,000 |
| Goodwill | 8,796,440 |
| Total assets acquired | 12,719,074 |
| Accounts payable and accrued liabilities | (798,631) |
| Total liabilities assumed | (798,631) |
| Net assets acquired | \$ 11,920,443 |

Goodwill and other intangible assets represent the excess of the purchase price over the fair value of the net tangible assets acquired. The Company used a discounted cash flow model to determine the value of the intangible assets and to allocate the excess purchase price to the intangible assets and goodwill as appropriate. In this model, expected cash flows from subscribers were discounted to their present value at a rate of return of 20% (incorporating the risk-free rate, expected inflation, and related business risks) over a period of twelve years. Expected costs such as income taxes and cost of sales were deducted from expected revenues to arrive at after tax cash flows. In accordance with SFAS 142, goodwill is not amortized and will be tested for impairment at least annually.

The subscriber list was valued at \$2,900,000 with an estimated useful life of twelve years. This intangible was amortized using that life, and amortization from the date of the acquisition through September 30, 2008, was taken as a charge against income in the consolidated statement of operations.

In accordance with SFAS 142, goodwill is not amortized and will be tested for impairment at least annually. We completed our annual impairment testing during the fourth quarter of 2007, and determined that there was no impairment to the carrying value of goodwill.

Acquisition of Newport Telecommunications Co. by Subsidiary

On July 18, 2007, Microwave Satellite Technologies, Inc., the wholly-owned subsidiary of the Company's majority owned subsidiary MSTI Holdings Inc., acquired substantially all of the assets of Newport Telecommunications Co., a New Jersey general partnership ("Newport"), relating to Newport's business of providing broadband internet and telephone services at certain residential and commercial properties in the development known as Newport in Jersey

City, New Jersey. Pursuant to the terms of the Newport acquisition, the total consideration paid was \$2,550,000, consisting of (i) 866,856 unregistered shares of the Company's common stock, equal to \$1,530,000 (which is based on the average closing prices for the Company common stock for the ten trading days immediately prior to the closing date), and (ii) \$1,020,000 in cash.

The acquisition of Newport was accounted for using the purchase method in accordance with SFAS 141, "Business Combinations." The value of the Company's common stock issued as a part of the acquisition was determined based on the average closing prices for the Company common stock for the ten trading days immediately prior to the closing date. The results of operations for Newport have been included in the Consolidated Statements of Operations since the date of acquisition. The components of the purchase price were as follows:

| | As Reported |
|--------------------------|--------------|
| Common stock | \$ 1,530,000 |
| Cash | 1,020,000 |
| Direct acquisition costs | 98,294 |
| Total Purchase Price | \$ 2,648,294 |

In accordance with Financial Accounting Standard (SFAS) No. 141, Business Combinations, the total purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. The fair value of the assets acquired was based on management's best estimates. The purchase price was allocated to the fair value of assets acquired and liabilities assumed as follows:

| | |
|--|--------------|
| Current assets | \$ - |
| Property, plant and equipment | 668,107 |
| Subscriber lists | 1,980,187 |
| Total assets acquired | 2,648,294 |
| Accounts payable and accrued liabilities | - |
| Total liabilities assumed | - |
| Net assets acquired | \$ 2,648,294 |

Goodwill and other intangible assets represent the excess of the purchase price over the fair value of the net tangible assets acquired. The subscriber list was valued at \$1,980,187 with an estimated useful life of eight years.

The following unaudited condensed combined pro forma results of operations reflect the pro forma combination of the Telkonet, MST, SSI, Ethostream and Newport businesses as if the combination had occurred at the beginning of the periods presented compared with the actual results of operations of Telkonet for the same period. The unaudited pro forma condensed combined results of operations do not purport to represent what the companies' combined results of operations would have been if such transaction had occurred at the beginning of the periods presented, and are not necessarily indicative of Telkonet's future results.

| | For The Three Months Ended September 30, | | For The Nine Months Ended September 30, | |
|--------------------------|--|----------------|---|-----------------|
| | 2008 | 2007 | 2008 | 2007 |
| Product revenue | \$ 3,964,419 | \$ 3,005,144 | \$ 11,333,574 | \$ 7,185,105 |
| Recurring revenue | 1,763,396 | 1,910,742 | 4,977,799 | 4,739,867 |
| Total | 5,727,815 | 4,915,886 | 16,311,373 | 11,924,972 |
| Net (loss) | \$ (2,878,757) | \$ (4,687,997) | \$ (12,231,629) | \$ (15,855,515) |
| Basic (loss) per share | (0.04) | (0.08) | (0.16) | (0.25) |
| Diluted (loss) per share | (0.04) | (0.08) | (0.16) | (0.25) |

NOTE C - INTANGIBLE ASSETS AND GOODWILL

As a result of the MST acquisition at January 31, 2006 and the Ethostream acquisition on March 15, 2007 and MST's acquisition of Newport on July 18, 2007, the Company had intangibles totaling \$7,344,114 at September 30, 2008 (Note B).

The Company has adopted Statement of Financial Accounting Standards No. 144 (SFAS 144). SFAS 144 requires that long-lived assets and certain identifiable intangibles held and used by the Company be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Events relating to recoverability may include significant unfavorable changes in business conditions, recurring losses, or a forecasted inability to achieve break-even operating results over an extended period. The Company has

determined that the value of MST's capitalized cable and related equipment has been impaired based upon management's assessment of forecasted discounted cash flow from subscriber revenue and has written off \$493,512 of its value, based on the lower of the carrying amount or the fair value less costs to sell, for the year ended December 31, 2007.

We used a discounted cash flow model to determine the value of the intangible assets and to allocate the excess purchase price to the intangible assets and goodwill as appropriate. In this model, expected cash flows from subscribers were discounted to their present value at a rate of return of 20% (incorporating the risk-free rate, expected inflation, and related business risks) over a determined length of life year. Expected costs such as income taxes and cost of sales were deducted from expected revenues to arrive at after tax cash flows.

We have applied the same discounted cash flow methodology to the assessment of value of the intangible assets of Ethostream, during the acquisition completed on March 15, 2007, for purposes of determining the purchase price.

The MST subscriber list was determined to have an eight-year life. This intangible was amortized using that life and amortization from the date of the acquisition through September 30, 2008 was taken as a charge against income in the consolidated statement of operations.

Total identifiable intangible assets acquired and their carrying values at December 31, 2007 are:

| | Gross Carrying Amount | Accumulated Amortization | Net | Residual Value | Weighted Average Amortization Period (Years) |
|---|-----------------------------|-----------------------------|------------------|-------------------|--|
| Amortized Identifiable Intangible Assets: | | | | | |
| Subscriber lists – MST | \$ 4,444,114 | \$ (703,765) | 3,740,349 | | 8.0 |
| Subscriber lists - Ethostream | 2,900,000 | \$ (191,320) | 2,708,680 | \$ - | 12.0 |
| Total Amortized Identifiable Intangible Assets | 7,344,114 | \$ (895,085) | 6,449,029 | - | 9.6 |
| Unamortized Identifiable Intangible Assets: | | | | | |
| Total | \$ 7,344,114 | \$ (895,085) | 6,449,029 | \$ - | 9.6 |

Total identifiable intangible assets acquired and their carrying values at September 30, 2008 are:

| | Gross Carrying Amount | Accumulated Amortization | Net | Residual Value | Weighted Average Amortization Period (Years) |
|---|-----------------------------|-----------------------------|------------------|-------------------|--|
| Amortized Identifiable Intangible Assets: | | | | | |
| Subscriber lists – MST | \$ 4,444,114 | \$ (1,120,399) | 3,323,715 | | 8.0 |
| Subscriber lists - Ethostream | 2,900,000 | \$ (372,569) | 2,527,431 | \$ - | 12.0 |
| Total Amortized Identifiable Intangible Assets | 7,344,114 | \$ (1,492,969) | 5,851,145 | - | 9.6 |
| Unamortized Identifiable Intangible Assets: | | | | | |
| Total | \$ 7,344,114 | \$ (1,492,969) | 5,851,145 | \$ - | 9.6 |

Total amortization expense charged to operations for the nine months ended September 30, 2008 was \$597,884. Estimated amortization expense as of September 30, 2008 is as follows:

| Fiscal | |
|--|---------------------|
| October 1 through December 31, 2008 | 199,295 |
| 2009 | 797,181 |
| 2010 | 797,181 |
| 2011 | 797,181 |
| 2012 and after | 3,260,307 |
| Total | \$ 5,851,145 |

The Company does not amortize goodwill. The Company recorded goodwill in the amount of \$1,977,768 as a result of the acquisition of MST during the year ended December 31, 2006, and additional \$14,670,455 as a result of the acquisition of Ethostream and SSI during the year ended December 31, 2007 (Note B). At December 31, 2007, the Company determined that the value of MST's goodwill has been impaired based upon management's assessment of operating results and forecasted discounted cash flow and has written off the entire \$1,977,768 of its value. For the nine months ended September 30, 2008, the Company has estimated a \$380,000 impairment of the carrying value of goodwill issued upon the release of the purchase price contingency escrow.

NOTE D - INVENTORIES

Inventories are stated at the lower of cost or market determined by the first-in, first-out (FIFO) method. Inventories consist of the primary components of the Telkonet iWire System™, which are Gateways, Extenders, iBridges and Couplers, and the primary components of the Telkonet SmartEnergy energy management solution, which are thermostats, sensors and controllers.

Components of inventories as of September 30, 2008 and December 31, 2007 are as follows:

| | 2008 | 2007 |
|----------------|--------------|--------------|
| Raw Materials | \$ 796,019 | \$ 928,739 |
| Finished Goods | 1,209,977 | 1,649,345 |
| Total | \$ 2,005,996 | \$ 2,578,084 |

NOTE E - SENIOR CONVERTIBLE DEBENTURES AND SENIOR NOTES PAYABLE

Senior Convertible Debenture

A summary of convertible debentures payable at September 30, 2008 and December 31, 2007 is as follows:

| | September 30, 2008 | December 31, 2007 |
|---|--------------------------|-------------------------|
| Senior Convertible Debentures, accrue interest at 13% per annum and mature on May 29, 2011 | \$ 2,790,000 | \$ - |
| Debt Discount - beneficial conversion feature, net of accumulated amortization of \$146,251 and \$0 at September 30, 2008 and December 31, 2007, respectively. | (574,713) | - |
| Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of \$137,545 and \$0 at September 30, 2008 and December 31, 2007, respectively. | (540,495) | - |
| Total | \$ 1,674,792 | \$ - |
| Less: current portion | - | - |
| | \$ 1,674,792 | \$ - |

On May 30, 2008, the Company entered into a Securities Purchase Agreement with YA Global Investments, L.P. (the "Buyer") pursuant to which the Company agreed to issue and sell to the Buyer up to \$3,500,000 of secured convertible debentures (the "Debentures") and warrants to purchase (the "Warrants") up to 2,500,000 shares of the Company's Common Stock, par value \$0.001 per share (the "Common Stock"). The sale of the Debentures and Warrants was effectuated in three separate closings, the first of which occurred on May 30, 2008, and the remainder of which occurred in June 2008. At the May 30, 2008 closing, the Company sold Debentures having an aggregate principal value of \$1,500,000 and Warrants to purchase 2,100,000 shares of Common Stock. In July 2008, the Company sold the remaining Debentures having an aggregate principal value of \$2,000,000 and Warrants to purchase 400,000 shares of Common Stock.

Through September 30, 2008, \$710,000 of the debt has been converted to equity. Accordingly, as of September 30, 2008, the Company has \$2,790,000 outstanding in convertible debentures. During the nine months ended September 30, 2008, the \$710,000 of convertible debentures was converted into 2,212,529 shares of common stock.

The Debentures accrue interest at a rate of 13% per annum and mature on May 29, 2011. The Debentures may be redeemed at any time, in whole or in part, by the Company upon payment by the Company of a redemption premium equal to 15% of the principal amount of Debentures being redeemed, provided that an Equity Conditions Failure (as defined in the Debentures) is not occurring at the time of such redemption. The Buyer may also convert all or a portion of the Debentures at any time at a price equal to the lesser of (i) \$0.58, or (ii) ninety percent (90%) of the lowest volume weighted average price of the Company's Common Stock during the ten (10) trading days immediately preceding the conversion date. The Warrants expire five years from the date of issuance and entitle the Buyers to purchase shares of the Company's Common Stock at a price per share of \$0.61.

The Debenture meets the definition of a hybrid instrument, as defined in SFAS 133, Accounting for Derivative Instruments and Hedging Activities (SFAS No. 133). The hybrid instrument is comprised of a i) a debt instrument, as the host contract and ii) an option to convert the debentures into common stock of the Company, as an embedded derivative. The embedded derivative derives its value based on the underlying fair value of the Company's common stock. The Embedded Derivative is not clearly and closely related to the underlying host debt instrument since the

economic characteristics and risk associated with this derivative are based on the common stock fair value. The Company has separated the embedded derivative from the hybrid instrument and classified the Embedded Derivative as a liability with an offsetting debit to debt discount, which will be amortized over the term of the debenture based on the effective interest method.

The embedded derivative does not qualify as a fair value or cash flow hedge under SFAS No. 133. Accordingly, changes in the fair value of the embedded derivative are immediately recognized in earnings and classified as a gain or loss on the embedded derivative financial instrument in the accompanying statements of operations. There was a loss of \$1,594,609 recognized for the nine months ended September 30, 2008.

The Company determines the fair value of the embedded derivatives and records them as a discount to the debt and a derivative liability on the date of issue. The Company recognizes an immediate financing expense for any excess in the fair value of the derivatives over the debt amount. Upon conversion of the debt to equity, any remaining unamortized discount is charged to financing expense.

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

Senior Convertible Debentures - MST

A summary of convertible promissory notes payable at September 30, 2008 and December 31, 2007 is as follows:

| | September 30, 2008 | December 31, 2007 |
|--|--------------------------|-------------------------|
| Senior Convertible Debentures, accrue interest at 8% per annum commencing on the first anniversary of the original issue date of the debentures, payable quarterly in cash or common stock, at MSTI Holdings Inc.'s option, and mature on April 30, 2010 | \$ 6,657,872 | \$ 6,576,350 |
| Original Issue Discount - net of accumulated amortization of \$528,524 and \$307,038 at September 30, 2008 and December 31, 2007, respectively. | (4,348) | (219,312) |
| Debt Discount - beneficial conversion feature, net of accumulated amortization of \$937,365 and \$283,464 at September 30, 2008 and December 31, 2007, respectively. | (1,187,204) | (1,174,351) |
| Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of \$702,301 and \$181,118 at September 30, 2008 and December 31, 2007, respectively. | (889,396) | (750,347) |
| Total | \$ 4,576,924 | \$ 4,432,342 |
| Less: current portion | - | - |
| | \$ 4,576,924 | \$ 4,432,342 |

During the year ended December 31, 2007, MSTI Holdings Inc., issued senior convertible debentures (the "Debentures") having a principal value of \$6,576,350 to investors, including an original issue discount of \$526,350, in exchange for \$6,050,000 from investors, exclusive of placement fees. The original issue discount to the MSTI Debentures is amortized over 12 months. The MSTI Debentures accrue interest at 8% per annum commencing on the first anniversary of the original issue date of the MSTI Debentures, payable quarterly in cash or common stock, at MSTI Holdings Inc.'s option, and mature on April 30, 2010. The MSTI Debentures are not callable and are convertible at a conversion price of \$0.65 per share into 10,117,462 shares of MSTI Holdings Inc. common stock, subject to certain limitations. The MSTI Debenture holders are subject to a "Beneficial Ownership Limitation" pursuant to which the number of shares of common stock of MSTI Holdings, Inc. held by such debenture holders immediately following conversion of the MSTI Debenture shall not exceed 4.99% of all of the issued and outstanding common stock of MSTI Holdings, Inc. The MSTI Debentures are senior indebtedness and the holders of the MSTI Debentures have a security interest in all of MSTI Holdings, Inc.'s assets.

In accordance with Emerging Issues Task Force Issue 98-5, Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios ("EITF 98-5"), MST recognized an imbedded beneficial conversion feature present in the MSTI Debentures. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to the MST additional paid in capital included in the Company's minority interest. The Company recognized and measured an aggregate of \$1,457,815 of the proceeds, which is equal to the intrinsic value of the imbedded beneficial conversion feature, to additional paid in capital and a discount against the MSTI Debentures issued during the year ended December 31, 2007. The debt discount attributed to the beneficial conversion feature is amortized over the MSTI Debentures maturity period (three years) as interest expense. On February 11, 2008, the MSTI Debenture holders executed a letter agreement with MSTI Holdings, Inc. waiving their rights to receive liquidated damages under the registration rights agreement, in exchange for a reduction in their warrant exercise price from \$1.00 to \$0.65. In connection with this waiver, the Company has recognized an additional \$641,294 of debt discount attributed to the beneficial conversion feature for the nine months ended September 30, 2008.

In connection with the placement of the MSTI Debentures, MSTI Holdings, Inc. also issued to the MSTI Debenture holders, five-year warrants to purchase an aggregate of 5,058,730 shares of MSTI Holdings, Inc. common stock at an exercise price of \$1.00 per share. MSTI Holdings Inc. valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 5.00%, a dividend yield of 0%, and volatility of 54%. The \$931,465 of debt discount attributed to the value of the warrants issued is amortized over the MSTI Debentures maturity period (three years) as interest expense. On February 11, 2008, the Debenture holders executed a letter agreement with MSTI Holdings, Inc. waiving their rights to receive liquidated damages under the registration rights agreement, in exchange for a reduction in their warrant exercise price from \$1.00 to \$0.65. In connection with this waiver, the Company has recognized an additional \$641,294 of debt discount attributed to the value of the warrants issued for the nine months ended September 30, 2008.

In connection with the issuance of the MSTI Debentures, MSTI Holdings Inc. incurred placement fees of \$423,500. Additionally, MSTI Holdings Inc. issued such agents five-year warrants to purchase 708,222 shares of MSTI Holdings Inc. common stock at an exercise price of \$1.00.

During the nine months ended September 30, 2008, MSTI Holdings Inc. issued additional convertible debentures with a principal value of \$81,522 to existing note holders with a maturity date of April 30, 2010. In connection with this debenture, the Company has recognized an additional \$6,522, \$25,460 and \$18,938 of debt discount attributed to the original issue discount, the beneficial conversion feature and the value of the attached warrants for the nine months ended September 30, 2008.

The Company amortized the original issue discount, the beneficial conversion feature and the value of the attached warrants, and recorded non-cash interest expense in the amount of \$221,486, \$653,901, and \$521,183, respectively, for the nine months ended September 30, 2008.

Registration Rights Liquidated Damages

On May 24, 2007, MSTI Holdings, Inc. completed a private placement, pursuant to which 5,597,664 shares of common stock and five-year warrants to purchase 2,798,836 shares of common stock were issued at an exercise price of \$1.00 per share, for total proceeds of \$2,694,020. Additionally, MSTI Holdings, Inc. also sold MSTI Debentures (as previously described) for total proceeds of \$6,050,000. The MSTI Debentures bear interest at a rate of 8% per annum, commencing on the first anniversary of the original issue date of the MSTI Debentures, payable quarterly in cash or common stock, at MSTI Holdings, Inc. option, and mature on April 30, 2010. The MSTI Debentures are not callable and are convertible at a price of \$0.65 per share into 10,117,462 shares of MSTI Holdings, Inc. common stock. In addition, holders of the MSTI Debentures received five-year warrants to purchase an aggregate of 5,058,730 shares of MSTI Holdings, Inc. common stock at an exercise price of \$1.00 per share.

MSTI Holdings, Inc. agreed to file a “resale” registration statement with the SEC within 60 days after the final closing of the private placement and the issuance of the MSTI Debentures covering all shares of common stock sold in the private placement and underlying the MSTI Debentures, as well as the warrants attached to the private placement. MSTI Holdings, Inc. also agreed to use its best efforts to have such “resale” registration statement declared effective by the SEC as soon as possible and, in any event, within 120 days after the initial closing of the private placement and the issuance of the MSTI Debentures.

In addition, with respect to the shares of common stock sold in the private placement and underlying the warrants, MSTI Holdings, Inc. agreed to maintain the effectiveness of the “resale” registration statement from the effective date until the earlier of (i) 18 months after the date of the closing of the private placement or (ii) the date on which all securities registered under the registration statement (a) have been sold, or (b) are otherwise able to be sold pursuant to Rule 144, at which time exempt sales may be permitted for purchasers of the common stock in the private placement, subject to MSTI Holdings right to suspend or defer the use of the registration statement in certain events.

The registration rights agreement requires the payment of liquidated damages to the investors of approximately 1% per month of the aggregate proceeds of \$9,128,717, or the value of the unregistered shares at the time that the liquidated damages are assessed, until the registration statement is declared effective. In accordance with EITF 00-19-2, the Company evaluated the likelihood of achieving registration statement effectiveness. Accordingly, the Company accrued \$500,000 as of December 31, 2007, to account for these potential liquidated damages until the expected effectiveness of the registration statement is achieved.

On February 11, 2008, the investors executed a letter agreement with MSTI Holdings, Inc. waiving their rights to receive liquidated damages under the registration rights agreement, in exchange for a reduction in their warrant exercise price from \$1.00 to \$0.65. As a result, the Company has reversed the accrued expense for the potential liquidated damages during the nine months ended September 30, 2008.

Senior Note Payable

A summary of the senior notes payable at September 30, 2008 and December 31, 2007 is as follows:

| | |
|-----------|--------------|
| September | |
| 30, | December 31, |
| 2008 | 2007 |

| | | | |
|---|-----------|----------|---------------------|
| Senior Note Payable, accrues interest at 6% per annum, and matures on the earlier to occur of (i) the closing of the Company's next financing, or (ii) January 28, 2008. | \$ | - | \$ 1,500,000 |
| Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of \$195,924 and \$166,744 at September 30, 2008 and December 31, 2007, respectively. | | - | (29,180) |
| Total | \$ | - | \$ 1,470,820 |
| Less: current portion | | - | 1,470,820 |
| | \$ | - | \$ - |

On July 24, 2007, Telkonet entered into a Senior Note Purchase Agreement with GRQ Consultants, Inc. ("GRQ") pursuant to which the Company issued to GRQ a Senior Promissory Note (the "Note") in the aggregate principal amount of \$1,500,000. The Note was due and payable on the earlier to occur of (i) the closing of the Company's next financing, or (ii) January 28, 2008, and bore interest at a rate of nine (6%) percent per annum. The Company incurred approximately \$25,000 in fees in connection with this transaction. The net proceeds from the issuance of the Note were for general working capital needs. On February 8, 2008, this note was repaid in full including \$49,750 in accrued but unpaid interest from the issuance date through the date of repayment.

In connection with the issuance of the Note, the Company also issued to GRQ warrants to purchase 359,712 shares of common stock at \$4.17 per share. These warrants expire five years from the date of issuance. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 4.00%, a dividend yield of 0%, and volatility of 76%. The \$195,924 of debt discount attributed to the value of the warrants issued is amortized over the note maturity period (six months) as non-cash interest expense. The Company amortized the value of the attached warrants, and recorded non-cash interest expense in the amount of \$29,180, respectively, during the nine months ended September 30, 2008.

Aggregate maturities of long-term debt as of September 30, 2008 are as follows:

| For the twelve months ended September 30, | Amount |
|--|--------------|
| 2009 | \$ - |
| 2010 | 6,657,872 |
| 2011 | 2,790,000 |
| | \$ 9,447,872 |

NOTE F – LINE OF CREDIT

In September 2008, the Company entered into a two-year line of credit facility with a third party financial institution. The line of credit has an aggregate principal amount of \$1,000,000 and is secured by the Company's inventory. The outstanding principal balance bears interest at the greater of (i) the Wall Street Journal Prime Rate plus nine (9%) percent per annum, adjusted on the date of any change in such prime or base rate, or (ii) Sixteen percent (16%). Interest, computed on a 365/360 simple interest basis, and fees on the credit facility are payable monthly in arrears on the last day of each month and continuing on the last day of each month until the maturity date. The Company may prepay amounts outstanding under the credit facility in whole or in part at any time. In the event of such prepayment, the lender will be entitled to receive a prepayment fee of four percent (4.0%) of the highest aggregate loan commitment amount if prepayment occurs before the end of the first year and three percent (3.0%) if prepayment occurs thereafter. The outstanding borrowing under the agreement at September 30, 2008 was \$475,000. The Company has incurred interest expense of \$4,491 related to the line of credit for the nine months ended September 30, 2008. The Prime Rate was 5.00% at September 30, 2008.

NOTE G – RELATED PARTY ADVANCES

On May 6, 2008, Telkonet executed a Promissory Note in the aggregate principal amount of \$400,000. The Note was due and payable on the earlier to occur of (i) the closing of the Company's next financing, or (ii) November 6, 2008. In connection with the issuance of the Note, the Company issued warrants to purchase 800,000 shares of Telkonet common stock at \$0.60 per share. These warrants expire five years from the date of issuance. The outstanding principal amount of the Note was paid in full as of September 30, 2008.

Additionally, a \$288,918 income tax refund for certain carry back tax losses of MST for the period prior to the Company's acquisition is payable to Frank Matarazzo.

From time to time the Company may receive advances from certain of its directors and officers to meet short term working capital needs. These advances may not have formal repayment terms or arrangements. As of September 30, 2008, there was \$60,000 due to a former member of the Board of Directors of the Company.

NOTE H - FACTORING AGREEMENT

In February 2008, the Company entered into a factoring agreement to sell, without recourse, certain receivables to an unrelated third party financial institution in an effort to accelerate cash flow. Under the terms of the factoring agreement the maximum amount of outstanding receivables at any one time is \$2.5 million. Proceeds on the transfer reflect the face value of the account less a discount. The discount is recorded as interest expense in the Consolidated Statement of Operations in the period of the sale. Net funds received reduced accounts receivable outstanding while increasing cash. Fees paid pursuant to this arrangement are included in "Financing expense" in the Consolidated Statement of Operations and amounted to \$165,068 for the nine months ended September 30, 2008.

NOTE I - CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock, with a par value of \$.001 per share. As of September 30, 2008, and December 31, 2007, the Company has no preferred stock issued and outstanding. The Company has authorized 130,000,000 shares of common stock, with a par value of \$.001 per share. As of September 30, 2008, and December 31, 2007, the Company has 82,380,364 and 70,826,544 shares, respectively, of common stock issued and outstanding.

During the nine months ended September 30, 2008, the Company amended certain stock purchase warrants held by private placement investors to reduce the exercise price under such warrants from \$4.17 per share to \$0.6978258 per share. The warrants entitled the holders to purchase an aggregate of up to 3,380,000 shares of Telkonet common stock. Subsequently, these private placement investors exercised all of their warrants on a cashless basis using the five day volume average weighted price (VWAP) as of January 31, 2008 of \$.99 resulting in the issuance of 1,000,000 shares of Company common stock.

During the nine months ended September 30, 2008, the Company issued 312,911 shares of common stock to consultants for services performed. These shares were valued at \$340,407, which approximated the fair value of the shares issued during the period services were completed and rendered.

During the nine months ended September 30, 2008, Telkonet completed a private placement with one investor for aggregate gross proceeds of \$1.5 million. Pursuant to this private placement, the Company issued 2,500,000 shares of common stock valued at \$0.60 per share.

During the nine months ended September 30, 2008, Telkonet issued an additional 3,046,425 shares of its common stock to the sellers of Geeks on Call America, Inc. to satisfy the adjustment provision in the stock purchase agreement dated October 19, 2007 (Note L).

During the nine months ended September 30, 2008, Telkonet issued an additional 1,882,225 shares of its common stock to the sellers of Smart Systems International (SSI), to satisfy the adjustment provision in the purchase agreement dated March 9, 2007 (Note L).

During the nine months ended September 30, 2008, Telkonet issued 600,000 shares of its common stock to Frank T. Matarazzo pursuant to the stock purchase agreement between Telkonet and MST, dated January 31, 2006. These shares were valued at \$380,000, which approximated the fair value of the shares on the date the shares were issued (Note L).

During the nine months ended September 30, 2008, Telkonet issued 2,212,529 shares of common stock at approximately \$0.32 per shares to its senior convertible debenture holders in exchange for \$710,000 of debentures.

NOTE J - STOCK OPTIONS AND WARRANTS

Employee Stock Options

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

| Exercise Prices | Options Outstanding | | Weighted Average Exercise Price | Options Exercisable | |
|-----------------|-----------------------|--|--|-----------------------|--|
| | Number Outstanding | Weighted Average Remaining Contractual Life (Years) | | Number Exercisable | Weighted Average Exercise Price |
| \$1.00 - \$1.99 | 4,263,429 | 4.54 | \$1.03 | 4,028,929 | \$1.01 |
| \$2.00 - \$2.99 | 1,281,000 | 6.07 | \$2.49 | 1,206,250 | \$2.48 |
| \$3.00 - \$3.99 | 1,501,250 | 6.57 | \$3.30 | 1,041,750 | \$3.36 |
| \$4.00 - \$4.99 | 105,000 | 6.45 | \$4.30 | 67,250 | \$4.30 |

Edgar Filing: TELKONET INC - Form 10-Q

| | | | | | |
|-----------------|-----------|------|--------|-----------|--------|
| \$5.00 - \$5.99 | 135,000 | 6.36 | \$5.24 | 90,500 | \$5.23 |
| | 7,285,679 | 5.29 | \$1.88 | 6,434,679 | \$1.76 |

21

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

| | Number of Shares | Weighted Average Price Per Share |
|-----------------------------------|---------------------|---|
| Outstanding at January 1, 2006 | 10,151,078 | \$ 1.85 |
| Granted | 1,125,000 | 3.01 |
| Exercised | (2,051,399) | 1.30 |
| Cancelled or expired | (703,750) | 2.67 |
| Outstanding at December 31, 2006 | 8,520,929 | \$ 2.06 |
| Granted | 935,000 | 2.55 |
| Exercised | (118,500) | 1.05 |
| Cancelled or expired | (1,232,000) | 3.00 |
| Outstanding at December 31, 2007 | 8,105,429 | \$ 1.98 |
| Granted | 160,000 | 1.00 |
| Exercised | - | - |
| Cancelled or expired | (979,750) | 2.59 |
| Outstanding at September 30, 2008 | 7,285,679 | \$ 1.88 |

The weighted-average fair value of stock options granted to employees during the nine months ended September 30, 2008 and 2007 and the weighted-average significant assumptions used to determine those fair values, using a Black-Scholes option pricing model are as follows:

| | 2008 | 2007 |
|---|---------|---------|
| Significant assumptions (weighted-average): | | |
| Risk-free interest rate at grant date | 3.0% | 4.8% |
| Expected stock price volatility | 74% | 70% |
| Expected dividend payout | - | - |
| Expected option life (in years) | 5.0 | 5.0 |
| Expected forfeiture rate | 12.0% | 12.0% |
| Fair value per share of options granted | \$ 0.62 | \$ 1.57 |

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-Merton option valuation model on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term equal to the expected life of the award. We have not paid any cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero in the Black-Scholes-Merton option valuation model. We use historical data to estimate pre-vesting option forfeitures and record share-based compensation for those awards that are expected to vest. In accordance with SFAS No. 123R, we adjust share-based compensation for changes to the estimate of expected equity award forfeitures based on actual forfeiture experience.

The total intrinsic value of the options exercised for the nine months ended September 30, 2007 was \$73,470. There were no options exercised during the nine months ended September 30, 2008. Additionally, the total fair value of shares vested during the nine months ended September 30, 2008 and 2007 was \$623,113 and \$1,115,867, respectively.

Total stock-based compensation expense recognized in the consolidated statement of earnings for the nine months ended September 30, 2008 and 2007 was \$623,113 and \$1,115,867, respectively, net of tax effect. Additionally, the aggregate intrinsic value of options outstanding and unvested as of September 30, 2008 is \$0.

Non-Employee Stock Options

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

| Exercise Prices | Options Outstanding | | Weighted Average Exercise Price | Options Exercisable | |
|-----------------|-----------------------|---|--|-----------------------|--|
| | Number Outstanding | Weighted Average Remaining Contractual Life (Years) | | Number Exercisable | Weighted Average Exercise Price |
| \$1.00 | 1,815,937 | 3.58 | \$1.00 | 1,815,937 | \$1.00 |

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

| | Number of Shares | Weighted Average Price Per Share |
|-----------------------------------|---------------------|--|
| Outstanding at January 1, 2006 | 1,841,774 | \$ 1.00 |
| Granted | - | - |
| Exercised | (25,837) | 1.00 |
| Canceled or expired | - | - |
| Outstanding at December 31, 2006 | 1,815,937 | \$ 1.00 |
| Granted | - | - |
| Exercised | - | - |
| Canceled or expired | - | - |
| Outstanding at December 31, 2007 | 1,815,937 | \$ 1.00 |
| Granted | - | - |
| Exercised | - | - |
| Canceled or expired | - | - |
| Outstanding at September 30, 2008 | 1,815,937 | \$ 1.00 |

There were no non-employee stock options vested during the nine months ended September 30, 2008 and 2007, respectively.

Warrants

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

| Exercise Prices | Warrants Outstanding | | Weighed Average | Warrants Exercisable | |
|-----------------|-----------------------|---------------------|--------------------|-----------------------|---------------------|
| | Number Outstanding | Weighted Average | | Number Exercisable | Weighted Average |

Edgar Filing: TELKONET INC - Form 10-Q

| | | Remaining Contractual Life (Years) | Exercise Price | | Exercise Price |
|--------|-----------|--|-------------------|-----------|-------------------|
| \$0.58 | 856,739 | 3.34 | \$0.58 | 856,739 | \$0.58 |
| \$0.60 | 800,000 | 4.60 | \$0.60 | 800,000 | \$0.60 |
| \$0.61 | 2,500,000 | 4.66 | \$0.61 | 2,500,000 | \$0.61 |
| \$2.59 | 862,452 | 2.87 | \$2.59 | 862,452 | \$2.59 |
| \$3.98 | 3,078,864 | 3.04 | \$3.98 | 3,078,864 | \$3.98 |
| \$4.17 | 359,712 | 3.81 | \$4.17 | 359,712 | \$4.17 |
| | 8,457,767 | 3.89 | \$2.19 | 8,457,767 | \$2.19 |

23

Transactions involving warrants are summarized as follows:

| | Number of Shares | Weighted Average Price Per Share |
|-----------------------------------|---------------------|---|
| Outstanding at January 1, 2006 | 1,230,000 | \$ 4.31 |
| Granted | 3,657,850 | 4.03 |
| Exercised | (47,750) | 1.15 |
| Canceled or expired | (282,250) | 2.64 |
| Outstanding at December 31, 2006 | 4,557,850 | \$ 4.20 |
| Granted | 3,115,777 | 4.18 |
| Exercised | - | - |
| Canceled or expired | - | - |
| Outstanding at December 31, 2007 | 7,673,627 | \$ 4.15 |
| Granted | 4,164,140 | 1.31 |
| Exercised (Note I) | (3,380,000) | 0.70* |
| Canceled or expired | - | - |
| Outstanding at September 30, 2008 | 8,457,767 | \$ 2.19 |

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

The Company granted 864,140 and 79,326 warrants to Convertible Senior Notes holders, 0 and 2,600,000 warrants to private placement investors (Note I), 2,500,000 and 0 to a Convertible Debenture holder, 800,000 and 0 to a Note holder, and 0 and 76,739 compensatory warrants to non-employees during the nine months ended September 30, 2008 and 2007, respectively. There was no compensatory warrant expense recorded for the nine months ended September 30, 2008. The estimated value of compensatory warrants granted during the nine months ended September 30, 2007 was determined using the Black-Scholes option pricing model and the following assumptions: contractual term of 5 years, a risk free interest rate of approximately 4.75%, a dividend yield of 0% and volatility of 70%. Compensation expense of \$139,112 was charged to operations for the nine months ended September 30, 2007.

The purchase price of the warrants issued to Convertible Senior Note holders was adjusted from \$4.70 to \$3.98 per share during the nine months ended September 30, 2008 in accordance with the anti-dilution protection provision of the Convertible Senior Notes Payable Agreement (“the Agreement”) dated October 27, 2005, upon the occurrence of certain events as defined in the Agreement.

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

NOTE K - BUSINESS SEGMENTS

The Company's reportable operating segments are strategic businesses differentiated by the nature of their products, activities and customers and are described as follows:

Telkonet (TKO) is a leading provider of innovative, centrally-managed solutions for integrated energy management, networking, building automation and proactive support solutions.

Microwave Satellite Technologies (MST) (Note B), offers complete sales, installation, and service of VSAT and business television networks, and became a full-service national Internet Service Provider (ISP). The MST solution offers a complete “Quad-play” solution to subscribers of multichannel video programming, VoIP telephony, NuVision Broadband Internet access and wireless fidelity (“Wi-Fi”) access, to commercial multi-dwelling units and hotels.

The measurement of losses and assets of the reportable segments is based on the same accounting principles applied in the consolidated financial statements.

Edgar Filing: TELKONET INC - Form 10-Q

Financial data relating to reportable operating segments is as follows:

| | Three Months ended September 30, | |
|------------------------------|-------------------------------------|------------|
| | 2008 | 2007 |
| | (In thousands of U.S. \$) | |
| Revenues: | | |
| Telkonet | \$ 4,565 | \$ 3,814 |
| MST | 1,163 | 775 |
| Total revenue | \$ 5,728 | \$ 4,589 |
| Gross Profit | | |
| Telkonet | \$ 2,241 | \$ 1,317 |
| MST | (35) | (97) |
| Total gross profit | \$ 2,206 | \$ 1,220 |
| Loss from Operations: | | |
| Telkonet | \$ (688) | \$ (1,772) |
| MST | (1,631) | (3,310) |
| Total operating loss | \$ (2,319) | \$ (5,082) |

| | Nine Months ended September 30, | |
|------------------------------|------------------------------------|-------------|
| | 2008 | 2007 |
| | (In thousands of U.S. \$) | |
| Revenues: | | |
| Telkonet | \$ 13,381 | \$ 7,736 |
| MST | 2,930 | 1,765 |
| Total revenue | \$ 16,311 | \$ 9,501 |
| Gross Profit | | |
| Telkonet | \$ 5,305 | \$ 2,486 |
| MST | (94) | (666) |
| Total gross profit | \$ 5,211 | \$ 1,820 |
| Loss from Operations: | | |
| Telkonet | \$ (5,033) | \$ (10,917) |
| MST | (4,315) | (4,211) |
| Total operating loss | \$ (9,348) | \$ (15,128) |

| | September | December |
|---------------|---------------------------|-------------|
| | 30, 2008 | 31, 2007 |
| | (In thousands of U.S. \$) | |
| Assets | | |
| Telkonet | \$ 25,863 | \$ 29,492 |
| MST | 7,000 | 9,249 |
| Total assets | \$ 32,863 | \$ 38,741 |

NOTE L - COMMITMENTS AND CONTINGENCIES

Office Leases Obligations

The Company leases office space under a sub-lease agreement through November 2010 for office space which occupies approximately 11,600 square feet in Germantown, MD. In April 2007, the Company entered into a sub-lease agreement for an additional 4,800 square feet of adjacent office space through December 2015.

In April 2005, the Company entered into a three-year lease agreement for 6,742 square feet of commercial office space in Crystal City, Virginia. Pursuant to this lease, the Company agreed to assume a portion of the build-out cost for this facility. In February 2007, the Company agreed to sub-lease the Crystal City, Virginia office through the remaining term of the contract resulting in a loss of approximately \$192,000. This lease expired in March 2008.

MST, which was acquired by the Company in January 2006, presently leases 12,600 square feet of commercial office space in Hawthorne, New Jersey for its office and warehouse spaces. This lease will expire in April 2010.

In the year ended September 2006, the Company leased a vehicle for the then Chief Executive Officer. This lease expired in September 2008.

Following the acquisitions of Smart Systems International and Ethostream, the Company assumed leases on 9,000 square feet of office space in Las Vegas, NV for Smart Systems International on a month to month basis and 4,100 square feet of office space in Milwaukee, WI for Ethostream. The Ethostream lease expires in May 2011. The Las Vegas, NV office lease expired on April 30, 2008.

Commitments for minimum rentals under non cancelable leases at September 30, 2008 are as follows:

| | |
|--------------------------------------|--------------|
| October 1 through September 30, 2008 | \$ 527,532 |
| 2009 | 379,207 |
| 2010 | 218,671 |
| 2011 | 179,214 |
| 2012 and thereafter | 360,237 |
| Total | \$ 1,664,861 |

Rental expenses charged to operations for the nine months ended September 30, 2008, was \$455,155.

Employment and Consulting 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.

The Company has consulting agreements with outside contractors to provide marketing and financial advisory services. The Agreements are generally for a term of 12 months from inception and renewable automatically from year to year unless either the Company or the contractor terminates such engagement by written notice.

The Company entered into an exclusive financial advisor and consulting agreement in January 2007. The agreement provides a minimum consideration fee, not less than \$250,000, in the event of equity or financing transaction where the advisor is engaged. The agreement may be terminated with sixty days notification by either party.

On August 1, 2007, the Company entered into an agreement with Barry Honig, President of GRQ Consultants, Inc. ("GRQ"). Telkonet agreed to pay Mr. Honig 50,000 shares of common stock per month for six (6) months, to provide

the Company with transaction advisory services. This agreement was terminated in February 2008. GRQ held a Senior Promissory Note issued by Telkonet on July 24, 2007, in the principal amount of \$1,500,000. On February 8, 2008, this note was repaid in full including \$49,750 in interest accrued from the issuance date through the date of repayment.

Jason Tienor, President and Chief Executive Officer, is employed pursuant to an employment agreement, dated March 15, 2007. Mr. Tienor's employment agreement has a term of three years and provides for a base salary of \$200,000 per year.

Jeff Sobieski, Executive Vice President, Energy Management, is employed pursuant to an employment agreement, dated March 15, 2007. Mr. Sobieski's employment agreement has a term of three years for a base salary of \$190,000 per year.

Frank T. Matarazzo, Chief Executive Officer, MSTI Holdings, Inc. is employed pursuant to an employment agreement that provides for an annual salary of \$300,000 and expires December 31, 2011.

Litigation

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

Senior Convertible Noteholder Claim

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

Purchase Price Contingency

In conjunction with the acquisition of MST on January 31, 2006, the purchase price contingency shares are price protected for the benefit of the former owner of MST (Note B). In the event the Company's common stock price is below \$4.50 per share upon the achievement of thirty three hundred (3,300) subscribers a pro rata adjustment in the number of shares will be required to support the aggregate consideration of \$5.4 million. The price protection provision provides a cash benefit to the former owner of MST if the as-defined market price of the Company's common stock is less than \$4.50 per share at the time of issuance from the escrow on or before January 31, 2009. The issuance of additional shares or distribution of other consideration upon resolution of the contingency based on the Company's common stock prices will not affect the cost of the acquisition. When the contingency is resolved or settled, and additional consideration is distributable, the Company will record the current fair value of the additional consideration and the amount previously recorded for the common stock issued will be simultaneously reduced to the lower current value of the Company's common stock. In addition, the Company agreed to fully fund the MST three year business plan, established on January 31, 2006, to satisfy the benchmarks established to achieve 3,300 subscribers. In the event, for any reason, the Company materially fails to satisfy its obligations under the acquisition agreement, then the former owners of MST shall be entitled to the release of any and all consideration held in reserve. In May 2008, the Company executed an agreement for a minimum commitment of \$2.3 million to fund MST's business plan in accordance with Section 11.1 of the Purchase Agreement between Telkonet and Frank T. Matarazzo. In addition, the adjustment date for the achievement of MST's 3,300 subscribers has been extended an additional six months. Additionally, in April 2008 the Company issued from escrow 200,000 shares of the purchase price contingency and advanced 400,000 shares in June 2008 in exchange for Mr. Matarazzo's agreement to a debt covenant restricting the use of proceeds in the Company's debenture financing with YA Global Investments LP (Note E).

On March 9, 2007, the Company acquired substantially all of the assets of Smart Systems International (SSI), a leading provider of energy management products and solutions to customers in the United States and Canada for cash and Company common stock having an aggregate value of \$6,875,000. The purchase price was comprised of \$875,000 in cash and 2,227,273 shares of the Company's common stock. The Company was obligated to register the stock portion of the purchase price on or before May 15, 2007. Pursuant to the registration rights agreement, the registration statement was required to be effective no later than July 14, 2007. The registration rights agreement does not expressly provide for penalties in the event this deadline is not met. This registration statement was declared effective on March 14, 2008.

Of the stock issued in the SSI acquisition, 1,090,909 shares were being held in an escrow account for a period of one year following the closing from which certain potential indemnification obligations under the purchase

agreement could be satisfied. The aggregate number of shares held in escrow was subject to adjustment upward or downward depending upon the trading price of the Company's common stock during the one year period following the closing date. On March 12, 2008, the Company released these shares from escrow and issued an additional 1,882,225 shares on June 12, 2008 pursuant to the adjustment provision in the SSI asset purchase agreement.

On October 19, 2007, the Company completed the acquisition of approximately 30.0% of the issued and outstanding shares of common stock of Geeks on Call America, Inc. ("GOCA"). Under the terms of the stock purchase agreement, the Company acquired approximately 1,160,043 shares of GOCA common stock in exchange for 2,940,202 shares of the Company's common stock for total consideration valued at approximately \$4.5 million. The number of shares issued in connection with this transaction was determined using a per share price equal to the average closing price of the Company's common stock on the American Stock Exchange (AMEX) during the ten trading days immediately preceding the closing date. The number of shares was subject to adjustment on the first to occur of (i) the date the registration statement relating to such shares was declared effective; and (ii) the date the shares become eligible for resale under Rule 144. The increase or decrease to the number of shares issued will be determined using a per share price equal to the average closing price of the Company's common stock on the AMEX during the ten trading days immediately preceding the adjustment date. On April 30, 2008, Telkonet issued an additional 3,046,425 shares of its common stock to the sellers of Geeks on Call America, Inc. to satisfy the adjustment provision.

Senior Convertible Debentures

On February 11, 2008, purchasers of MSTI Holdings, Inc. Debentures executed a letter agreement with MSTI Holdings, Inc. providing that, among other things, in the event Frank Matarazzo ceases being Chief Executive Officer of MSTI Holdings, Inc., MSTI Holdings, Inc. will be in default under the Debentures.

NOTE M - MINORITY INTEREST IN SUBSIDIARY

Minority interest in results of operations of consolidated subsidiaries represents the minority shareholders' share of the income or loss of the consolidated subsidiary MST. The minority interest in the consolidated balance sheet reflects the original investment by these minority shareholders in the consolidated subsidiaries, along with their proportional share of the earnings or losses of the subsidiaries.

On January 31, 2006, the Company acquired a 90% interest in MST from Frank Matarazzo, the sole stockholder of MST in exchange for \$1.8 million in cash and 1.6 million unregistered shares of the Company's common stock for an aggregate purchase price of \$9,000,000 (See Note B). This transaction resulted in a minority interest of \$19,569, which reflects the original investment by the minority shareholder of MST.

On May 24, 2007, MST merged with a wholly-owned subsidiary of MSTI Holdings, Inc. (formerly Fitness Xpress, Inc.). Immediately following the merger, MSTI Holdings Inc. completed an equity financing of approximately \$3.1 million through the private placement of common stock and warrants and a debt financing of approximately \$6 million through the private placement of debentures and warrants. These transactions resulted in additional minority interest of \$4,576,740 and increased the minority interest from 10% to 37% of MSTI Holding, Inc. outstanding common shares.

For the nine months ended September 30, 2008 and 2007, the minority shareholder's share of the loss of MST was limited to \$508,435 and \$0 respectively. The minority interest in MST through September 30, 2008 was a deficit and, in accordance with Accounting Research Bulletin No. 51, subsidiary losses should not be charged against the minority interest to the extent of reducing it to a negative amount. As such, any losses will be charged against the Company's operations, as majority owner. However, if future earnings do materialize, the majority owner should be credited to the extent of such losses previously absorbed in the amount of \$545,745.

Minority interest at September 30, 2008 and December 31, 2007 amounted to \$2,668,058 and \$2,978,918, respectively.

NOTE N - BUSINESS CONCENTRATION

Revenue from three (3) major customers approximated \$6,782,000 or 42% of total revenues for the nine months ended September 30, 2008. There were no major customers with revenues representing more than 10% of total revenues for the period ending September 30, 2007. Total accounts receivable of \$674,800, or 36% of total accounts receivable, was due from these customers as of September 30, 2008. There were no outstanding accounts receivables from major customers as of September 30, 2007.

Purchases from one (1) major supplier approximated \$2,014,380, or 47% of purchases for the nine months ended September 30, 2008, and purchases from three (3) major suppliers approximated \$2,034,353, or 34% of purchases, for the nine months ended September 30, 2007. Total accounts payable of approximately \$145,769, or 3% of total accounts payable, was due to this supplier as of September 30, 2008, and approximately \$451,768, or 17% of total accounts payable, was due to these suppliers as of September 30, 2007.

NOTE O – SUBSEQUENT EVENTS

Senior Convertible Debentures - MST

The purchase agreement executed in connection with the May 2007 private offering of convertible debentures (the "Debentures") and warrants to purchase common stock (the "Warrants") prohibits MST from directly or indirectly, among other things, creating or incurring any indebtedness (other than Permitted Indebtedness, as such term is defined in the

Purchase Agreement) without the consent of the holders of at least 85% of the principal amount of outstanding Debentures.

On October 16, 2008, the Purchasers executed a letter agreement (the "Letter Agreement") with MST pursuant to which, among other things:

- (i) the Purchasers consented to the issuance of additional debentures in the aggregate principal amount of \$352,631 (the "Additional Debentures");
- (ii) the Purchasers consented to the issuance of 2 million shares of common stock along with the additional debentures;
- (iii) the Purchasers consented to the issuance of up to \$2.0 million of shares of the Company's common stock and the same number of common stock purchase warrants at a purchase price of at least \$0.125 per share;
- (iv) the Maturity Date of the Additional Debentures will be automatically extended to April 30, 2010, as same may be accelerated pursuant to the terms of the Additional Debentures upon the occurrence of both the following conditions: (i) the non-occurrence of an Event of Default (as defined in the Additional Debenture) or an event which with the passage of time or the giving of notice could become an Event of Default, and (ii) the receipt of net proceeds by the Company from a Qualified Offering (as defined in the Letter Agreement); and
- (v) The Purchase Agreement was amended to include the Additional Debentures and the shares issuable upon the conversion of the Additional Debentures.

Senior Convertible Debenture

In October 2008, the Company issued 4,361,528 shares of its common stock for the repayment of \$550,000 of the principal value of the outstanding convertible debentures issued to YA Global Investments LP.

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

The following discussion and analysis of the Company's financial condition and results of operations should be read in conjunction with the accompanying financial statements and related notes thereto for the quarter ended September 30, 2008 and 2007, 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, 2007 filed on March 31, 2008.

Business

Telkonet, Inc., formed in 1999 and incorporated under the laws of the State of Utah, is a leading provider of innovative, centrally managed solutions for integrated energy management, networking, building automation and proactive support services.

Through the revolutionary Telkonet iWire System™ and newly released Series 5 platform, Telkonet utilizes proven PLC technology to deliver commercial high-speed Broadband access from an IP "platform" that is easy to deploy, reliable and cost-effective by leveraging a building's existing electrical infrastructure. The building's existing electrical wiring becomes the backbone of a local area network (LAN), which converts virtually every electrical outlet into a high-speed data port without the costly installation of additional wiring or major disruption of business activity.

Through the Company's majority-owned subsidiary MSTI Holdings, Inc. (MST), the Company is able to offer quadruple play ("Quad-Play") services to multi-tenant unit ("MTU") and multi-dwelling unit ("MDU") residential, hospitality and commercial properties. These Quad-Play services include video, voice, high-speed internet and wireless fidelity ("Wi-Fi") access.

The Company's acquisition of EthoStream, LLC, a leading high-speed wireless internet technology and services provider for the hospitality industry (as described in greater detail below under "Segment Reporting"), has enabled Telkonet to provide installation and support for PLC and HSIA products and third party applications to customers across North America. The Company's new operating division represented by the assets acquired from Smart Systems International, a leading provider of energy management products and solutions (as described in greater detail below under "Segment Reporting"), permits the Company to offer new energy management products and solutions to its customers in the United States and Canada.

As a result of Telkonet's acquisition of Smart Systems International and EthoStream, the Company can now provide hospitality owners with a greater return on technology investments. Hotel owners can leverage the Telkonet platform to support wired and wireless Internet access, digital video surveillance, digital displays and the networked energy management system. With the synergy of EthoStream's centralized remote monitoring and management platform extending over HSIA, digital video surveillance and energy management, hospitality owners will have a complete technology offering based on Telkonet's core PLC system as the infrastructure backbone, demonstrating true technology convergence.

The Company's headquarters are located at 20374 Seneca Meadows Parkway, Germantown, Maryland 20876. The reports that the Company files pursuant to the Securities Exchange Act of 1934 can be found at the Company's web site at www.telkonet.com.

The highlights and business developments for the nine months ended September 30, 2008 include the following:

- Consolidated revenue growth of 72% driven by an increase in sales of the Telkonet iWire System™ and Telkonet SmartEnergy products
- Gross profit on consolidated net sales increased to 32% during the nine months ended September 30, 2008, compared to 19% for the nine months ended September 30, 2007

- Selling, general and administrative expenses decreased by 21% during the nine months ended September 30, 2008, when compared to the nine months ended September 30, 2007
- The raising of \$1.5 million through a private placement of 2.5 million shares of common stock
- The closing of a \$2.5 million revolving credit facility secured by the Company's accounts receivable.
- Completion of the sale of \$3.5 million convertible debentures offering.
- The closing of a \$1.0 million line of credit facility secured by the Company's inventory.

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

Telkonet Segment

The Telkonet Segment consists of the Telkonet iWire System™ and Series 5 platform, Telkonet SmartEnergy energy management products, and centrally managed high-speed internet network platforms integrated to form a complete SAAS technology platform. This segment employs both direct and indirect sales models to distribute and support its products on a worldwide basis and serves five major markets: hospitality, commercial, industrial, government (including defense and education) and retail.

The Telkonet iWire System™ and Series 5 platform offer a viable and cost-effective alternative to the challenges of hardwiring and wireless local area networks (LANs). Telkonet's products are designed for use in residential, commercial and industrial applications, including multi-dwelling, hospitality, government and utility markets. Applications supported by the Telkonet "platform" include, but are not limited to, VoIP telephones, internet connectivity, local area networking, video conferencing, closed circuit security surveillance, point of sale, digital signage and a host of other information services.

Telkonet has been shipping PLC products since 2003, initially targeting the hospitality market followed by the multi-dwelling unit (MDU) market as well as the government and other commercial markets.

The Company released its Series 5 product on March 1, 2008. The Series 5 product provides enhancements to the Telkonet iWire System™ which include, but are not limited to, the following:

- speed more than 14 times faster than the legacy product,
- more robust security and data encryption,
- enhanced quality of service, or QOS,
- the use of both alternating current, and direct current which makes it highly compatible within utility and industrial space,
- increased survivability in harsh environments, and
- additional physical interfaces.

On March 9, 2007, the Company acquired substantially all of the assets of Smart Systems International (SSI), a leading provider of energy management products and solutions to customers in the United States and Canada for cash and Company common stock having an aggregate value of \$6,875,000. The purchase price was comprised of \$875,000 in cash and 2,227,273 shares of the Company's common stock. 1,090,909 of these shares were held in an escrow account for a period of one year following the closing from which certain potential indemnification obligations under the purchase agreement could be satisfied. The aggregate number of shares held in escrow was subject to adjustment upward or downward depending upon the trading price of the Company's common stock during the one year period following the closing date. On March 12, 2008, the Company released these shares from escrow and issued an additional 1,882,225 shares on June 12, 2008 pursuant to the adjustment provision in the SSI asset purchase agreement.

Many of the largest initiatives within Telkonet center on the sale of energy management products and services. The Telkonet SmartEnergy system uses a combination of occupancy sensors along with intelligent programmable thermostats or controllers to adjust and maintain room temperature according to occupancy, time of day, and environmental factors, for a preset configuration eliminating wasteful heating and cooling of unoccupied rooms, and limiting the damaging impact of improper temperature fluctuations. On average, the installation of these devices can save 30% per year on heating and cooling energy consumption.

Thus far the hospitality, MDU, educational, and government industries have been highly interested in energy management devices and Telkonet has increased quarterly sales in these markets consistently during the past year. In addition, Telkonet continues to recognize increased interest and significant wins internationally with its SmartEnergy offering. Telkonet intends to expand these efforts to facilitate growth acceleration in the installation of our Telkonet SmartEnergy product line. This effort is supported by the enforcement of new energy conservation legislation such as the Energy Independence and Security Act signed into law by President Bush on December 19, 2007, which contains provisions to improve energy efficiency in appliances and commercial products and reduce federal government energy usage. Telkonet continues to support these initiatives and will remain at the forefront of green technology solutions throughout 2008 with introductions such as our networked Telkonet SmartEnergy product line.

Additionally, the integration of the Series Five product line with the energy management products will allow Telkonet to use the electrical grid of commercial buildings as a backbone for the networked Telkonet SmartEnergy solution making it easier, quicker, less intrusive, and less expensive to install and operate the system within a commercial environment. The benefits of this are twofold. First, reduced costs provide the possibility of increased margins on

Telkonet's sales. Second, Telkonet has increased price flexibility in order to respond to competitive market pressures.

On March 15, 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, LLC acquisition enables Telkonet to provide installation and support for PLC products and third party applications to customers across North America. The purchase price of \$11,756,097 was comprised of \$2.0 million in cash and 3,459,609 shares of the Company's common stock. The entire stock portion of the purchase price was deposited into escrow upon closing to satisfy certain potential indemnification obligations of the sellers under the purchase agreement. The shares held in escrow are distributable over the three years following the closing. As of November 10, 2008, 876,804 shares remain in escrow pursuant to the purchase agreement.

One of Telkonet's largest recurring revenue streams is the Milwaukee-based technical support center that was acquired in the EthoStream transaction. This support center is one of the only internally-operated hospitality HSIA support centers and the key driver in the quality and customer satisfaction with which EthoStream is credited. Telkonet's support center is a fully operating 24/7, 365 day full-service customer support center that provides e-mail, phone, and technical support not only to hospitality internet access customers but to the third party vendors as well.

This has been a growth market for the past several years due to business travel demand for high quality internet access in hotel rooms. Additionally, over the past year, the demands for high speed wireless internet access have extended beyond the traditional business traveler with a significant number of leisure travelers also demanding that the service be available. We have partnered with several large hotel chains allowing us to service more than 2,500 total properties and providing connectivity to more than 2 million travelers monthly. We continue these efforts and Telkonet's hospitality market expansion through working with additional franchisors through approved or preferred affiliations and franchise upgrades or rollouts.

MST Segment

MST is a communications service provider offering Quad-Play services to MTU and MDU residential, hospitality and commercial properties. These Quad-Play services include video, voice, high-speed internet and Wi-Fi access. In addition, MST currently offers or plans to offer a variety of next-generation telecommunications solutions and services, including satellite installation, video conferencing, surveillance/security and energy management, and other complementary professional services.

NuVisions™

MST currently offers digital television service through DISH Network, a national satellite television provider, under its private label NuVisions™ brand of services. The NuVisions TV offering currently includes over 500 channels of video and audio programming, with a large high definition (more than 40 channels) and ethnic offering (over 100 channels from 17 countries) available in the market today. MST also offers its NuVisions Broadband high speed internet service and NuVisions Digital Voice telephone service to multi-family residences and commercial properties. MST delivers its broadband based services using terrestrial fiber optic links and in February 2005, began deployment in New York City of a proprietary wireless gigabit network that connects properties served in a redundant gigabit ring - a virtual fiber optic network in the air.

Wi-Fi Network

MST has constructed a large NuVisions Wi-Fi footprint in New York City intended to create a ubiquitous citywide Wi-Fi network. NuVisions Wi-Fi offers Internet access in the southern-half of Central Park, Riverside Park from 60th to 79th Streets, Dag Hammarskjold Plaza, and the United Nations Plaza. In addition, MST provides NuVisions Wi-Fi service in and around Trump Tower on Fifth Avenue, Trump World Tower on First Avenue, the Trump Place properties located on Riverside Boulevard, Trump Palace, Trump Parc, Trump Parc East as well as portions of Roosevelt Island surrounding the Octagon residential community. MST currently has plans to deploy additional Wi-Fi “Hot Zones” throughout New York City and continue to enlarge its Wi-Fi footprint as new properties are served.

Internet Protocol Television (“IPTV”)

IPTV is a method of distributing television content over IP that enables a more user-defined, on-demand and interactive experience than traditional cable or satellite television. The IPTV service delivers traditional cable TV programming and enables subscribers to surf the Internet, receive on-demand content, and perform a host of Internet-based functions via their TV sets.

Forward Looking Statements

This report may contain “forward-looking statements,” which represent the Company’s expectations or beliefs, including, but not limited to, statements concerning industry performance and the Company’s results, operations, performance, financial condition, plans, growth and strategies, which include, without limitation, statements preceded or followed by or that include the words “may,” “will,” “expect,” “anticipate,” “intend,” “could,” “estimate,” or “continue” or the negative variations thereof or comparable terminology. Any statements contained in this report or the information incorporated by reference that are not statements of historical fact may be deemed to be forward-looking statements within the meaning of Section 27(A) of the Securities Act of 1933 and Section 21(F) of the Securities Exchange Act of 1934. For such statements, the Company claims the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. These statements by their nature involve substantial risks and uncertainties, some of which are beyond the Company’s control, and actual results may differ materially depending on a variety of important factors, including those risk factors discussed under “Trends, Risks and Uncertainties”, many of

which are also beyond the Company's control. You should not place undue reliance on these forward-looking statements, which speak only as of the date of this report. The Company does not undertake any obligation to update or release any revisions to these forward-looking statements to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events, except to the extent such updates and/or revisions are required by applicable law.

Critical Accounting Policies and Estimates

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

Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with Staff Accounting Bulletin No. 104, Revenue Recognition (“SAB104”), which superseded Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements (“SAB101”). SAB 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on management’s judgments regarding the fixed nature of the selling prices of the products delivered and the collectibility of those amounts. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. The Company defers any revenue for which the product has not been delivered or is subject to refund until such time that the Company and the customer jointly determine that the product has been delivered or no refund will be required. SAB 104 incorporates Emerging Issues Task Force 00-21 (“EITF 00-21”), Multiple-Deliverable Revenue Arrangements. EITF 00-21 addresses accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

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

MST accounts for the revenue, costs and expense related to residential cable services as the related services are performed in accordance with SFAS No. 51, Financial Reporting by Cable Television Companies. Installation revenue for residential cable services is recognized to the extent of direct selling costs incurred. Direct selling costs have exceeded installation revenue in all reported periods. Generally, credit risk is managed by disconnecting services to customers who are delinquent. The capitalized cost of this equipment is depreciated from three to ten years, on a straight-line basis down to the Company’s original estimate of the projected value of the equipment at the end of the scheduled lease term and appears on the balance sheet in “Cable and Related Equipment.”

Management identifies a delinquent customer based upon the delinquent payment status of an outstanding invoice, generally greater than 30 days past due. The delinquent account designation does not trigger an accounting transaction until such time the account is deemed uncollectible. Accounts are deemed uncollectible on a case-by-case basis, at management’s discretion, based upon an examination of the communication with the delinquent customer and payment history. Typically, accounts are only escalated to “uncollectible” status after multiple attempts have been made to communicate with the customer. The allowance for doubtful accounts is determined by examining the reserve history and any outstanding invoices that are over 30 days past due as of the end of the reporting period.

Guarantees and Product Warranties

FASB Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others” (“FIN 45”), requires that, upon issuance of a guarantee, the guarantor must disclose and recognize a liability for the fair value of the obligation it assumes under that guarantee.

The Company’s guarantees were issued subject to the recognition and disclosure requirements of FIN 45 as of September 30, 2008 and December 31, 2007. The Company records a liability for potential warranty claims. 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. During the nine months ended September 30, 2008 and the year ended December 31, 2007, the Company experienced approximately three percent of units returned under its product warranty policy. As of September 30, 2008 and December 31, 2007, the Company recorded warranty liabilities in the amount of \$130,883 and \$102,534, respectively, using this experience factor.

New Accounting Pronouncements

In March 2008, the Financial Accounting Standards Board (FASB) issued Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 requires companies to provide enhanced disclosures regarding derivative instruments and hedging activities and requires companies to better convey the purpose of derivative use in terms of the risks they intend to manage. Disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS No. 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect a company's financial position, financial performance, and cash flows are required. SFAS 161 retains the same scope as SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, and is effective for fiscal years and interim periods beginning after November 15, 2008. We do not expect the adoption of SFAS No. 161 to have a material impact, if any, on our consolidated financial statements.

In February 2008, the FASB issued a FASB Staff Position (FSP) on Accounting for Transfers of Financial Assets and Repurchase Financing Transactions (FSP FAS 140-3). This FSP addresses the issue of whether the transfer of financial assets and the repurchase financing transactions should be viewed as two separate transactions or as one linked transaction. The FSP includes a rebuttable presumption that the two transactions are linked unless the presumption can be overcome by meeting certain criteria. The FSP will be effective for fiscal years beginning after November 15, 2008 and will apply only to original transfers made after that date; early adoption will not be allowed. We do not expect the adoption of FSP FAS 140-3 to have a material impact, if any, on our consolidated financial statements.

Revenues

The Company's revenue is derived from product sales and recurring (lease) revenue in the commercial, government and international markets of the Telkonet Segment. MST revenue is derived from Quad-Play services provided to a subscriber portfolio of MDU properties with bulk service agreements and/or access licenses to service the individual subscribers in metropolitan New York.

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

| | September 30, 2008 | | Three Months Ended September 30, 2007 | | Variance | |
|-------------------|--------------------|------|--|------|--------------|-----|
| Product | \$ 3,964,419 | 69% | \$ 3,005,144 | 65% | \$ 959,275 | 32% |
| Recurring (lease) | 1,763,396 | 31% | 1,583,633 | 35% | 179,764 | 11% |
| Total | \$ 5,727,815 | 100% | \$ 4,588,777 | 100% | \$ 1,139,039 | 25% |

| | September 30, 2008 | | Nine Months Ended September 30, 2007 | | Variance | |
|-------------------|--------------------|------|---|------|--------------|-----|
| Product | \$ 11,333,574 | 69% | \$ 6,269,079 | 66% | \$ 5,064,495 | 81% |
| Recurring (lease) | 4,977,799 | 31% | 3,232,574 | 34% | 1,745,226 | 54% |
| Total | \$ 16,311,373 | 100% | \$ 9,501,653 | 100% | \$ 6,809,721 | 72% |

Product revenue

The Telkonet Segment product revenue principally arises from the sale and installation of broadband networking and energy management equipment, including the Telkonet iWire System™ to commercial resellers, and directly to customers in the hospitality, government and international markets. The Telkonet iWire System™ consists of the Telkonet Gateway, the Telkonet Extender, the patented Telkonet Coupler, and the Telkonet iBridge. The Telkonet SmartEnergy energy management solution consists of thermostats, sensors and controllers.

For the three and nine months ended September 30, 2008, product revenue in the Telkonet Segment was approximately \$3,838,000 and \$10,821,000, respectively, and increased by 24% and 73% when compared to the prior year period. Telkonet Segment product revenue for the three and nine months ended September 30, 2008 includes approximately \$1,619,000 and \$6,501,000 attributed to the sale of energy management products, and approximately \$1,733,000 and \$3,363,000 of products and services to the hospitality market. We anticipate a continued consistent upward trend of quarterly growth in the energy management and hospitality markets. The release of our Series 5 product suite in March 2008 provides significant opportunities for increased PLC sales in the utility and government markets.

The MST Segment product revenue arises from the sale of equipment, installations and ancillary services provided to customers independent of the subscriber model. Product revenue in this segment for the three and nine months ended September 30, 2008 was approximately \$127,000 and \$512,000, respectively, and increased by 36% and 96% when compared to the prior year period.

Recurring (lease) Revenue

The recurring revenue in the Telkonet segment includes over 2,500 hotels in our broadband network portfolio, and we currently support over 200,000 HSIA rooms, with over 2 million monthly users. For the three and nine months ended September 30, 2008, recurring revenue was approximately \$897,000 and \$2,560,000, respectively, and increased by 48% when compared to the nine months ended September 30, 2007. We anticipate growth to our subscriber base as we deploy additional sites under contract.

The recurring revenue for the MST Segment subscriber base increased by approximately \$184,000 and \$914,000, respectively, for the three and nine months ended September 30, 2008 compared to 2007 as a result of subscriber growth and the acquisition of Newport Telecommunications Co. in July 2007. The MST Segment subscriber portfolio includes approximately 22 MDU properties with bulk service agreements and/or access licenses to service the individual subscribers in metropolitan New York.

Cost of Sales

| | September 30, 2008 | | Three Months Ended September 30, 2007 | | Variance | |
|-------------------|--------------------|-----|--|-----|------------|-----|
| Product | \$ 2,165,379 | 55% | \$ 2,139,034 | 68% | \$ 26,345 | 1% |
| Recurring (lease) | 1,355,985 | 77% | 1,229,985 | 84% | 126,000 | 10% |
| Total | \$ 3,521,364 | 61% | \$ 3,369,019 | 73% | \$ 152,345 | 5% |

| | September 30, 2008 | | Nine Months Ended September 30, 2007 | | Variance | |
|-------------------|--------------------|-----|---|------|--------------|-----|
| Product | \$ 7,124,696 | 63% | \$ 4,503,983 | 71% | \$ 2,620,713 | 58% |
| Recurring (lease) | 3,975,648 | 80% | 3,177,386 | 102% | 798,262 | 25% |
| Total | 11,100,344 | 68% | \$ 7,681,369 | 81% | \$ 3,418,975 | 45% |

Product Costs

The Telkonet Segment product costs include equipment and installation labor related to the sale of broadband networking and energy management equipment, including the Telkonet iWire System™. For the three and nine months ended September 30, 2008, product costs in the Telkonet Segment were approximately \$2,077,000 and \$6,801,000, respectively, and increased by 1% and 59% when compared to the prior year periods. Telkonet Segment product costs have increased in connection with the increased sales to the hospitality, energy management and government markets.

The MST Segment product costs primarily consist of equipment and installation labor for installation and ancillary services provided to customers. For the three and nine months ended September 30, 2008, product costs for the MST segment amounted to approximately \$89,000 and \$324,000, respectively.

Recurring (lease) Costs

For the three and nine months ended September 30, 2008, recurring costs for the Telkonet segment were approximately \$417,000 and \$1,275,000, respectively, and increased by 33% when compared to the nine months ended September 30, 2007. This increase is primarily due to the increase in recurring revenue for the Telkonet Segment and the addition of Ethostream's customer service and support infrastructure, including an internal call center, to support the Telkonet Segment's customer portfolio.

The MST Segment's recurring costs amounted to approximately \$939,000 and \$2,701,000, respectively, for the three and nine months ended September 30, 2008. These costs consist of customer support, programming and amortization of the capitalized costs to support the subscriber revenue. Although MST's programming fees are a significant portion of the cost, MST continues to pursue competitive agreements and volume discounts in conjunction with the anticipated growth of the subscriber base. The customer support costs include build-out of the support services necessary to develop and support the build-out of the Quad-Play subscriber base in metropolitan New York. The capitalized costs are amortized over the lease term and include equipment and installation labor.

Gross Profit

| | September 30, 2008 | Three Months Ended September 30, 2007 | Variance |
|--|--------------------|--|----------|
|--|--------------------|--|----------|

Edgar Filing: TELKONET INC - Form 10-Q

| | | | | | | |
|-------------------|--------------|-----|--------------|-----|------------|------|
| Product | \$ 1,799,040 | 45% | \$ 866,110 | 29% | \$ 932,930 | 108% |
| Recurring (lease) | 407,411 | 23% | 353,648 | 22% | 53,764 | -15% |
| Total | \$ 2,206,451 | 39% | \$ 1,219,758 | 27% | \$ 986,694 | 81% |

| | September 30, 2008 | | Nine Months Ended September 30, 2007 | | Variance | |
|-------------------|--------------------|-----|---|-----|--------------|--------|
| Product | \$ 4,208,878 | 37% | \$ 1,765,096 | 28% | \$ 2,443,782 | 138% |
| Recurring (lease) | 1,002,151 | 20% | 55,188 | 2% | 946,964 | 1,716% |
| Total | \$ 5,211,029 | 32% | \$ 1,820,284 | 19% | \$ 3,390,746 | 186% |

Product Gross Profit

The gross profit for the three and nine months ended September 30, 2008 increased compared to the prior year period as a result of product sales and installations in the Telkonet Segment and represented 46% and 37% of product revenue, respectively. We anticipate an increase in our gross profit trend for product sales as energy management, utility and government market opportunities expand. Additionally, the integration of acquired companies has resulted in opportunities to internalize installation services and streamline processes.

Recurring (lease) Gross Profit

The Telkonet Segment's gross profit associated with recurring (lease) revenue increased for the three and nine months ended September 30, 2008, and represented approximately 54% and 50%, respectively, of recurring (lease) revenue. The centralized remote monitoring and management platform and internal call support center will provide the platform to maintain and expand gross profit for the Telkonet Segment's recurring revenue.

The MST Segment's gross profit represented approximately -4% and -3%, respectively, of total revenue for the three and nine months ended September 30, 2008, compared to the prior year period, primarily due to programming costs and the support infrastructure. MST anticipates that an expanded subscriber base utilizing the current infrastructure and reduced programming costs will facilitate increased gross profit.

Operating Expenses

| | September 30, 2008 | Three Months Ended September 30, 2007 | | Variance |
|-------|--------------------|--|----------------|----------|
| Total | \$ 4,525,565 | \$ 6,301,640 | \$ (1,776,075) | -28% |

| | September 30, 2008 | Nine Months Ended September 30, 2007 | | Variance |
|-------|--------------------|---|----------------|----------|
| Total | \$ 14,559,112 | \$ 16,948,853 | \$ (2,389,743) | -14% |

During the three and nine months ended September 30, 2008, operating expenses for the Telkonet Segment were approximately \$2,930,000 and \$10,338,000, and decreased by -37% and -23%, respectively, when compared to the prior year periods. The Company has achieved significant operating efficiencies since the acquisition of SSI and Ethostream in March 2007 primarily as a result of the organizational realignment initiated in the fourth quarter of 2007.

During the three and nine months ended September 30, 2008, operating expenses for the MST Segment were approximately \$1,596,000 and \$4,221,000, respectively. For the three months ended September 30, 2008, operating expenses decreased by -5% and for the nine months ended September 30, 2008, operating expenses increased by 10%, when compared to the prior year periods. The MST Segment expenses were impacted in the third quarter 2008 by a one-time non-cash charge of \$330,000 for the impairment write-down of MST's fixed assets.

Research and Development

| | September 30, 2008 | Three Months Ended September 30, 2007 | | Variance |
|-------|--------------------|--|--------------|----------|
| Total | \$ 509,418 | \$ 646,848 | \$ (137,430) | -21% |

| | September 30, 2008 | Nine Months Ended September 30, 2007 | | Variance |
|-------|--------------------|---|-------------|----------|
| Total | \$ 1,667,229 | \$ 1,736,656 | \$ (69,427) | -4% |

Telkonet's research and development costs related to both present and future products are expensed in the period incurred. Total expenses decreased for the three months and nine months ended September 30, 2008 by approximately \$137,000 and \$69,000, or -21% and -4%, respectively. The Research and Development costs are associated with the development of the Series 5 product suite and the integration of new applications to the Telkonet iWire System, and the development of Telkonet SmartEnergy product suite. The Company does not anticipate significant cost increases throughout 2008.

Selling, General and Administrative Expenses

| | Three Months Ended | | Variance |
|-------|--------------------|--------------------|---------------------|
| | September 30, 2008 | September 30, 2007 | |
| Total | \$ 3,111,570 | \$ 4,553,161 | \$ (1,441,591) -32% |

| | Nine Months Ended | | Variance |
|-------|--------------------|--------------------|---------------------|
| | September 30, 2008 | September 30, 2007 | |
| Total | \$ 10,317,209 | \$ 13,057,979 | \$ (2,740,770) -21% |

Selling, general and administrative expenses decreased for the three and nine months ended September 30, 2008 over the comparable prior year by approximately \$1,442,000 and \$2,741,000, or -32% and -21%, respectively. This decrease is primarily the result of the efficiencies in the organization resulting in salary and related costs reductions as well as reduced travel costs, professional fees and rent and related costs for the Telkonet Segment as compared to the prior year period. We expect to maintain a consistent quarterly selling, general and administrative expenses as compared to the three months ended September 30, 2008 during the remainder of 2008.

Backlog

The Telkonet Segment maintains contracts and monthly services for more than 2,500 hotels which are expected to generate approximately \$3,600,000 annual recurring support and internet advertising revenue. In addition Telkonet has approximately 33 agreements under contract in the HSIA market, and the total contracted HSIA installations currently amount to approximately \$200,000, excluding monthly services. The current HSIA backlog trends on a 4-8 week delivery.

The Telkonet Segment has maintained certain purchase orders relating to a major utilities energy management initiative provided through the two selected providers. The current order backlog amounts to approximately \$800,000 and the estimated remaining program value amounts to \$4,500,000 for products and services to be provided through March 2010. In addition, the Company recently contracted a similar energy efficiency program in Wisconsin estimated to achieve 5,000 rooms and establish offerings within utility programs nationally.

The MST subscriber portfolio includes approximately 22 MDU properties with bulk service agreements and/or access licenses to service the individual subscribers in metropolitan New York. The remaining terms of the access agreements provide MST access rights from 7 to 15 years with the final agreement expiring in 2016 and the revenues to be recognized under non-cancelable bulk agreements provide a minimum of \$1,720,000 in revenue through 2013.

Liquidity and Capital Resources

Working Capital

Our working capital decreased by \$1,729,931 during the nine months ended September 30, 2008 from a working capital deficit of \$(2,990,664) at December 31, 2007 to a working capital deficit of \$(4,720,596) at September 30, 2008. The decrease in working capital for the nine months ended September 30, 2008 is due to a combination of factors, of which the significant factors include:

- Cash had a net decrease from working capital by \$1,479,590 for the nine months ended September 30, 2008. The most significant uses and proceeds of cash were:

- o Approximately \$4,184,000 of cash consumed directly in operating activities
- o A private placement from the sale of 2,500,000 shares of common stock at \$0.60 per share provided proceeds of \$1,500,000.
- o A repayment of a Senior Note in the amount of \$1,500,000 issued to GRQ Consultants, Inc.
- o A sale of convertible debentures for proceeds of \$1,000,000 and \$2,500,000 in May and July 2008, respectively.

Of the total current assets of \$4,385,478 as of September 30, 2008, cash represented \$149,993. Of the total current assets of \$7,004,168 as of December 31, 2007, cash represented \$1,629,583.

Convertible Debenture

On May 30, 2008, the Company entered into a Securities Purchase Agreement with YA Global Investments, L.P. (the "Buyer") pursuant to which the Company agreed to issue and sell to the Buyer up to \$3,500,000 of secured convertible debentures (the "Debentures") and warrants to purchase (the "Warrants") up to 2,500,000 shares of the Company's Common Stock, par value \$0.001 per share (the "Common Stock"). The sale of the Debentures and Warrants was effectuated in three separate closings, the first of which occurred on May 30, 2008, and the remainder of which occurred in July 2008. At the May 30, 2008 closing, the Company sold Debentures having an aggregate principal value of \$1,500,000 and Warrants to purchase 2,100,000 shares of Common Stock. In July 2008, the Company sold the remaining Debentures having an aggregate principal value of \$2,000,000 and Warrants to purchase 400,000 shares of Common Stock.

The Debentures accrue interest at a rate of 13% per annum and mature on May 29, 2011. The Debentures may be redeemed at any time, in whole or in part, by the Company upon payment by the Company of a redemption premium equal to 15% of the principal amount of Debentures being redeemed, provided that an Equity Conditions Failure (as defined in the Debentures) is not occurring at the time of such redemption. The Buyer may also convert all or a portion of the Debentures at any time at a price equal to the lesser of (i) \$0.58, or (ii) ninety percent (90%) of the lowest volume weighted average price of the Company's Common Stock during the ten (10) trading days immediately preceding the conversion date. The Warrants expire five years from the date of issuance and entitle the Buyers to purchase shares of the Company's Common Stock at a price per share of \$0.61.

Senior Note Payable

On July 24, 2007, Telkonet entered into a Senior Note Purchase Agreement with GRQ Consultants, Inc. pursuant to which the Company issued to GRQ a Senior Promissory Note in the aggregate principal amount of \$1,500,000. The Note was due and payable on the earlier to occur of (i) the closing of the Company's next financing, or (ii) January 28, 2008, and bore interest at a rate of six (6%) percent per annum. The Company incurred approximately \$25,000 in fees in connection with this transaction. The net proceeds from the issuance of the Note were used for general working capital needs. In connection with the issuance of the Note, the Company also issued to GRQ warrants to purchase 359,712 shares of common stock at \$4.17 per share. These warrants expire five years from the date of issuance. On February 8, 2008, this note was repaid in full including \$49,750 in interest from the issuance date through the date of repayment.

Convertible Senior Debentures-MST

In May 2007, MST issued Debentures having a principal value of \$6,576,350, plus an original issue discount of \$526,350, in exchange for \$6,050,000 from investors, exclusive of placement fees. The original issue discount to the MST Debentures is amortized over 12 months. The MST Debentures accrue interest at 8% per annum commencing on the first anniversary of the original issue date of the MST Debentures, payable quarterly in cash or common stock, at MST's option, and mature on April 30, 2010. The MST Debentures are not callable and are convertible at a conversion price of \$0.65 per share into 10,117,462 shares of MST common stock, subject to certain limitations.

In connection with the placement of the MST Debentures, MST also issued to the MST Debenture holders, five-year warrants to purchase an aggregate of 5,058,730 shares of MST common stock at an exercise price of \$1.00 per share. In connection with the issuance of the MST Debentures, MST incurred placement fees of \$423,500. Additionally, MST issued its placement agents five-year warrants to purchase 708,222 shares of MST common stock at an exercise price of \$1.00 per share. On February 11, 2008, the MST Debenture holders executed a letter agreement with MSTI waiving their rights to receive any potential liquidated damages under the registration rights agreement executed in connection with this transaction in exchange for a reduction in their warrant exercise price from \$1.00 to

\$0.65.

The purchase agreement executed in connection with the May 2007 private offering of convertible debentures (the “Debentures”) and warrants to purchase common stock (the “Warrants”) prohibits MST from directly or indirectly, among other things, creating or incurring any indebtedness (other than Permitted Indebtedness, as such term is defined in the Purchase Agreement) without the consent of the holders of at least 85% of the principal amount of outstanding Debentures.

On October 16, 2008, the Purchasers executed a letter agreement (the “Letter Agreement”) with MST pursuant to which, among other things:

- (i) the Purchasers consented to the issuance of additional debentures in the aggregate principal amount of \$352,631 (the “Additional Debentures”);
- (ii) the Purchasers consented to the issuance of 2 million shares of common stock along with the additional debentures;
- (iii) the Purchasers consented to the issuance of up to \$2.0 million of shares of the Company’s common stock and the same number of common stock purchase warrants at a purchase price of at least \$0.125 per share;
- (iv) the Maturity Date of the Additional Debentures will be automatically extended to April 30, 2010, as same may be accelerated pursuant to the terms of the Additional Debentures upon the occurrence of both the following conditions: (i) the non-occurrence of an Event of Default (as defined in the Additional Debenture) or an event which with the passage of time or the giving of notice could become an Event of Default, and (ii) the receipt of net proceeds by the Company from a Qualified Offering (as defined in the Letter Agreement); and
- (v) The Purchase Agreement was amended to include the Additional Debentures and the shares issuable upon the conversion of the Additional Debentures.

Related Party Promissory Note

On May 6, 2008, Telkonet executed a Promissory Note in the aggregate principal amount of \$400,000. The Note was due and payable on the earlier to occur of (i) the closing of the Company's next financing, or (ii) November 6, 2008. In connection with the issuance of the Note, the Company issued warrants to purchase 800,000 shares of Telkonet common stock at \$0.60 per share. These warrants expire five years from the date of issuance. The note was repaid in July 2008.

Acquisition of Microwave Satellite Technologies, Inc. (MST)

On January 31, 2006, the Company acquired a 90% interest in MST from Frank Matarazzo, the sole stockholder of MST in exchange for \$1.8 million in cash and 1.6 million unregistered shares of the Company's common stock for an aggregate purchase price of \$9,000,000. The cash portion of the purchase price was paid in two installments, \$900,000 at closing and \$900,000 in February 2007. The stock portion is payable from shares held in escrow, 400,000 shares of which were paid at closing and the remaining 1,200,000 shares of which shall be issued based on the achievement of 3,300 "Triple Play" subscribers over a three year period. As of November 1, 2008, the Company has issued 800,000 shares of the purchase price contingency. In the event the Company's common stock price is below \$4.50 per share upon the final issuance of shares from escrow, a pro rata adjustment in the number of shares will be required to support the aggregate consideration of \$5.4 million. As of May 1, 2008, the Company's common stock price was below \$4.50. To the extent that the market price of the Company's common stock is below \$4.50 per share upon issuance of the shares from escrow, the number of shares issuable on conversion is ratably increased, which could result in further dilution of the Company's stockholders.

In April 2008, the Company released from escrow 200,000 shares of the purchase price contingency. In June 2008, the Company released from escrow an additional 400,000 shares in exchange for Mr. Matarazzo's agreement to a debt covenant contained in the transaction documents executed in connection with the debenture financing with YA Global Investments LP which prohibits the use of the proceeds obtained in the debt financing to fund MST.

Acquisition of Smart Systems International (SSI)

On March 9, 2007, the Company acquired substantially all of the assets of Smart Systems International (SSI), a leading provider of energy management products and solutions to customers in the United States and Canada for cash and Company common stock having an aggregate value of \$6,875,000. The purchase price was comprised of \$875,000 in cash and 2,227,273 shares of the Company's common stock.

Of the stock issued in the transaction, 1,090,909 shares were held in an escrow account for a period of one year following the closing from which certain potential indemnification obligations under the purchase agreement could be satisfied. The aggregate number of shares held in escrow was subject to adjustment upward or downward depending upon the trading price of the Company's common stock during the one year period following the closing date. On March 12, 2008, the Company released these shares from escrow and issued an additional 1,882,225 shares on June 12, 2008 pursuant to the adjustment provisions of the SSI asset purchase agreement.

Acquisition of Ethostream, LLC

On March 15, 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 purchase price of \$11,756,097 was comprised of \$2.0 million in cash and 3,459,609 shares of the Company's common stock. The entire stock portion of the purchase price was deposited into escrow upon closing to satisfy certain

potential indemnification obligations of the sellers under the purchase agreement. The shares held in escrow are distributable over the three years following the closing. As of November 10, 2008, 876,804 shares remain in escrow pursuant to the purchase agreement.

Proceeds from the issuance of common stock

During the nine months ended September 30, 2008, the Company issued 2,500,000 shares of common stock valued at \$0.60 per share for an aggregate purchase price of \$1,500,000. The proceeds of this offering were used to repay the principal of the Senior Promissory Note to GRQ.

Cashflow analysis

Cash utilized in operating activities was \$4,094,908 during the nine months ended September 30, 2008 compared to \$12,591,264 in the previous comparable period. The primary use of cash during the nine months ended September 30, 2008 was for operating activities.

[For the remainder of fiscal 2008, our primary capital needs are for operating expenses, including funds to support our business strategy, which primarily includes working capital necessary to fund inventory purchases. We anticipate funding our operations through working capital generated by the following: (i) cash flow from sales of our products; (ii) reducing our inventory levels and managing our operating expenses; (iii) maximizing our trade payables with our domestic and international suppliers; (iv) increasing collection efforts on existing accounts receivables; and (v) utilizing our receivable and inventory-based agreements.]

The Company utilized cash for investing activities of \$1,008,719 and \$6,499,669 during the nine months ended September 30, 2008 and 2007, respectively. During the nine months ended September 30, 2008, these expenditures were primarily due to the purchase of equipment under operating lease by MST. In 2007, these expenditures primarily arose from the payment of the cash portion of the MST purchase price of \$900,000, cash payments of \$875,000 and \$2,000,000, for the acquisitions of SSI and Ethostream, respectively, and \$1,020,000 for the acquisition of Newport Telecommunications in July 2007 by our MST subsidiary. The cost of equipment under operating leases amounted to \$999,718 and \$1,162,832 for the nine months ended September 30, 2008 and 2007, respectively. Purchases of property and equipment amounted to \$80,407 and \$266,280 for the nine months ended September 30, 2008 and 2007, respectively.

The Company had cash from financing activities of \$3,624,037 and \$19,029,482 during the nine months ended September 30, 2008 and 2007, respectively. The financing activities involved the sale of 2.5 million shares of common stock at \$0.60 per share for a total of \$1,500,000, in February 2008, the proceeds of which were used to repay the outstanding principal amount on the GRQ Note. Additionally, the Company sold debentures for gross proceeds of \$3,500,000 in May and July 2008, and the Company received a \$400,000 loan from a board member, which was offset by \$462,511 in financing costs paid. During the nine months ended September 30, 2007, the financing activities represented proceeds of \$9,610,000, net of placement fees, from the sale of 4.0 million shares of common stock at \$2.50 per share, the issuance of a senior note payable in the principal amount of \$1,500,000 and proceeds from the exercise of stock options and warrants of \$111,960. Through its majority-owned subsidiary MSTI Holdings, Inc., the Company raised \$5,303,238 through the sale of debentures, and \$2,694,020 through the sale of common stock, during the nine months ended September 30, 2007.

We are reducing cash required for operations by reducing operating costs and staff levels. In addition, we are working to manage our current liabilities while we continue to make changes in operations to improve our cash flow and liquidity position.

Our registered independent certified public accountants have stated in their report dated March 31, 2008, that we have incurred operating losses in the past years, and that we are dependent upon management's ability to develop profitable operations. These factors, among others, may raise substantial doubt about our ability to continue as a going concern.

While we have raised capital to meet our working capital and financing needs, additional financing is required in order to meet our current and projected cash flow requirements from operations and development. Additional investments are being sought, but we cannot guarantee that we will be able to obtain such investments on favorable terms or at all. 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 downturn in the U.S. stock and debt markets 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 which we may not be able to obtain. 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.

Inflation

We do not believe that inflation has had a material effect on our business, financial condition or results of operations. If our costs were to become subject to significant inflationary pressures, we may not be able to fully offset such higher costs through price increases. Our inability or failure to do so could adversely affect our business, financial condition and results of operations.

Acquisition or Disposition of Property and Equipment

During the nine months ended September 30, 2008, fixed assets and costs of equipment under operating leases increased \$999,718 primarily from purchases of equipment for the MST Quad-Play build-out. The remainder is related to computer equipment and peripherals used in day-to-day operations. The Company anticipates significant expenditures in the MST Segment to continue the build-out the head-end equipment, IPTV and other related projects. The Telkonet Segment does not anticipate the sale or purchase of any significant property, plant or equipment during the next twelve months, other than the purchase of computer equipment and peripherals to be used in the Company's day-to-day operations.

In April 2005, the Company entered into a three-year lease agreement for 6,742 square feet of commercial office space in Crystal City, Virginia. Pursuant to this lease, the Company agreed to assume a portion of the build-out cost for this facility. In February 2007, the Company agreed to sub-lease the Crystal City, Virginia office through the remaining term of the contract resulting in a loss of approximately \$192,000. This lease terminated in March 2008.

MST presently leases 12,600 square feet of commercial office space in Hawthorne, New Jersey for its office and warehouse spaces. This lease will expire in April 2010.

Following the acquisitions of Smart Systems International and Ethostream, the Company assumed leases on 9,000 square feet of office space in Las Vegas, NV for Smart Systems International on a month to month basis and 4,100 square feet of office space in Milwaukee, WI for Ethostream. The Ethostream lease expires in May 2011. The Las Vegas, NV office lease expired on April 30, 2008.

Number of Employees

As of November 1, 2008, the Company had 140 full time employees.

Disclosure of Contractual Obligations

| Contractual obligations | Total | Payment Due by Period | | | |
|--|----------------------|-----------------------|-------------------|----------------|-------------------|
| | | Less than 1 year | 1-3 years | 3-5 years | More than 5 years |
| Long-Term Debt Obligations | \$ 9,922,872 | 475,000 | 9,447,872 | - | - |
| Capital Lease Obligations | \$ 207,959 | 8,296 | 129,945 | 69,718 | - |
| Operating Lease Obligations | \$ 1,664,861 | 527,532 | 597,878 | 280,752 | 258,699 |
| Purchase Obligations (1) | \$ 184,200 | 184,200 | - | - | - |
| Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet Under GAAP | \$ - | - | - | - | - |
| Total | \$ 11,979,892 | 1,195,028 | 10,175,695 | 350,470 | 258,699 |

(1) Purchase commitment for inventory orders of energy management products through December 2008. The Company has prepaid approximately \$39,000 as of November 1, 2008.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Short Term Investments

Our excess cash is held in money market accounts in a bank and brokerage firms both of which are nationally ranked top tier firms with an average return of approximately 400 basis points. Due to the conservative nature of our investment portfolio, an increase or decrease of 100 basis points in interest rates would not have a material effect on our results of operations or the fair value of our portfolio.

Marketable Securities

Telkonet maintained investments in two publicly-traded companies for the nine months ended September 30, 2008. The Company has classified these securities as available for sale. Such securities are carried at fair market value. Unrealized gains and losses on these securities, if any, are reported as accumulated other comprehensive income (loss), which is a separate component of stockholders' equity. Unrealized losses of \$2,776,304 were recorded for the nine months ended September 30, 2008 and there were no unrealized gains or losses for the nine months ended September 30, 2007. Realized gains and losses and declines in value judged to be other than temporary on securities

available for sale, if any, are included in operations. There were no realized gains or losses for the nine months ended September 30, 2008 and 2007.

Investments in Privately Held Companies

We have invested in a privately held company, which is in the startup or development stage. This investment is inherently risky because the market for the products of this company is developing and may never materialize. As a result, we could lose our entire initial investment in this company. In addition, we could also be required to hold our investment indefinitely, since there is presently no public market in the securities of this company and none is expected to develop. This investment is carried at cost, which as of November 1, 2008 was \$8,000 and recorded in other assets in the Consolidated Balance Sheet.

Item 4. Controls and Procedures.

As of September 30, 2008, the Company performed an evaluation, under the supervision and with the participation of management, including the Chief Executive Officer and Chief Financial Officer (Principal Accounting Officer), of the effectiveness of the design and operation of its disclosure controls and procedures as defined in Rules 13a - 15(e) or 15d - 15(e) promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information required to be included in the Company's periodic filings with the U.S. Securities and Exchange Commission. During the nine months ended September 30, 2008, there was no change in the Company's internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

On July 2, 2008, Ethostream was named as a defendant in Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc., et al, filed in the Eastern District of Texas. The suit names 22 defendants and claims that the defendants' services, including those of Ethostream infringe a wireless network security patent held by Linksmart. Linksmart is seeking a judgment for damages (including statutory enhanced damages), costs, expenses and prejudgment and post-judgment interest and a permanent injunction enjoining the defendants from infringing its patent. In connection with a Vendor Direct Supplier Agreement between Ethostream and WWC Supplier Services, Inc., the Company has determined that it owes the duty to defend and indemnify Defendant Ramada Worldwide, Inc. and it has assumed Ramada's defense. The Company believes the claim is without merit and intends to vigorously defend the allegations.

Item 1A. Risk Factors.

The Company's results of operations, financial condition and cash flows can be adversely affected by various risks. These risks include, but are not limited to, the principal factors listed below and the other matters set forth in this quarterly report on Form 10-Q. You should carefully consider all of these risks.

The Company has a history of operating losses and an accumulated deficit and expects to continue to incur losses for the foreseeable future.

Since inception through September 30, 2008, the Company has incurred cumulative losses of \$103,047,408 and has never generated enough funds through operations to support its business. Additional capital may be required in order to provide working capital requirements for the next twelve months.

A significant portion of our total assets consists of goodwill, which is subject to a periodic impairment analysis and a significant impairment determination in any future period could have an adverse effect on our results of operations even without a significant loss of revenue or increase in cash expenses attributable to such period.

We have goodwill totaling approximately \$14.7 million at September 30, 2008 resulting from recent and past acquisitions. We evaluate this goodwill for impairment based on the fair value of the operating business units to which this goodwill relates at least once a year. This estimated fair value could change if we are unable to achieve operating results at the levels that have been forecasted, the market valuation of those business units decreases based on transactions involving similar companies, or there is a permanent, negative change in the market demand for the services offered by the business units. These changes could result in an impairment of the existing goodwill balance that could require a material non-cash charge to our results of operations.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

Edgar Filing: TELKONET INC - Form 10-Q

On June 26, 2008, the Company held its annual meeting of stockholders at which the Company's stockholders elected five (5) directors, voted to approve an amendment to the Company's Articles of Incorporation to increase the number of authorized shares and ratified the appointment of the Company's independent accountants for 2008.

The following directors were elected at the annual meeting based on the number of votes indicated below. Each director was elected to serve until the next annual meeting of stockholders or until his successor is elected and qualified.

| Director Name | For | Against | Abstain | Broker Non-votes |
|--------------------|------------|---------|------------|------------------|
| Warren V. Musser | 47,259,165 | 0 | 10,554,291 | 0 |
| Thomas C. Lynch | 48,327,292 | 0 | 9,486,164 | 0 |
| Thomas M. Hall | 48,214,790 | 0 | 9,598,666 | 0 |
| Anthony J. Paoni | 48,363,692 | 0 | 9,449,764 | 0 |
| Seth D. Blumenfeld | 45,014,560 | 0 | 12,798,896 | 0 |

The stockholders also ratified the appointment of the Company's independent accountants for 2008 and approved the proposed amendment to the Company's Articles of Incorporation increasing the number of shares the Company is authorized to issue from 100,000,000 shares to 130,000,000 shares. The Amendment to the Company's Articles of Incorporation was filed with the Secretary of State of the State of Utah and became effective on June 27, 2008.

The other matters presented at the meeting were approved by the Company's stockholders as follows:

| Matter Voted Upon | For | Against | Abstain | Broker Non-votes |
|---|------------|-----------|-----------|------------------|
| Ratification of Independent Accountants | 54,243,483 | 894,714 | 2,675,259 | 0 |
| Amendment to Articles of Incorporation | 14,534,182 | 4,094,270 | 919,753 | 38,265,251 |

Item 5. Other Information.

None.

Item 6. Exhibits.

| Exhibit Number | Description Of Document |
|----------------|--|
| 2.1 | MST Stock Purchase Agreement and Amendment (incorporated by reference to our 8-K filed on February 2, 2006) |
| 2.2 | Asset Purchase Agreement by and between Telkonet, Inc. and Smart Systems International, dated as of February 23, 2007 (incorporated by reference to our Form 8-K filed on March 2, 2007) |
| 2.3 | Unit Purchase Agreement by and among Telkonet, Inc., Ethostream, LLC and the members of Ethostream, LLC dated as of March 15, 2007 (incorporated by reference to our Form 8-K filed on March 16, 2007) |
| 3.1 | Articles of Incorporation of the Registrant (incorporated by reference to our Form 8-K (No. 000-27305), filed on August 30, 2000 and our Form S-8 (No. 333-47986), filed on October 16, 2000) |
| 3.2 | Amendment to Articles of Incorporation |
| 3.3 | Bylaws of the Registrant (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003) |
| 4.1 | Form of Series A Convertible Debenture (incorporated by reference to our Form 10-KSB (No. 000-27305), filed on March 31, 2003) |
| 4.2 | Form of Series A Non-Detachable Warrant (incorporated by reference to our Form 10-KSB (No. 000-27305), filed on March 31, 2003) |
| 4.3 | Form of Series B Convertible Debenture (incorporated by reference to our Form 10-KSB (No. 000-27305), filed on March 31, 2003) |
| 4.4 | Form of Series B Non-Detachable Warrant (incorporated by reference to our Form 10-KSB (No. 000-27305), filed on March 31, 2003) |
| 4.5 | Form of Senior Note (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003) |
| 4.6 | Form of Non-Detachable Senior Note Warrant (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003) |
| 4.7 | Senior Convertible Note by Telkonet, Inc. in favor of Portside Growth & Opportunity Fund (incorporated by reference to our Form 8-K (No. 001-31972), filed on October 31, 2005) |
| 4.8 | Senior Convertible Note by Telkonet, Inc. in favor of Kings Road Investments Ltd. (incorporated by reference to our Form 8-K (No. 001-31972), filed on October 31, 2005) |
| 4.11 | Warrant to Purchase Common Stock by Telkonet, Inc. in favor of Portside Growth & Opportunity Fund (incorporated by reference to our Form 8-K (No. 001-31972), filed on October 31, 2005) |
| 4.12 | Warrant to Purchase Common Stock by Telkonet, Inc. in favor of Kings Road Investments Ltd. (incorporated by reference to our Form 8-K (No. 001-31972), filed on October 31, 2005) |
| 4.13 | Form of Warrant to Purchase Common Stock (incorporated by reference to our Current Report on Form 8-K (No. 001-31972), filed on September 6, 2006) |
| 4.14 | Form of Accelerated Payment Option Warrant to Purchase Common Stock (incorporated by reference to our Registration Statement on Form S-3 (No. 333-137703), filed on September 29, 2006. |
| 4.15 | |

Edgar Filing: TELKONET INC - Form 10-Q

| | |
|-------|---|
| | Form of Warrant to Purchase Common Stock (incorporated by reference to our Current Report on Form 8-K filed on February 5, 2007) |
| 4.16 | Senior Note by Telkonet, Inc. in favor of GRQ Consultants, Inc. |
| 4.17 | Warrant to Purchase Common Stock by Telkonet, Inc in favor of GRQ Consultants, Inc |
| 4.18 | Form of Promissory Note (incorporated by reference to our Form 8-K (No. 001-31972) filed on May 12, 2008. |
| 4.19 | Form of Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K (No. 001-31972) filed on May 12, 2008. |
| 4.20 | Form of Convertible Debenture (incorporated by reference to our Form 8-K (No. 001-31972) filed on June 5, 2008. |
| 4.21 | Form of Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K (No. 001-31972) filed on June 5, 2008. |
| 10.1 | Amended and Restated Telkonet, Inc. Incentive Stock Option Plan (incorporated by reference to our Registration Statement on Form S-8 (No. 333-412), filed on April 17, 2002) |
| 10.2 | Employment Agreement by and between Telkonet, Inc. and Frank T. Matarazzo, dated as of February 1, 2006 (incorporated by reference to our Form 10-K (No. 001-31972), filed March 16, 2006) |
| 10.3 | Settlement Agreement by and among Telkonet, Inc. and Kings Road Investments Ltd., dated as of August 14, 2006 (incorporated by reference to our Form 8-K (No. 001-31972), filed on August 16, 2006) |
| 10.4 | Settlement Agreement by and among Telkonet, Inc. and Portside Growth & Opportunity Fund, dated as of August 14, 2006 (incorporated by reference to our Form 8-K (No. 001-31972), filed on August 16, 2006) |
| 10.5 | Securities Purchase Agreement, dated August 31, 2006, by and among Telkonet, Inc., Enable Growth Partners LP, Enable Opportunity Partners LP and Pierce Diversified Strategy Master Fund LLC, Ena (incorporated by reference to our Form 8-K (No. 001-31972), filed on September 6, 2006) |
| 10.6 | Registration Rights Agreement, dated August 31, 2006, by and among Telkonet, Inc., Enable Growth Partners LP, Enable Opportunity Partners LP and Pierce Diversified Strategy Master Fund LLC, Ena (incorporated by reference to our Form 8-K (No. 001-31972), filed on September 6, 2006) |
| 10.7 | Securities Purchase Agreement, dated February 1, 2007, by and among Telkonet, Inc., Enable Growth Partners LP, Enable Opportunity Partners LP, Pierce Diversified Strategy Master Fund LLC, Ena, Hudson Bay Fund LP and Hudson Bay Overseas Fund, Ltd. (incorporated by reference to our Current Report on Form 8-K filed on February 5, 2007) |
| 10.8 | Registration Rights Agreement, dated February 1, 2007, by and among Telkonet, Inc., Enable Growth Partners LP, Enable Opportunity Partners LP and Pierce Diversified Strategy Master Fund LLC, Ena, Hudson Bay Fund LP and Hudson Bay Overseas Fund, Ltd. (incorporated by reference to our Current Report on Form 8-K filed on February 5, 2007) |
| 10.09 | Employment Agreement by and between Telkonet, Inc. and Jason Tienor, dated as of March 15, 2007(incorporated by reference to our Form 10-K (No. 001-31972), filed March 16, 2007) |
| 10.10 | Employment Agreement by and between Telkonet, Inc. and Jeff Sobieski, dated as of March 15, 2007(incorporated by reference to our Form 10-K (No. 001-31972), filed March 16, 2007) |
| 10.11 | Securities Purchase Agreement, dated May 30, 2008, by and between Telkonet, Inc. and YA Global Investments LP (incorporated by reference to our Current Report on Form 8-K filed on June 5, 2008) |

Edgar Filing: TELKONET INC - Form 10-Q

- | | |
|-------|---|
| 10.12 | Registration Rights Agreement, dated May 30, 2008, by and between Telkonet, Inc. and YA Global Investments LP (incorporated by reference to our Current Report on Form 8-K filed on June 5, 2008) |
| 10.13 | Security Agreement, dated May 30, 2008, by and between Telkonet, Inc. and YA Global Investments LP (incorporated by reference to our Current Report on Form 8-K filed on June 5, 2008) |
| 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 J. Leimbach |
| 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 J. Leimbach pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

SIGNATURES

In accordance with 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 10, 2008

By:

/s/ Jason L. Tienor
Jason L. Tienor
Chief Executive Officer