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TELKONET INC
Form 10QSB
November 15, 2004

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

FORM 10QSB

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

For the period ended September 30, 2004

Commission file number 000-27305

TELKONET, INC.
(Name of Small Business Issuer in Its Charter)

Utah
(State of Incorporation)

87-0627421
(IRS Employer Identification No.)

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

(240) 912-1800
Issuer's Telephone Number

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 44,065,642 shares of Common Stock (\$.001 par value) as of November 9, 2004.

Transitional small business disclosure format: Yes No

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TELKONET, INC.

QUARTERLY REPORT ON FORM 10-QSB FOR THE
QUARTERLY PERIOD ENDING SEPTEMBER 30, 2004

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Item 1. Financial Statements (Unaudited)

TELKONET, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

| | (Unaudited) September 30 |
|--|-----------------------------|
| | ----- |
| ASSETS | |
| CURRENT ASSETS: | |
| Cash and cash equivalents | \$ 15,422, |
| Accounts Receivable: trade and other, net of allowance for doubtful accounts of \$13,000 and \$7,000 at September 30, 2004 and December 31, 2003, respectively | 28, |
| Inventory (Note F) | 1,533, |
| Prepaid expenses and deposits | 112, |
| | ----- |
| Total current assets | 17,096, |
| PROPERTY AND EQUIPMENT: | |
| Furniture and equipment, at cost | 631, |
| Less: accumulated depreciation | 112, |
| | ----- |
| Total property and equipment, net | 519, |
| EQUIPMENT UNDER OPERATING LEASES: | |

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| | |
|---|---------------------|
| Capitalized equipment, at cost | 400, |
| Less: accumulated depreciation | 45, |
| | ----- |
| Total equipment under operating leases, net | 355, |
| OTHER ASSETS: | |
| Deposits | 76, |
| | ----- |
| TOTAL ASSETS | \$ 18,047, ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | |
| CURRENT LIABILITIES: | |
| Accounts payable and accrued liabilities | \$ 1,288, |
| Customer deposits | 21, |
| Capital leases | |
| | ----- |
| Total current liabilities | 1,310, |
| LONG TERM LIABILITIES: | |
| Convertible debentures, net of discounts - including related parties (Note B) | 129, |
| Senior notes payable (Note C) | 450, |
| Deferred lease liability | 20, |
| | ----- |
| Total long term liabilities | 600, |
| COMMITMENTS AND CONTINGENCIES | |
| STOCKHOLDERS' EQUITY : | |
| Preferred stock, par value \$.001 per share; 15,000,000 shares authorized; none issued at September 30, 2004 and December 31, 2003 (Note E) | |
| Common stock, par value \$.001 per share; 100,000,000 shares authorized; 44,033,743 and 30,689,522 shares issued and outstanding at September 30, 2004 and December 31, 2003, respectively (Note E) | 44, |
| Additional paid-in-capital | 39,869, |
| Accumulated deficit | (23,777, |
| | ----- |
| Stockholders' equity | 16,136, |
| | ----- |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 18,047, ===== |

See accompanying footnotes to the unaudited condensed consolidated financial

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TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENTS OF LOSSES
(UNAUDITED)

| | For The Three Months Ended September 30, 2004 ---- | September 30, 2003 ---- | For The Nine 200 ---- |
|--------------|--|-------------------------------|-----------------------------|
| Net Revenues | \$ 79,335 | \$ 13,848 | \$ 49 |

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| | | | |
|--|----------------|----------------|----------|
| Cost of Sales | 68,873 | 4,216 | 48 |
| | ----- | ----- | ----- |
| Gross Profit | 10,462 | 9,632 | |
| Costs and Expenses: | | | |
| Research and Development | 417,663 | 367,374 | 1,26 |
| Selling, General and Administrative | 2,071,889 | 1,030,794 | 5,23 |
| Consulting Fees (Note E) | -- | -- | 2,50 |
| Non-Employee Stock Options and Warrants (Note D) | 155,875 | 188,988 | 62 |
| Depreciation and Amortization | 22,227 | 18,704 | 5 |
| | ----- | ----- | ----- |
| Total Operating Expense | 2,667,654 | 1,605,860 | 9,67 |
| Loss from Operations | (2,657,192) | (1,596,228) | (9,66 |
| Other Income (Expenses): | | | |
| Interest Income | 36,328 | -- | 8 |
| Interest Expense | (20,411) | (393,825) | (8 |
| | ----- | ----- | ----- |
| Total Other Income (Expenses) | 15,917 | (393,825) | |
| Loss Before Provision for Income Taxes | (2,641,275) | (1,990,053) | (9,66 |
| Provision for Income Taxes | -- | -- | |
| | ----- | ----- | ----- |
| Net Loss | \$ (2,641,275) | \$ (1,990,053) | \$ (9,66 |
| | ===== | ===== | ===== |
| Loss per common share (basic and assuming dilution) | \$ (0.06) | \$ (0.09) | \$ |
| | ===== | ===== | ===== |
| Weighted average common shares outstanding | 43,890,515 | 20,962,065 | 40,67 |

See accompanying footnotes to the unaudited condensed consolidated financial

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TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
FOR THE PERIOD FROM JANUARY 1, 2004 TO SEPTEMBER 30, 2004
(UNAUDITED)

| | Preferred Shares | Preferred Stock Amount | Common Shares | Common Stock Amount | Addit Paid in |
|--|---------------------|------------------------------|------------------|------------------------|------------------|
| BALANCE AT JANUARY 1, 2004 | -- | -- | 30,689,522 | \$ 30,690 | \$ 16,4 |
| Shares issued for employee stock options exercised at approximately \$1.02 per share | -- | -- | 356,333 | 356 | 3 |
| Shares issued in exchange for non-employee options exercised at \$1.00 per share | -- | -- | 255,416 | 255 | 2 |
| Shares issued to consultants in exchange for services rendered | | | | | |

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| | | | | | |
|---|-------|-------|------------|-----------|---------|
| at approximately \$3.07 per share | -- | -- | 62,302 | 62 | 1 |
| Shares issued for senior note conversion at \$2.10 per share (Note C) | -- | -- | 1,209,038 | 1,209 | 2,5 |
| Shares issued in connection with private placement at \$2.00 per share, net of costs | -- | -- | 6,387,600 | 6,388 | 12,7 |
| Shares issued to consultants for warrants exercised at \$2.54 per share | -- | -- | 37,500 | 38 | |
| Shares issued to noteholders for warrants exercised at \$1.00 per share | -- | -- | 3,978,450 | 3,978 | 3,9 |
| Shares issued to noteholders for cashless warrants exercised | -- | -- | 203,751 | 204 | |
| Shares issued for cashless exercise of underwriter warrants | -- | -- | 165,116 | 165 | |
| Shares issued in exchange for convertible debentures at \$0.50 per share (Note B) | -- | -- | 124,000 | 124 | |
| Shares issued in exchange for convertible debentures at \$0.55 per share (Note B) | -- | -- | 200,001 | 200 | 1 |
| Shares issued in exchange for accrued interest on convertible debentures (Note B) | -- | -- | 42,999 | 43 | |
| Shares issued to an employee in exchange for services at approximately \$2.80 per share | -- | -- | 27,000 | 27 | |
| Shares issued to consultants in exchange for consulting fees at \$2.50 per share | -- | -- | 1,000,000 | 1,000 | 2,4 |
| Founders shares returned and canceled in connection with January 2002 capital restructure | -- | -- | (705,285) | (705) | |
| Write-off of beneficial conversion features and warrants attached to convertible debentures in connection with conversion of Debenture-1 and Series B debentures (Note B) | -- | -- | -- | -- | (1 |
| Stock options and warrants granted to consultants in exchange for services rendered (Note D) | -- | -- | -- | -- | 6 |
| Net Loss | -- | -- | -- | -- | |
| BALANCE AT SEPTEMBER 30, 2004 | \$ | \$ | 44,033,743 | \$ 44,034 | \$ 39,8 |
| | ===== | ===== | ===== | ===== | ===== |

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See accompanying footnotes to the unaudited condensed consolidated financial statements

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

| | For The Nine Months Ended |
|---|---------------------------|
| | 2004 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | |
| Net loss from operating activities | \$ (9,660,440) |
| Adjustments to reconcile net loss from operations to cash used in operating activities | |
| Amortization of debt discount - beneficial conversion feature of convertible debentures | 16,416 |
| Amortization of debt discount - value of warrants attached to convertible debentures | 7,614 |
| Stock options and warrants issued in exchange for services rendered (Note D) | 620,965 |
| Common stock issued in exchange for services rendered (Note E) | 267,489 |
| Common stock issued in exchange for conversion of interest (Note B) | 23,276 |
| Common stock issued in exchange for consulting fees | 2,500,000 |
| Depreciation and amortization | 93,274 |
| (Increase) decrease in: | |
| Accounts receivable | 29,930 |
| Inventory | (925,327) |
| Prepaid expenses and deposits | (420) |
| Accounts payable and accrued expenses, net | 658,826 |
| Deferred lease liability | 20,608 |
| NET CASH (USED IN) OPERATING ACTIVITIES | (6,347,789) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | |
| Costs of equipment under operating leases | (366,774) |
| Purchase of property and equipment, net | (447,126) |
| NET CASH (USED IN) INVESTING ACTIVITIES | (813,900) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | |
| Proceeds from sale of common stock, net of costs (Note E) | 12,726,843 |
| Proceeds from (repayments of) stockholder advances | -- |
| Proceeds from issuance of convertible debentures, net of costs (Note B) | -- |
| Proceeds from issuance of senior notes, net of costs (Note C) | -- |
| Repayment of loans | -- |
| Proceeds from exercise of warrants attached to notes payable (Note E) | 4,073,700 |
| Proceeds from exercise of employee and non-employee stock options and warrants | 620,249 |
| Payment of capital leases | (15,000) |
| NET CASH PROVIDED BY FINANCING ACTIVITIES | 17,405,792 |
| NET INCREASE IN CASH AND EQUIVALENTS | 10,244,103 |
| CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD | 5,177,918 |

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CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD

\$ 15,422,021
=====

See accompanying footnotes to the unaudited condensed consolidated financial informat

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

For The Nine Months Ended

2004

Supplemental Disclosures of Cash Flow Information

| | | |
|---|-----------|-----|
| Cash paid during the period for interest | \$ 90,747 | \$ |
| Income taxes paid | -- | |
| Non-cash transactions: | | |
| Issuance of stock options and warrants in exchange for services rendered (Note D) | 620,965 | 4 |
| Issuance of stock warrants in exchange for financing costs (Note D) | -- | |
| Common stock issued for services rendered | 267,489 | 3 |
| Common stock issued in exchange for interest (Note B and E) | 23,276 | 2 |
| Common stock issued in exchange for consulting services (Note E) | 2,500,000 | |
| Common stock issued in exchange for conversion of Senior Notes (Note C) | 2,539,000 | 2,0 |
| Common stock issued in exchange for convertible debentures (Note B) | 172,000 | 3,7 |
| Notes payable issued in connection with capital lease | -- | |
| Write-off of beneficial conversion feature of conversion of debenture (Note B) | 134,134 | |
| Write-off of value of warrants attached to debenture in connection with conversion (Note B) | 531 | |
| Beneficial conversion feature on convertible debentures (Note B) | -- | 1,7 |
| Value of warrants attached to convertible debentures (Note B) | -- | 2 |

See accompanying footnotes to the unaudited condensed consolidated financial informati

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TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
SEPTEMBER 30, 2004
(UNAUDITED)

NOTE A - SUMMARY OF ACCOUNTING POLICIES

General

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions to Form 10-QSB. Accordingly, they do not include all of the information and

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footnotes required by generally accepted accounting principles for complete financial statements.

In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Accordingly, the results from operations for the nine-month period ended September 30, 2004, are not necessarily indicative of the results that may be expected for the year ended December 31, 2004. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated December 31, 2003 financial statements and footnotes thereto included in the Company's Form 10-KSB for the year ended December 31, 2003.

Basis of Presentation

Telkonet, Inc. (the "Company"), formerly Comstock Coal Company, Inc., was formed on November 3, 1999 under the laws of the state of Utah. The Company was a "development stage enterprise" (as defined in statement of Financial Accounting Standards No. 7) until December 31, 2003. The Company is engaged in the business of developing, producing and marketing proprietary equipment enabling the transmission of voice and data over electric utility lines.

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

Reclassification

Certain reclassifications have been made to conform prior periods' data to the current presentation. These reclassifications had no effect on reported losses.

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 \$13,000 and \$7,000 at September 30, 2004 and December 31, 2003, respectively.

Stock Based Compensation

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure-an amendment of SFAS 123." This statement amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25 and related interpretations. Accordingly, compensation expense for stock options is measured as the excess, if any, of the fair market value of the Company's stock at the date of the grant over the exercise price of the related option. The Company has adopted the annual disclosure provisions of SFAS No. 148 in its financial reports for the year ended December 31, 2003 and has adopted the interim disclosure provisions for its financial reports for the subsequent periods.

TELKONET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
 SEPTEMBER 30, 2004
 (UNAUDITED)

NOTE A - SUMMARY OF ACCOUNTING POLICIES

Stock Based Compensation (Continued)

Had compensation costs for the Company's stock options been determined based on the fair value at the grant dates for the awards, the Company's net loss and losses per share would have been as follows (transactions involving stock options issued to employees and Black-Scholes model assumptions are presented in Note D):

| | For the three months ended September 30, | |
|--|---|----------------|
| | 2004 | 2003 |
| | ---- | ---- |
| Net loss - as reported | \$ (2,641,275) | \$ (1,990,053) |
| Add: Total stock based employee compensation expense as reported under intrinsic value method (APB. No. 25) | -- | -- |
| Deduct: Total stock based employee compensation expense as reported under fair value based method (SFAS No. 123) | (1,104,254) | (1,053,747) |
| | ----- | ----- |
| Net loss - Pro Forma | \$ (3,745,529) | \$ (3,043,800) |
| Net loss attributable to common stockholders - Pro forma | \$ (3,745,529) | \$ (3,043,800) |
| Basic (and assuming dilution) loss per share - as reported | \$ (0.06) | \$ (0.09) |
| Basic (and assuming dilution) loss per share - Pro forma | \$ (0.09) | \$ (0.15) |

Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with Staff Accounting Bulletin No. 104, REVENUE RECOGNITION ("SAB104"), which superceded 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

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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. The effect of implementing EITF 00-21 on the Company's consolidated financial position and results of operations was not significant.

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, together with the initial direct costs of installation and support are capitalized, and appear on the balance sheet as "Equipment Under Operating Leases". The capitalized cost of this equipment is depreciated from two to five 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.

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TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
SEPTEMBER 30, 2004
(UNAUDITED)

NOTE B - CONVERTIBLE PROMISSORY NOTES PAYABLE

A summary of convertible promissory notes payable at September 30, 2004 and December 31, 2003 is as follows:

| | September 30, 2004 | December 31, 2003 |
|---|--------------------|-------------------|
| Convertible notes payable ("Debenture-1"), in quarterly installments of interest only at 8% per annum, unsecured and due three years from the date of the note with the latest maturity May 2005; Noteholder has the option to convert unpaid note principal, together with accrued and unpaid interest, to the Company's common stock at a rate of \$.50 per share six months after issuance | \$ -- | \$ 62,000 |
| Debt Discount - beneficial conversion feature, net of accumulated amortization of \$0 and \$41,411 at September 30, 2004 and December 31, 2003, respectively | -- | (24,718) |
| Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of \$0 and \$3,605 at September 30, 2004 and December 31, 2003, respectively | -- | (2,116) |
| | -- | 35,166 |
| Convertible notes payable ("Series B Debenture"), in quarterly installments of interest only at 8% per annum, unsecured and due three years from the date of the note with the latest maturity February 2006; Noteholder has the option to convert unpaid note | | |

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| | | |
|---|------------|------------|
| principal, together with accrued and unpaid interest, to the Company's common stock at a rate of \$.55 per share six months after issuance | 210,000 | 320,000 |
| Debt Discount - beneficial conversion feature, net of accumulated amortization of \$43,777 and \$75,426 at September 30, 2004 and December 31, 2003, respectively | (54,715) | (180,546) |
| Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of \$20,303 and \$13,194 at September 30, 2004 and December 31, 2003, respectively | (25,385) | (31,415) |
| | ----- | ----- |
| | 129,900 | 108,039 |
| | ----- | ----- |
| Total | \$ 129,900 | \$ 143,205 |
| | ----- | ----- |
| Less: current portion | -- | -- |
| | ----- | ----- |
| | \$ 129,900 | \$ 143,205 |
| | ===== | ===== |

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TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
SEPTEMBER 30, 2004
(UNAUDITED)

NOTE B - CONVERTIBLE PROMISSORY NOTES PAYABLE (CONTINUED)

Convertible Debentures

During the year ended December 31, 2001, the Company issued convertible promissory notes (the "Debenture-1") to Company officers, shareholders, and sophisticated investors in exchange for \$940,000, exclusive of placement costs and fees. The Debenture-1 accrues interest at 8% per annum and is due and payable three years from the date of the note with the latest maturity date of November 2004. The noteholders have the option to convert any unpaid note principal, together with accrued and unpaid interest, to the Company's common stock at a rate of \$.50 per share beginning six months after issuance. In accordance with EMERGING ISSUES TASK FORCE ISSUE 98-5, ACCOUNTING FOR CONVERTIBLE SECURITIES WITH A BENEFICIAL CONVERSION FEATURES OR CONTINGENTLY ADJUSTABLE CONVERSION RATIOS ("EITF 98-5"), the Company recognized an imbedded beneficial conversion feature present in the Debenture-1 note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid in capital. The Company recognized and measured an aggregate of \$837,874 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 Debenture-1. The debt discount attributed to the beneficial conversion feature is amortized over the Debenture-1's maturity period (three years) as interest expense.

In connection with the placement of the Debenture-1 notes, the Company issued non-detachable warrants granting the holders the right to acquire, in the aggregate, 940,000 shares of the Company's common stock at \$1.00 per share. In

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accordance with EMERGING ISSUES TASK FORCE ISSUE 00-27, APPLICATION OF ISSUE NO. 98-5 TO CERTAIN CONVERTIBLE INSTRUMENTS ("EITF 00-27"), the Company recognized the value attributable to the warrants in the amount of \$77,254 to additional paid-in capital and a discount against the Debenture-1. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 1.25%, a dividend yield of 0%, and volatility of 26%. The debt discount attributed to the value of the warrants issued is amortized over the Debenture-1's maturity period (three years) as interest expense.

During the year ended December 31, 2002, the Company issued the Debenture-1 to Company officers, shareholders, and sophisticated investors in exchange for \$749,100, exclusive of placement costs and fees. The Debenture-1 accrues interest at 8% per annum and is due and payable three years from the date of the note with the latest maturity date of May 2005. Noteholders have the option to convert any unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of \$.50 per share beginning six months after issuance.

In accordance with EITF 98-5, the Company recognized an imbedded beneficial conversion feature present in the Debenture-1 note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid in capital. The Company recognized and measured an aggregate of \$693,018 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 Debenture-1. The debt discount attributed to the beneficial conversion feature is amortized over the Debenture-1's maturity period (three years) as interest expense.

In connection with the placement of the Debenture-1 notes in 2002, the Company issued non-detachable warrants granting the holders the right to acquire, in the aggregate, 749,100 shares of the Company's common stock at \$1.00 per share. In accordance with EITF 00-27, the Company recognized the value attributable to the warrants in the amount of \$56,082 to additional paid in capital and a discount against the Debenture-1. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 1.67%, a dividend yield of 0%, and volatility of 26%. The debt discount attributed to the value of the warrants issued is amortized over the Debenture-1's maturity period (three years) as interest expense.

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TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
SEPTEMBER 30, 2004
(UNAUDITED)

NOTE B - CONVERTIBLE PROMISSORY NOTES PAYABLE (CONTINUED)

Series B Debentures

In 2002, the Company issued convertible promissory notes (the "Series B Debentures") to Company officers, shareholders, and sophisticated investors in exchange for \$472,900, exclusive of placement costs and fees. The Series B Debentures accrue interest at 8% per annum and are due and payable three years from the date of the note with the latest maturity date of December 2005. Noteholders have the option to convert any unpaid note principal, together with accrued and unpaid interest, to the Company's common stock at a rate of \$.55 per share beginning six months after issuance.

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In accordance with EITF 98-5, the Company recognized an imbedded beneficial conversion feature present in the Series B Debenture note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of \$147,859 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 Series B Debentures. The debt discount attributed to the beneficial conversion feature is amortized over the Series B Debentures maturity period (three years) as interest expense.

In connection with the placement of the Series B Debentures in 2002, the Company issued non-detachable warrants granting the holders the right to acquire, in the aggregate, 472,900 shares of the Company's common stock at \$1.00 per share. In accordance with EITF 00-27 the Company recognized the value attributable to the warrants in the amount of \$68,595 to additional paid in capital and a discount against the Series B Debentures. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 1.67%, a dividend yield of 0%, and volatility of 26%. The debt discount attributed to the value of the warrants issued is amortized over the Series B Debentures maturity period (three years) as interest expense.

In 2003, the Company issued convertible Series B Debentures to Company officers, shareholders, and sophisticated investors in exchange for \$2,027,100, exclusive of placement costs and fees. The Series B Debentures accrue interest at 8% per annum and are payable and due three years from the date of the note with the latest maturity date of February 2006. Noteholders have the option to convert any unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of \$.55 per share beginning six months after issuance.

In accordance with EITF 98-5, the Company recognized an imbedded beneficial conversion feature present in the Series B Debenture note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of \$1,761,675 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 Series B Debentures. The debt discount attributed to the beneficial conversion feature is amortized over the Series B Debentures maturity period (three years) as interest expense.

In connection with the placement of the Series B Debenture notes in 2003, the Company issued non-detachable warrants granting the holders the right to acquire, in the aggregate, 2,027,100 shares of the Company's common stock at \$1.00 per share. In accordance with EITF 00-27, the Company recognized the value attributable to the warrants in the amount of \$265,425 to additional paid in capital and a discount against the Series B Debentures. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 1.25%, a dividend yield of 0%, and volatility of 26%. The debt discount attributed to the value of the warrants issued is amortized over the Series B Debentures maturity period (three years) as interest expense.

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NOTE B - CONVERTIBLE PROMISSORY NOTES PAYABLE (CONTINUED)

The Company amortized the Debenture 1 and the Series B Debenture debt discount attributed to the beneficial conversion feature and the value of the attached warrants and recorded non-cash interest expense of \$24,030 and \$714,832 for the nine months ended September 30, 2004 and 2003, respectively.

During the year ended December 31, 2003, the Debenture-1 noteholders demanded registration of that number of common shares of the Company sufficient to cover the conversion of their debentures and exercise of the attached warrants. Accordingly, the Company notified the Series B Debenture noteholders, Senior noteholders (Note C) and warrant holders with piggy-back registration rights of their right to participate in the registration. During the year ended December 31, 2003, the Company issued an aggregate of 7,217,836 shares of common stock in connection with the conversion of \$1,627,100 aggregate principal amount of the Debenture-1 and \$2,180,000 aggregate principal amount of the Series B Debentures. The Company also issued an aggregate of 525,403 shares of common stock in exchange for accrued interest of \$195,148 and \$85,586 for Debenture 1 and Series B Debentures, respectively. During the nine months ended September 30, 2004, the Company issued an aggregate of 324,001 shares of common stock in connection with the conversion of \$62,000 aggregate principal amount of the Debenture-1 and \$110,000 aggregate principal amount of the Series B Debentures. The Company also issued an aggregate of 42,999 shares of common stock in exchange for accrued interest of \$23,276 for Debenture 1 and Series B Debentures (see Note E).

In connection with the conversion of Debenture-1 and Series B Debentures, the Company wrote off the unamortized debt discount attributed to the beneficial conversion feature and the value of the attached warrants in the amount of \$2,046,479 and \$296,470, respectively, as of December 31, 2003, and an additional \$134,134 and \$531, respectively, during the nine months ended September 30, 2004.

NOTE C - SENIOR NOTES PAYABLE

In the second quarter of 2003, the Company issued Senior Notes to Company officers, shareholders, and sophisticated investors in exchange for \$5,000,000, exclusive of placement costs and fees. The Senior Notes are denominated in units of \$100,000, accrue interest at 8% per annum and are due three years from the date of issuance with the latest maturity date of June 2006. Attached to each Senior Note are warrants to purchase 125,000 shares of common stock. The warrants have a three-year contractual life and are exercisable immediately after the issuance of the Senior Note at an exercise price of \$1.00 per share. The Senior Notes are secured by a first priority security interest in all intellectual property assets of the Company. The Company plans to use the proceeds from the Senior Notes for expansion of sales, marketing and strategic partnership programs, building required infrastructure and for working capital.

In September 2003, certain Senior noteholders elected to surrender their Senior Note as consideration for the exercise of warrants to purchase shares of common stock of the Company. The Company issued an aggregate of 2,011,000 restricted shares of common stock for warrants exercised at \$1.00 per share, in exchange for \$2,011,000 of Senior Notes. The aggregate value of the Senior Notes outstanding as of December 31, 2003, including accrued but unpaid interest, was \$2,989,000.

In January 2004, certain noteholders elected to convert \$2,539,000 of their senior notes into Company restricted shares of common stock at a conversion price of \$2.10 per share. The remaining outstanding senior notes as of September 30, 2004 after the conversion is \$450,000.

NOTE D - STOCK OPTIONS AND WARRANTS

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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.

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TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
SEPTEMBER 30, 2004
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NOTE D - STOCK OPTIONS AND WARRANTS (CONTINUED)

Employee Stock Options (Continued)

| Exercise Prices ----- | Options Outstanding ----- | | | Options Exercisable ----- |
|--------------------------|------------------------------|--|--|------------------------------|
| | Number Outstanding ----- | Weighted Average Remaining Contractual Life (Years) ----- | Weighted Average Exercise Price ----- | |
| \$1.00 - \$1.99 | 6,346,000 | 7.73 | \$ 1.00 | 4,115,518 |
| \$2.00 - \$2.99 | 1,960,666 | 9.37 | \$ 2.26 | 499,750 |
| \$3.00 - \$3.99 | 945,000 | 10.02 | \$ 3.44 | 65,850 |
| | ----- | ----- | ----- | ----- |
| | 9,251,666 | 8.29 | \$ 1.53 | 4,681,118 |
| | ===== | ===== | ===== | ===== |

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

| | Number of Shares ----- | Weighted Average Price Per Share ----- |
|--|---------------------------|---|
| Outstanding at January 1, 2002 | 1,055,000 | \$ 1.00 |
| Granted | 3,335,000 | 1.00 |
| Exercised | (1,000,000) | 1.00 |
| Cancelled or expired | (1,440,000) | 1.00 |
| | ----- | ----- |
| Outstanding at December 31, 2002 (as restated) | 1,950,000 | 1.00 |
| | ===== | ===== |
| Granted | 7,202,333 | 1.22 |
| Exercised | (109,333) | 1.01 |
| Cancelled or expired | (750,000) | 1.00 |
| | ----- | ----- |
| Outstanding at December 31, 2003 | 8,293,000 | \$ 1.19 |
| | ===== | ===== |
| Granted | 1,510,000 | 3.06 |
| Exercised | (356,333) | 1.02 |
| Cancelled or expired | (195,001) | 1.47 |
| | ----- | ----- |
| Outstanding at September 30, 2004 | 9,251,666 | \$ 1.53 |

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The weighted-average fair value of stock options granted to employees during the period ended September 30, 2004 and 2003 and the weighted-average significant assumptions used to determine those fair values, using a Black-Scholes option pricing model are as follows:

| | 2004 ---- | 2003 ---- |
|---|--------------|--------------|
| Significant assumptions (weighted-average): | | |
| Risk-free interest rate at grant date | 1.43% | 1.02% |
| Expected stock price volatility | 25% | 26% |
| Expected dividend payout | - | - |
| Expected option life-years (a) | 10 | 10 |

(a) The expected option life is based on contractual expiration dates.

If the Company recognized compensation cost for the non-qualified employee stock option plan in accordance with SFAS No. 123, the Company's pro forma net loss and net loss per share would have been \$(13,903,630) and \$(0.34) for the nine months ended September 30, 2004 and \$(7,794,650) and \$(0.44) for the nine months ended September 30, 2003, respectively.

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TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
SEPTEMBER 30, 2004
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NOTE D - STOCK OPTIONS AND WARRANTS (CONTINUED)

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 Price ----- | Options Outstanding ----- | | | Options Exercisable ----- |
|-------------------------|------------------------------|--|---|------------------------------|
| | Number Outstanding ----- | Weighted Average Remaining Contractual Life (Years) ----- | Weighed Average Exercise Price ----- | |
| \$ 1.00 | 2,012,084 | 7.62 | \$ 1.00 | 1,593,333 |

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

| | Number of Shares ----- | Weighted Average Price Per Share ----- |
|--------------------------------|---------------------------|---|
| Outstanding at January 1, 2002 | 246,502 | \$ 0. |
| Granted | 2,455,000 | 1. |
| Exercised | (1,146,502) | 0. |

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| | | |
|-----------------------------------|-------------|-------|
| Canceled or expired | - | |
| Outstanding at December 31, 2002 | 1,555,000 | 1. |
| Granted | 1,900,000 | 1. |
| Exercised | (187,500) | 0. |
| Canceled or expired | - | |
| Outstanding at December 31, 2003 | 3,267,500 | \$ 1. |
| Granted | - | |
| Exercised | (255,416) | 1. |
| Canceled or expired | (1,000,000) | 1. |
| Outstanding at September 30, 2004 | 2,012,084 | \$ 1. |

The estimated value of the non-employee stock options vested during the period ended September 30, 2004 was determined using the Black-Scholes option pricing model and the following assumptions: contractual term of 10 years, a risk free interest rate of 1.43%, a dividend yield of 0% and volatility of 25%. The amount of the expense charged to operations in connection with granting the options was \$603,527 and \$475,892 during the period ended September 30, 2004 and 2003, 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.

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TELKONET, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
 SEPTEMBER 30, 2004
 (UNAUDITED)

NOTE D - STOCK OPTIONS AND WARRANTS (CONTINUED)

Warrants (Continued)

| Exercise Prices | Warrants Outstanding | | | Warrants Exercisable |
|-----------------|----------------------|---|---------------------------------|----------------------|
| | Number Outstanding | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | |
| \$ 1.00 | 655,900 | 1.16 | \$ 1.00 | 655,900 |
| \$ 2.54 | 12,500 | 1.64 | \$ 2.54 | 12,500 |
| \$ 2.97 | 35,000 | 1.64 | \$ 2.97 | 35,000 |
| | 703,400 | 1.19 | \$ 1.13 | 703,400 |

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Transactions involving warrants are summarized as follows:

| | Number of Shares | Weighted Average Price Per Share |
|-----------------------------------|------------------|----------------------------------|
| | ----- | ----- |
| Outstanding at January 1, 2002 | 3,528,665 | \$ 0. |
| Granted | 1,667,460 | 0. |
| Exercised | (1,650,675) | 0. |
| Canceled or expired | (13,990) | 1. |
| | ----- | ----- |
| Outstanding at December 31, 2002 | 3,531,460 | \$ 0. |
| | ===== | ===== |
| Granted | 8,591,800 | 1. |
| Exercised | (6,963,770) | 0. |
| Canceled or expired | - | |
| | ----- | ----- |
| Outstanding at December 31, 2003 | 5,159,490 | \$ 1. |
| | ===== | ===== |
| Granted | - | |
| Exercised | (4,456,090) | 1. |
| Canceled or expired | - | |
| | ----- | ----- |
| Outstanding at September 30, 2004 | 703,400 | \$ 1. |
| | ===== | ===== |

The Company did not grant any compensatory warrants to non-employees during the period ended September 30, 2004. The estimated value of previously granted warrants vested during the period ended September 30, 2004 was determined using the Black-Scholes option pricing model and the following assumptions: contractual term of 10 years, a risk free interest rate of 1.43%, a dividend yield of 0% and volatility of 25%. Compensation expense of \$17,438 was charged to operations for the period ended September 30, 2004. The Company capitalized financing costs of \$87,217 for compensatory warrants granted in connection with placement of convertible debentures during the period ended September 30, 2003. The financing cost was amortized over the life of the convertible debentures and all unamortized financing cost was expensed upon the conversion of the convertible debentures during the year ended December 31, 2003.

NOTE E - CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock, par value \$.001 per share. As of September 30, 2004 and December 31, 2003, the Company has no preferred stock issued and outstanding. The Company has authorized 100,000,000 shares of common stock, par value \$.001 per share. As of September 30, 2004 and December 31, 2003, the Company had 44,033,743 and 30,689,522 shares of common stock issued and outstanding, respectively.

During the period ended September 30, 2004, the Company issued 356,333 shares of common stock for an aggregate purchase price of \$364,833 to certain employees upon exercise of employee stock options at approximately \$1.02 per share. Additionally, the Company issued 255,416 shares of common stock for an aggregate purchase price of \$255,416 to consultants upon exercise of non-employee stock options at approximately \$1.00 per share.

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NOTE E - CAPITAL STOCK

During the period ended September 30, 2004, the Company issued an aggregate of 62,302 shares of common stock, having an aggregate fair market value of \$191,815, to consultants in exchange for services rendered, which approximated the fair value of the shares issued during the period services were completed and rendered.

The Company issued an aggregate of 1,209,038 of restricted shares of common stock upon the election of certain senior note holders (see Note C) to convert their senior notes into equity at a conversion price of \$2.10 per share.

The Company issued 6,387,600 shares of its common stock for an aggregate purchase price of \$12,726,843, net of costs and fees.

The Company issued an aggregate of 3,978,450 shares of common stock upon the exercise of warrants at approximately \$1.00 per share and an aggregate of 203,751 shares of common stock in exchange for 253,203 outstanding warrants.

The Company issued an aggregate of 165,116 shares of common stock in exchange for 195,204 outstanding warrants. Additionally, the Company issued an aggregate of 37,500 shares of common stock to consultants pursuant to warrants exercised at \$2.54 per share.

The Company issued an aggregate of 324,001 shares of common stock in connection with the conversion of \$62,000 aggregate principal amount of the Debenture-1 and \$110,000 aggregate principal amount of the Series B Debentures. The Company also issued an aggregate of 42,999 shares of common stock in exchange for accrued interest of \$23,276 for Debenture 1 and Series B Debentures (Note B).

The Company issued an aggregate of 27,000 shares of common stock to an employee in exchange for \$75,674 of services rendered, which approximated the fair value of the shares issued during the period services were completed and rendered. Compensation costs of \$75,674 were charged to operations.

In March 2004, the Company entered into consulting agreements (the "Agreements") with Aware Capital Consultants, Inc. and Scarborough, Ltd. ("Consultants"). Pursuant to the Agreements, the Company issued an aggregate of 1,000,000 shares of its restricted common stock to Consultants in exchange for professional services rendered and to be rendered. In accordance with EMERGING ISSUES TASK FORCE ISSUE 96-18, ACCOUNTING FOR EQUITY INSTRUMENTS THAT ARE ISSUED TO OTHER THAN EMPLOYEES FOR ACQUIRING, OR IN CONJUNCTION WITH SELLING, GOODS OR SERVICES ("EITF 96-18"), the measurement date to determine fair value was the date at which a commitment for performance by the counter party to earn the equity instrument was reached. The Company valued the shares issued for consulting services at the rate which represents the fair value of the services received which did not differ materially from the value of the stock issued. Compensation cost of \$2,500,000 was charged to operations during the period ended September 30, 2004.

The Company reorganized its capital structure in January 2002 whereby the Company agreed to repurchase common stock held by the founders of the Company. All founders shares were returned and canceled in March 2002, except for 705,285 shares which remained outstanding, but were subject to repurchase by the Company pending receipt of the share certificate evidencing those shares. During the period ending September 30, 2004, the remaining 705,285 shares of founder's stock were returned to and canceled by the Company.

Share amounts presented in the consolidated balance sheets and consolidated statements of stockholders' equity reflect the actual share amounts outstanding

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for each period presented.

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TELKONET, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
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NOTE F - INVENTORIES

Inventories are stated at the lower of cost or market determined by the first-in, first-out (FIFO) method. Inventories primarily consist of Gateways, iBridges and Couplers, which are the significant components of the Telkonet solution. Components of inventories as of September 30, 2004 and December 31, 2003 are as follows:

| | September 30, 2004 | December 31, 2003 |
|----------------|--------------------|-------------------|
| Raw Materials | \$ 924,352 | \$ 374,794 |
| Finished Goods | 609,491 | 233,722 |
| | \$ 1,533,843 | \$ 608,516 |

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

The following should be read in conjunction with the Company's Consolidated Financial Statements and Notes thereto, included elsewhere within this Report.

Description of the Company

The Company was formed in 1999 to develop products for use in the powerline communications (PLC) industry. PLC products use existing electrical wiring in commercial buildings and residences to carry high speed data communications signals, including the Internet. Since the Company's formation, it has worked on the development and marketing of its PLC technology.

The Company's PLC technology, the "PlugPlus(TM)" product suite, consists of three separate components, the Gateway, the Coupler and the iBridge. The Gateway, the hub of the PlugPlus(TM) product suite, is a modular, self-contained unit that accepts data from an existing network on one port and distributes it via a second port. The Gateway integrates a communications processor that runs a series of proprietary applications under Linux. The signal generated by the Gateway can be directly coupled into low voltage wiring via the Coupler, which interfaces directly between the Gateway and the building's electrical panel. Multi-panel buildings typically require multiple Couplers, which are connected to the Gateway via inexpensive coaxial cable and concentrated using standard radio frequency splitters. A suite of software applications running on the Gateway can perform communications functions or system management functions. The iBridge serves as the user's network access device and connects to a user's personal computer through a standard Ethernet cable. The iBridge's AC line cord serves as its power source as well as its network interface. The Company also offers the eXtender, a fourth optional device, as part of its PlugPlus(TM) product suite. The eXtender is used to extend the reach of the Gateway in larger

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buildings or campus environments.

The PlugPlus(TM) product suite delivers data to the user at speeds in excess of 7 Mega bits per second (Mbps), with burst speeds of 12.6 Mbps. The PlugPlus(TM) product suite is installed by connecting an incoming broadband signal (DSL, TL, satellite or cable modem) into the Gateway and connecting the Gateway to a building's electrical panel using one or more Couplers. Once installed, the Gateway distributes the high-speed Internet signal throughout the entire existing network of electrical wires within the building. The user may access a high-speed Internet signal by plugging the iBridge into any electrical outlet and connecting a personal computer to the iBridge using the computer's built-in Ethernet port. Multiple personal computers connected to the iBridge can communicate with one another and can share a single broadband resource via the Gateway.

In September 2002, the Company confirmed through an independent, Federal Communications Commission (FCC) certified testing lab that its PLC product line meets the FCC technical requirements for Class A digital devices. In June 2003, the Company confirmed that its PLC product line also meets the requirements for Class B digital devices. As a result, no further testing of these products is required and the devices may be manufactured and marketed for commercial or residential use. The FCC permits the operation of unlicensed digital devices that radiate radio frequency emissions if the manufacturer complies with certain equipment authorization procedures, technical requirements, marketing restrictions and product labeling requirements.

The Company has applied for patents that cover its unique technology and has utilized the recently announced advancements in transmission speeds to build its next generation of products. The Company continues to identify, design and develop enhancements to its core technologies that will provide additional functionality, diversification of application and desirability for current and future users. The Company intends to protect this intellectual property by filing additional patent applications.

In September 2003, the Company received approval from the U.S. Patent and Trademark Office for its "Method and Apparatus for Providing Telephonic Communication Services" patent. Notwithstanding the issuance of this patent, there can be no assurance that any of the Company 's current or future patent applications will be granted, or, if granted, that such patents will provide necessary protection for the Company's technology or its product offerings, or be of commercial benefit to the Company.

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 or other 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

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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, 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.

Revenues

The Company emerged from its development stage as of December 31, 2003 and, therefore, there were no comparable revenues in the prior year. During the third quarter, the Company changed its sales model in the Hospitality and Multi-Dwelling markets from principally product sales to a recurring (lease) sales model. Accordingly, revenues are recognized over a three to five year term. The table below outlines product versus recurring (lease) revenues for each quarter in 2004:

| | 2004 | | | | | |
|-------------------|--------------|------|--------------|------|--------------|------|
| Revenue: | 1st. Quarter | | 2nd. Quarter | | 3rd. Quarter | |
| Recurring (lease) | \$20,309 | 14% | \$45,881 | 17% | \$69,209 | 87% |
| Product | 119,790 | 86% | 226,022 | 83% | 10,126 | 13% |
| Total | \$140,099 | 100% | \$271,903 | 100% | \$79,335 | 100% |

Recurring revenue:

As of September 30, 2004, revenue to be recognized under non-cancelable contracts (backlog) was approximately \$642,000 with a weighted average remaining term of approximately 31 months. The remaining costs to be amortized in connection with these contracts is approximately \$283,000.

Product revenue:

Product revenue during the quarter represents additional iBridges sold to existing customers.

Revenues to date have primarily been derived from the Hospitality and Multi-Dwelling business units. The Company has expanded its pilot programs in the International and Government markets and anticipates full deployment of its product upon successful product certification in each of these respective markets.

Costs and expenses

Overall expenses increased for the three and nine months ended September 30, 2004 over the comparable period in 2003 by \$1,061,794, or 66%, and \$5,403,878, or 127%, respectively. Excluding the fee paid pursuant to the Agreements with the Consultants of \$2,500,000, which was expensed during the second quarter, the increase in overall expenses for the nine months ended September 30, 2004 was

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\$2,903,878, or 68%. The overall increase is principally due to payroll and related costs for administrative sales and marketing increased advertising and trade show attendance and rent and related relocation costs for our corporate and sales offices.

Liquidity and Capital Resources

As of September 30, 2004, the Company's current assets exceeded current liabilities by \$15,786,376. Of the total current assets of \$17,096,739, cash represented \$15,422,021 of this amount as of September 30, 2004.

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While the Company believes it has sufficient capital to meet its working capital requirements for the next twelve months, additional financing may be required in order to meet growth opportunities in financing and/or investing activities. If additional capital is required and the Company is not successful in generating sufficient liquidity from operations or in raising sufficient capital resources on terms acceptable to the Company, this could have a material adverse effect on the Company's business, results of operations, liquidity and financial condition.

During the nine months ended September 30, 2004, the Company filed a Form S-3 Registration Statement with the Securities and Exchange Commission to register 15,560,495 shares of its common stock. These shares were issued primarily in conjunction with the conversion of \$2,539,000 aggregate principal amount of Senior Notes into common stock at \$2.10 per share in January 2004, a \$12.8 million private placement closed in February 2004 and the conversion of debentures and exercise of warrants in March 2004. The registration statement was declared effective by the SEC on April 24, 2004.

Product Research and Development

Company-sponsored research and development costs related to both present and future products are expended in the period incurred. Total expenses for the three and nine months ended September 30, 2004 increased over the comparable period in 2003 by \$50,289, or 14%, and \$298,943, or 31%, respectively. This increase was primarily related to an increase in salaries and related costs associated with the addition of full-time employees and costs related to independent lab testing and certification of the Company's product.

Selling, General and Administrative

Selling, general and administrative expenses increased for the three and nine months ended September 30, 2004 over the comparable period in 2003 by \$1,041,095 or 100% and \$2,510,652 or 92%, respectively. The increase is related to an increase in payroll and associated costs for management, sales and marketing resources, advertising and trade show attendance and related relocation costs for corporate and new sales offices.

Acquisition or Disposition of Plant and Equipment

During the nine months ended September 30, 2004, fixed assets increased \$440,738, which is primarily related to leasehold improvements associated with the Company's relocation of its corporate offices to Germantown, Maryland. The Company does not anticipate the sale or purchase of any significant property, plant or equipment during the next twelve months, other than purchases of

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leasehold improvements, computer equipment and peripherals to be used in the Company's day-to-day operations. During the nine months ended September 30, 2004, the Company signed a lease to accommodate the expansion of its sales organization in White Marsh, Baltimore County, Maryland. The three-year lease provides 1,820 square feet and expires May 2007.

Number of Employees

As of September 30, 2004, the Company had 48 employees. In order for the Company to attract and retain quality personnel, the Company anticipates it will continue to offer competitive salaries to current and future employees. As the Company continues to expand, the Company will incur additional costs for personnel.

Trends, Risks and Uncertainties

The Company has sought to identify what it believes to be the most significant risks to its business, but cannot predict whether or to what extent any of such risks may be realized nor can there be any assurances that the Company has identified all possible risks that might arise. Investors should carefully consider all such risk factors in evaluating the Company's financial outlook.

TELKONET RECENTLY EMERGED FROM ITS DEVELOPMENT STAGE AND HAS NO OPERATING HISTORY ON WHICH TO BASE AN EVALUATION OF ITS CURRENT BUSINESS AND FUTURE PROSPECTS.

The Company recently emerged from its development stage. As a result, it has no operating history upon which to base an evaluation of its current business and future prospects. The Company has not generated substantial revenues since its inception. Because of the Company's lack of an operating history, management has limited insight into trends that may emerge and could materially adversely affect the Company's business. Prospective investors should consider the risks and difficulties the Company may encounter in its new and rapidly evolving market, especially given the Company's lack of operating history. These risks include the Company's ability to:

- o market the PlugPlus(TM) product suite;

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- o build a customer base;
- o generate revenues;
- o compete favorably in a highly competitive market;
- o access sufficient capital to support growth;
- o recruit and retain qualified employees;
- o introduce new products and services; and
- o build technology and support systems.

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, 2004, the Company has incurred

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cumulative losses of \$23,777,052 and has never generated enough funds through operations to support its business. The Company expects to continue to incur substantial operating losses through 2004. The Company's losses to date have resulted principally from:

- o research and development costs relating to the development of the PlugPlus(TM) product suite;
- o costs and expenses associated with manufacturing, distribution and marketing of the Company's products;
- o general and administrative costs relating to the Company's operations; and
- o interest expense related to the Company's indebtedness.

The Company is currently unprofitable and may never become profitable. Since inception, the Company has funded its research and development activities primarily from private placements of equity and debt securities, a bank loan and short term loans from certain of its executive officers. As a result of its substantial research and development expenditures and limited product revenues, the Company has incurred substantial net losses. The Company's ability to achieve profitability will depend primarily on its ability to successfully commercialize the PlugPlus(TM) product suite.

POTENTIAL FLUCTUATIONS IN OPERATING RESULTS COULD HAVE A NEGATIVE EFFECT ON THE PRICE OF THE COMPANY'S COMMON STOCK.

The Company's operating results may fluctuate significantly in the future as a result of a variety of factors, most of which are outside the Company's control, including:

- o the level of use of the Internet;
- o the demand for high-tech goods;
- o the amount and timing of capital expenditures and other costs relating to the expansion of the Company's operations;
- o price competition or pricing changes in the industry;
- o technical difficulties or system downtime;
- o economic conditions specific to the internet and communications industry; and
- o general economic conditions.

The Company's quarterly results may also be significantly impacted by certain accounting treatment of acquisitions, financing transactions or other matters. Such accounting treatment could have a material impact on the Company's results of operations and have a negative impact on the price of the Company's common stock.

THE COMPANY'S DIRECTORS AND EXECUTIVE OFFICERS OWN A SUBSTANTIAL PERCENTAGE OF THE COMPANY'S ISSUED AND OUTSTANDING COMMON STOCK. THEIR OWNERSHIP COULD ALLOW THEM TO EXERCISE SIGNIFICANT CONTROL OVER CORPORATE DECISIONS.

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20.5% of the Company's issued and outstanding common stock. This means that the Company's officers and directors, as a group, exercise significant control over matters upon which the Company's stockholders may vote, including the selection of the Board of Directors, mergers, acquisitions and other significant corporate transactions.

FURTHER ISSUANCES OF EQUITY SECURITIES MAY BE DILUTIVE TO CURRENT STOCKHOLDERS.

Although the funds raised in the Company's debenture offerings, the note offering and the private placement of common stock are being used for general working capital purposes, it is likely that the Company will be required to seek additional capital in the future. This capital funding could involve one or more types of equity securities, including convertible debt, common or convertible preferred stock and warrants to acquire common or preferred stock. Such equity securities could be issued at or below the then-prevailing market price for the Company's common stock. Any issuance of additional shares of the Company's common stock will be dilutive to existing stockholders and could adversely affect the market price of the Company's common stock.

THE EXERCISE OF OPTIONS AND WARRANTS OUTSTANDING AND AVAILABLE FOR ISSUANCE MAY ADVERSELY AFFECT THE MARKET PRICE OF THE COMPANY'S COMMON STOCK.

As of September 30, 2004, the Company had outstanding employee options to purchase a total of 9,251,666 shares of common stock at exercise prices ranging from \$1.00 to \$3.78 per share, with a weighted average exercise price of \$1.53. As of September 30, 2004, the Company had outstanding non-employee options to purchase a total of 2,012,084 shares of common stock at exercise prices of \$1.00 per share. As of September 30, 2004, the Company had warrants outstanding to purchase a total of 703,400 shares of common stock at exercise prices ranging from \$1.00 to \$2.97 per share, with a weighted average exercise price of \$1.13. In addition, as of September 30, 2004, the Company had 681,166 additional shares of common stock which may be issued in the future under the Amended and Restated Telkonet, Inc. Stock Incentive Plan. The exercise of outstanding options and warrants and the sale in the public market of the shares purchased upon such exercise will be dilutive to existing stockholders and could adversely affect the market price of the Company's common stock.

THE POWERLINE COMMUNICATIONS INDUSTRY IS INTENSELY COMPETITIVE AND RAPIDLY EVOLVING.

The Company operates in a highly competitive, quickly changing environment, and the Company's future success will depend on its ability to develop and introduce new products and product enhancements that achieve broad market acceptance in commercial and governmental sectors. The Company will also need to respond effectively to new product announcements by its competitors by quickly introducing competitive products.

Delays in product development and introduction could result in:

- o loss of or delay in revenue and loss of market share;
- o negative publicity and damage to the Company's reputation and brand; and
- o decline in the average selling price of the Company's products.

GOVERNMENT REGULATION OF THE COMPANY'S PRODUCTS COULD IMPAIR THE COMPANY'S ABILITY TO SELL SUCH PRODUCTS IN CERTAIN MARKETS.

FCC rules permit the operation of unlicensed digital devices that radiate radio frequency emissions if the manufacturer complies with certain

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equipment authorization procedures, technical requirements, marketing restrictions and product labeling requirements. Differing technical requirements apply to "Class A" devices intended for use in commercial settings, and "Class B" devices intended for residential use to which more stringent standards apply. An independent, FCC-certified testing lab has verified that the Company's PlugPlus(TM) product suite complies with the FCC technical requirements for Class A and Class B digital devices. No further testing of these devices is required and the devices may be manufactured and marketed for commercial and residential use. Additional devices designed by the Company for commercial and residential use will be subject to the FCC rules for unlicensed digital devices. Moreover, if in the future, the FCC changes its technical requirements for unlicensed digital devices, further testing and/or modifications of devices may be necessary. Failure to comply with any FCC technical requirements could impair the Company's ability to sell its products in certain markets and could have a negative impact on its business and results of operations.

PRODUCTS SOLD BY THE COMPANY'S COMPETITORS COULD BECOME MORE POPULAR THAN THE COMPANY'S PRODUCTS OR RENDER THE COMPANY'S PRODUCTS OBSOLETE.

The market for powerline communications products is highly competitive. The Company believes it has the only commercial solution for "in-building" distribution of broadband utilizing the electrical wiring infrastructure. Linksys Group, Inc. and Netgear, Inc. offer similar PLC solutions for the

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residential market. There can be no assurance that Linksys Group, Netgear or any other company will not develop PLC products that compete with the Company's products in the future. These potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources. These potential competitors may, among other things, undertake more extensive marketing campaigns, adopt more aggressive pricing policies, obtain more favorable pricing from suppliers and manufacturers and exert more influence on the sales channel than the Company can. As a result, the Company may not be able to compete successfully with these potential competitors and these potential competitors may develop or market technologies and products that are more widely accepted than those being developed by the Company or that would render the Company's products obsolete or noncompetitive. The Company anticipates that potential competitors will also intensify their efforts to penetrate the Company's target markets. These potential competitors may have more advanced technology, more extensive distribution channels, stronger brand names, bigger promotional budgets and larger customer bases than the Company does. These companies could devote more capital resources to develop, manufacture and market competing products than the Company could. If any of these companies are successful in competing against the Company, sales could decline, margins could be negatively impacted, and the Company could lose market share, any of which could have a material adverse effect on the Company's business and results of operations.

THE FAILURE OF THE INTERNET TO CONTINUE AS AN ACCEPTED MEDIUM FOR BUSINESS COMMERCE COULD HAVE A NEGATIVE IMPACT ON THE COMPANY'S RESULTS OF OPERATIONS.

The Company's long-term viability is substantially dependent upon the continued widespread acceptance and use of the Internet as a medium for business commerce. The Internet has experienced, and is expected to continue to experience, significant growth in the number of users. There can be no assurance that the Internet infrastructure will continue to be able to support the demands placed on it by this continued growth. In addition, delays in the development or adoption of new standards and protocols to handle increased levels of Internet activity or increased governmental regulation could slow or stop the growth of

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the Internet as a viable medium for business commerce. Moreover, critical issues concerning the commercial use of the Internet (including security, reliability, accessibility and quality of service) remain unresolved and may adversely affect the growth of Internet use or the attractiveness of its use for business commerce. The failure of the necessary infrastructure to further develop in a timely manner or the failure of the Internet to continue to develop rapidly as a valid medium for business would have a negative impact on the Company's results of operations.

FAILURE OF THE COMPANY'S SERVICES AND PRODUCTS TO BE SUCCESSFUL IN THE MARKETPLACE COULD HAVE A NEGATIVE EFFECT ON THE COMPANY'S RESULTS OF OPERATIONS.

Since the Company is just emerging from its development stage, it does not know with any certainty whether its services and/or products will be accepted within the business marketplace. If the Company's services and/or products prove to be unsuccessful within the marketplace, or if the Company fails to attain market acceptance, it could have a negative effect on the Company's results of operations.

THE COMPANY MAY NOT BE ABLE TO OBTAIN PATENTS, WHICH COULD HAVE A MATERIAL ADVERSE EFFECT ON ITS BUSINESS.

The Company's ability to compete effectively in the powerline technology industry will depend on its success in acquiring suitable patent protection. The Company currently has several patents pending. The Company also intends to file additional patent applications that it deems to be economically beneficial. If the Company is not successful in obtaining patents, it will have limited protection against those who might copy its technology. As a result, the failure to obtain patents could negatively impact the Company's business and results of operations.

INFRINGEMENT BY THIRD PARTIES ON THE COMPANY'S PROPRIETARY TECHNOLOGY AND DEVELOPMENT OF SUBSTANTIALLY EQUIVALENT PROPRIETARY TECHNOLOGY BY THE COMPANY'S COMPETITORS COULD NEGATIVELY IMPACT THE COMPANY'S BUSINESS.

The Company's success depends partly on its ability to maintain patent and trade secret protection, to obtain future patents and licenses, and to operate without infringing on the proprietary rights of third parties. There can be no assurance that the measures the Company has taken to protect its intellectual property, including those integrated to its PlugPlus(TM) product suite, will prevent misappropriation or circumvention. In addition, there can be no assurance that any patent application, when filed, will result in an issued patent, or that the Company's existing patents, or any patents that may be issued in the future, will provide the Company with significant protection against competitors. Moreover, there can be no assurance that any patents issued to, or licensed by, the Company will not be infringed upon or circumvented by others. Infringement by third parties on the Company's proprietary technology could negatively impact its business. Moreover, litigation to establish the

validity of patents, to assert infringement claims against others, and to defend against patent infringement claims can be expensive and time-consuming, even if the outcome is in the Company's favor. The Company also relies to a lesser extent on unpatented proprietary technology, and no assurance can be given that others will not independently develop substantially equivalent proprietary information, techniques or processes or that the Company can meaningfully protect its rights to such unpatented proprietary technology. Development of substantially equivalent technology by the Company's competitors could negatively impact its business.

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THE COMPANY DEPENDS ON A SMALL TEAM OF SENIOR MANAGEMENT, AND IT MAY HAVE DIFFICULTY ATTRACTING AND RETAINING ADDITIONAL PERSONNEL.

The Company's future success will depend in large part upon the continued services and performance of senior management and other key personnel. If the Company loses the services of any member of its senior management team, its overall operations could be materially and adversely affected. In addition, the Company's future success will depend on its ability to identify, attract, hire, train, retain and motivate other highly skilled technical, managerial, marketing, purchasing and customer service personnel when they are needed. Competition for these individuals is intense. The Company cannot ensure that it will be able to successfully attract, integrate or retain sufficiently qualified personnel when the need arises. Any failure to attract and retain the necessary technical, managerial, marketing, purchasing and customer service personnel could have a negative effect on the Company's financial condition and results of operations.

Item 3. Controls and Procedures.

As of September 30, 2004, the Company performed an evaluation, under the supervision and with the participation of management, including the Chief Executive and Chief Financial Officers, of the effectiveness of the design and operation of its disclosure controls and procedures as defined in Rules 13a - 15(c) and 15d - 15(c) promulgated under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, the Chief Executive and Chief Financial Officers 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. There were no significant changes in the Company's internal controls or in other factors that have materially affected, or are reasonable likely to materially affect, the Company's internal controls subsequent to the date of the most recent evaluation.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

NONE

Item 2. Changes in Securities and Small Business Issuer Purchases of Equity Securities.

During the three months ended September 30, 2004, the Company agreed to issue 9,000 shares of common stock to Ronald W. Pickett, the Company's Chief Executive Officer, pursuant to his employment agreement, dated January 30, 2004.

The foregoing was effected in reliance on the exemption from registration provided by Section 4(2) of the Securities Act of 1933 and/or Rule 506 of Regulation D promulgated thereunder.

During the three months ended September 30, 2004, the Company granted options to purchase 565,000 shares of common stock to certain employees of the Company. These options are exercisable at an average exercise price of \$3.23 per share. The options were issued pursuant to the Amended and Restated Telkonet, Inc. Stock Incentive Plan. The shares of common stock underlying the options have been registered with the Securities and Exchange Commission on a Form S-8 Registration Statement.

SMALL BUSINESS ISSUER PURCHASES OF EQUITY SECURITIES

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| PERIOD | (a) TOTAL NUMBER OF SHARES PURCHASED | (b) AVERAGE PRICE PAID PER SHARE | (c) TOTAL NUMBER OF SHARES PURCHASED AS PART OF PUBLICLY ANNOUNCED PLANS OR PROGRAMS |
|----------------------|---|-------------------------------------|--|
| July 1-30, 2004 | 0 | n/a | 0 |
| August 1-31, 2004 | 0 | n/a | 0 |
| September 1-30, 2004 | 1,000,000 (1) | \$0.01 | 0 |
| Total | 1,000,000 | \$0.01 | 0 |

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(1) This transaction represents the repurchase by the Company of fully vested options to purchase 1,000,000 shares of the Company's common stock which were exercisable at a price equal to fair market value on the date of exercise, but not less than \$1.00, per share.

Item 3. Defaults Upon Senior Securities.

None.

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

None.

Item 5. Other Information.

None.

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Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

| No. | Description |
|-----|--|
| 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 | 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) |

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- 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)
 - 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 Stephen L. Sadle, dated as of January 18, 2003 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
 - 10.3 Employment Agreement by and between Telkonet, Inc. and Robert P. Crabb, dated as of January 18, 2003 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
 - 10.4 Employment Agreement by and between Telkonet, Inc. and Ronald W. Pickett, dated as of January 30, 2003 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
 - 10.5 Employment Agreement by and between Telkonet, Inc. and E. Barry Smith, dated as of February 17, 2003 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
 - 24 Power of Attorney (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
 - 31.1 Certification of Ronald W. Pickett pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
 - 31.2 Certification of E. Barry Smith pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
 - 32.1 Certification of Ronald W. Pickett 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 E. Barry Smith pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- (b) Reports on Form 8-K filed during the three months ended September 30, 2004.

None

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 15, 2004

By: /s/ Ronald W. Pickett

Ronald W. Pickett
Chief Executive Officer