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| | |
|--|-----------|
| | (425,458 |
|) | |
| Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of \$395,373 and \$277,913 at June 30, 2009 and December 31, 2008, respectively. | |
| | (282,667 |
|) | |
| | (400,127 |
|) | |
| Total | |
| \$ | 986,973 |
| \$ | |
| | 1,311,065 |
| Less: current portion | |
| | - |
| | - |
| \$ | |
| | 986,973 |
| \$ | |
| | 1,311,065 |

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

The Company amortized the beneficial conversion feature and the value of the attached warrants, and recorded non-cash interest expense in the amount of \$174,998 and \$117,460, and \$20,027, and \$15,716, respectively, for the six months ended June 30, 2009, and 2008.

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

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On July 8, 2009, the Company and YA Global amended the Debentures to provide for monthly payments of interest, as opposed to quarterly payments. The Company and YA Global agreed that the Company shall pay \$72,008 representing accrued and unpaid interest through June 30, 2009 upon the earlier to occur of (i) August 15, 2009 or (ii) the date the Company receives the proceeds of financing from the Wisconsin Department of Commerce. On August 13, 2009, YA Global agreed to defer the August 15, 2009 interest payment until September 15, 2009.

At June 30, 2009, the Senior Convertible Debenture had an estimated fair value of \$1.0 million.

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

| | |
|---|--------------|
| For the twelve months ended December 31, | Amount |
| 2009 | \$ - |
| 2010 | - |
| 2011 | 1,606,023 |
| | \$ 1,606,023 |

NOTE I - CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock, with a par value of \$.001 per share. As of June 30, 2009 and December 31, 2008, the Company has no preferred stock issued and outstanding. The Company has authorized 155,000,000 shares of common stock, with a par value of \$.001 per share. As of June 30, 2009 and December 31, 2008, the Company has 95,833,871 and 87,525,495, respectively, shares of common stock issued and outstanding.

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

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

NOTE J - STOCK OPTIONS AND WARRANTS

Employee Stock Options

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

| Exercise Prices | Options Outstanding | | | Options Exercisable | | |
|--------------------|-----------------------|--|--|-----------------------|--|--|
| | Number Outstanding | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price | |
| 1.00 - \$ 1.99 | 4,417,133 | 4.18 | \$ 1.02 | 4,266,883 | \$ 1.01 | |

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| | | | | | | | |
|----|--------|-----------|------|----|------|-----------|---------|
| | 2.00 - | | | | | | |
| \$ | \$2.99 | 997,500 | 5.73 | \$ | 2.52 | 951,250 | \$ 2.51 |
| | 3.00 - | | | | | | |
| \$ | \$3.99 | 540,000 | 6.33 | \$ | 3.23 | 400,500 | \$ 3.29 |
| | 4.00 - | | | | | | |
| \$ | \$4.99 | 70,000 | 6.08 | \$ | 4.33 | 55,000 | \$ 4.34 |
| | 5.00 - | | | | | | |
| \$ | \$5.99 | 100,000 | 5.82 | \$ | 5.17 | 83,000 | \$ 5.16 |
| | | 6,124,633 | 4.67 | \$ | 1.56 | 5,756,633 | \$ 1.53 |

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

| | Number of Shares | Weighted Average Price Per Share |
|----------------------------------|---------------------|---|
| Outstanding at January 1, 2008 | 8,105,429 | \$ 1.98 |
| Granted | 185,000 | 1.00 |
| Exercised | - | - |
| Cancelled or expired | (1,296,500) | 2.71 |
| Outstanding at December 31, 2008 | 6,993,929 | \$ 1.82 |
| Granted | 320,000 | 1.00 |
| Exercised | - | - |
| Cancelled or expired | (1,189,296) | 2.91 |
| Outstanding at June 30, 2009 | 6,124,633 | \$ 1.56 |

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

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

The expected life of awards granted represents the period of time that they are expected to be outstanding. We determine the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules, exercise patterns and pre-vesting and post-vesting forfeitures. We estimate the volatility of our common stock based on the calculated historical volatility of our own common stock using the trailing 60 months of share price data prior to the date of the award. We base the risk-free interest rate used in the Black-Scholes-Merton option valuation model on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term equal to the expected life of the award. We have not paid any cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero in the Black-Scholes-Merton option valuation model. We use historical data to estimate pre-vesting option forfeitures and record share-based compensation for those awards that are expected to vest. In accordance with SFAS No. 123R, we adjust share-based compensation for changes to the estimate of expected equity award forfeitures based on actual forfeiture experience.

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

The total fair value of shares vested during the period ended June 30, 2009 and 2008 was \$167,620 and \$428,630, respectively.

Total stock-based compensation expense recognized in the consolidated statement of earnings for the three and six months ended June 30, 2009 and 2008 was \$83,810 and \$177,670, and \$206,432 and \$510,130, respectively, net of tax effect. Additionally, the aggregate intrinsic value of options outstanding and unvested as of June 30, 2009 is \$0.

Non-Employee Stock Options

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

| Options Outstanding | | Options Exercisable | | |
|---------------------|----------|---------------------|--------|----------|
| Number | Weighted | Weighted | Number | Weighted |

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| Exercise Prices | Outstanding | Average Remaining Contractual Life (Years) | Average Exercise Price | Exercisable | Average Exercise Price |
|-----------------|-------------|--|------------------------|-------------|------------------------|
| \$ 1.00 | 1,815,937 | 2.84 | \$ 1.00 | 1,815,937 | \$ 1.00 |

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TELKONET, INC.
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Transactions involving options issued to non-employees are summarized as follows:

| | Number of Shares | Weighted Average Price Per Share |
|----------------------------------|---------------------|---|
| Outstanding at January 1, 2008 | 1,815,937 | \$ 1.00 |
| Granted | - | - |
| Exercised | - | - |
| Canceled or expired | - | - |
| Outstanding at December 31, 2008 | 1,815,937 | \$ 1.00 |
| Granted | - | - |
| Exercised | - | - |
| Canceled or expired | - | - |
| Outstanding at June 30, 2009 | 1,815,937 | \$ 1.00 |

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

Warrants

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

| Exercise Prices | Warrants Outstanding | | | Warrants Exercisable | | |
|--------------------|-----------------------|---|--|-----------------------|--|--|
| | Number Outstanding | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price | |
| \$ 0.58 | 806,639 | 2.59 | \$ 0.58 | 856,639 | \$ 0.58 | |
| \$ 0.60 | 800,000 | 3.85 | \$ 0.60 | 800,000 | \$ 0.60 | |
| \$ 0.61 | 2,500,000 | 3.92 | \$ 0.61 | 2,500,000 | \$ 0.61 | |
| \$ 2.59 | 862,452 | 2.12 | \$ 2.59 | 862,452 | \$ 2.59 | |
| \$ 3.98 | 3,078,864 | 2.29 | \$ 3.98 | 3,078,864 | \$ 3.98 | |
| \$ 4.17 | 359,712 | 3.06 | \$ 4.17 | 359,712 | \$ 4.17 | |
| | 8,407,667 | 2.97 | \$ 2.19 | 8,457,667 | \$ 2.19 | |

Transactions involving warrants are summarized as follows:

Number of Weighted

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| | Shares | Average Price Per Share |
|----------------------------------|-------------|-------------------------------|
| Outstanding at January 1, 2008 | 7,673,627 | \$ 4.15 |
| Issued | 4,164,140 | 1.31 |
| Exercised | (3,380,000) | 0.70* |
| Canceled or expired | - | - |
| Outstanding at December 31, 2008 | 8,457,767 | \$ 2.19 |
| Issued | - | - |
| Exercised | (50,100) | 0.10 |
| Canceled or expired | - | - |
| Outstanding at June 30, 2009 | 8,407,667 | \$ 2.19 |

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

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

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

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

NOTE K - COMMITMENTS AND CONTINGENCIES

Employment and Consulting Agreements

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

Litigation

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

Senior Convertible Noteholder Claim

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

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Purchase Price Contingency

In conjunction with the acquisition of MST on January 31, 2006, the stock portion of the purchase price was price protected for the benefit of the former owner of MST. In the event the Company's common stock price is below \$4.50 per share upon the achievement of thirty three hundred (3,300) subscribers during the three (3) year period following the closing (as extended) a pro rata adjustment in the number of shares will be required to support the aggregate consideration of \$5.4 million. The issuance of additional shares or distribution of other consideration upon resolution of the contingency based on the Company's common stock prices will not affect the cost of the acquisition. When the contingency is resolved or settled, and additional consideration is distributable, the Company will record the current fair value of the additional consideration and the amount previously recorded for the common stock issued will be simultaneously reduced to the lower current value of the Company's common stock. In addition, the Company agreed to fully fund the MST three year business plan, established on January 31, 2006. The parties originally agreed, in the event, for any reason, the Company materially fails to satisfy its funding obligations under the acquisition agreement, that the former owners of MST shall be entitled to the release of any and all consideration held in reserve. However the parties deleted this provision in a May, 2008 agreement wherein the Company made a minimum commitment of \$2.3 million to fund MST's business plan in accordance with Section 11.1 of the Stock Purchase Agreement between Telkonet and Frank T. Matarazzo. In addition, the adjustment date for the achievement of MST's 3,300 subscribers was extended an additional six months from January 31, 2009 to July 31, 2009. In April 2008 the Company issued from escrow 200,000 shares of the reserve shares and advanced 400,000 of such shares in June 2008 in exchange for Mr. Matarazzo's agreement to a debt covenant restricting the use of proceeds in the Company's debenture financing with YA Global Investments LP.

NOTE L- BUSINESS CONCENTRATION

Revenue from one major customer approximated \$785,649 or 13% of total revenues for the period ended June 30, 2009. Revenue from two (2) major customers approximated \$4,233,118 or 49% of total revenues for the period ended June 30, 2008. Total accounts receivable of \$80,776, or 4% of total accounts receivable, were due from these customers as of June 30, 2009. Total accounts receivable of \$532,190, or 29% of total accounts receivable, was due from these customers as of June 30, 2008.

Purchases from one major supplier approximated \$698,482, or 62% of purchases during the period ended June 30, 2009, and \$1,395,828, or 47% of purchases, for the period ended June 30, 2008, respectively. Total accounts payable of approximately \$92,507, or 3% of total accounts payable, was due to this supplier as of June 30, 2009, and \$1,167,254, or 18% of total accounts payable, was due to this supplier as of June 30, 2008.

NOTE M- FAIR VALUE MEASUREMENTS

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

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Level 2 of the fair value hierarchy because they are valued using inputs which are not actively observable, either directly or indirectly.

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

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The following table sets forth the Company's short- and long-term investments as of June 30, 2009 which are measured at fair value on a recurring basis by level within the fair value hierarchy. As required by SFAS No. 157, these are classified based on the lowest level of input that is significant to the fair value measurement, (in thousands):

| (in thousands) | Level 1 | Level 2 | Level 3 | Assets at fair value |
|---------------------------|---------|----------|---------|-------------------------|
| Cash and cash equivalents | \$ 120 | \$ - | \$ - | \$ 120 |
| Marketable securities | 368 | - | - | 368 |
| Long-term investments | - | - | 8 | 8 |
| Derivative liabilities | - | 1,219 | - | 1,219 |
| Long-term debt | - | - | \$ 987 | 987 |
| Total | \$ 488 | \$ 1,219 | \$ 995 | \$ 2,702 |

NOTE N – DISCONTINUED OPERATIONS

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

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

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

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

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

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

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The following table summarizes net income from discontinued operations for the three and six months ended June 30, 2009:

| | Three Months Ended June 30, (Unaudited) | | Six Months Ended June 30, (Unaudited) | |
|--|--|-----------------|--|-----------------|
| | 2009 | 2008 | 2009 | 2008 |
| Loss from operations | \$ (123,438) | \$ (1,174,339) | \$ (635,735) | \$ (2,041,760) |
| Elimination of liabilities, net of assets | 7,000,185 | - | 7,000,185 | - |
| Other expenses | (67,599) | - | (67,599) | - |
| Income (loss) from discontinued operations | \$ 6,809,148 | \$ (1,174,339) | \$ 6,296,851 | \$ (2,041,760) |

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 June 30, 2009 and 2008, as well as the Company's consolidated financial statements and related notes thereto and management's discussion and analysis of financial condition and results of operations in the Company's Form 10-K for the year ended December 31, 2008 filed on April 1, 2009.

Business

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

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

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

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

On April 22, 2009, the Company completed the deconsolidation of MSTI Holdings, Inc. (MSTI). To effect the deconsolidation of MSTI, the Company was required to reduce its ownership percentage and board membership. On February 26, 2009, the Company executed a Stock Purchase Agreement pursuant to which the Company sold 2.8

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million shares of MSTI common stock and following this transaction, the Company beneficially owns 49% of the issued and outstanding shares of MSTI common stock. On April 22, 2009, Warren V. Musser and Thomas C. Lynch, members of the Company's Board of Directors, submitted their resignations as directors of MSTI. As a result, the majority of MSTI's board of directors is no longer controlled by the Company. As a result of the deconsolidation, the interim financial statements have been revised to present the previously consolidated operations as discontinued operations.

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

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

Forward Looking Statements

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

Critical Accounting Policies and Estimates

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

Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with Staff Accounting Bulletin No. 104, Revenue Recognition (“SAB104”), which includes the provisions of 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.

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

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

Revenue from sales-type leases for Ethostream products is recognized at the time of lease 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 June 30, 2009 and December 31, 2008. 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 period ended June 30, 2009 and the year ended December 31, 2008, the Company experienced approximately three percent of units returned under its product warranty policy. As of June 30, 2009 and December 31, 2008, the Company recorded warranty liabilities in the amount of \$124,446 and \$146,951, respectively, using this experience factor.

New Accounting Pronouncements

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

Revenues

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

| | June 30, 2009 | | Three Months Ended June 30, 2008 | | Variance | |
|-----------|---------------|------|-------------------------------------|------|----------------|------|
| Product | \$ 2,098,640 | 67% | \$ 3,781,214 | 82% | \$ (1,682,574) | -44% |
| Recurring | 1,011,729 | 33% | 826,917 | 18% | 184,812 | 23% |
| Total | \$ 3,110,369 | 100% | \$ 4,608,131 | 100% | \$ (1,497,762) | -33% |

| | June 30, 2009 | | Six Months Ended June 30, 2008 | | Variance | |
|-----------|---------------|------|-----------------------------------|------|----------------|------|
| Product | \$ 4,017,067 | 67% | \$ 6,983,451 | 81% | \$ (2,966,384) | -42% |
| Recurring | 1,991,254 | 33% | 1,662,246 | 19% | 329,008 | 20% |
| Total | \$ 6,008,321 | 100% | \$ 8,645,697 | 100% | \$ (2,637,376) | -31% |

Product revenue

Product revenue principally arises from the sale and installation of SmartGrid and broadband networking equipment, including Telkonet SmartEnergy™ products, Telkonet Series 5™ products and the Telkonet iWire System™. Telkonet

markets and sells to hospitality, education, healthcare and government markets. The Telkonet Series 5™ and the Telkonet iWire System™ consist of the Telkonet Gateways, Telkonet Extenders, the patented Telkonet Coupler, and Telkonet iBridges. The Telkonet SmartEnergy™ product suite consists of thermostats, sensors and controllers.

For the three and six months ended June 30, 2009, product revenue decreased by 44% and 42%, respectively, when compared to the prior year periods, primarily due to the prior year rollout of an energy management contract with a national hotel operator, which accounted for 35% and 44% of product revenue for the three and six months ended June 30, 2008. Product revenue for the three and six months ended June 30, 2009 includes approximately \$1.3 million and \$2.7 million, respectively, attributed to the sale of energy management products, and approximately \$750,000 and \$1.1 million, respectively, from the sales of broadband networking products and services to the hospitality market. In addition, product revenues for the three and six months ended June 30, 2009 were down overall due to the impact of the current economy, which has continued to cause delays in planned opportunities with new and existing customers. However, quarter over quarter revenue has increased in 2009 by approximately 7% and management believes that our products and services, specifically energy management, will provide the Company additional growth opportunities. We anticipate nominal quarterly growth in the energy management and hospitality markets during the year ended December 31, 2009.

Recurring Revenue

Recurring revenue includes approximately 2,500 hotels in our broadband network portfolio. We currently support over 200,000 HSIA rooms, with over 2 million monthly users. For the three and six months ended June 30, 2009, recurring revenue increased by 23% and 20%, respectively, when compared to the prior year periods. We anticipate growth to our subscriber base as we deploy additional sites under contract and increase Telkonet's strategic franchise and group alliances through the Ethostream brand.

Cost of Sales

| | June 30, 2009 | | Three Months Ended June 30, 2008 | | Variance | |
|-----------|---------------|-----|-------------------------------------|-----|----------------|------|
| Product | \$ 1,032,183 | 49% | \$ 2,265,073 | 60% | \$ (1,232,890) | -54% |
| Recurring | 303,513 | 30% | 422,680 | 51% | (119,167) | -28% |
| Total | \$ 1,335,696 | 43% | \$ 2,687,753 | 58% | \$ (1,352,057) | -50% |

| | June 30, 2009 | | Six Months Ended June 30, 2008 | | Variance | |
|-----------|---------------|-----|-----------------------------------|-----|----------------|------|
| Product | \$ 2,108,822 | 52% | \$ 4,723,851 | 68% | \$ (2,615,029) | -55% |
| Recurring | 609,347 | 31% | 858,063 | 52% | (248,716) | -29% |
| Total | \$ 2,718,169 | 45% | \$ 5,581,914 | 65% | \$ (2,863,745) | -51% |

Product Costs

Product costs include equipment and installation labor related to the sale of Telkonet SmartEnergy™ products, Telkonet Series 5™ products and the Telkonet iWire System™. For the three and six months ended June 30, 2009, product costs decreased by 54% and 55% when compared to the prior year periods, primarily in connection with the decreased sales in the prior year periods. However, product costs for the three and six months ended June 30, 2009 also decreased as a percentage of revenue from 60% to 49%, and 68% to 52%, when compared to the prior year periods, which is reflective of the consolidation of operations in the Milwaukee, WI operations center.

Recurring Costs

For the three and six months ended June 30, 2009, recurring costs decreased by 28% and 29% when compared to the prior year periods, primarily due to the increase in efficiency in providing support services to EthoStream's customers through the Milwaukee, WI operations center.

Gross Profit

| | June 30, 2009 | | Three Months Ended June 30, 2008 | | Variance | |
|-----------|---------------|-----|-------------------------------------|-----|--------------|------|
| Product | \$ 1,066,457 | 51% | \$ 1,516,141 | 40% | \$ (449,684) | -29% |
| Recurring | 708,216 | 70% | 404,237 | 49% | 303,979 | 75% |
| Total | \$ 1,774,673 | 57% | \$ 1,920,378 | 42% | \$ (145,705) | -7% |

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| | June 30, 2009 | | Six Months Ended June 30, 2008 | | Variance | |
|-----------|---------------|-----|-----------------------------------|-----|--------------|------|
| Product | \$ 1,908,245 | 48% | \$ 2,259,600 | 32% | \$ (351,355) | -16% |
| Recurring | 1,381,907 | 69% | 804,183 | 48% | 577,724 | 72% |
| Total | \$ 3,290,152 | 55% | \$ 3,063,783 | 35% | \$ 226,369 | 7% |

Product Gross Profit

Gross profit margins for the three and six months ended June 30, 2009 increased from 40% to 51%, and 32% to 48% when compared to the prior year periods as a result of increased operating efficiencies. We expect to maintain our gross profit margins between 45% to 50% on our sales of energy management products and services, to hospitality, utility and government market customers.

Recurring Gross Profit

Gross profit margins associated with recurring revenue were 70% and 69% for the three and six months ended June 30, 2009. The centralized remote monitoring and management platform and internal call support center has provided the platform to increase and maintain healthy profit margins on recurring revenue.

Operating Expenses

| | June 30, 2009 | Three Months Ended June 30, 2008 | | Variance |
|-------|------------------|--|----------------|----------|
| Total | \$ 2,137,185 | \$ 3,806,595 | \$ (1,669,410) | -44% |
| | June 30, 2009 | Six Months Ended June 30, 2008 | | Variance |
| Total | \$ 4,213,583 | \$ 7,408,435 | \$ (3,194,852) | -43% |

During the three and six months ended June 30, 2009, operating expenses decreased by 44% and 43%, respectively, when compared to the prior year periods. This decrease is primarily related to the overall reduction in operating expenses in 2008 in connection with the corporate restructuring, and the reduction of research and development and overhead staffing at the corporate headquarters office. We do not anticipate any significant changes to operating expenses for the remainder of 2009.

Research and Development

| | June 30, 2009 | Three Months Ended June 30, 2008 | | Variance |
|-------|------------------|--|--------------|----------|
| Total | \$ 222,316 | \$ 492,689 | \$ (270,373) | -55% |
| | June 30, 2009 | Six Months Ended June 30, 2008 | | Variance |
| Total | \$ 498,278 | \$ 1,157,811 | \$ (659,533) | -57% |

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 and six months ended June 30, 2009 by approximately \$270,000, or

-55%, and \$660,000, or -57%, respectively. The Research and Development costs are associated with the development of the Telkonet Series 5™ product suite and the integration of new applications to the Telkonet iWire System™, and the development of next generation Telkonet SmartEnergy™ (TSE) and Networked Telkonet SmartEnergy™ (NTSE) products. The Company expects to maintain the current cost structure for research and development in 2009.

Selling, General and Administrative Expenses

| | June 30, 2009 | June 30, 2008 | Three Months Ended June 30, 2008 | Variance |
|-------|------------------|------------------|--|----------|
| Total | \$ 1,737,376 | \$ 2,619,897 | \$ (882,521) | -34% |

| | June 30, 2009 | June 30, 2008 | Three Months Ended June 30, 2008 | Variance |
|-------|------------------|------------------|--|----------|
| Total | \$ 3,357,168 | \$ 5,145,340 | \$ (1,788,172) | -35% |

During the three and six months ended June 30, 2009, selling, general and administrative expenses decreased over the comparable prior year periods by approximately 34% and 35%, respectively. This decrease when compared to the prior year periods is primarily the result of the efficiencies in the organization resulting in reduced salary and related costs by \$420,000 and \$750,000, respectively, as well as other significant reductions in sales and marketing expenses of \$214,000 and \$452,000, respectively, professional fees of \$70,000 and \$235,000, office expenses of \$70,000 and \$164,000, and travel costs of \$92,000 and \$179,000. We do not expect to significantly increase our selling, general and administrative expenses in 2009, except as necessary to meet future growth opportunities.

Discontinued Operations

We had net income from discontinued operations of \$6,296,851, or \$0.07 per share, for the six months ended June 30, 2009, compared to net loss from discontinued operations of \$(2,041,760), or \$(0.03) per share, for the six months ended June 30, 2008. Net income from discontinued operations for the six months ended June 30, 2009 includes the gain on deconsolidation of \$6,932,586, offset by MSTI's net loss of \$635,735 for the six months ended June 30, 2009.

Backlog

The Telkonet Segment maintains contracts and monthly services for approximately 2,500 hotels which are expected to generate approximately \$3,600,000 annual recurring support and internet advertising revenue.

Liquidity and Capital Resources

Working Capital

Our working capital decreased by \$751,113 during the six months ended June 30, 2009 from a working capital deficit of \$2,439,988 at December 31, 2008 to a working capital deficit of \$3,191,101 at June 30, 2009, excluding working capital attributed to discontinued operations. The decrease in working capital for the six months ended June 30, 2009 is due to a combination of factors, of which the significant factors include:

- Cash had a net decrease from working capital by \$48,319 for the six months ended June 30, 2009. The most significant uses and proceeds of cash were:
 - o Approximately \$112,000 of cash provided by continuing operations;
 - o A sale of our investment in Multiband for proceeds of approximately \$33,000;

- o Net proceeds of \$140,000 on our line of credit to fund inventory purchases, net of repayments; and
- o Advances to our former subsidiary of approximately \$305,000.

Of the total current assets of \$2,440,934 as of June 30, 2009, cash represented \$120,173. Of the total current assets, excluding current assets from discontinued operations, of \$2,969,307 as of December 31, 2008, cash represented \$168,492.

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 June 30, 2009 was \$714,020. The Company has incurred interest expense of \$78,069 related to the line of credit for the six months ended June 30, 2009. The Prime Rate was 3.25% at June 30, 2009.

On August 13, 2009, the Company received a notice of waiver of the “minimum cash flow to debt service ratio” and the “tangible net worth” requirements under the line of credit facility, as such terms are defined in items D(10)a and D(10)b, respectively, of the line of credit agreement. The waiver is in effect as of June 30, 2009 and continues for the 90 day period thereafter.

Convertible Debenture

On May 30, 2008, the Company entered into a Securities Purchase Agreement with YA Global Investments, L.P. pursuant to which the Company agreed to issue and sell to YA Global 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. 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. YA Global 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 YA Global to purchase shares of the Company’s Common Stock at a price per share of \$0.61.

On February 20, 2009, the Company and YA Global entered into an Agreement of Clarification pursuant to which the parties agreed that interest accrued as of December 31, 2008, in the amount of \$191,887 shall be added to the principal amount outstanding under the Debentures and that each Debenture be amended to reflect the applicable increase in principal amount.

On July 8, 2009, the Company and YA Global amended the Debentures to provide for monthly payments on interest, as opposed to quarterly payments. The Company and YA Global also agreed that the Company shall pay \$72,008 representing accrued and unpaid interest through June 30, 2009 upon the earlier to occur of (i) August 15, 2009, or (ii) the date the Company receives the proceeds of financing from the Wisconsin Department of Commerce. On August 13, 2009, YA Global agreed to defer the August 15, 2009 interest payment until September 15, 2009.

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.

Acquisition of Microwave Satellite Technologies, Inc. (MSTI)

On January 31, 2006, the Company acquired a 90% interest in MSTI from Frank Matarazzo, the sole stockholder of MSTI 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 reserve shares, which shall be issued based on the achievement of 3,300 video and data subscribers over a three year period from the closing (later extended to July 2009 pursuant to a May 2008 agreement between the parties). As of August 14, 2009, the Company has issued 800,000 shares of the reserve shares. The escrow agreement terminated on July 31, 2009.

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.

Proceeds from the issuance of common stock

During the six months ended June 30, 2009, the Company received \$4,595 from the exercise of investor stock purchase warrants.

Cashflow analysis

Cash provided by continuing operations was \$111,870 during the six months ended June 30, 2009 compared to cash used in continuing operations of \$1,360,161 during the prior year period. For the remainder of the year ended December 31, 2009, 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, and reducing our trade payables. 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 from continuing operations of \$275,085 and \$14,375 during the six months ended June 30, 2009, and 2008, respectively. During the six months ended June 30, 2009, these activities involved intercompany loans to MSTI of approximately \$305,000, which was partially offset by the sale of the Company's remaining investment in Multiband for proceeds of \$33,129, and capital expenditures of approximately \$2,700 for the purchase of computer equipment. During the six months ended June 30, 2008, these expenditures were primarily due to the purchase of computer and related equipment.

The Company had cash from financing activities from continuing operations of \$114,896 and \$1,434,067 during the six months ended June 30, 2009 and 2008, respectively. During the six months ended June 30, 2009, these activities involved proceeds of \$140,000 from the working capital line of credit for inventory purchases, net of repayments, and \$25,000 in financing costs paid during the period related to the accounts receivable factoring program. During the six months ended June 30, 2008, 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 \$1,500,000 in May 2008, and the Company received a \$400,000 loan from a board member, which was offset by \$462,511 in financing costs.

We have reduced cash required for operations by reducing operating costs and reducing 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 April 1, 2009, 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.

Management expects that global economic conditions will continue to present a challenging operating environment for at least the rest of the year. To the extent permitted by working capital resources, management intends to continue making targeted investments in strategic operating and growth initiatives. Working capital management will continue to be a high priority for the remainder of 2009.

While the Company has been able to manage its working capital needs with the current credit facilities, additional financing is required in order to meet its current and projected cash flow requirements from operations. Additional investments are being sought, but we cannot guarantee that we will be able to obtain such investments. Financing transactions may include the issuance of equity or debt securities, obtaining credit facilities, or other financing mechanisms. However, the trading price of our common stock and the 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. 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.

In addition to working capital, a portion of the proceeds from a new financing will be used to retire the Company's current convertible debenture and inventory line of credit facilities. The Company cannot predict whether this new financing will be in the form of equity or debt. The Company may not be able to obtain the necessary additional capital on a timely basis, on acceptable terms, or at all, in which case the Company may be unable to implement its current plans to retire the convertible debenture and line of credit facilities. Each of the convertible debenture and line of credit facilities contain provisions for the payment of a pre-payment fee in connection with a prepayment. The line of credit facility provides for 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 after the end of the first year. The convertible debenture provides for a prepayment fee equal to 15% of the principal amount of the Debentures being redeemed. It is the Company's intention to negotiate its obligation to pay such fees and/or the reduction of such fees. However there can be no guarantee that it will be successful in achieving such a reduction.

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 six months ended June 30, 2009, fixed assets and cost of equipment under operating leases increased \$2,700, primarily from purchases of computer equipment and peripherals used in day-to-day operations. The Company does not anticipate the sale or purchase of any significant property, plant or equipment during the next twelve months, other than computer equipment and peripherals to be used in the Company's day-to-day operations.

The Company presently leases 16,400 square feet of commercial office space in Germantown, Maryland for its corporate headquarters. The Germantown lease expires in December 2015. We are currently actively pursuing a sublease for all or a portion of this office space for the remaining term of the lease.

The Company presently leases approximately 12,000 square feet of office space in Milwaukee, WI for the Company's operations center. The Milwaukee lease expires in February 2019.

Number of Employees

As of August 1, 2009, the Company had 94 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 | \$ 1,606,023 | - | 1,606,023 | - | - |
| Operating Lease Obligations | \$ 1,985,904 | 180,769 | 522,820 | 406,022 | 876,292 |
| Purchase Obligations | \$ - | - | - | - | - |
| Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet Under GAAP | \$ - | - | - | - | - |
| Total | \$ 3,591,927 | 180,769 | 2,128,843 | 406,022 | 876,292 |

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 period ended June 30, 2009. The Company has classified these securities as available for sale. Such securities are carried at fair market value. Unrealized gains and losses on these securities, if any, are reported as accumulated other comprehensive income (loss), which is a separate component of stockholders' equity. Unrealized gains on the sale of one investment resulted in a gain of \$32,750 recorded for the period ended June 30, 2009 and unrealized losses of \$1,558,204 were recorded for the period ended June 30, 2008. Realized gains and losses and declines in value judged to be other than temporary on securities available for sale, if any, are included in operations. Realized losses of \$29,371 were recorded for the sale of the Company's investment in Multiband during the period ended June 30, 2009. There were no realized gains or losses for the period ended June 30, 2008.

Investments in Privately Held Companies

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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 August 1, 2009 was \$8,000 and recorded in other assets in the Consolidated Balance Sheet.

Item 4. Controls and Procedures.

As of June 30, 2009, 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 on that evaluation and due to the lack of segregation of duties and failure to implement accounting controls of acquired businesses, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were ineffective as of the end of the period covered by this report. During the period ended June 30, 2009, 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.

On April 29, 2009, the Company was named a defendant in a lawsuit brought against the Company by Ronald Pickett, the Company's former CEO, in the Circuit Court for Montgomery County, Maryland. The complaint alleges that the Company failed to make certain agreed upon severance payments to Mr. Pickett and failed to reimburse Mr. Pickett for his cellular phone bills and high speed internet access during the severance period. The complaint further alleges that the Company failed to pay certain travel expenses from Air Wilmington of approximately \$40,000 that the Company had previously agreed to pay on Mr. Pickett's behalf. Mr. Pickett is seeking a judgment for \$294,000 plus interest, costs and attorneys fees. Additionally, Mr. Pickett makes a claim for treble damages under the Maryland Wage Payment and Collection Act. The Company intends to vigorously defend against this claim.

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 June 30, 2009, the Company has incurred cumulative losses of \$(108,499,531) 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 \$12.7 million at June 30, 2009 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.

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

In their report dated April 1, 2009, our independent auditors stated that our financial statements for the year ended December 31, 2008 were prepared assuming that we would continue as a going concern, and that they have substantial doubt about our ability to continue as a going concern. Our auditors' doubts are based on our net losses and deficits in cash flows from operations. We continue to experience net operating losses. Our ability to continue as a going concern is subject to our ability to generate a profit and/or obtain necessary funding from outside sources, including by the sale of our securities, or obtaining loans from financial institutions, where possible. Our continued net operating losses and our auditors' doubts increase the difficulty of our meeting such goals. If we are not successful in raising sufficient additional capital, we may not be able to continue as a going concern and our stockholders may lose their entire investment.

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.

On May 28, 2009, 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 2009.

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 | 58,537,181 | 0 | 22,223,923 | 0 |
| Thomas C. Lynch | 59,980,112 | 0 | 20,780,992 | 0 |
| Thomas M. Hall | 59,400,048 | 0 | 21,361,056 | 0 |
| Anthony J. Paoni | 63,826,297 | 0 | 16,934,807 | 0 |
| Seth D. Blumenfeld | 59,427,678 | 0 | 21,333,426 | 0 |

The stockholders also ratified the appointment of the Company's independent accountants for 2009 and approved the proposed amendment to the Company's Articles of Incorporation increasing the number of shares the Company is authorized to issue from 130,000,000 shares to 155,000,000 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 11, 2009.

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

| Matter Voted Upon | For | Against | Abstain | Broker Non-votes |
|---|------------|------------|-----------|------------------|
| Ratification of Independent Accountants | 67,834,441 | 10,077,648 | 2,849,015 | 0 |
| Amendment to Articles of Incorporation | 21,678,709 | 13,052,820 | 170,218 | 45,859,357 |
| Issuance of Shares to YA Global Investments, LP | 11,757,380 | 22,776,651 | 367,716 | 45,859,357 |

Item 5. Other Information.

None.

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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 (incorporated by reference to our Form 10-Q (No. 001-31972), filed August 11, 2008) |
| 3.3 | Amendment to Articles of Incorporation |
| 3.4 | 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 Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K (No. 001-31972) filed on May 12, 2008) |
| 4.2 | Form of Convertible Debenture (incorporated by reference to our Form 8-K (No. 001-31972) filed on June 5, 2008) |
| 4.3 | Form of Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K (No. 001-31972) filed on June 5, 2008) |
| 4.4 | Promissory Note in Favor of Thermo Credit, LLC (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 10, 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 | 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) |
| 10.6 | Employment Agreement by and between Telkonet, Inc. and Jeff Sobieski, dated as of March 15, 2007(incorporated by reference to our |

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|-------|---|
| | Form 10-K (No. 001-31972), filed March 16, 2007) |
| 10.7 | 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) |
| 10.8 | 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) |
| 10.9 | 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) |
| 10.10 | Commercial Business Loan Agreement, dated September 9, 2008, by and between Telkonet, Inc. and Thermo Credit, LLC (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 10, 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: December 11, 2009

By: /s/ Jason L. Tienor
Jason L. Tienor
Chief Executive Officer
(Duly authorized officer)

By: /s/ Richard J. Leimbach
Richard J. Leimbach
Chief Financial Officer
(Duly authorized officer and principal
financial officer)

