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

FORM 10-Q

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

OR

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

For the transition period from _____ to _____.

For the period ended September 30, 2007

Commission file number 001-31972

TELKONET, INC.

(Exact name of Issuer as specified 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

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

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

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company as defined in Rule 12b-2 of the Exchange Act. Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 67,786,342 shares of Common Stock (\$.001 par value) as of November 1, 2007.

TELKONET, INC.
FORM 10-Q for the Quarter Ended September 30, 2007

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TELKONET, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

	(Unaudited)	December
	September	31,
	30, 2007	2006
	<u> </u>	<u> </u>
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 1,582,586	\$ 1,644,037
Accounts Receivable: net of allowance for doubtful accounts of \$207,000 and \$60,000 at September 30, 2007 and December 31, 2006, respectively	2,616,205	295,116
Income tax receivable	291,000	291,000
Note receivable	17,876	-
Inventories	2,125,082	1,306,593
Deposits - Inventory	379,281	-
Other	585,239	229,333
Total current assets	<u>7,597,269</u>	<u>3,766,079</u>
Property and Equipment:		
Furniture and equipment, at cost	1,616,058	1,370,780
Less: accumulated depreciation	<u>741,856</u>	<u>577,759</u>
Total property and equipment, net	874,202	793,021
Cable Equipment, Installation and Equipment under Operating Leases:		
Capitalized equipment, at cost	5,773,229	4,026,255
Less: accumulated depreciation	<u>1,130,731</u>	<u>568,721</u>
Total cable equipment, installation and equipment under operating leases, net	4,642,498	3,457,534
Other Assets:		
Long-term investments	193,847	193,847
Intangible assets, net of accumulated amortization of \$693,229 and \$282,325 at September 30, 2007 and December 31, 2006, respectively	6,552,591	2,181,602
	764,151	-
Financing costs, net of accumulated amortization of \$101,663		
Goodwill	16,877,978	1,977,768
Note receivable	17,974	-
Deposits and other	154,357	146,665
Total other assets	<u>24,560,898</u>	<u>4,499,882</u>
Total Assets	<u><u>\$ 37,674,867</u></u>	<u><u>\$ 12,516,516</u></u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable and accrued liabilities	\$ 4,850,231	\$ 2,859,863
Notes payable - officer	-	80,444
Income tax refund due to officer	291,000	291,000
Deferred revenue	218,076	160,125
Senior note payable, net of discount for warrant feature of \$125,058	1,374,942	-
Registration Rights Liability of subsidiary	500,000	-
Note payable under subsidiary acquisition	-	900,000
Customer deposits and other	195,241	5,281
Total current liabilities	<u>7,429,490</u>	<u>4,296,713</u>
Long Term Liabilities:		
Deferred Revenue	13,903	42,019
Deferred lease liability & other	61,841	42,561
Convertible debentures, net	4,605,920	-
Total long term liabilities	<u>4,681,664</u>	<u>84,580</u>
Total Liabilities	12,111,154	4,381,293
Commitments and Contingencies		
Minority Interest	3,783,829	-
Stockholders' Equity :		
Preferred stock, par value \$.001 per share; 15,000,000 shares authorized; none issued and outstanding at September 30, 2007 and December 31, 2006	-	-

Common stock, par value \$.001 per share; 100,000,000 shares authorized; 67,736,342 and 56,992,301 shares issued and outstanding at September 30, 2007 and December 31, 2006, respectively	67,736	56,992
Additional paid-in-capital	107,078,791	78,502,900
Accumulated deficit	<u>(85,366,643)</u>	<u>(70,424,669)</u>
Stockholders' equity	<u>21,779,884</u>	<u>8,135,223</u>
Total Liabilities And Stockholders' Equity	<u>\$ 37,674,867</u>	<u>\$ 12,516,516</u>

See accompanying footnotes to the unaudited condensed consolidated financial information

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

	For The Three months		For The Nine months	
	Ended		Ended	
	September 30,		September 30,	
	2007	2006	2007	2006
Revenues, net:				
Product	\$ 3,005,144	\$ 585,535	\$ 6,269,079	\$ 2,697,424
Rental	1,583,633	557,562	3,232,574	1,542,056
Total Revenue	<u>4,588,777</u>	<u>1,143,097</u>	<u>9,501,653</u>	<u>4,239,480</u>
Cost of Sales:				
Product	2,139,034	345,244	4,503,983	2,349,056
Rental	1,229,985	714,804	3,177,386	1,019,404
Total Cost of Sales	<u>3,369,019</u>	<u>1,060,048</u>	<u>7,681,369</u>	<u>3,368,460</u>
Gross Profit	1,219,758	83,049	1,820,284	871,020
Costs and Expenses:				
Research and Development	646,848	447,092	1,736,656	1,411,791
Selling, General and Administrative	4,553,161	3,551,569	13,057,979	10,390,864
Impairment write-down in investment in affiliate	-	-	-	38,000
Non-Employee Stock Based Compensation	400,220	-	400,220	277,344
Employee Stock Based Compensation	425,800	230,991	1,115,867	815,809
Depreciation and Amortization	275,611	141,548	638,131	412,267
Total Operating Expense	<u>6,301,640</u>	<u>4,371,200</u>	<u>16,948,853</u>	<u>13,346,075</u>
Loss from Operations	(5,081,882)	(4,288,151)	(15,128,569)	(12,475,055)
Other Income (Expenses):				
Loss on early extinguishment of debt	-	(4,626,679)	-	(4,626,679)
Registration rights liquidated damages of subsidiary	(500,000)	-	(500,000)	-
Interest Income	37,883	106,074	110,343	294,614
Interest Expense	(328,611)	(1,665,030)	(529,168)	(5,515,378)
Total Other Income (Expenses)	<u>(790,728)</u>	<u>(6,185,635)</u>	<u>(918,825)</u>	<u>(9,847,443)</u>
Loss Before Provision for Income Taxes	(5,872,610)	(10,473,786)	(16,047,394)	(22,322,498)
Provision for Income Taxes	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Loss Before Minority Interest	(5,872,610)	(10,473,786)	(16,047,394)	(22,322,498)
Minority Interest	916,980	-	1,105,420	19,569
Net Loss	<u>\$ (4,955,630)</u>	<u>\$ (10,473,786)</u>	<u>\$ (14,941,974)</u>	<u>\$ (22,302,929)</u>
Loss per common share (basic and assuming dilution)	<u>\$ (0.07)</u>	<u>\$ (0.20)</u>	<u>\$ (0.23)</u>	<u>\$ (0.46)</u>
Weighted average common shares outstanding	67,520,571	52,602,757	64,324,325	48,784,948

See accompanying footnotes to the unaudited condensed consolidated financial information

TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)
FOR THE PERIOD FROM JANUARY 1, 2007 THROUGH SEPTEMBER 30, 2007

	<u>Preferred Shares</u>	<u>Preferred Stock Amount</u>	<u>Common Shares</u>	<u>Common Stock Amount</u>	<u>Additional Paid in Capital</u>	<u>Accumulated Deficit</u>	<u>Total</u>
Balance at January 1, 2007	-	-	56,992,301	\$ 56,992	\$ 78,502,900	\$ (70,424,669)	\$ 8,135,223
Shares issued for employee stock options exercised at approximately \$1.05 per share	-	-	118,500	119	124,342		124,460
Shares issued in exchange for services rendered at approximately \$2.63 per share	-	-	21,803	22	57,320		57,342
Issuance of shares for purchase of subsidiary	-	-	2,227,273	2,227	5,997,773		6,000,000
Issuance of shares for purchase of subsidiary	-	-	3,459,609	3,460	9,752,637		9,756,097
Shares Issued in connection with Private Placement	-	-	4,000,000	4,000	9,606,000		9,610,000
Issuance of shares for acquisition by subsidiary			866,856	867	1,529,133		1,530,000
Shares issued in exchange for services at \$1.68 per share			50,000	50	83,950		84,000
Value of additional warrants issued in conjunction with exchange of convertible debentures	-	-	-	-	132,949		132,949
Debt discount attributable to warrants attached to Note			-	-	195,924		195,924
Stock-based compensation expense related to employee stock options	-	-	-	-	941,900		941,900
Stock-based compensation related to Stock option expenses accrued in prior period	-	-	-	-	153,963		153,963
Net Loss	-	-				(14,941,974)	(14,941,974)
Balance at September 30, 2007	<u>-</u>	<u>\$ -</u>	<u>67,736,342</u>	<u>\$ 67,736</u>	<u>\$ 107,078,791</u>	<u>\$ (85,366,643)</u>	<u>\$ 21,779,884</u>

See accompanying footnotes to the unaudited condensed consolidated financial information

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

	For The Nine months Ended September 30,	
	2007	2006
Cash Flows from Operating Activities:		
Net loss	\$ (14,941,974)	\$ (22,302,929)
Adjustments to reconcile net loss from operations to cash used in operating activities		
Minority interest	(1,105,420)	(19,569)
Amortization and write-off of financing costs in connection with conversion of convertible debentures	-	1,145,911
Amortization of financing costs	101,663	-
Write-off of fixed assets in conjunction with loss on sublease	64,608	-
Registration rights liquidated damages of subsidiary	500,000	-
Warrants issued for interest expense	319,495	-
Warrants issued with conversion of convertible debentures	-	2,921,023
Common stock issued in exchange for and penalty in connection with early extinguishment of debt	-	1,982,078
Common stock issued in exchange for interest expense	-	23,951
Amortization of debt discount	175,450	-
Amortization and write-off of debt discount - beneficial conversion feature of convertible debentures	-	1,390,137
Amortization and write-off of debt discount - value of warrants attached to convertible debentures	-	2,743,342
Stock options and warrants issued in exchange for services rendered	1,115,867	1,093,153
Common stock issued in exchange for services rendered	308,342	203,027
Impairment write-down in investment in Amperion	-	38,000
Depreciation, including depreciation of equipment under operating leases	1,181,149	699,268
Increase / decrease in:		
Accounts receivable	(1,573,744)	(327,325)
Inventory	474,432	172,041
Prepaid expenses and deposits	(713,831)	(425,359)
Customer deposits and other	129,368	(72,662)
Accounts payable and accrued expenses	1,480,144	(217,001)
Deferred revenue	(115,927)	87,467
Deferred lease liability and other	9,114	245
Net Cash (Used in) Operating Activities	(12,591,264)	(10,014,484)
Cash Flows from Investing Activities:		
Costs of cable equipment, installation and equipment under operating leases	(1,162,832)	(1,576,980)
Proceeds from sale of equipment under operating lease	-	350,571
Released funds from Restricted Certificate of Deposit	-	10,000,000
Investment in Newport	(1,020,000)	-
Payment of note payable and investment in subsidiary	(900,000)	(1,017,822)
Net cash acquired from MST	-	59,384
Investment in subsidiaries	(3,150,557)	-
Investment in affiliate	-	(44)
Purchase of property and equipment, net	(266,280)	(708,598)
Net Cash Provided by (Used in) Investing Activities	(6,499,669)	7,106,511
Cash Flows from Financing Activities:		
Proceeds from sale of common stock, net of costs	9,610,000	6,000,000
Proceeds from the issuance of senior note payable	1,500,000	-
Proceeds from subsidiaries' sale of common stock, net of costs	2,694,020	-
Proceeds from the issuance of convertible debentures, net of costs and fees	5,303,238	-
Repayment of convertible debentures	-	(7,750,000)
Repayment of senior notes	-	(100,000)
Proceeds from exercise of stock options and warrants	124,460	2,371,300
Repayment of subsidiary loans	(202,236)	(412,119)
Net Cash Provided by Financing Activities	19,029,482	109,181
Net (Decrease) in Cash and Cash Equivalents	(61,451)	(2,798,792)
Cash and cash equivalents at the beginning of the period	1,644,037	8,422,079
Cash and cash equivalents at the end of the period	\$ 1,582,586	\$ 5,623,287

See accompanying footnotes to the unaudited condensed consolidated financial information

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

	For The Nine months Ended September 30,	
	2007	2006
Supplemental Disclosures of Cash Flow Information		
Cash paid during the period for interest	\$ 3,995	\$ 1,014,797
Income taxes paid	-	-
Non-cash transactions:		
Note payable under subsidiary acquisition	-	900,000
Common stock issued in exchange for convertible debentures	-	12,250,000
Common stock issued in exchange for interest expense and penalty in connection with early extinguishment of debt	-	2,006,029
Registration rights liquidated damages of subsidiary	500,000	-
Issuance of shares for purchase of subsidiary	17,286,097	2,700,000
Employee stock-based compensation	1,095,863	815,809
Issuance of stock options and warrants in exchange for services rendered	-	277,344
Common stock issued for services rendered	141,342	203,026
Value of stock options issued for accrued expenses	153,963	-
Acquisition of subsidiaries (Note B):		
Assets acquired	3,052,880	1,656,673
Subscriber lists	4,781,893	2,463,927
Goodwill (including purchase price contingency)	15,096,922	6,477,767
Minority Interest	-	(19,569)
Liabilities assumed	(1,356,415)	(1,460,976)
Common stock issued	(17,286,097)	(2,700,000)
Notes payable issued	-	(900,000)
Purchase price contingency	-	(4,500,000)
Direct acquisition costs	(394,183)	(117,822)
Cash paid for acquisition	<u>\$ (3,895,000)</u>	<u>\$ (900,000)</u>

See accompanying footnotes to the unaudited condensed consolidated financial information

TELKONET, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2007
(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-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Accordingly, the results from operations for the three and nine-month period ended September 30, 2007, are not necessarily indicative of the results that may be expected for the year ended December 31, 2007. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated December 31, 2006 financial statements and footnotes thereto included in the Company's Form 10-K for the year ended December 31, 2006.

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 by 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.

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

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

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

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

In July 2007, Microwave Satellite Technologies, Inc., the wholly-owned subsidiary of the Company's majority owned subsidiary MSTI Holdings Inc., acquired substantially all of the assets of Newport Telecommunications Co., a New Jersey general partnership. Pursuant to the terms of the acquisition, the total consideration paid was \$2,550,000, consisting of unregistered shares of the Company's common stock, equal to \$1,530,000, and (ii) \$1,020,000 in cash, subject to adjustments. The total consideration will be increased or decreased depending on the number of subscriber accounts acquired in the acquisition that were in good standing at that time.

TELKONET, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2007
(UNAUDITED)

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Telkonet Communications, Inc. and Ethostream, LLC and 63%-owned subsidiary MSTI Holdings Inc. (reported as the Company's MST segment). Significant intercompany transactions have been eliminated in consolidation.

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

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 Company periodically reviews its trade receivables in determining its allowance for doubtful accounts. The allowance for doubtful accounts was \$207,000 and \$60,000 at September 30, 2007 and December 31, 2006, respectively.

Liquidity

As shown in the accompanying consolidated financial statements, the Company incurred net loss of \$14,941,974 and \$22,302,929 for the nine months ended September 30, 2007 and 2006, respectively. Net loss included \$1,161,216 and \$5,304,765 of non-cash expense in connection with the convertible debentures, \$0 and \$4,626,769 of non-cash expense in connection with the early extinguishment of debt, and \$1,516,087 and \$1,093,153 of non-cash compensation to employees and non-employees in connection with stock options granted and vested for the nine months ended September 30, 2007 and 2006, respectively. The Company's current assets, on a consolidated basis, exceeded its current liabilities by \$167,779 as of September 30, 2007.

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 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.

TELKONET, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2007
(UNAUDITED)

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

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

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

Guarantees and Product Warranties

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

The Company's guarantees were issued subject to the recognition and disclosure requirements of FIN 45 as of September 30, 2007 and December 31, 2006. The Company records a liability for potential warranty claims. The amount of the liability is based on the trend in the historical ratio of claims to sales, the historical length of time between the sale and resulting warranty claim, new product introductions and other factors. The products sold are generally covered by a warranty for a period of one year. In the event the Company determines that its current or future product repair and replacement costs exceed its estimates, an adjustment to these reserves would be charged to earnings in the period such determination is made. During the nine months ended September 30, 2007 and the year ended December 31, 2006, the Company experienced approximately three percent of units returned under its product warranty policy. As of September 30, 2007 and December 31, 2006, the Company recorded warranty liabilities in the amount of \$58,817 and \$47,300, respectively, using this experience factor.

Registration Payment Arrangements

The Company accounts for registration payment arrangements under Financial Accounting Standards board (FASB) Staff Position EITF 00-19-2, "Accounting for Registration Payment Arrangements" (FSP EITF 00-19-2). FSP EITF 00-19-2 specifies that the contingent obligation to make future payments under a registration payment arrangement should be separately recognized and measured in accordance with SFAS No. 5, Accounting for Contingencies. FSP EITF 00-19-2 was issued in December, 2006. As of September 30, 2007, the Company had accrued an estimated penalty (see Note E).

New Accounting Pronouncements

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities." SFAS 159 permits entities to choose to measure many financial instruments, and certain other items, at fair value. SFAS 159 applies to reporting periods beginning after November 15, 2007. The adoption of SFAS 159 is not expected to have a material impact on the Company's financial condition or results of operations.

TELKONET, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2007
(UNAUDITED)

NOTE B - ACQUISITION OF SUBSIDIARY

Acquisition of Microwave Technologies, Inc .

On January 31, 2006, the Company acquired a 90% interest in Microwave Satellite Technologies, Inc. ("MST") from Frank Matarazzo, the sole stockholder of MST, in exchange for \$1.8 million in cash and 1.6 million unregistered shares of the Company's common stock for an aggregate purchase price of \$9,000,000. The purchase price of \$9,000,000 was increased by \$117,822 for direct costs related to the acquisition. These direct costs included legal, accounting and other professional fees. The cash portion of the purchase price was payable in two installments, \$900,000 at closing and \$900,000 payable in January 2007. The stock portion is payable from shares held in escrow, 400,000 shares at closing and the remaining 1,200,000 "purchase price contingency" shares issued based on the achievement of 3,300 "Triple Play" subscribers over a three year period. During the quarter ended September 30, 2006, the Company issued 200,000 shares of the purchase price contingency valued at \$900,000 as an adjustment to Goodwill.

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

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

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

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

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

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

(*) At the date of the acquisition, the effect of the "purchase price contingency" shares valued at approximately \$5.4 million had not been recorded in accordance with FAS 141. During the quarter ended September 30, 2006, the Company issued 200,000 shares of the purchase price contingency valued at \$900,000 as an adjustment to Goodwill. The remaining shares, when issued, will reflect an adjustment to Goodwill and Other Intangibles.

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

At December 31, 2006, the Company performed an impairment test on the goodwill and intangibles acquired, it was determined that there were no changes in the carrying value of goodwill and intangibles acquired.

On May 24, 2007, MST completed a merger transaction pursuant to which it became a wholly-owned subsidiary of MSTI Holdings, Inc. (formerly Fitness Xpress, Inc. ("FXS")), an inactive publicly registered shell corporation with no significant assets or operations. As a result of the merger, there was a change in control of the public shell corporation. In accordance with SFAS No. 141, MST was the acquiring entity. While the transaction is accounted for using the purchase method of accounting, in substance the transaction represented a recapitalization of MST's capital structure. For accounting purposes, the Company accounted for the transaction as a reverse acquisition and MST is the surviving entity. MST did not recognize goodwill or any intangible assets in connection with the transaction. In connection with the acquisition, the Company's 90% interest in MST was converted to a 63% interest in MSTI Holdings, Inc.

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Acquisition of Smart Systems International, Inc.

On March 9, 2007, the Company acquired substantially all of the assets of Smart Systems International (SSI), a leading provider of energy management products and solutions to customers in the United States and Canada for cash and Company common stock having an aggregate value of \$6,875,000. The purchase price was comprised of \$875,000 in cash and 2,227,273 shares of the Company's common stock. The Company is obligated to register the stock portion of the purchase price on or before May 15, 2007 and 1,090,909 shares are being held in an escrow account for a period of one year following the closing from which certain potential indemnification obligations under the purchase agreement may be satisfied. The aggregate number of shares held in escrow is 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.

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

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

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

Current assets	\$ 1,416,299
Property, plant and equipment	36,020
Other assets	8,237
Goodwill	6,103,771
Total assets acquired	7,564,327
Accounts payable and accrued liabilities	(557,784)
Total liabilities assumed	(557,784)
Net assets acquired	\$ 7,006,543

Due to its recent date of acquisition, the purchase price allocation to Goodwill is based upon preliminary data that is subject to adjustment and could change significantly. In accordance with SFAS 142, goodwill is not amortized and will be tested for impairment at least annually.

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Acquisition of Ethostream LLC

On March 15, 2007, the Company acquired 100% of the outstanding membership units of Ethostream, LLC, a network solutions integration company that offers installation, sales and service to the hospitality industry. The Ethostream acquisition will enable Telkonet to provide installation and support for PLC products and third party applications to customers across North America. The purchase price of \$11,756,097 was comprised of \$2.0 million in cash and 3,459,609 shares of the Company's common stock. The entire stock portion of the purchase price is being held in escrow 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. If during the twelve months following the Closing, the common stock has a volume-weighted average trading price of at least \$4.50, as reported on the American Stock Exchange, for twenty (20) consecutive trading days, the aggregate number of shares of common stock issuable to the sellers shall be adjusted such that the number of shares of common stock issuable as the stock consideration shall be determined assuming a per share price equal to \$4.50.

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

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

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

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

Goodwill and other intangible assets represent the excess of the purchase price over the fair value of the net tangible assets acquired. Due to its recent date of acquisition, the purchase price allocation to Intangibles and Goodwill is based upon preliminary data that is subject to adjustment and could change significantly pending the completion of management's valuation to accurately evaluate this allocation. In accordance with SFAS 142, goodwill is not amortized and will be tested for impairment at least annually. The subscriber list was preliminarily valued and could also change significantly pending the completion of management's appraisal at \$2,900,000 with an estimated useful life of twelve years.

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Acquisition of Newport Telecommunications Co. by Subsidiary

On July 18, 2007, Microwave Satellite Technologies, Inc., the wholly-owned subsidiary of the Company's majority owned subsidiary MSTI Holdings Inc., acquired substantially all of the assets of Newport Telecommunications Co., a New Jersey general partnership ("NTC"), relating to NTC's business of providing broadband internet and telephone services at certain residential and commercial properties in the development known as Newport in Jersey City, New Jersey. Pursuant to the terms of the NTC acquisition, the total consideration paid was \$2,550,000, consisting of (i) 866,856 unregistered shares of the Company's common stock, equal to \$1,530,000 (which is based on the average closing prices for the Company common stock for the ten trading days immediately prior to the closing date), and (ii) \$1,020,000 in cash, subject to adjustments. The total consideration will be increased or decreased depending on the number of subscriber accounts acquired in the NTC acquisition that were in good standing at that time. The number will be determined within 120 days of the closing. The stock certificates representing the Company common stock, and \$510,000 of the cash consideration were paid to an escrow agent to be released after the final determination of the number of subscriber accounts in good standing acquired at closing.

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

	<u>As Reported</u>
Common stock	\$ 1,530,000
Cash	1,020,000
Direct acquisition costs	98,294
Total Purchase Price	<u>\$ 2,648,294</u>

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

Current assets	\$ -
Property, plant and equipment	668,107
Other assets	98,294
Subscriber lists	1,881,893
Goodwill	-
Total assets acquired	<u>2,648,294</u>
Accounts payable and accrued liabilities	-
Total liabilities assumed	<u>-</u>
Net assets acquired	<u>\$ 2,648,294</u>

Goodwill and other intangible assets represent the excess of the purchase price over the fair value of the net tangible assets acquired. Due to its recent date of acquisition, the purchase price allocation to Intangibles and Goodwill is based upon preliminary data that is subject to adjustment and could change significantly pending the completion of management's valuation to accurately evaluate this allocation. In accordance with SFAS 142, goodwill is not amortized and will be tested for impairment at least annually. The subscriber list was preliminarily valued and could also change significantly pending the completion of management's appraisal at \$1,881,893 with an estimated useful life of eight years.

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

	Nine months Ended	
	September 30,	
	Proforma	Proforma
	2007	2006
Product revenue	\$ 7,185,105	\$ 5,636,119
Rental revenue	4,739,867	3,666,301
Total revenues	<u>11,924,972</u>	<u>9,302,420</u>
Net (loss)	\$ (15,855,515)	\$ (23,185,452)
Basic (loss) per share	\$ (0.25)	\$ (0.39)
Diluted (loss) per share	\$ (0.25)	\$ (0.39)

NOTE C - 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, eXtenders, Couplers and iBridges, which are the significant components of the Telkonet solution. Components of inventories as of September 30, 2007 and December 31, 2006 are as follows:

	September	December 31,
	30, 2007	2006
Raw Materials	\$ 1,050,880	\$ 516,604
Finished Goods	1,074,202	789,989
	<u>\$ 2,125,082</u>	<u>\$ 1,306,593</u>

NOTE D - INTANGIBLE ASSETS AND GOODWILL

As a result of the MST acquisition at January 31, 2006 and the Ethostream acquisition on March 15, 2007 and MSTI Holdings, Inc.'s acquisition of Newport on July 18, 2007, the Company had intangibles totaling \$7,245,820 at September 30, 2007 (Note B).

In accordance with SFAS 142, *Goodwill and Other Intangible Assets* (SFAF No. 142), an impairment test will be performed on these assets at least annually. The consolidated statement of operations for the three and nine months ended September 30, 2007 includes only charges for amortization of these intangibles.

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

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

The MST subscriber list was determined to have an eight-year life. This intangible was amortized using that life and amortization from the date of the acquisition through September 30, 2007 was taken as a charge against income in the consolidated statement of operations. MST's goodwill of \$1,977,767, excluding the purchase price contingency, represented the excess of the purchase price over the fair value of the net tangible and intangible assets acquired.

Additionally, the MST subscriber list includes the acquisition of subscribers from Newport Telecommunications. This subscriber list was determined to have an eight-year life. This intangible was amortized using that life and amortization from the date of the acquisition through September 30, 2007 was taken as a charge against income in the consolidated statement of operations.

The Ethostream subscriber list was estimated to have a twelve-year life. This intangible was amortized using that life and amortization from the date of the acquisition through September 30, 2007 was taken as a charge against income in the consolidated statement of operations. Ethostream's goodwill of \$8,796,440 represented the excess of the purchase price over the fair value of the net tangible and intangible assets acquired.

Total identifiable intangible assets acquired and their carrying values at December 31, 2006 are:

	Gross Carrying Amount	Accumulated Amortization	Net	Residual Value	Weighted Average Amortization Period (Years)
Amortized Identifiable intangible Assets:					
Subscriber lists	\$ 2,463,927	\$ (282,325)	\$ 2,181,602	\$ -	8.0
Total Amortized Identifiable Intangible Assets	2,463,927	(282,325)	2,181,602	\$ -	8.0
Unamortized Identifiable Intangible Assets:	None				
Total	<u>\$ 2,463,927</u>	<u>\$ (282,325)</u>	<u>\$ 2,181,602</u>	<u>\$ -</u>	<u>8.0</u>

Total identifiable intangible assets acquired and their carrying values at September 30, 2007 are:

	Gross Carrying Amount	Accumulated Amortization	Net	Residual Value	Weighted Average Amortization Period (Years)
Amortized Identifiable Intangible Assets:					
Subscriber lists – MST	\$ 4,345,820	\$ (562,326)	3,783,494		8.0
Subscriber lists - Ethostream	2,900,000	\$ (130,903)	2,769,097	\$ -	12.0
Total Amortized Identifiable Intangible Assets	7,245,820	\$ (693,229)	6,552,591	-	9.6
Unamortized Identifiable Intangible Assets:	None				
Total	<u>\$ 7,245,820</u>	<u>\$ (693,229)</u>	<u>6,552,591</u>	<u>\$ -</u>	<u>9.6</u>

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Total amortization expense charged to operations for the nine months ended September 30, 2007 and 2006 was \$413,508 and \$209,958, respectively. Estimated amortization expense as of September 30, 2007 is as follows:

Fiscal	
October 1 - December 31, 2007	196,223
2008	784,894
2009	784,894
2010	784,894
2011	784,894
2012 and after	<u>3,216,792</u>
Total	<u>\$ 6,552,591</u>

The Company does not amortize goodwill. As a result of the acquisition of MST, Ethostream, and SSI, the Company recorded goodwill in the amount of \$16,877,978 as of September 30, 2007. There were no changes in the carrying amount of goodwill for the nine months ended September 30, 2007.

NOTE E - SENIOR CONVERTIBLE DEBENTURES AND SENIOR NOTES PAYABLE

A summary of convertible promissory notes payable at September 30, 2007 and December 31, 2006 is as follows:

	2007	2006
Senior Convertible Debentures, accrue interest at 8% per annum commencing on the first anniversary of the original issue date of the debentures, payable quarterly in cash or common stock, at MSTI Holdings Inc.'s option, and mature on April 30, 2010	\$ 6,576,350	\$ -
Original Issue Discount - net of accumulated amortization of \$175,450 and \$0 at September 30, 2007 and December 31, 2006, respectively.	(350,900)	-
Debt Discount - beneficial conversion feature, net of accumulated amortization of \$57,840 and \$0 at September 30, 2007 and December 31, 2006, respectively.	(809,765)	-
Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of \$57,840 and \$0 at September 30, 2007 and December 31, 2006, respectively.	<u>(809,765)</u>	<u>-</u>
Total	\$ 4,605,920	\$ -
Less: current portion	<u>-</u>	<u>-</u>
	<u>\$ 4,605,920</u>	<u>\$ -</u>

Aggregate maturities of long-term debt as of September 30, 2007 are as follows:

<u>For the twelve months ended September 30</u>	<u>Amount</u>
2007	-
2008	-
2009	-
2010	<u>6,576,350</u>
	<u>\$ 6,576,350</u>

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During the nine months ended September 30, 2007, MSTI Holdings Inc., a majority owned subsidiary of Telkonet, Inc., issued senior convertible debentures (the "Debentures") having a principal value of \$6,576,350 to investors, including an original issue discount of \$526,350, in exchange for \$6,050,000 from investors, exclusive of placement fees. The original issue discount to the Debentures is amortized over 12 months. The Debentures accrue interest at 8% per annum commencing on the first anniversary of the original issue date of the Debentures, payable quarterly in cash or common stock, at MSTI Holdings Inc.'s option, and mature on April 30, 2010. The Debentures are not callable and are convertible at a conversion price of \$0.65 per share into 10,117,462 shares of MSTI Holdings Inc. common stock, subject to certain limitations.

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 notes. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to the MST additional paid in capital included in the Company's minority interest. The Company recognized and measured an aggregate of \$867,605 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 Notes issued during the period ended September 30, 2007. The debt discount attributed to the beneficial conversion feature is amortized over the Notes maturity period (three years) as interest expense.

In connection with the placement of the Debentures, MSTI Holdings, Inc. has also agreed to issue to the Noteholders, five-year warrants to purchase an aggregate of 5,058,730 shares of MSTI Holdings, Inc. common stock at an exercise price of \$1.00 per share. MSTI Holdings Inc. valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 5.00%, a dividend yield of 0%, and volatility of 54%. The \$867,605 of debt discount attributed to the value of the warrants issued is amortized over the Notes maturity period (three years) as interest expense.

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

The Company amortized the original issue discount, the beneficial conversion feature and the value of the attached warrants, and recorded non-cash interest expense in the amount of \$175,450, \$57,840 and \$57,840, respectively, for the period ended September 30, 2007.

Registration Rights Liquidated Damages

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

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

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

The registration rights agreement requires the payment of liquidated damages to the investors of approximately 1% per month of the aggregate proceeds of \$9,128,717, or the value of the unregistered shares at the time that the liquidated damages are assessed, until the registration statement is declared effective, payable at the option of MSTI Holdings, Inc. In accordance with EITF 00-19-2, the Company evaluated the likelihood of achieving registration statement effectiveness. Accordingly, the Company has accrued an estimate of \$500,000 as of September 30, 2007, to account for these potential liquidated damages until the expected effectiveness of the registration statement is achieved.

Senior Convertible Notes

During the year ended December 31, 2005, the Company issued convertible senior notes (the "Convertible Senior Notes") having an aggregate principal value of \$20 million to sophisticated investors in exchange for \$20,000,000, exclusive of \$1,219,410 in placement costs and fees. The Convertible Senior Notes accrue interest at 7.25% per annum and call for monthly principal installments beginning March 1, 2006. The maturity date is 3 years from the date of issuance of the notes. At any time or times, the Noteholders shall be entitled to convert any portion of the outstanding and unpaid note amount into fully paid and nonassessable shares of the Company's common Shares at \$5 per share. At any time at the option of the Company, the principal payments may be paid either in cash or in common stock at the lower of \$5 or 92.5% of the average recent market price. At any time after nine months should the stock trade at or above \$8.75 for 20 of 30 consecutive trading days, the Company can cause a mandatory redemption and conversion to shares at \$5 per share. At any time, the Company can pre-pay the notes with cash or common stock. Should the Company pre-pay the Notes other than by mandatory conversion, the Company must issue additional warrants to the Noteholders covering 65% of the amount pre-paid at a strike price of \$5 per share. In addition to standard financial covenants, the Company has agreed to maintain a letter of credit in favor of the Noteholders equal to \$10 million. Once the principal amount of the note declines below \$15 million, the balance is reduced by \$.50 for every \$1 amortized. 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 notes. 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 \$1,479,300 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 Notes issued during the year ended December 31, 2005. The debt discount attributed to the beneficial conversion feature is amortized over the Notes maturity period (three years) as interest expense.

In connection with the placement of the Notes in October 2005, the Company has also agreed to issue to the Noteholders one million warrants to purchase company common stock exercisable for five years at \$5 per share. The Company recognized the value attributable to the warrants in the amount of \$2,919,300 to a derivative liability due to the possibility of the Company having to make a cash settlement, including penalties, in the event the Company failed to register the shares underlying the warrants under the Securities Act of 1933, as amended, within 90 days after the closing of the transaction. The Company accounted for this warrant derivative in accordance with EITF 00-19 Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock. The warrants were included as a liability and valued at fair market value until the Company met the criteria under EITF 00-19 for permanent equity. A registration statement covering shares issuable to the Noteholders upon conversion, amortization and/or redemption of the Convertible Senior Notes and upon exercise of the warrants was filed with the Securities and Exchange Commission on Form S-3 on November 23, 2005 and was declared effective on December 13, 2005. The warrant derivative liability was valued at the issuance date of the Notes in the amount of \$2,919,300 and then revalued at \$2,910,700 on December 13, 2005 upon effectiveness of the Form S-3. The Company charged \$8,600 to Other Income and the derivative warrant liability was reclassified to additional paid in capital at December 13, 2005. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 4.00%, a dividend yield of 0%, and volatility of 76%. The \$2,919,300 of debt discount attributed to the value of the warrants issued is amortized over the Notes maturity period (three years) as interest expense.

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Principal Payments of Debt

For the period of January 1, 2006 through August 14, 2006, the Company paid down principal of \$1,250,000 in cash and issued an aggregate of 4,226,246 shares of common stock in connection with the conversion of \$10,821,686 aggregate principal amount of the Senior Convertible Notes. Pursuant to the note agreement, the Company issued warrants to purchase 1,081,820 shares of common stock to the Noteholders, at a strike price of \$5.00 per share, which represented 65% of the \$8,321,686 accelerated principal at a strike price of \$5 per share. The Company valued the warrants at \$1,906,089 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 5.00%, a dividend yield of 0%, and volatility of 65%. The warrants are subject to anti-dilution protection in conjunction with the issuance of certain equity securities. The Company has warrants due the Noteholders as a result of the anti-dilution impact from a \$6,000,000 private placement in September 2006 (Note J). The Company has accounted for the additional warrants issued as interest expense during the period ended September 30, 2006.

For the period of January 1, 2006 through August 14, 2006, the Company amortized the debt discount to the beneficial conversion feature and value of the attached warrants, and recorded non-cash interest expense in the amount of \$251,759 and \$500,353, respectively. The Company also wrote-off the unamortized debt discount attributed to the beneficial conversion feature and the value of the attached warrants in the amount of \$708,338 and \$1,397,857, respectively, in connection with paydown and conversion of the note.

The Company has warrants due the Noteholders as a result of the anti-dilution impact from a \$10,000,000 private placement in February 2007 (Note I). The Company has accounted for the additional 76,230 warrants issued, valued at \$131,009, as interest expense during the period ended September 30, 2007. The Company valued the warrants using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 4.75%, a dividend yield of 0%, and volatility of 70%.

Early Extinguishment of Debt

On August 14, 2006, the Company executed separate settlement agreements with the lenders of its Convertible Senior Notes. Pursuant to the settlement agreements the Company paid to the lenders on August 15, 2006 in the aggregate \$9,910,392 plus accrued but unpaid interest of \$23,951 and certain premiums specified in the Notes in satisfaction of the amounts then outstanding under the Notes. Of the amount to be paid to the lenders under the Notes, \$6,500,000 was paid in cash through a drawdown on a letter of credit previously pledged as collateral for the Company's obligations under the Notes. The remaining note balance of \$1,428,314 and a Redemption Premium of \$1,982,078, calculated as 25% of remaining principal, was paid to the lenders in shares of the Company's common stock valued at the lower of \$5.00 per share and 92.5% of the arithmetic average of the weighted average price of the Company's common stock on the American Stock Exchange for the twenty trading days beginning on August 16, 2006. The Company also issued 862,452 warrants to purchase shares of the Company's common stock at the exercise price of \$2.58 per share (92.5% of the average trading price as described above). The Company valued the warrants at \$1,014,934 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 5.00%, a dividend yield of 0%, and volatility of 65%. The Company has accounted for the Redemption Premium and the additional warrants issued as non-cash early extinguishment of debt expense during the year ended December 31, 2006. Registration statements covering the shares underlying the warrants, were filed with the Securities and Exchange Commission on Form S-3 on September 29, 2006 and October 13, 2006 and were declared effective on October 16, 2006 and October 24, 2006, respectively. The achievement of permanent equity had been realized on October 16, 2006 and October 24, 2006 upon the declared effectiveness of the Form S-3. Upon the declared effectiveness of the Form S-3, the registration rights agreement requirements had been satisfied and achieved; therefore the warrants were accounted for as equity. The registration rights agreement required the payment of liquidated damages in the event of failure to achieve the registration with the SEC.

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As a result of the execution of the settlement agreements and the payments required thereby, the Company fully believes it repaid and satisfied all of its obligations under the Notes. The Company also agreed to pay the expenses of the lenders incurred in connection with the negotiation and execution of the settlement agreements. The settlement agreements were negotiated following the allegation by one of the lenders that the Company's failure to meet the minimum revenue test for the period ending June 30, 2006 as specified on the Notes constituted an event of default under the Notes, which allegation the Company disputed.

The Settlement Agreement provides 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.

Senior Note Payable

A summary of the senior notes payable at September 30, 2007 and December 31, 2006 is as follows:

	2007	2006
Senior Note Payable, accrues interest at 6% per annum, and mature on the earlier to occur of (i) the closing of the Company's next financing, or (ii) January 28, 2008.	\$ 1,500,000	\$ -
Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of \$70,866 and \$0 at September 30, 2007 and December 31, 2006, respectively.	(125,058)	-
Total	\$ 1,374,942	\$ -
Less: current portion	1,374,942	-
	\$ -	\$ -

Aggregate maturities of senior note as of September 30, 2007 are as follows:

<u>For the twelve months ended September 30</u>	<u>Amount</u>
2007	\$ -
2008	1,500,000
2009	-
2010	-
	\$ 1,500,000

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On July 24, 2007, Telkonet entered into a Senior Note Purchase Agreement with GRQ Consultants, Inc. ("GRQ") pursuant to which the Company issued to GRQ a Senior Promissory Note (the "Note") in the aggregate principal amount of \$1,500,000. The Note is due and payable on the earlier to occur of (i) the closing of the Company's next financing, or (ii) January 28, 2008, and bears interest at a rate of six (6%) percent per annum. The Company has incurred approximately \$25,000 in fees in connection with this transaction. The net proceeds from the issuance of the Note will be 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. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 4.00%, a dividend yield of 0%, and volatility of 76%. The \$195,924 of debt discount attributed to the value of the warrants issued is amortized over the note maturity period (six months) as non-cash interest expense. The Company amortized the value of the attached warrants, and recorded non-cash interest expense in the amount of \$70,866, respectively, for the period ended September 30, 2007.

NOTE F - 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.

<u>Exercise Prices</u>	<u>Options Outstanding</u>		<u>Weighted Average Exercise Price</u>	<u>Options Exercisable</u>	
	<u>Number Outstanding</u>	<u>Weighted Average Remaining Contractual Life (Years)</u>		<u>Number Exercisable</u>	<u>Weighted Average Exercise Price</u>
\$ 1.00-\$1.99	4,273,429	5.41	\$ 1.04	4,083,429	\$ 1.00
\$ 2.00-\$2.99	1,995,750	7.37	\$ 2.54	1,329,750	\$ 2.49
\$ 3.00-\$3.99	1,811,000	7.68	\$ 3.27	1,177,750	\$ 3.38
\$ 4.00-\$4.99	160,000	7.47	\$ 4.44	66,500	\$ 4.44
\$ 5.00-\$5.99	146,750	7.36	\$ 5.24	70,250	\$ 5.21
	<u>8,386,929</u>	<u>6.44</u>	<u>\$ 2.01</u>	<u>6,456,179</u>	<u>\$ 1.72</u>

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

	<u>Number of Shares</u>	<u>Weighted Average Price Per Share</u>
Outstanding at January 1, 2005	9,614,767	\$ 1.61
Granted	1,325,000	3.97
Exercised	(415,989)	1.18
Canceled or expired	(372,200)	3.74
Outstanding at December 31, 2005	<u>10,151,078</u>	<u>\$ 1.85</u>
Granted	1,125,000	3.01
Exercised	(2,051,399)	1.30
Canceled or expired	(703,750)	2.67
Outstanding at December 31, 2006	<u>8,520,929</u>	<u>\$ 2.06</u>
Granted	935,000	2.55
Exercised (Note J)	(118,500)	1.05
Canceled or expired	(950,500)	3.01
Outstanding at September 30, 2007	<u>8,386,929</u>	<u>\$ 2.01</u>

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The weighted-average fair value of stock options granted to employees during the period ended September 30, 2007 and 2006 and the weighted-average significant assumptions used to determine those fair values, using a Black-Scholes option pricing model are as follows:

	<u>2007</u>	<u>2006</u>
Significant assumptions (weighted-average):		
Risk-free interest rate at grant date	4.8%	5.0%
Expected stock price volatility	70%	65%
Expected dividend payout	-	-
Expected option life-years	5.0	5.0
Expected forfeiture rate	12%	12%
Fair value per share of options granted	\$ 1.57	\$ 1.94

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

The total intrinsic value of the options exercised during the nine months ended September 30, 2007 and 2006 is \$73,470, and \$2,510,591, respectively. Additionally, the total fair value of shares vested during these periods is \$941,900 and \$815,809, respectively.

Total stock-based compensation expense recognized in the consolidated statement of earnings for the nine months ended September 30, 2007 was \$941,900, net of tax effect, excluding \$173,967 of expense attributable to MST. Additionally, the aggregate intrinsic value of options outstanding and unvested at September 30, 2007 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.

<u>Exercise Price</u>	<u>Options Outstanding</u>		<u>Weighed Average Exercise Price</u>	<u>Options Exercisable</u>	
	<u>Number Outstanding</u>	<u>Weighted Average Remaining Contractual Life (Years)</u>		<u>Number Exercisable</u>	<u>Weighted Average Exercise Price</u>
\$ 1.00	1,815,937	4.59	\$ 1.00	1,815,937	\$ 1.00

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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, 2005	1,999,169	\$ 1.07
Granted	15,000	3.45
Exercised	(172,395)	2.07
Canceled or expired	-	-
Outstanding at December 31, 2005	<u>1,841,774</u>	<u>\$ 1.00</u>
Granted	-	-
Exercised	(25,837)	1.00
Canceled or expired	-	-
Outstanding at December 31, 2006	<u>1,815,937</u>	<u>\$ 1.00</u>
Granted	-	-
Exercised	-	-
Canceled or expired	-	-
Outstanding at September 30, 2007	<u>1,815,937</u>	<u>\$ 1.00</u>

The amount of the expense charged to operations in connection with granting stock options to non employees was \$0 and \$273,499 during the nine months ended September 30, 2007 and 2006, 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 in connection with placement of convertible debentures.

Exercise Prices	Warrants Outstanding			Warrants Exercisable		
	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighed Average Exercise Price	Number Exercisable	Weighted Average Exercise Price	
\$ 2.59	862,452	3.87	\$ 2.59	862,452	\$ 2.59	
\$ 4.17	4,596,451	4.23	\$ 4.17	4,596,451	\$ 4.17	
\$ 4.70	2,214,724	3.46	\$ 4.70	2,214,724	\$ 4.70	
	<u>7,673,627</u>	<u>3.97</u>	<u>\$ 4.15</u>	<u>7,673,627</u>	<u>\$ 4.15</u>	

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Transactions involving warrants are summarized as follows:

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2005	575,900	\$ 1.12
Granted	1,040,000	4.85
Exercised	(371,900)	1.00
Canceled or expired	(14,000)	1.00
Outstanding at December 31, 2005	1,230,000	\$ 4.31
Granted	3,657,850	4.03
Exercised	(47,750)	1.15
Canceled or expired	(282,250)	2.64
Outstanding at December 31, 2006	4,557,850	\$ 4.20
Granted	3,115,777	4.18
Exercised	-	-
Canceled or expired	-	-
Outstanding at September 30, 2007	7,673,627	\$ 4.15

The Company has warrants due the Noteholders as a result of the anti-dilution impact from a \$10,000,000 private placement in February 2007 (Note I). The Company has accounted for the additional 76,230 warrants issued, valued at \$131,009, as non-cash interest expense during the period ended September 30, 2007. The Company valued the warrants using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk-free interest rate of 4.75%, a dividend yield of 0%, and volatility of 70%.

The estimated value of compensatory warrants vested during the period ended September 30, 2006 was determined using the Black-Scholes option pricing model and the following assumptions: warrant remaining life of 0.14 years, a risk free interest rate of 4.77%, a dividend yield of 0% and volatility of 67%. In-the-money warrants granted were charged to operations at grant date. Total expense of \$3,845 was charged to operations for the period ended September 30, 2006.

The anti-dilution impact of the private placements from August 2006 and February 2007 to the existing Noteholders, obligated the Company to re-price all of the affected purchase warrants outstanding from a price per share of \$5.00, to \$4.87 as of December 31, 2006 and \$4.70 as of September 30, 2007, respectively.

In addition, the Company issued 2,600,000 warrants to investors and 76,739 warrants to its placement agent in connection with the private placement in February 2007 (Note I). The warrants issued to the placement agent were valued at \$139,112 using the Black-Scholes pricing model and the following assumptions: contractual term of 5 years, an average risk-free interest rate of 4.75% a dividend yield of 0% and volatility of 70%.

NOTE G - BUSINESS SEGMENTS

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

Telkonet (TKO) is engaged in the business of developing 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.

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

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

Financial data relating to reportable operating segments is as follows:

	Nine months ended September 30,	
	<u>2007</u>	<u>2006</u>
	(In thousands of U.S. \$)	
Revenues:		
Telkonet	\$ 7,736	\$ 2,978
MST	1,765	1,261
Total revenue	<u>\$ 9,501</u>	<u>\$ 4,239</u>

	Nine months ended September 30,	
	<u>2007</u>	<u>2006</u>
	(In thousands of U.S. \$)	
Gross Profit		
Telkonet	\$ 2,486	\$ 1,099
MST	(666)	(228)
Total gross profit	<u>\$ 1,820</u>	<u>\$ 871</u>

Loss from Operations:		
Telkonet	\$ (10,917)	\$ (10,439)
MST	(4,211)	(2,036)
Total operating loss	<u>\$ (15,128)</u>	<u>\$ (12,475)</u>

	September 30, 2007	December 31, 2006
	<u>2007</u>	<u>2006</u>
	(In thousands of U.S. \$)	
Assets		
Telkonet	\$ 24,540	\$ 4,137
MST	13,135	8,379
Total assets	<u>\$ 37,675</u>	<u>\$ 12,517</u>

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NOTE H - MINORITY INTEREST IN SUBSIDIARY

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

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

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

For the nine months ended September 30, 2007 and 2006, the minority shareholder's share of the loss of MST was limited to \$920,419 and \$19,569, respectively. The minority interest in MST through May 24, 2007 was a deficit and, in accordance with Accounting Research Bulletin No. 51, subsidiary losses should not be charged against the minority interest to the extent of reducing it to a negative amount. As such, any losses will be charged against the Company's operations, as majority owner. However, if future earnings do materialize, the majority owner should be credited to the extent of such losses previously absorbed in the amount of \$545,745.

Minority interest at September 30, 2007 and December 31, 2006 amount to \$3,783,829 and \$0, respectively.

NOTE I - CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock, par value \$.001 per share. As of September 30, 2007 and December 31, 2006, the Company had 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, 2007 and December 31, 2006, the Company had 67,736,342 and 56,992,301 shares of common stock issued and outstanding, respectively.

During the period ended September 30, 2007, the Company issued an aggregate of 118,500 shares of common stock for an aggregate purchase price of \$124,460 to certain employees upon exercise of employee stock options at approximately \$1.05 per share. (Note F).

During the period ended September 30, 2007, the Company issued an aggregate of 21,803 shares of common stock, valued at \$57,342, to a consultant and an employee in exchange for services, which approximated the fair value of the shares issued during the period services were completed and rendered.

During the period ended September 30, 2007, the Company issued 50,000 shares of common stock pursuant to a consulting agreement. These shares were valued at \$84,000, which approximated the fair value of the shares issued during the period services were completed and rendered.

On March 9, 2007, the Company entered into an Asset Purchase Agreement ("Agreement") with Smart Systems International, a privately held company. Pursuant to the Agreement, the Company issued 2,227,273 shares of Common Stock at approximately \$2.69 per share (Note B).

On March 15, 2007, the Company entered into a Purchase Agreement ("Agreement") with Ethostream, LLC, a privately held company. Pursuant to the Agreement, the Company issued 3,459,609 shares of Common Stock at approximately \$2.82 per share (Note B).

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On July 18, 2007, Telkonet issued 866,856 unregistered shares of common stock of Telkonet, Inc. in connection with the acquisition of substantially all of the assets of Newport Telecommunications Co. by the Telkonet majority-owned subsidiary, Microwave Satellite Holdings, Inc. The Common Stock issued by Telkonet represented \$1,530,000 of the total consideration of \$2,550,000 paid in the asset purchase.

In February 2007, the Company issued 4,000,000 shares of Common Stock valued at \$2.50 per share for an aggregate purchase price of \$9,610,000, net of placement fees. The Company also issued to this investor warrants to purchase 2.6 million shares of its common stock at an exercise price of \$4.17 per share in this private placement transaction. A registration statement covering the shares underlying the warrants, was filed with the Securities and Exchange Commission on Form S-3 on March 5, 2007 and was declared effective on March 20, 2007. In accordance with EITF 00-19-02, "Accounting for Registration Payment Arrangements", at the time of the issuance of the equity for registration the Company deemed it probable that a registration of shares would be deemed effective therefore a loss contingency would not be necessary and the equity was recorded at fair value on the date of issuance.

NOTE J - COMMITMENTS AND CONTINGENCIES

Employment and Consulting Agreements

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

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

The Company entered into an exclusive financial advisory and consulting agreement in January 2007. The agreement provides for a minimum consideration fee of \$250,000, in the event of an equity sale or other financing transaction where the advisor is engaged. The agreement may be terminated with sixty days notification by either party.

On August 1, 2007, the Company entered into an agreement with Barry Honig, President of GRQ Consultants, Inc. ("GRQ"). Telkonet 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. GRQ holds a Senior Promissory Note issued by Telkonet in the principal amount of \$1,500,000. The Note was issued on July 24, 2007 (Note E).

Litigation

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

Senior Convertible Noteholder Claim

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

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In the Company's opinion, the ultimate disposition of these matters will not have a material adverse effect on the Company's results of operations or financial position.

Purchase Price Contingency

In conjunction with the acquisition of MST on January 31, 2006, the purchase price contingency shares are price protected for the benefit of the former owner of MST (Note B). In the event the Company's common stock price is below \$4.50 per share upon issuance of the shares from escrow, a pro rata adjustment in the number of shares will be required to support the aggregate consideration of \$5.4 million. The price protection provision provides a cash benefit to the former owner of MST if the as-defined market price of the Company's common stock is less than \$4.50 per share at the time of issuance from the escrow. The issuance of additional shares or distribution of other consideration upon resolution of the contingency based on the Company's common stock prices will not affect the cost of the acquisition. When the contingency is resolved or settled, and additional consideration is distributable, the Company will record the current fair value of the additional consideration and the amount previously recorded for the common stock issued will be simultaneously reduced to the lower current value of the Company's common stock.

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

Of the stock issued in the SSI acquisition, 1,090,909 shares are being held in an escrow account for a period of one year following the closing from which certain potential indemnification obligations under the purchase agreement may be satisfied. The aggregate number of shares held in escrow is 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 15, 2007, the Company acquired 100% of the outstanding membership units of Ethostream, LLC, a network solutions integration company that offers installation, sales and service to the hospitality industry. The Ethostream acquisition will enable Telkonet to provide installation and support for PLC products and third party applications to customers across North America. The purchase price of \$11,756,097 was comprised of \$2.0 million in cash and 3,459,609 shares of the Company's common stock. The entire stock portion of the purchase price is being held in escrow 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. The aggregate number of shares issuable to the sellers is subject to downward adjustment in the event the Company's common stock trades at or above a price of \$4.50 per share for twenty consecutive trading days during the one year period following the closing.

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NOTE K - NOTE RECEIVABLE

In conjunction with the acquisition of Ethostream on March 15, 2007, the Company maintains a net investment in certain sales-type lease notes receivable as of September 30, 2007 consisting of the following:

Total Minimum Lease Payments to be Received	\$ 38,915
Less: Unearned Interest Income	<u>(3,065)</u>
Net Investment in Sales-Type Lease Notes Receivable	35,850
Less: Current Maturities	<u>(17,876)</u>
Non-Current Portion	<u><u>\$ 17,974</u></u>

Aggregate future minimum lease payments to be received under the above leases are as follows as of September 30, 2007:

2007	\$ 17,876
2008	9,900
2009	7,175
2010	899
	<u><u>\$ 35,850</u></u>

NOTE L - EMPLOYEE BENEFIT PLAN

The Company maintains a Profit Sharing and Retirement Savings Plan for qualified employees of its subsidiary MST as of the acquisition on January 31, 2006. MST's expense for these benefits was \$11,695 for the period ending September 30, 2007.

NOTE M - BUSINESS CONCENTRATION

There were no major customers with revenues representing more than 10% of total revenues for the nine month period ending September 30, 2007. Revenue from one major customer approximated \$881,023 or 21% of sales for the nine-month period ended September 30, 2006. Total accounts receivable of \$8,774 or 2% of total accounts receivable, was due from the one major customer as of September 30, 2006.

Purchases from three (3) major suppliers approximated \$2,034,353 or 34% of purchases and \$374,481 or 66% of purchases for the nine month period ended September 30, 2007 and 2006, respectively. Total accounts payable of approximately \$451,768 or 17% of total accounts payable was due to these three suppliers as of September 30, 2007 and approximately \$42,702 or 8% of total accounts payable was due to these three suppliers as of September 30, 2006.

NOTE N - SUBSEQUENT EVENTS

Acquisition of Geeks on Call America, Inc.

On October 19, 2007, the Company completed the acquisition of approximately 30.0% of the issued and outstanding shares of common stock of Geeks on Call America, Inc. ("GOCA"), the nation's premier provider of on-site computer services. Under the terms of the stock purchase agreement, the Company acquired approximately 1,160,043 shares of GOCA common stock from several GOCA stockholders in exchange for 2,940,200 shares of the Company's common stock for total consideration valued at approximately \$4.5 million. The number of shares issued in connection with this transaction was determined using a per share price equal to the average closing price of the Company's common stock on the American Stock Exchange (AMEX) during the ten trading days immediately preceding the closing date. The number of shares is subject to adjustment on the date the Company files a registration statement for the shares issued in this transaction, which must occur no later than the 90th day following the closing date. The increase or decrease to the number of shares issued will be determined using a per share price equal to the average closing price of the Company's common stock on the AMEX during the ten trading days immediately preceding the date the registration statement is filed.

Sale of Investment in BPL Global

On November 7, 2007, the Company completed the sale of its investment in BPL Global, Ltd for \$2,000,000 in cash to certain existing stockholders of BPL Global. The Company owned an equity interest of approximately 4.67% of BPL Global with a fair value on the Company's balance sheet of \$131,044.

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 three and nine months ended September 30, 2007 and 2006, 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, 2006 filed on March 16, 2007.

Business

Telkonet, Inc., formed in 1999, develops and markets technology for the transmission of high-speed voice, video and data communications over the existing electrical wiring within a building. Telkonet has made definitive inroads into the Powerline communication (PLC) market and established the "leading" position for in-building commercial communication solutions.

Through our indirect subsidiary, MST, we are able to offer quadruple-play ("Quad-Play") services to multi-tenant unit and multi-dwelling unit ("MDU") residential, hospitality and commercial properties. These Quad-Play services include video, voice, high-speed internet and wireless fidelity ("Wi-Fi") access. In addition, MST is also a national ISP and offers a suite of ancillary services including the design, installation and service of satellite and IP based video conferencing and surveillance systems.

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

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

The highlights and business developments for the nine months ended September 30, 2007 include the following:

- Consolidated revenue growth of 124% driven by acquisitions, as well as an increase in sales of the Telkonet iWire System™.
- The acquisition of 1,800 hotel customers through the addition of Ethostream to the Telkonet segment in March 2007. As of September 30, 2007, the Company has over 2,200 hotels under management.
- The acquisition of exclusive and patented technology from Smart Systems International, a leading provider of energy management products to customers in the U.S.
- The raising of \$10 million through a private placement of 4 million shares of common stock.
- Completion of a merger by MST with a wholly-owned subsidiary of a public shell corporation and a subsequent raise by the public shell corporation of \$9.1 million through sales of convertible debentures and a private placement of common stock of the newly formed corporation. Following these transactions, the Company owns approximately 63% of the outstanding shares of MSTI Holdings, Inc., the newly created publicly traded company.
- The acquisition of approximately 1,900 internet and telephone subscribers from Newport Telecommunications Co. by the MST segment in July 2007.

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

Telkonet Segment ("Telkonet")

The Telkonet segment markets and sells broadband network equipment and solutions, including the Telkonet iWire System™ and wireless network technology, and energy management solutions to commercial resellers, hospitality owners such as hotels and resorts, government and international markets. Through the revolutionary Telkonet iWire System™, Telkonet utilizes proven PLC technology to deliver commercial high-speed Broadband access from an IP "platform" that is easy to deploy, reliable and cost-effective by leveraging a building's existing electrical infrastructure. The building's existing electrical wiring becomes the backbone of the local area network, which converts virtually every electrical outlet into a high-speed data port, without the costly installation of additional wiring or major disruption of business activity. Additionally, we provide customer service to our customers through support and maintenance contracts maintained by our centralized remote monitoring and management platform. The Telkonet segment's net revenues for the three and nine months ended September 30, 2007 were \$3,813,846, and \$7,736,557, representing 83% and 81%, respectively, of the Company's consolidated net revenues.

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

Of the stock issued in the SSI acquisition, 1,090,909 shares are being held in an escrow account for a period of one year following the closing from which certain potential indemnification obligations under the purchase agreement may be satisfied. The aggregate number of shares held in escrow is 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 15, 2007, the Company acquired 100% of the outstanding membership units of Ethostream, LLC, a network solutions integration company that offers installation, sales and service to the hospitality industry. The Ethostream, LLC acquisition will enable Telkonet to provide installation and support for PLC products and third party applications to customers across North America. The purchase price of \$11,756,097 was comprised of \$2.0 million in cash and 3,459,609 shares of the Company's common stock. The entire stock portion of the purchase price is being held in escrow 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. If during the twelve months following the Closing, the common stock has a volume-weighted average trading price of at least \$4.50, as reported on the American Stock Exchange, for twenty (20) consecutive trading days, the aggregate number of shares of common stock issuable to the sellers shall be adjusted such that the number of shares of common stock issuable as the stock consideration shall be determined assuming a per share price equal to \$4.50.

MST Segment (“MST”)

MST is a communications service provider offering Quad-Play services to multi-tenant unit and MDU residential, hospitality and commercial properties. These Quad-Play services include video, voice, high-speed internet and Wi-Fi access. In addition, MST is also a national ISP and offers a suite of ancillary services including the design, installation and service of satellite and IP based video conferencing and surveillance systems.

Revenue for the MST segment is subject to fluctuations due to the timing of sales of high-value products and service projects, the impact of seasonal spending patterns, the timing and size of research projects its customers perform, changes in overall spending levels in the telecommunication industry and other unpredictable factors that may affect customer ordering patterns. Any significant delays in the commercial launch or any lack or delay of commercial acceptance of new products, unfavorable sales trends in existing product lines, or impacts from the other factors mentioned above, could adversely affect revenue growth or cause a sequential decline in quarterly revenue. Due to the possibility of fluctuations in revenue and net income or loss, quarterly comparisons of MST’s operating results are not necessarily indicative of future performance. Net sales for this segment for the three and nine months ended September 30, 2007 were \$774,931, and \$1,765,096, representing 17% and 19%, respectively, of the Company’s consolidated net revenues.

On May 24, 2007, MST was merged into a wholly-owned subsidiary of MSTI Holdings, Inc. (formerly Fitness Xpress, Inc. (“FXS")), an inactive publicly registered shell corporation with no significant assets or operations. As a result of the merger, there was a change in control of the public shell corporation. In accordance with SFAS No. 141, MST was the acquiring entity. While the transaction is accounted for using the purchase method of accounting, in substance the transaction represents a recapitalization of MST’s capital structure. For accounting purposes, the Company accounted for the transaction as a reverse acquisition with MST as the surviving entity. MST did not recognize goodwill or any intangible assets in connection with the transaction. In connection with the acquisition, the Company’s 90% interest in MST was exchanged for a 63% interest in MSTI Holdings, Inc.

On July 18, 2007, MST, the wholly-owned subsidiary of MSTI Holdings Inc., acquired substantially all of the assets of Newport Telecommunications Co., a New Jersey general partnership (“NTC”), relating to NTC’s business of providing broadband internet and telephone services at certain residential and commercial properties in the development known as Newport in Jersey City, New Jersey. Pursuant to the terms of the NTC acquisition, the total consideration paid was \$2,550,000, consisting of (i) 866,856 unregistered shares of the Company’s common stock, equal to \$1,530,000 (which is based on the average closing prices for the Company common stock for the ten trading days immediately prior to the closing date), and (ii) \$1,020,000 in cash, subject to adjustments. The total consideration will be increased or decreased depending on the number of subscriber accounts acquired in the NTC acquisition that were in good standing at that time. The number will be determined within 120 days of the closing. The stock certificates representing the Company common stock, and \$510,000 of the cash consideration were paid to an escrow agent to be released after the final determination of the number of subscriber accounts in good standing acquired at closing.

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 for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. These statements by their nature involve substantial risks and uncertainties, some of which are beyond the Company’s control, and actual results may differ materially depending on a variety of important factors, including those risk factors discussed under “Trends, Risks and Uncertainties”, many of which are also beyond the Company’s control. You should not place undue reliance on these forward-looking statements, which speak only as of the date of this report. The Company does not undertake any obligation to update or release any revisions to these forward-looking statements to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events, except to the extent such updates and/or revisions are required by applicable law.

Critical Accounting Policies and Estimates

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

Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with Staff Accounting Bulletin No. 104, *Revenue Recognition* (“SAB104”), which 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 be required. SAB 104 incorporates Emerging Issues Task Force 00-21 (“EITF 00-21”), *Multiple-Deliverable Revenue Arrangements*. EITF 00-21 addresses accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

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

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

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

Guarantees and Product Warranties

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

The Company's guarantees were issued subject to the recognition and disclosure requirements of FIN 45 as of September 30, 2007 and December 31, 2006. The Company records a liability for potential warranty claims. The amount of the liability is based on the trend in the historical ratio of claims to sales, the historical length of time between the sale and resulting warranty claim, new product introductions and other factors. The products sold are generally covered by a warranty for a period of one year. In the event the Company determines that its current or future product repair and replacement costs exceed its estimates, an adjustment to these reserves would be charged to earnings in the period such determination is made. During the nine months ended September 30, 2007 and the year ended December 31, 2006, the Company experienced approximately three percent of units returned under its product warranty policy. As of September 30, 2007 and December 31, 2006, the Company recorded warranty liabilities in the amount of \$58,817 and \$47,300, respectively, using this experience factor.

New Accounting Pronouncements

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities." SFAS 159 permits entities to choose to measure many financial instruments, and certain other items, at fair value. SFAS 159 applies to reporting periods beginning after November 15, 2007. The adoption of SFAS 159 is not expected to have a material impact on the Company's financial condition or results of operations.

Revenues

The Company's revenue consists of product sales and a recurring (lease) model in the commercial, government and international markets of the Telkonet Segment including activity for SSI and Ethostream from the date of acquisition through September 30, 2007. The MST Segment revenue consists of Quad-Play services provided to a subscriber portfolio of MDU properties with bulk service agreements and/or access licenses to service the individual subscribers in metropolitan New York. The MST Segment is included in revenue since the acquisition of MST on January 31, 2006.

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

	Three months Ended					
	September 30, 2007		September 30, 2006		Variance	
Product	\$3,005,144	65%	\$585,535	51%	\$2,419,609	413%
Recurring (lease)	1,583,633	35%	557,562	49%	1,026,071	184%
Total	<u>\$4,588,777</u>	100%	<u>\$1,143,097</u>	100%	<u>\$3,445,680</u>	301%

	Nine months Ended					
	September 30, 2007		September 30, 2006		Variance	
Product	\$6,269,079	66%	\$2,697,424	64%	\$3,571,655	132%
Recurring (lease)	3,232,574	34%	1,542,056	36%	1,690,518	110%
Total	<u>\$9,501,653</u>	100%	<u>\$4,239,480</u>	100%	<u>\$5,262,173</u>	124%

Product revenue

The Telkonet Segment product revenue principally arises from the sale and installation of broadband networking and energy management equipment, including the Telkonet iWire System™ to commercial resellers, and directly to customers in the hospitality, government and international markets. The Telkonet iWire System™ consists of the Telkonet Gateway, the Telkonet Extender, the patented Telkonet Coupler, and the Telkonet iBridge, which “bridges” the connection from a computer to the data port. Customers can purchase Telkonet iBridges on an as-needed basis, allowing vendors to supply equipment to meet their occupancy demands. Product revenue in the Telkonet Segment increased by approximately \$2,392,000 and \$3,525,000 for the three and nine months ended September 30, 2007, including approximately \$1,320,000 and \$2,091,000 attributed to the sale of energy management products, and approximately \$1,067,000 and \$2,453,000 of products and services to the hospitality market. Additionally, revenues generated in the government market were approximately \$694,000 and \$1,121,000 for the three and nine months ended September 30, 2007, and were related to site evaluations and deployments of certain government installations. We anticipate a continued upward trend of quarterly growth in the hospitality, energy management and government markets of the Telkonet segment.

The MST Segment product revenue consists of equipment, installations and ancillary services provided to customers independent of the subscriber model. Product revenue in this segment for the three and nine months ended September 30, 2007 was approximately \$93,000 and \$261,000, respectively.

Recurring (lease) Revenue

The increase in recurring revenue in the Telkonet segment for the three and nine months ended September 30, 2007, reflects the addition of Ethostream’s hospitality portfolio in March 2007. During the nine months ended September 30, 2007, we added approximately 2,000 hotels to our broadband network portfolio, and currently support over 180,000 HSIA rooms, resulting in additional recurring revenue of \$646,000 and \$1,254,000 for the three and nine months ended September 30, 2007. Telkonet segment on-going monthly recurring revenue is approximately \$300,000 and we anticipate growth to our subscriber base as we deploy additional sites under contract in the hospitality and government markets.

The recurring revenue for the MST segment subscriber base increased by approximately \$262,000 and \$457,000 for the three and nine months ended September 30, 2007, respectively. The MST Segment subscriber portfolio includes approximately 22 MDU properties with bulk service agreements and/or access licenses to service the individual subscribers in metropolitan New York. Additionally, the MST segment added approximately 1,900 internet and telephone subscribers through the acquisition of Newport Telecommunications Co. in July 2007.

Cost of Sales

	Three months Ended					
	September 30, 2007		September 30, 2006		Variance	
Product	\$2,139,034	68%	\$345,244	59%	\$1,793,790	520%
Recurring (lease)	1,229,985	84%	714,804	128%	515,181	72%
Total	<u>\$3,369,019</u>	73%	<u>\$1,060,048</u>	93%	<u>\$2,308,971</u>	218%

	Nine months Ended					
	September 30, 2007		September 30, 2006		Variance	
Product	\$4,503,983	71%	\$2,349,056	87%	\$2,154,927	92%
Recurring (lease)	3,177,386	102%	1,019,404	66%	2,157,982	212%
Total	<u>\$7,681,369</u>	81%	<u>\$3,368,460</u>	79%	<u>\$4,312,909</u>	128%

Product Costs

The Telkonet Segment product costs include equipment and installation labor related to the Telkonet iWire System™ product suite, as well as wireless networking and energy management products. During the three and nine months ended September 30, 2007, product costs increased by approximately \$1,774,000 and \$2,857,000, respectively, for the Telkonet Segment in conjunction with the increased sales to the hospitality, energy management and government markets.

The MST segment product costs primarily consist of equipment and installation labor for installation and ancillary services provided to customers. For the three and nine months ended September 30, 2007, product costs for the MST segment amount to approximately \$74,000 and \$214,000.

Recurring (lease) Costs

The Telkonet segment recurring costs increased by \$278,000 and \$514,000 for the three and nine months ended September 30, 2007, respectively, when compared to the prior year period. This increase is primarily due to the addition of Ethostream's customer service and support infrastructure, including an internal call center, to support the Telkonet segment's recurring revenue from its customer portfolio.

The MST segment's recurring costs increased by \$238,000 and \$1,644,000 for the three and nine months ended September 30, 2007, respectively. These costs consist of customer support, programming and amortization of the capitalized costs to support the subscriber revenue. Although MST's programming fees are a significant portion of the cost, MST continues to pursue competitive agreements and volume discounts in conjunction with the anticipated growth of the subscriber base. The customer support costs include build-out of the support services necessary to develop and support the build-out of the Quad-Play subscriber base in metropolitan New York. The capitalized costs are amortized over the lease term and include equipment and installation labor. Additionally, MST's recurring costs increased due to the addition of the Newport subscribers in July 2007.

Gross Profit

	Three months Ended					
	September 30, 2007		September 30, 2006		Variance	
Product	\$866,110	29%	\$240,293	41%	\$625,817	260%
Recurring (lease)	353,648	22%	(157,242)	-28%	510,890	325%
Total	<u>\$1,219,758</u>	27%	<u>\$83,051</u>	7%	<u>\$1,136,707</u>	1369%

	Nine months Ended					
	September 30, 2007		September 30, 2006		Variance	
Product	\$1,765,096	28%	\$348,368	13%	\$1,416,728	407%
Recurring (lease)	55,188	2%	522,652	34%	(467,466)	-89%
Total	<u>\$1,820,284</u>	19%	<u>\$871,020</u>	21%	<u>\$949,262</u>	109%

Product Gross Profit

The gross profit for the three and nine months ended September 30, 2007 increased compared to the prior year period as a result of product sales and installations in the Telkonet Segment and represented 29% and 29% of product revenue, respectively. We anticipate an increase in our gross profit trend for product sales as energy management and government market opportunities expand. Additionally, the integration of acquired companies has resulted in opportunities to internalize installation services and streamline processes.

Recurring (lease) Gross Profit

The Telkonet Segment's gross profit associated with recurring (lease) revenue increased for the three months and nine months ended September 30, 2007 by approximately \$486,000 and \$720,000, respectively. Gross profit represented approximately 52% and 44% of recurring (lease) revenue for the three and nine months ended September 30, 2007. The centralized remote monitoring and management platform and internal call support center will provide the platform to maintain and expand gross profit for the Telkonet segment's recurring revenue.

The MST segment gross profit decreased by approximately \$25,000 and \$1,187,000 for the three and nine months ended September 30, 2007, respectively, compared to the prior year, primarily due to programming costs and the support infrastructure. MST anticipates that an expanded subscriber base utilizing the current infrastructure and reduced programming costs through mediums such as IPTV will facilitate increased gross profit. Gross profit represented approximately -17% and -47% of recurring (lease) revenue for the three and nine months ended September 30, 2007.

Operating Expenses

	Three months Ended			
	September 30, 2007	September 30, 2006	Variance	
Total	<u>\$6,301,640</u>	<u>\$4,371,200</u>	<u>\$1,930,440</u>	44%
Nine months Ended				
	September 30, 2007	September 30, 2006	Variance	
Total	<u>\$16,948,853</u>	<u>\$13,346,075</u>	<u>\$3,602,778</u>	27%

Overall expenses increased for the three and nine months ended September 30, 2007 over the comparable period in 2006 by approximately \$1,930,440 and \$3,602,778, or 44% and 27%. The principal reason for this increase was additional operating costs of SSI and Ethostream of approximately \$1,032,000 and \$2,167,000 for the three and nine months ended September 30, 2007, respectively. Additionally, there was an increase in research and development costs (see discussion below), as well as an increase in non-cash stock compensation during the three and nine months ended September 30, 2007 of \$595,000 and \$423,000, respectively, related to options and shares earned by employees and consultants, and additional non-cash depreciation expense of \$134,000 and \$236,000 for the three and nine months ended September 30, 2007, respectively. Also, there was an increase in selling and administrative expenses for the Telkonet and MST segment during the three and nine months ended September 30, 2007, respectively. We expect our quarterly operating expenses to decrease in the final quarter of 2007, when compared to the three months ended September 30, 2007, as the integration of the acquired businesses provides us with operating efficiencies and we reduce our administrative costs.

Research and Development

	Three months Ended			
	September 30, 2007	September 30, 2006	Variance	
Total	<u>\$646,848</u>	<u>\$447,092</u>	<u>\$199,756</u>	45%
Nine months Ended				
	September 30, 2007	September 30, 2006	Variance	
Total	<u>\$1,736,656</u>	<u>\$1,411,791</u>	<u>\$324,865</u>	23%

Telkonet's research and development costs related to both present and future products are expensed in the period incurred. Total expenses for the three and nine months ended September 30, 2007 increased by \$199,756 or 45%, and \$324,865, or 23%, respectively. This increase was primarily related to costs associated with the development of the next generation product suite and the integration of new applications to the Telkonet iWire System, as well as an additional \$206,000 related to the development of energy management products pursuant to the acquisition of SSI.

Selling, General and Administrative Expenses

	Three months Ended			
	September 30, 2007	September 30, 2006	Variance	
Total	<u>\$4,553,161</u>	<u>\$3,551,569</u>	<u>\$1,001,592</u>	28%
Nine months Ended				
	September 30, 2007	September 30, 2006	Variance	
Total	<u>\$13,057,979</u>	<u>\$10,390,864</u>	<u>\$2,667,115</u>	26%

Selling, general and administrative expenses increased for the three and nine months ended September 30, 2007 over the comparable prior year by \$1,001,592 or 28%, and \$2,667,115 or 26%, respectively. This increase is primarily attributed to the administrative expenses of the acquired businesses of approximately \$874,000 and \$1,818,000 for the three and nine months ended September 30, 2007, respectively. Additionally, sales and marketing costs increased following the launch of our new integrated product offerings, and professional fees increased due to the equity financing in February 2007, the acquisition of SSI, Ethostream and Newport, and the merger of MST with a public shell corporation. Prior year expenses related to the amortization and write-off of financing fees \$435,000 and \$535,000 partially offset the overall increase. We expect quarterly selling, general and administrative expenses as compared to the three months ending September 30, 2007 to decrease in the fourth quarter of 2007 as the integration of the acquired businesses provides for certain operating efficiencies and we reduce our administrative costs.

Backlog

In conjunction with the acquisition of Ethostream on March 15, 2007, the Telkonet Segment maintains contracts and monthly services for more than 2,200 hotels which are expected to generate approximately \$3,000,000 annual recurring support and internet advertising revenue.

In conjunction with the acquisition of Smart Systems International on March 9, 2007, Telkonet assumed certain purchase orders relating to a major utilities energy management initiative provided through the two selected providers. The current order backlog amounts to approximately \$1,100,000 and the estimated remaining program value amounts to \$3,000,000 for products and services to be provided through 2008.

The MST subscriber portfolio includes approximately 22 MDU properties with bulk service agreements and/or access licenses to service the individual subscribers in metropolitan New York. The remaining terms of the access agreements provide MST access rights from 7 to 15 years with the final agreement expiring in 2016 and the revenues to be recognized under non-cancelable bulk agreements provide a minimum of \$2,000,000 in revenue through 2013.

Liquidity and Capital Resources

Working Capital

Our working capital increased by \$698,413 during the nine months ended September 30, 2007 from a working capital deficit of \$(530,634) at December 31, 2006 to a working capital of \$167,779 at September 30, 2007. The increase in working capital for the nine months ended September 30, 2007, is due to a combination of factors, of which the significant factors are set out below:

- Cash had a net decrease from working capital by \$61,451 for the nine months ended September 30, 2007. The most significant uses and proceeds of cash are as follows:
 - o Approximately \$12,591,000 of cash consumed directly in operating activities
 - o A cash payment of \$900,000 representing the second installment of the cash portion of the purchase price for the acquisition of MST
 - o The cash payment in the acquisition of Ethostream amounted to approximately \$2,000,000, and as part of the acquisition the debt payoff amounted to approximately \$200,000—see discussion of acquisition below;
 - o The cash payments in the acquisition of SSI amounted to approximately \$875,000—see discussion of acquisition below;
 - o A private placement from the sale of 4,000,000 shares of common stock at \$2.50 per share provided proceeds of \$9,610,000.
 - o A private placement and sale of debentures by MSTI Holdings Inc. for proceeds, net of placement fees, of \$2,694,000 and \$5,303,000, respectively.
 - o A bridge loan in the amount of \$1,500,000 issued as a Senior Note payable to GRQ Consultants, Inc.

Of the total \$7,597,269 current assets as of September 30, 2007, cash represented \$1,582,586. Of the total \$3,766,079 current assets as of December 31, 2006, cash represented \$1,644,037.

Senior Note Payable

On July 24, 2007, Telkonet entered into a Senior Note Purchase Agreement with GRQ Consultants, Inc. (“GRQ”) pursuant to which the Company issued to GRQ a Senior Promissory Note (the “Note”) in the aggregate principal amount of \$1,500,000. The Note is due and payable on the earlier to occur of (i) the closing of the Company’s next financing, or (ii) January 28, 2008, and bears interest at a rate of six (6%) percent per annum. The Company has incurred approximately \$25,000 in fees in connection with this transaction. The net proceeds from the issuance of the Note will be 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.

Convertible Senior Debentures-MSTI

During the nine months ended September 30, 2007, MSTI Holdings Inc., a majority-owned subsidiary of Telkonet, issued senior convertible debentures (the “Debentures”) having a principal value of \$6,576,350, plus an original issue discount of \$526,350, in exchange for \$6,050,000 from investors, exclusive of placement fees. The original issue discount to the Debentures is amortized over 36 months. The Debentures accrue interest at 8% per annum commencing on the first anniversary of the original issue date of the Debentures, payable quarterly in cash or common stock, at MSTI Holdings Inc.’s option, and mature on April 30, 2010. The Debentures are not callable and are convertible at a conversion price of \$0.65 per share into 10,117,462 shares of MSTI Holdings Inc. common stock, subject to certain limitations.

In connection with the placement of the Debentures, MSTI Holdings Inc. has also agreed to issue to the Noteholders, five-year warrants to purchase an aggregate of 5,058,730 shares of MSTI Holdings Inc. common stock at an exercise price of \$1.00 per share. In connection with the issuance of the Debentures, we incurred placement fees of \$423,500. Additionally, MSTI Holdings Inc. issued such agents five-year warrants to purchase 708,222 shares of MSTI Holdings Inc. common stock at an exercise price of \$1.00.

Convertible Senior Notes

In October 2005, the Company completed an offering of convertible senior notes (the "Notes") in the aggregate principal amount of \$20 million. The capital raised in the Note offering was used for general working capital purposes. The Notes bore interest at a rate of 7.25%, payable in cash, and called for monthly principal installments beginning March 1, 2006. The maturity date was 3 years from the date of issuance of the Notes. The Noteholders were entitled, at any time, to convert any portion of the outstanding and unpaid Conversion Amount into shares of Company common stock. At the option of the Company, the principal payments could be paid either in cash or in common stock. Upon conversion into common stock, the value of the stock was determined by the lower of \$5 or 92.5% of the average recent market price. The Company also issued one million warrants to the Noteholders exercisable for five years at \$5 per share. At any time after nine months, should the stock trade at or above \$8.75 for 20 of 30 consecutive trading days, the Company could cause a mandatory redemption and conversion to shares at \$5 per share. At any time, the Company was entitled to pre-pay the notes with cash or common stock. If the Company elected to use common stock to pre-pay the Notes, the price of the common stock would be deemed to be the lower of \$5 or 92.5% of the average recent market price. If the Company prepaid the Notes other than by mandatory conversion, the Company was obligated to issue additional warrants to the Noteholders covering 65% of the amount pre-paid at a strike price of \$5 per share. In addition to standard financial covenants, the Company agreed to maintain a letter of credit in favor of the Noteholders equal to \$10 million. Once the principal amount outstanding on the notes declined below \$15 million, the balance on the letter of credit was reduced by \$.50 for every \$1 amortized.

These notes were repaid on August 14, 2006 as discussed in greater detail below under "Early Extinguishment of Debt."

Principal Payments of Debt

For the period of January 1, 2006 through August 14, 2006, the Company paid down principal of \$1,250,000 in cash and issued an aggregate of 4,226,246 shares of common stock in connection with the conversion of \$10,821,686 aggregate principal amount of the Senior Convertible Notes. Pursuant to the note agreement, the Company issued warrants to purchase 1,081,820 shares of common stock to the Noteholders, at a strike price of \$5.00, which represented 65% of the \$8,321,686 accelerated principal.

For the period of January 1, 2006 through August 14, 2006, the Company amortized the debt discount to the beneficial conversion feature and value of the attached warrants, and recorded non-cash interest expense in the amount of \$251,759 and \$500,353, respectively. The Company also wrote-off the unamortized debt discount attributed to the beneficial conversion feature and the value of the attached warrants in the amount of \$708,338 and \$1,397,857, respectively, in connection with paydown and conversion of the note.

Early Extinguishment of Debt

On August 14, 2006, the Company executed separate settlement agreements with the lenders of its Notes. Pursuant to the settlement agreements the Company paid to the lenders in the aggregate \$9,910,392 plus accrued but unpaid interest of \$23,951 and certain premiums specified in the Notes in satisfaction of the amounts then outstanding under the Notes. Of the amount to be paid to the lenders under the Notes, \$6,500,000 was paid in cash through a drawdown on a letter of credit previously pledged as collateral for the Company's obligations under the Notes. The remaining note balance of \$1,428,314 and a Redemption Premium of \$1,982,078, calculated as 25% of remaining principal, was paid to the lenders in shares of Company's common stock valued at the lower of \$5.00 per share and 92.5% of the arithmetic average of the weighted average price of the Company's common stock on the American Stock Exchange for the twenty trading days beginning on August 16, 2006. The Company also issued 862,452 warrants to purchase shares of the Company's common stock at the exercise price of the lower of \$2.58 per share and 92.5% of the average trading price as described above. The Company has accounted for the Redemption Premium and the additional warrants issued as non-cash early extinguishment of debt expense during the year ended December 31, 2006.

As a result of the execution of the settlement agreements and the payments required thereby, the Company fully repaid and believes it satisfied all of its obligations under the Notes. The Company also agreed to pay the expenses of the lenders incurred in connection with the negotiation and execution of the settlement agreements. The settlement agreements were negotiated following the allegation by one of the lenders that the Company's failure to meet the minimum revenue test for the period ending June 30, 2006 as specified on the Notes may have constituted an event of default under the Notes, which allegation the Company disputed.

In conjunction with the settlement agreement, the Company recorded \$4,626,679 of loss from early extinguishment of debt, which consists of \$1,982,078 redemption premium paid with the Company's common stock, \$1,014,934 of additional warrants issued to the lenders, write-off of the remaining unamortized debt discount attributed to the beneficial conversion feature and the value of the attached warrants in the amount of \$430,040 and \$845,143, respectively, and write-off the remaining unamortized financing costs of \$354,484.

The settlement agreements provide 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 agreements pending resolution of this disagreement. One of the noteholders 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. As of November 9, 2007, no legal claim has been filed by the noteholder.

Acquisition of Microwave Satellite Technologies, Inc.

On January 31, 2006, the Company acquired a 90% interest in MST from Frank Matarazzo, the sole stockholder of MST in exchange for \$1.8 million in cash and 1.6 million unregistered shares of the Company's common stock for an aggregate purchase price of \$9,000,000. The 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 which will be held in escrow, 400,000 shares of which were paid at closing and the remaining 1,200,000 shares of which shall be issued based on the achievement of 3,300 "Triple Play" subscribers over a three year period. In the period ended December 31, 2006, the Company issued 200,000 shares of the purchase price contingency valued at \$900,000 as an adjustment to goodwill. In the event the Company's common stock price is below \$4.50 per share upon issuance of the shares from escrow, a pro rata adjustment in the number of shares will be required to support the aggregate consideration of \$5.4 million. As of September 30, 2007, the Company's common stock price was below \$4.50. To the extent that the market price of Company's common stock is below \$4.50 per share upon issuance of the shares from escrow, the number of shares issuable on conversion is ratably increased, which could result in further dilution of the Company's stockholders.

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. The Company was obligated to register the stock portion of the purchase price on or before May 15, 2007. Pursuant to the registration rights agreement, the registration statement was required to be effective no later than July 14, 2007. As of November 9, 2007, the registration statement has not been declared effective. The registration rights agreement does not expressly provide for penalties in the event this deadline is not met.

Of the stock issued in the transaction, 1,090,909 shares are being held in an escrow account for a period of one year following the closing from which certain potential indemnification obligations under the purchase agreement may be satisfied. The aggregate number of shares held in escrow is 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.

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 is being held in escrow 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. The aggregate number of shares issuable to the sellers is subject to downward adjustment in the event the Company's common stock trades at or above a price of \$4.50 per share for twenty consecutive trading days during the one year period following the closing.

Proceeds from the issuance of common stock

During the nine months ended September 30, 2007, the Company received \$124,460 from the exercise of employee stock options.

During the nine months ended September 30, 2007, the Company issued 4,000,000 shares of common stock valued at \$2.50 per share for an aggregate purchase price of \$9,610,000, net of placement fees. The Company also issued to the same investor warrants to purchase 2.6 million shares of its common stock at an exercise price of \$4.17 per share in this transaction.

Additionally, during the nine months ended September 30, 2007, MSTI Holdings Inc. completed a private placement resulting in proceeds of approximately \$2,694,000.

Cashflow analysis

Cash utilized in operating activities was \$12,591,264 during the nine months ended September 30, 2007 compared to \$10,014,484 in the previous comparable period. The primary use of cash during the nine months ended September 30, 2007 was for operating activities.

The Company utilized cash for investing activities of \$6,499,669 and \$7,106,511 during the nine months ended September 30, 2007 and 2006, respectively. These expenditures were primarily the result of the payment of cash portion of the MST purchase price of \$900,000 in February 2007, and cash payments of \$875,000 and \$2,000,000, for the acquisition of SSI and Ethostream, respectively, in March 2007 and \$1,020,000 for the acquisition of Newport Telecommunications in July 2007. Additionally, cost of equipment under operating leases amounted to \$1,162,832 and \$1,226,409 for the nine months ended September 30, 2007 and 2006. Equipment costs were net of \$350,571 proceeds from the sale of certain equipment under operating lease during the nine months ended September 30, 2006. Furthermore, purchases of property and equipment amounted to \$266,280 and \$708,598 for the nine months ended September 30, 2007 and 2006, respectively.

The Company was provided cash from financing activities of \$19,029,482 and \$109,181 during the nine months ended September 30, 2007 and 2006, respectively. The financing activities involved the sale of 4.0 million shares of common stock at \$2.50 per share for a total of \$9,610,000, net of placement fees, in February 2007. Additionally, proceeds from the exercise of stock options and warrants were \$124,460 and \$2,371,300 during the nine months ended September 30, 2007 and 2006, respectively. In July 2007, the Company issued a senior note payable in the principal amount of \$1,500,000. Through its majority-owned subsidiary MSTI Holdings, Inc., the Company raised \$5,303,238 through the sale of debentures, and \$2,694,020 through the sale of common stock, during the nine months ended September 30, 2007. The proceeds of the financing activities were offset by repayment of debt principal of \$8,162,119 in 2006, including \$7,750,000 of principal payments in conjunction with the conversion and settlement agreement with the lenders of its Convertible Senior Notes and approximately \$410,000 in conjunction with the acquisition of MST.

The Company believes it has sufficient access to capital to meet its working capital requirements through the remainder of 2007 in available cash and in cash generated from operations. 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 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.

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.

Off Balance Sheet Arrangements

None.

Acquisition or Disposition of Property and Equipment

During the nine months ended September 30, 2007, fixed assets and costs under operating leases increased \$1,299,922 primarily for additions to the MST Segment equipment purchases for the MST Quad-Play build-out. The remainder related to computer equipment and peripherals used in day-to-day operations. The Company anticipates significant expenditures in the MST Segment to continue the build-out the head-end equipment, IPTV and other related projects. The Telkonet segment does not anticipate the sale or purchase of any significant property, plant or equipment during the next twelve months, other than the purchase of computer equipment and peripherals to be used in the Company's day-to-day operations.

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

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

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

Number of Employees

As of November 1, 2007, the Company had 184 full time employees.

Disclosure of Contractual Obligations

Contractual obligations	Payment Due by Period				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Long-Term Debt Obligations	\$ 6,576,350	-	6,576,350	-	-
Current Debt Obligations	\$ 1,500,000	1,500,000	-	-	-
Capital Lease Obligations	\$ -	-	-	-	-
Operating Lease Obligations	\$ 2,465,139	521,541	1,113,026	440,335	390,237
Purchase Obligations (1)(2)	\$ 2,576,442	2,576,442	-	-	-
Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet Under GAAP	\$ -	-	-	-	-
Total	\$ 13,117,931	4,597,983	7,689,376	440,335	390,237

(1) Purchase commitment for the IPTV build-out of MST subscriber base in the second half of 2007 in the amount of \$693,224

(2) Purchase commitment of \$1,883,218 for inventory orders of energy management products through April 2008. The Company has prepaid approximately \$380,000 as of September 30, 2007.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Short Term Investments

We held no marketable securities as of September 30, 2007. 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.

Investments in Privately Held Companies

We have invested in privately held companies, which are in the startup or development stages. These investments are inherently risky because the markets for the technologies or products these companies are developing are typically in the early stages and may never materialize. As a result, we could lose our entire initial investment in these companies. In addition, we could also be required to hold our investment indefinitely, since there is presently no public market in the securities of these companies and none is expected to develop. These investments are carried at cost, which as of November 1, 2007 was \$131,044 and \$8,000 in BPL Global and Amperion, respectively, and at September 30, 2007, are recorded in other assets in the Consolidated Balance Sheets.

Item 4. Controls and Procedures.

As of September 30, 2007, the Company performed an evaluation, under the supervision and with the participation of management, including the Chief Executive Officer and Vice President Finance (Principal Accounting Officer), of the effectiveness of the design and operation of its disclosure controls and procedures as defined in Rules 13a - 15(e) or 15d - 15(e) promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based upon that evaluation, the Chief Executive Officer and Vice President Finance concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information required to be included in the Company's periodic filings with the U.S. Securities and Exchange Commission. During the nine months ended September 30, 2007, 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.

None.

Item 1A. Risk Factors.

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

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

Since inception through September 30, 2007, the Company has incurred cumulative losses of \$85,366,643 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 \$16.9 million at September 30, 2007 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.

MSTI Holdings, Inc. may be unable to register for resale all of the common stock included within the units sold in its Private Placement, which would cause a default under the Registration Rights Agreement executed in connection with such Private Placement.

MSTI Holdings, Inc. is obligated to file a "resale" registration statement with the SEC that covers all of the common stock included within the units sold in the Private Placement and issuable upon conversion of the Debentures and the exercise of the warrants thereto and to use its best efforts to have such "resale" registration statement declared effective by the SEC as set forth therein. Nevertheless, it is possible that the SEC may not permit MSTI Holdings, Inc. to register all of such shares of common stock for resale. In certain circumstances, the SEC may take the view that the private placement requires MSTI Holdings, Inc. to register the issuance of the securities as a primary offering. Without sufficient disclosure of this risk, rescission of the private placement could be sought by investors or an offer of rescission may be mandated by the SEC, which would result in a material adverse affect to MSTI Holdings and us since we consolidate the financial statements of MSTI Holdings, Inc.

MSTI Holdings, Inc. has agreed to file a registration statement with the SEC within 60 days of the final closing of the Private Placement and the issuance of the Debentures and to use its best efforts to have the registration statement declared effective by the SEC within 120 days after the final closing of the Private Placement and the original issuance of the Debentures. There are many reasons, including those over which MSTI Holdings, Inc. has no control, which could delay the filing or effectiveness of the registration statement, including delays resulting from the SEC review process and comments raised by the SEC during that process. Failure to file or cause a registration statement to become effective in a timely manner or maintain its effectiveness could materially adversely affect MSTI Holdings, Inc. and require MSTI Holdings, Inc. to pay substantial penalties to the holders of those securities pursuant to the terms of the registration rights agreement. Since we consolidate the financial statements of MSTI Holdings, Inc., the incurrence of a significant penalty by MSTI Holdings, Inc. under the Registration Rights Agreement could materially adversely affect our results of operations.

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

None.

Item 3. Defaults Upon Senior Securities.

None.

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

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

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

- 4.14 Form of Accelerated Payment Option Warrant to Purchase Common Stock (incorporated by reference to our Registration Statement on Form S-3 (No. 333-137703), filed on September 29, 2006.
- 4.15 Form of Warrant to Purchase Common Stock (incorporated by reference to our Current Report on Form 8-K filed on February 5, 2007)
- 4.16 Senior Note by Telkonet, Inc. in favor of GRQ Consultants, Inc.
- 4.17 Warrant to Purchase Common Stock by Telkonet, Inc in favor of GRQ Consultants, Inc
- 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 Registration Rights Agreement by and among Telkonet, Inc., Kings Road Investments Ltd. and Portside Growth & Opportunity Fund, dated October 27, 2005 (incorporated by reference to our Form 8-K (No. 001-31972), filed on October 31, 2005)
- 10.6 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)
- 10.7 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)
- 10.8 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)
- 10.9 Securities Purchase Agreement, dated August 31, 2006, by and among Telkonet, Inc., Enable Growth Partners LP, Enable Opportunity Partners LP and Pierce Diversified Strategy Master Fund LLC, Ena (incorporated by reference to our Form 8-K (No. 001-31972), filed on September 6, 2006)
- 10.10 Registration Rights Agreement, dated August 31, 2006, by and among Telkonet, Inc., Enable Growth Partners LP, Enable Opportunity Partners LP and Pierce Diversified Strategy Master Fund LLC, Ena (incorporated by reference to our Form 8-K (No. 001-31972), filed on September 6, 2006)
- 10.11 Securities Purchase Agreement, dated February 1, 2007, by and among Telkonet, Inc., Enable Growth Partners LP, Enable Opportunity Partners LP, Pierce Diversified Strategy Master Fund LLC, Ena, Hudson Bay Fund LP and Hudson Bay Overseas Fund, Ltd. (incorporated by reference to our Current Report on Form 8-K filed on February 5, 2007)
- 10.12 Registration Rights Agreement, dated February 1, 2007, by and among Telkonet, Inc., Enable Growth Partners LP, Enable Opportunity Partners LP and Pierce Diversified Strategy Master Fund LLC, Ena, Hudson Bay Fund LP and Hudson Bay Overseas Fund, Ltd. (incorporated by reference to our Current Report on Form 8-K filed on February 5, 2007)
- 10.13 Employment Agreement by and between Telkonet, Inc. and William Dukes, dated as of March 9, 2007(incorporated by reference to our Form 10-K (No. 001-31972), filed March 16, 2007)
- 10.14 Employment Agreement by and between Telkonet, Inc. and Robert Zirpoli, dated as of March 9, 2007(incorporated by reference to our Form 10-K (No. 001-31972), filed March 16, 2007)
- 10.15 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)
- 10.16 Employment Agreement by and between Telkonet, Inc. and Jeff Sobieski, dated as of March 15, 2007(incorporated by reference to our Form 10-K (No. 001-31972), filed March 16, 2007)
- 31.1 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Ronald W. Pickett
- 31.2 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Richard J. Leimbach
- 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 Richard J. Leimbach pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

Telkonet, Inc.
Registrant

Date: November 9, 2007

By: /s/ Ronald W. Pickett
Ronald W. Pickett
Chief Executive Officer

SENIOR NOTE PURCHASE AGREEMENT

This Senior Note Purchase Agreement (this "Agreement") is made as of July __, 2007 (the "Closing Date") by and between Telkonet Inc., a Utah corporation (the "Company"), GRQ Consultants, Inc. ("Holder"), and the persons or entities listed as investors on the signature page hereto and as set forth on Schedule 1 annexed hereto (the "Purchasers").

WITNESSETH:

WHEREAS, Company has advised Holder that Company is pursuing a financing transaction in which Company is seeking a minimum of \$3 million in equity financing through private investments in public company ("PIPE") transactions which Company expects to close prior to January 28, 2008 and Company desires to obtain from Holder a bridge loan for working capital, and Company desires to sell and issue to the Purchasers, and the Purchasers desire to purchase from the Company, an aggregate of \$1,500,000.00 principal amount of the Company's six (6%) percent promissory notes (the "Notes") due January 28, 2008 (the "Maturity Date") having the rights and privileges set forth in the Form of Note of the Company annexed hereto as Exhibit A; and

Now, therefore, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties to this Agreement hereby agree as follows:

1. Deliveries.

(a) On the Closing Date, the Purchasers shall deliver to the Company an aggregate of \$1,500,000.00 in cash (the "Funds") by delivery of a certified check payable to the Company or by wire transfer to the account of the Company.

(b) On the Closing Date, the Company shall deliver to the Purchaser: (i) a Note with the principal amount equal to the principal amount set forth opposite such Purchaser's name in Schedule 1 hereto, registered in the name of such Purchaser substantially in the form of Exhibit A annexed hereto (the "Note"); and (ii) a Warrant exercisable for 359,712 shares of Common Stock (as hereinafter defined) substantially in the form of Exhibit B annexed hereto, (the "Warrant").

2. Representations and Warranties of the Company. The Company hereby represents and warrants to the Purchasers as follows:

(a) Representations and Warranties of the Company. As a material inducement to each Holder to enter into this Agreement and consummate the transactions contemplated hereby, and except as set forth on Schedule I hereto, the Company hereby represents and warrants that:

(i) Organization and Corporate Power. The Company is a corporation duly organized, validly existing and in good standing under the laws of the State of Utah and the Company is duly qualified or registered to do business as a foreign corporation in each jurisdiction in which the failure to be so qualified or registered would have a Material Adverse Effect. As used in this Agreement, the term "Material Adverse Effect" means any change or effect that is materially adverse to the properties, assets, business, financial condition or operations of the Company. The Company does not directly or indirectly own any equity or similar interest in, or any interest convertible into or exchangeable or exercisable for any equity or similar interest in, any corporation, partnership, joint venture or other business association or entity. The Company has all required corporate power and authority to carry on its business as presently conducted, and to enter into and perform this Agreement, the Notes, the Warrants and each other document, agreement or instrument entered into by it or any of its officers in connection herein or therewith or pursuant hereto or thereto (collectively, the "Transaction Documents" and individually a "Transaction Document"). The Company is not in violation of any term of its certificate of incorporation or bylaws, true, accurate and complete copies of which are on file with the United States Securities and Exchange Commission (the "SEC"). The Company is not in violation of any term of any agreement, instrument, judgment, decree, order, statute, rule or government regulation applicable to the Company or to which the Company is a party except for such violations that individually, or in the aggregate, would not reasonably be expected to result in a Material Adverse Effect.

(i i) Capitalization. The authorized capital stock of the Company (the "Equity Securities") immediately prior to the initial Closing, consists of such number of shares of common stock, \$0.001 par value per share, of the Company (the "Common Stock") as are set forth on the most recent periodic report (the "Report") filed by the Company with the SEC. Other than shares reserved for issuance under the Company's existing plans adopted for employees and other persons associated with the Company (the "Plan") which has been approved by stockholders, the Company does not have any outstanding commitments to issue or sell Equity Securities, and no securities or obligations evidencing any such right are outstanding, except as set forth in the Report. The Company is not under any contractual obligation to register any of its presently outstanding securities or any of its securities which may hereafter be issued. There are no outstanding obligations, written or otherwise, of any stockholder or other holder of Equity Securities of the Company to repurchase, redeem or otherwise acquire any Equity Securities. There are no preemptive rights in respect of any Equity Securities of the Company. Any Equity Securities which were issued and reacquired by the Company were so reacquired (and, if reissued, so reissued) in compliance with all applicable laws, and the Company does not have any outstanding obligation or liability with respect thereto. Each of the foregoing representations and warranties is qualified to the extent of the true and accurate information provided in the most recent periodic report of the Company filed with the SEC prior to the date hereof.

(i i i) Authorization and Non-Contravention. The Transaction Documents are valid and binding obligations of the Company, enforceable in accordance with their terms. The execution, delivery and performance of the Transaction Documents have been duly authorized by all necessary corporate or other action of the Company. The execution, delivery and performance of these Transaction Documents will not:

(A) violate or result in a default under any contract or obligation to which the Company is a party or by which it or its assets are bound, or any provision of (A) the certificate of incorporation of the Company, as amended to date (the “Charter”), (B) the bylaws of the Company, as amended to date or (C) cause the creation of any encumbrance upon any of the assets of the Company;

(B) violate or result in a violation of, or constitute a default (whether after the giving of notice, lapse of time or both) under, any provision of any law, regulation or rule, or any order of, or any restriction imposed by any court or other governmental agency applicable to the Company;

(C) require from the Company any notice to, declaration or filing with, or consent or approval of any governmental authority or other third party, which such notice, consent, declaration, filing or approval has not been obtained as of the Closing; or

(D) accelerate any obligation of the Company under, give rise to a right of termination of, accelerate any right of a person under or trigger any change of control or similar provision in, any agreement, permit, license or authorization to which the Company is a party or by which the Company is bound.

(iv) Valid Issuance.

(A) The Note and the Warrants will be duly and validly issued when issued, sold and delivered at the Closing in accordance with the terms of this Agreement and the Warrant Shares (as defined in the Warrant), when issued, sold and delivered in accordance with the terms of this Agreement and the Note for the consideration provided for herein and therein, will be duly and validly issued, fully paid and non-assessable.

(B) Based in part on the representations made by each Holder, the offer and sale of the Notes solely to the Holders in accordance with this Agreement are exempt from the registration and prospectus delivery requirements of the Securities Act of 1933, as amended (the “Securities Act”), and the securities registration and qualification requirements of the currently effective provisions of the securities law of the state in which each Holder is a resident.

(C) The conversion of the Warrant into Warrant Shares, if at all, will not require any further corporate or stockholder action and will not be subject to preemptive rights of any present or future stockholders of the Company that have not been heretofore waived in writing.

(v) Litigation. There is no litigation or governmental proceeding or investigation pending or, to the Company's knowledge, threatened against the Company affecting any of its respective properties or assets, or against any officer, employee or holder of more than 5% of the Equity Securities of the Company relating to such person's performance of duties for the Company or relating to his stock ownership in the Company or otherwise relating to the business of the Company, nor to the knowledge of the Company has there occurred any event or does there exist any condition on the basis of which any such litigation, proceeding or investigation might properly be instituted. Neither the Company nor any officer, employee or, to the knowledge of the Company, holder of more than 5% of the Equity Securities of the Company is in default with respect to any order, writ, injunction, decree, ruling or decision of any court, commission, board or other governmental agency relating to the Company or its business. There are no actions, suits, claims, investigations or proceedings pending or, to the Company's knowledge, threatened (or any basis therefore). The foregoing sentences include, without limiting their generality, actions pending or, to the knowledge of the Company, threatened (or any basis therefore) involving the prior employment of any of the Company's officers or employees or their use in connection with the Company's business of any information or techniques allegedly proprietary to any of their former employers.

Financial Information. The audited financial statements of the Company as of and for the fiscal year ended December 31, 2006 and the unaudited consolidated financial statements for the three months period ended March 31, 2007 set forth in the Company's filings and reports made with the SEC present fairly in all material respects the financial position of the Company and the results of operations for the periods covered thereby (subject, in the case of such interim financial statements, to immaterial year end audit adjustments) and have been prepared in accordance with generally accepted accounting principles ("GAAP") in effect in the United States consistently applied, except for the absence of footnotes not customarily included in such statements (the "Financial Statements"). There is no liability, contingent or otherwise, not adequately reflected in or reserved against in the Financial Statements other than (i) liabilities incurred in the ordinary course of business subsequent to March 31, 2007 and (ii) liabilities not required under GAAP to be reflected in the Financial Statements. Since March 31, 2007, (i) there has been no material adverse change in the business, assets or condition, financial or otherwise, or operations of the Company, (ii) neither the business, condition, or operations of the Company nor any of the properties or assets of the Company have been materially adversely affected as the result of any legislative or regulatory change, any revocation or change in any franchise, permit, license or right to do business, nor have the business, condition, or operations of the Company nor any of the properties or assets of the Company been materially adversely affected by any other event or occurrence, whether or not insured against; and (iii) the Company has not entered into any transaction other than in the ordinary course of business, made any dividend or distribution on its Equity Securities, or redeemed or repurchased any of its Equity Securities. As of the date hereof the Company has no indebtedness for money borrowed and no Liens. "Liens" means a lien, charge, security interest, encumbrance, right of first refusal, preemptive right or other restriction.

(vi) Intellectual Property.

(A) Except as set forth in the filings and reports made with the SEC, each item of the Company's Intellectual Property is in full force and effect (including, without limitation, current payment of maintenance fees, annuities and the like), and either: (i) owned solely by the Company free and clear of any Liens or licenses (other than to third parties who have executed an end user license agreement in the ordinary course of the Company's business); or (ii) rightfully used and authorized for use by the Company or its successors pursuant to a valid and enforceable written license. Except as set forth in filings and reports made with the SEC, no item of the Company's Intellectual Property, including without limitation all or any portion of source code, is held in escrow or required to be held in escrow.

(B) The Company is not in violation of any license, sublicense or other agreement to which it is a party or otherwise bound relating to any of the Company's Intellectual Property.

(C) Except as set forth in filings and reports made with the SEC, to the Company's knowledge, the current and currently proposed use of the Company's Intellectual Property by the Company does not and will not infringe any other Person's copyright, patent, trademark, service mark, trade name, firm name, logo, trade dress, trade secret rights, right of privacy, right in personal data or other intellectual property right. No claims (A) challenging the validity, enforceability, effectiveness or ownership by the Company of any of the Company's Intellectual Property or (B) to the effect that the use, reproduction, modification, manufacture, distribution, licensing, sublicensing, sale, or any other exercise of rights under or in connection with any of the Company's Intellectual Property by the Company, infringes or will infringe on any intellectual property or other proprietary or personal right of any person have been asserted against the Company or, to the Company's knowledge, are threatened by any person nor does there exist any valid basis for such a claim. To the Company's knowledge, there are no legal or governmental proceedings, including interference, re-examination, reissue, opposition, nullity, or cancellation proceedings pending that relate to any of the Company's Intellectual Property, other than review of pending patent applications, and, to the Company's knowledge, no proceedings are threatened or contemplated by any governmental entity or any other person. All granted or issued patents, all trademarks and service marks, and all copyrights owned by the Company are valid, enforceable and subsisting. To the Company's knowledge, there is no unauthorized use, infringement, or misappropriation of any of the Company's Intellectual Property by any third party, employee or former employee. As used in this Agreement, the term "to the Company's knowledge" and similar expressions refer to the actual knowledge, after reasonable diligent inquiry, of any officer of the Company who has managerial responsibility for any significant department or function of the Company, including, without limitation, the Company's Chief Executive Officers, Chief Financial Officer and Chief Technology Officer.

(D) Except as set forth in filings and reports made with the SEC the Company has secured from all parties (including employees) who have created any portion of, or otherwise have any rights in or to, the Company's Intellectual Property valid and enforceable written assignments of any such work, invention, improvement or other rights to the Company and has made available true and complete copies of such assignments to the Holder. The Company has taken commercially reasonable measures to protect the proprietary nature of the Company's Intellectual Property and to maintain in confidence all trade secrets and confidential information owned or used by the Company.

(E) As used in this Agreement, "Intellectual Property" means all tangible or intangible proprietary information and materials, including, without limitation: (A) (I) all inventions (whether patentable or unpatentable and whether or not reduced to practice), all improvements thereon, and all patents, patent applications (including provisional applications) and patent disclosures, together with all re-issuances, continuations, continuations in part, divisions, revisions, extensions and re-examinations thereof, (II) all trademarks, services marks, trade dress, logos, trade names, domain names, and corporate names, together with all translations, adaptations, derivations and combinations thereof and including all goodwill associated therewith, and all applications, registrations and renewals in connection therewith, (III) all copyrights (whether or not registered) and all applications, registrations and renewals in connection therewith, (IV) all trade secrets and confidential business information (including ideas, research and development, know how, formulas, compositions, manufacturing and production process and techniques, methods, schematics, technology, technical data, designs, drawings, flowcharts, block diagrams, specifications, customer and supplier lists, pricing and cost information and business and marketing plans and proposals), and (V) all software and firmware (including data, databases and related documentation); (B) all documents, records and files relating to design, end user documentation, manufacturing, quality control, sales, marketing or customer support for, and tangible embodiments of, all intellectual property described herein; and (C) all licenses, agreements and other rights in any third party product or any third party intellectual property described in (A) and (B) above other than any "off-the-shelf" third party software or related intellectual property.

(F) As used in this Agreement, "Person" means an individual, corporation, partnership, association, trust or other entity or organization, including a government or political subdivision or an agency or instrumentality thereof

(vii) Brokers. Neither the Purchasers nor the Company has taken any action which would give rise to any claim by any person for brokerage commissions, finder's fees or similar payments by the Company or the Purchasers relating to this Agreement or the transactions contemplated hereby.

3 . Representations and Warranties of the Purchasers. Each of the Purchasers represents and warrants to the Company as of the Closing Date as:

(a) All action on the part of such Purchaser for the authorization, execution, delivery and performance by Purchaser of this Agreement have been taken, and this Agreement constitutes a valid and binding obligation of such Purchaser, enforceable in accordance with its terms, except as may be limited by applicable bankruptcy, insolvency, reorganization, or similar laws relating to or affecting the enforcement of creditors' rights.

(b) The Purchaser is acquiring the Notes for investment for its own account and not with a view to, or for resale in connection with, any distribution. The Purchaser understands that the Notes to be acquired have not been registered under the Act of 1933, as amended (the "Act"), by reason of a specific exemption from the registration provisions of the Act which depends upon, among other things, the bona fide nature of the investment intent as expressed herein.

(c) The Purchaser represents that it is an Accredited Investor, as defined in Rule 501 promulgated under the Act.

(d) The Purchaser is experienced in evaluating and investing in securities of companies similarly situated to the Company, and acknowledges that it is able to fend for itself, can bear the economic risk of an investment in the Notes, and has such knowledge and experience in financial or business matters that it is capable of evaluating the merits and risks of the investment in the Notes.

(e) The Purchaser believes it has received all the information it considers necessary or appropriate for deciding whether to purchase the Notes. The Purchaser further represents that it has had an opportunity to ask questions and receive answers from the Company regarding the terms and conditions of the offering of the Notes and the business, properties, prospects and financial condition of the Company.

(f) The Purchaser acknowledges that the Notes must be held indefinitely unless subsequently registered under the Act or unless an exemption from such registration is available. The Purchaser is aware of the provisions of Rule 144 promulgated under the Act which permits limited resale of securities purchased in a private placement subject to the satisfaction of certain conditions, including, unless the Purchaser is an affiliate of the Company, among other things, the availability of certain current public information about the Company, the resale occurring not less than one year after a party has purchased and paid for the securities to be sold, the sale being through a "broker's transaction" or in transactions directly with a "market maker," and the number of shares being sold during any three-month period not exceeding specified limitations.

(g) The Purchaser hereby represents that it has satisfied itself as to the full observance of the laws of its jurisdiction in connection with any invitation to subscribe for the Notes or any use of this Agreement, including: (i) the legal requirements within the Purchaser's jurisdiction for the purchase of the Notes; (ii) any foreign exchange restrictions applicable to such purchase; (iii) any governmental or other consents that may need to be obtained; and (iv) the income tax and other tax consequences, if any, that may be relevant to the purchase, holding, redemption, conversion, sale, or transfer of the Notes. The Purchaser's subscription and payment for, and the Purchaser's continued beneficial ownership of the Notes, will not violate any applicable securities or other laws of the Purchaser's jurisdiction. The Purchaser understands and agrees that it (and not the Company) shall be responsible for its own tax liability that may arise as a result of this investment or the transactions contemplated by this Agreement

4. Legends. All certificates representing any of the Notes and Warrants issued pursuant to the terms hereof shall have endorsed thereon a legend substantially as follows:

“THESE SECURITIES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933. THEY MAY NOT BE SOLD, OFFERED FOR SALE, PLEDGED OR HYPOTHECATED IN THE ABSENCE OF AN EFFECTIVE REGISTRATION STATEMENT AS TO THE SECURITIES UNDER SAID ACT OR AN OPINION OF COUNSEL SATISFACTORY TO THE COMPANY THAT SUCH REGISTRATION IS NOT REQUIRED.”

5. Additional Agreements

(a) Absence of Non-public Information. Company represents and warrants that Company has not provided to Holder, and Holder has not received and will not be provided with, any material non-public information concerning Company. In the event that any material non-public information is hereafter provided to Holder such materials shall be included in a Regulation FD disclosure filing made by the Company within one business day following the date on which such materials are provided to Holder. The absence of such a filing shall be deemed conclusive evidence that the Company does not believe such materials contain any material non-public information or disclosures which could result in Holder investors being deemed “insiders” for purposes of any securities laws.

(b) Liens and Indebtedness. The Company agrees it shall not incur any indebtedness for money borrowed or incur any Liens prior to the repayment in full of the Note.

(c) Indemnification of Purchasers. The Company will indemnify and hold each Purchaser and its directors, officers, shareholders, members, partners, employees and agents (and any other Persons with a functionally equivalent role of a Person holding such titles notwithstanding a lack of such title or any other title), each Person who controls such Purchaser (within the meaning of Section 15 of the Securities Act and Section 20 of the Securities Exchange Act of 1934, as amended), and the directors, officers, shareholders, agents, members, partners or employees (and any other Persons with a functionally equivalent role of a Person holding such titles notwithstanding a lack of such title or any other title) of such controlling person (each, a “Purchaser Party”) harmless from any and all losses, liabilities, obligations, claims, contingencies, damages, costs and expenses, including all judgments, amounts paid in settlements, court costs and reasonable attorneys’ fees and costs of investigation that any such Purchaser Party may suffer or incur as a result of or relating to (a) any breach of any of the representations, warranties, covenants or agreements made by the Company in this Agreement or in the other Transaction Documents or (b) any action instituted against a Purchaser, or any of them or their respective Affiliates, by any stockholder of the Company who is not an Affiliate of such Purchaser, with respect to any of the transactions contemplated by the Transaction Documents (unless such action is based upon a breach of such Purchaser’s representations, warranties or covenants under the Transaction Documents or any agreements or understandings such Purchaser may have with any such stockholder or any violations by the Purchaser of state or federal securities laws or any conduct by such Purchaser which constitutes fraud, gross negligence, willful misconduct or malfeasance). If any action shall be brought against any Purchaser Party in respect of which indemnity may be sought pursuant to this Agreement, such Purchaser Party shall promptly notify the Company in writing, and the Company shall have the right to assume the defense thereof with counsel of its own choosing reasonably acceptable to the Purchaser Party. Any Purchaser Party shall have the right to employ separate counsel in any such action and participate in the defense thereof, but the fees and expenses of such counsel shall be at the expense of such Purchaser Party except to the extent that (i) the employment thereof has been specifically authorized by the Company in writing, (ii) the Company has failed after a reasonable period of time to assume such defense and to employ counsel or (iii) in such action there is, in the reasonable opinion of such separate counsel, a material conflict on any material issue between the position of the Company and the position of such Purchaser Party, in which case the Company shall be responsible for the reasonable fees and expenses of no more than one such separate counsel. The Company will not be liable to any Purchaser Party under this Agreement (i) for any settlement by a Purchaser Party effected without the Company’s prior written consent, which shall not be unreasonably withheld or delayed; or (ii) to the extent, but only to the extent that a loss, claim, damage or liability is attributable to any Purchaser Party’s breach of any of the representations, warranties, covenants or agreements made by such Purchaser Party in this Agreement or in the other Transaction Documents.

6. General Provisions.

(a) Governing Law; Jurisdiction. THIS AGREEMENT SHALL BE GOVERNED IN ALL RESPECTS BY THE INTERNAL LAWS OF THE STATE OF NEW YORK WITHOUT REFERENCE TO PRINCIPLES OF CONFLICTS OF LAWS. COMPANY CONSENTS TO THE EXCLUSIVE JURISDICTION OF THE FEDERAL OR STATE COURT LOCATED IN NEW YORK, NEW YORK, WITH RESPECT TO ANY CLAIM OR CONTROVERSY RELATED TO THE ENFORCEMENT OR INTERPRETATION OF THIS NOTE.

(b) Notices. Any notice or other communication required or permitted to be given hereunder shall be in writing by mail, facsimile or personal delivery and shall be effective upon actual receipt of such notice. The addresses for such communications shall be as set forth below until notice is received that any such address or contact information has been changed:

If to the Company:

Telkonet, Inc.
20374 Seneca Meadows Parkway
Germantown, MD 20876
Att: Ronald W. Pickett

If to the Purchasers:

To such names and addresses as shall be set forth on
Schedule 1 hereto
With a copy to:
Haynes and Boone, LLP
153 East 53rd Street
Suite 4900
New York, New York 10022
Fax: (212) 918-8989
Attn: Harvey Kesner, Esq.

(c) Entire Agreement. Except as otherwise provided herein, this Agreement, the Note and the other documents delivered pursuant hereto constitute the full and entire understanding and agreement between the parties with regard to the subjects hereof and thereof.

(d) Amendment. This Agreement may only be amended, waived, discharged or terminated by a written instrument signed by the party against whom enforcement of any such amendment, waiver, discharge or termination is sought.

(e) Successors and Assigns. This Agreement, the Notes, the Warrants and the Warrant Shares held by Purchasers may be transferred or assigned by the Purchasers in whole or in part, in such Purchaser's sole and absolute discretion. Except as otherwise expressly provided in this Agreement, the provisions of this Agreement shall inure to the benefit of, and be binding upon, the successors, assigns, heirs, executors and administrators of the parties hereto.

(f) Severability. In case any provision of this Agreement shall be invalid, illegal or unenforceable, the validity, legality and enforceability of the remaining provisions shall not in any way be affected or impaired thereby.

(g) Titles and Subtitles. The titles of the Sections of this Agreement are for convenience of reference only and are not to be considered in construing this Agreement.

(h) Expenses. The Company and the Purchasers shall each bear their own expenses incurred with respect to this transaction, provided, however, that on the Closing Date, Company shall pay legal fees and expenses of Haynes and Boone LLP, counsel to Purchasers, in the amount of \$20,000 from the proceeds of the sale of the Notes.

(i) Counterparts. This Agreement may be executed in any number of counterparts, each of which shall be an original, but all of which together shall be deemed to constitute one instrument.

(j) Counsel. All parties hereto have been represented by counsel, and no inference shall be drawn in favor of or against any party by virtue of the fact that such party's counsel was or was not the principal draftsman of this Agreement.

IN WITNESS WHEREOF, the parties have caused this agreement to be executed by its officers thereunto duly authorized.

TELKONET, INC.

November 9, 2007

By: /s/ Ronald W. Pickett

Ronald W. Pickett

Chief Executive Officer

**“Purchasers”
GRQ CONSULTANTS, INC.**

November 9, 2007

By: /s/ Barry Honig

Barry Honig
President

Schedule 1

Purchasers

Name and Address	Principal Amount of Notes
GRQ Consultants, Inc. 595 S. Federal Highway Suite 60 Boca Raton, Florida 33431 Att: Barry Honig, President	\$1,500,000

THE SECURITIES REPRESENTED BY THIS INSTRUMENT HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, OR THE SECURITIES LAWS OF ANY STATE, AND MAY NOT BE SOLD, TRANSFERRED, ASSIGNED, PLEDGED OR HYPOTHECATED UNLESS AND UNTIL REGISTERED UNDER SUCH ACT AND/OR APPLICABLE STATE SECURITIES LAWS, OR UNLESS THE CORPORATION HAS RECEIVED AN OPINION OF COUNSEL OR OTHER EVIDENCE, REASONABLY SATISFACTORY TO THE CORPORATION AND ITS COUNSEL, THAT SUCH REGISTRATION IS NOT REQUIRED.

Dated: July __, 2007

Void after the date
specified below in Section 1

TELKONET, INC.

WARRANT TO PURCHASE COMMON STOCK

THIS CERTIFIES THAT, for value received, GRQ Consultants, Inc. and its permitted assigns (hereinafter called the "Holder") is entitled to purchase from Telkonet, Inc., a Utah corporation (the "Company"), in whole or in part and at the times set forth below in Section 1, up to 359,712 shares of common stock, par value \$.001 per share, of the Company (the "Warrant Shares") at an exercise price per share of \$4.17 per share (the "Exercise Price"), as may be adjusted in accordance with this Warrant.

1. Term. This Warrant shall be exercisable on and after the date hereof until 5:00 pm, New York City time, on July 31, 2012; and
2. Method of Exercise; Payment; Issuance Of New Warrant.

2.1 Deliverables. Subject to the provisions herein, the purchase right represented by this Warrant may be exercised by the Holder, in whole or in part, by the surrender of this Warrant, together with a completed notice of exercise in the form attached hereto as Attachment A, an executed investment representation statement in the form attached hereto as Attachment B and, if applicable, a check, payable to the Company, in an amount equal to the Exercise Price per share multiplied by the number of Warrant Shares then being purchased (such aggregate amount of money being herein referred to as, the "Purchase Price") at the principal office of the Company.

2.2 Status; Taxes. Upon receipt of this Warrant, such notice of exercise and such investment representation together with the Purchase Price (if applicable) by the Company at its principal office (or, if the Company shall then have a stock transfer agent or warrant agent, then by such agent at its office), the Holder shall be deemed to be the holder of record of the applicable Warrant Shares, notwithstanding that the stock transfer books of the Company shall then be closed or that certificates representing such Warrant Shares shall not then be actually delivered to the Holder. The Company shall collect from the Holder and pay any and all documentary, stamp or similar issue or transfer taxes payable in respect of the issue or delivery of the Warrant Shares.

2.3 Net Exercise. In addition to and without limiting the rights of the Holder under the terms of this Warrant, the Holder may elect to convert this Warrant or any portion thereof (the "Conversion Right") into Warrant Shares, the aggregate value of which Warrant Shares shall be equal to the value of this Warrant or the portion thereof being converted. The Conversion Right may be exercised by the Holder by surrender of this Warrant at the principal office of the Company (or, if applicable, at the offices of the Company's stock transfer agent or warrant agent) together with notice of the Holder's intention to exercise the Conversion Right, in which event the Company shall issue to the Holder a number of Warrant Shares computed using the following formula:

$$X = \frac{Y(A - B)}{A}$$

- Where:
- X = The number of Warrant Shares to be issued to the Holder upon exercise of its Conversion Right.
 - Y = The number of Warrant Shares issuable under this Warrant at the date of calculation.
 - A = The fair market value of one Warrant Share, which shall equal the average closing price per share of the Common Stock on the NASDAQ Stock Market (including the OTC Bulletin Board, if applicable) for the five consecutive trading days immediately preceding the date of exercise, or if the Common Stock is not then listed on NASDAQ, as determined in good faith by the board of directors of the Company as at the time the Conversion Right is exercised pursuant to this Section 2.
 - B = Exercise Price (as adjusted to the date of such calculations).

2.4 Partial Exercise. In the event that this Warrant is being exercised for less than all of the then current number of Warrant Shares, the Company shall, concurrently with the issuance by the Company of the number of Warrant Shares for which this Warrant is then being exercised, issue a new Warrant exercisable for the remaining number of Warrant Shares.

3. Stock Fully Paid; Reservation of Warrant Shares.

All shares of stock which may be issued upon the exercise of the rights represented by this Warrant will, upon such exercise and issuance in accordance with the terms and conditions herein contained, be validly issued, fully paid and non-assessable. The Company shall, at all times during which this Warrant is exercisable, have authorized and reserved for issuance a number of shares of Common Stock sufficient to permit the full exercise of this Warrant.

4. Adjustment of Exercise Price and Number of Warrant Shares.

The number of and kind of securities purchasable upon exercise of this Warrant and the Exercise Price shall be subject to adjustment from time to time as follows:

4.1 Subdivisions, Combinations and Other Issuances. If the Company shall at any time after the date hereof and prior to the expiration of this Warrant subdivide its Common Stock, by split-up or otherwise, or combine its Common Stock, or issue additional shares of its Common Stock as a dividend with respect to any shares of its Common Stock, the number of Warrant Shares issuable upon the exercise of this Warrant shall forthwith be proportionately increased in the case of a subdivision or stock dividend, or proportionately decreased in the case of a combination. Appropriate adjustments shall also be made to the Exercise Price payable per share, but the aggregate Purchase Price payable for the total number of Warrant Shares purchasable under this Warrant (as adjusted) shall remain the same. Any adjustment under this Section 4.1 shall become effective at the close of business on the date the subdivision or combination becomes effective, or as of the record date of such dividend, or in the event that no record date is fixed, upon the making of such dividend.

4.2 Reclassification, Reorganization and Consolidation. In case of any reclassification, capital reorganization, or change in the Common Stock of the Company (other than as a result of a subdivision, combination, or stock dividend provided for in Section 4.1 or as a result of a Change of Control), then, as a condition to such reclassification, reorganization, or change, lawful provision shall be made, and duly executed documents evidencing the same from the Company or its successor shall be delivered to the Holder, so that the Holder shall have the right at any time prior to the expiration of this Warrant to purchase, at a purchase price equal to the Purchase Price payable upon the exercise of this Warrant, the kind and amount of shares of stock and other securities and property receivable in connection with such reclassification, reorganization, or change by a holder of the same number of shares of Common Stock as were purchasable by the Holder immediately prior to such reclassification, reorganization, or change. In any such case, appropriate provisions shall be made with respect to the rights and interest of the Holder so that the provisions hereof shall thereafter be applicable with respect to any shares of stock or other securities and property deliverable upon the exercise hereof, and appropriate adjustments shall be made to the Exercise Price, *provided*, that the Purchase Price shall remain the same.

4.3 Public Transaction. If the Company shall at anytime prior to the expiration hereof, merge with a publicly-traded company ("Pubco") that will acquire all of the capital stock and business of the Company, then the Holder shall have the option to exchange this Warrant for a number of shares of capital stock of Pubco equal to the number of shares of capital stock of Pubco that would be received in such merger for the number of shares of Common Stock then issuable upon the exercise of this Warrant pursuant to Section 2 hereof.

4.4 Certain Events. If any change in the outstanding Common Stock of the Company or any other event occurs as to which the other provisions of this Section 4 are not strictly applicable or if strictly applicable would not fairly protect the purchase rights of the Holder in accordance with such provisions, then the Board of Directors of the Company shall make an adjustment in the number and class of shares available under this Warrant, the Purchase Price or the application of such provisions, so as to protect such purchase rights as aforesaid. The adjustment shall be such as will give the Holder upon exercise for the same aggregate Purchase Price the total number, class and kind of shares as he or she would have owned had this Warrant been exercised prior to the event and had he or she continued to hold such shares until after the event requiring such adjustment.

4.5 Notice of Adjustment. When any adjustment is required to be made in the number or kind of shares purchasable upon exercise of this Warrant, or in the Exercise Price, the Company shall promptly notify the Holder of such event.

5. Fractional Warrant Shares.

No fractional Warrant Shares will be issued in connection with any exercise hereunder, but in lieu of such fractional shares the Company shall make a cash payment therefor upon the basis of the Exercise Price then in effect.

6. Compliance with Securities Act.

The Holder, by acceptance hereof, represents and agrees that this Warrant and the Warrant Shares are being acquired for investment and that he or she will not offer, sell or otherwise dispose of this Warrant or any Warrant Shares except as permitted under this Warrant and under circumstances which will not result in a violation of the Securities Act of 1933, as amended (the "Act"). Upon exercise of this Warrant, the Holder shall confirm in writing, in the form of Attachment B hereto, that the Warrant Shares so purchased are being acquired for investment and not with a view toward distribution or resale in violation of law. This Warrant and all Warrant Shares (unless registered under the Act) shall be stamped or imprinted with legends in substantially the following form:

“THESE SECURITIES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE “ACT”) OR THE SECURITIES LAWS OF ANY STATE AND MAY NOT BE SOLD, PLEDGED OR OTHERWISE TRANSFERRED OR HYPOTHECATED WITHOUT (1) THE PRIOR WRITTEN CONSENT OF THE COMPANY AND (2) AN EFFECTIVE REGISTRATION STATEMENT UNDER THE ACT AND APPLICABLE STATE SECURITIES LAWS RELATING TO THESE SECURITIES OR AN AVAILABLE EXEMPTION FROM SUCH REGISTRATION SUPPORTED BY AN OPINION OF COUNSEL REASONABLY SATISFACTORY TO THE COMPANY THAT SUCH REGISTRATION IS NOT REQUIRED.”

7. Transferability of Warrant.

This Warrant may be transferred or assigned in whole or in part in Holder’s sole and absolute discretion except as prohibited by applicable federal and state securities laws.

8. Disposition of Warrant Shares.

With respect to any offer, sale or other disposition of any Warrant Shares prior to registration of such shares, the Holder and each subsequent Holder of this Warrant agrees to give written notice to the Company prior thereto, describing briefly the manner thereof, together with a written opinion of such Holder’s counsel, if reasonably requested by the Company, to the effect that such offer, sale or other disposition may be effected without registration or qualification of such Warrant Shares under the Act (as then in effect) or any other Federal or state laws then in effect; *provided, however*, that no such opinion of counsel shall be necessary for a transfer by bona fide gift, will or intestate succession by the Holder to his or her spouse or lineal descendants or ancestors or any trust for the benefit of any of the foregoing if the transferee agrees in writing to be subject to the terms hereof to the same extent as if he/she were an original Holder hereunder. Notwithstanding the foregoing, such Warrant Shares may be offered, sold or otherwise disposed of in accordance with Rule 144.

9. No Rights as Stockholder.

No Holder of this Warrant shall be entitled to vote or be deemed the holder of stock or any other securities of the Company which may at any time be issuable on the exercise hereof for any purpose, nor shall anything contained herein be construed to confer upon the Holder of this Warrant, as such, any of the rights of a stockholder of the Company or any right to vote for the election of directors or upon any matter submitted to stockholders at any meeting thereof, or to give or withhold consent to any corporate action (whether upon any recapitalization, issuance of stock, reclassification of stock, change of par value or change of stock to no par value, consolidation, merger, conveyance, or otherwise) or to receive notice of meetings, or to receive dividends or subscription rights or otherwise until this Warrant has been exercised and the Warrant Shares shall have become deliverable, as provided herein.

10. Governing Law; Jurisdiction.

The terms and conditions of this Warrant shall be governed by and construed in accordance with the laws of the State of New York, without regard to any provisions thereof relating to conflicts of laws among different jurisdictions. The parties consents to the exclusive jurisdiction of the federal or state court located in New York, New York, with respect to any claim or controversy related to the enforcement or interpretation of this note.

11. Notices.

All notices, requests, demands and other communications that are required or may be given under this Agreement shall be in writing and shall be deemed to have been duly given (i) when received if personally delivered, (ii) upon electronic confirmation of receipt, if transmitted by telecopy, (iii) the business day after it is sent, if sent for next day delivery to a domestic address by a nationally recognized overnight delivery service (i.e., Federal Express) or (iv) three days from the date of deposit in the U.S. mails, if sent by certified or registered U.S. mail, return receipt requested. In each case such notice shall be addressed as follows:

To the Company:
Telkonet, Inc.
20374 Seneca Meadows Parkway
Germantown, MD 20876
Att: Ronald W. Pickett To Holder:
Fax: _____

12. Miscellaneous.

The headings in this Warrant are for purposes of convenience and reference only, and shall not be deemed to constitute a part hereof. Neither this Warrant nor any term hereof may be changed, waived, discharged or terminated orally, but only by an instrument in writing signed by the Company and the registered Holder.

TELKONET, INC.

November 9, 2007

By: /s/ Ronald W. Pickett

Ronald W. Pickett
Chief Executive Officer

HOLDER:

GRQ CONSULTANTS, INC.

November 9, 2007

By: /s/ Barry Honig

Barry Honig
President

ATTACHMENT A TO WARRANT
NOTICE OF EXERCISE

TO: Telkonet, Inc. (the "Company"):

1. The undersigned hereby elects to purchase _____ shares of common stock, no par value per share ("Common Stock"), of Telkonet, Inc., pursuant to the terms of the attached warrant (the "Warrant") and tenders herewith payment of the aggregate purchase price of such shares in full, together with all applicable transfer taxes, if any.

2. The undersigned hereby elects to convert the attached Warrant into shares of Common Stock in the manner specified in Section 2.3 of the Warrant. This conversion is exercised with respect to _____ of the shares covered by the Warrant.

3. Please issue a certificate(s) representing said shares of Common Stock in the name of the undersigned or in such other name as is specified below:

(Name)

(Address)

4. The undersigned represents that the aforesaid shares of Common Stock are being acquired for the account of the undersigned for investment and not with a view to, or for resale in connection with, the distribution thereof and that the undersigned has no present intention of distributing or reselling such shares. In support thereof, the undersigned has executed and delivered to the Company an Investment Representation Statement in the form of Attachment B to the attached Warrant.

INDIVIDUAL HOLDER SIGNATURE:

Name:

CORPORATE HOLDER SIGNATURE:

Name:

By: _____

Name: _____

Title: _____

INVESTMENT REPRESENTATION STATEMENT

PURCHASER:
COMPANY: Telkonet, Inc. (the “Company”)
SECURITY: Warrants to purchase common stock, \$.001 par value per share, of the Company.
AMOUNT:
DATE:

In connection with my purchase of the above-listed warrants and shares issuable upon the exercise of such warrants (collectively, the “Securities”), I, _____, hereby represent to the Company as follows:

(a) I am aware of the Company’s business affairs and financial condition, and have acquired sufficient information about the Company to reach an informed and knowledgeable decision to acquire the Securities. I am purchasing the Securities for my own account for investment purposes only and not with a view to, or for the resale in connection with, any “distribution” thereof for purposes of the Securities Act of 1933, as amended (the “Securities Act”).

(b) I understand that the Securities have not been registered under the Securities Act or the securities laws of any state and have been issued in reliance upon a specific exemption therefrom, which exemption depends upon, among other things, the bonafide nature of my investment intent as expressed herein. In this connection, I understand that, in the view of the Securities and Exchange Commission, the statutory basis for such exemption may be unavailable if my representation was predicated solely upon a present intention to hold these Securities for the minimum capital gains period specified under tax statutes, for a deferred sale, for or until an increase or decrease in the market price of the Securities, or for a period of one year or any other fixed period in the future.

(c) I understand that I must hold the Securities indefinitely unless they are subsequently registered under the Securities Act or an exemption from such registration is available. In addition, I understand that all certificates evidencing the Securities will be imprinted with a legend that prohibits the transfer of the Securities without (1) the prior consent of the Company, and (2) an effective registration statement under the Securities Act covering the Securities or an available exemption from such registration. I further understand that in the event that I propose to transfer any of the Securities in reliance upon an exemption from registration under the Securities Act I may be required to submit to the Company an opinion of counsel reasonable satisfactory to the Company regarding such proposed transfer and exemption.

**INDIVIDUAL PURCHASER
SIGNATURE:**

CORPORATE PURCHASER SIGNATURE:

Name:

Name:
By: _____
Name:
Title:

CERTIFICATIONS

I, Ronald W. Pickett, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Telkonet, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 9, 2007

By: /s/ Ronald W. Pickett
Ronald W. Pickett
Chief Executive Officer

CERTIFICATIONS

I, Richard J. Leimbach, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Telkonet, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 9, 2007

By: /s/ Richard J. Leimbach
Richard J. Leimbach
Vice President Finance

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of **Telkonet Inc.** (the "Company") on Form 10-Q for the period ending **September 30, 2007** as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, **Ronald W. Pickett**, Chief Executive Officer of Telkonet, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Ronald W. Pickett

Ronald W. Pickett
Chief Executive Officer
November 9, 2007

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of **Telkonet Inc.** (the "Company") on Form 10-Q for the period ending **September 30, 2007** as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, **Richard J. Leimbach**, Vice President Finance of Telkonet, certify, pursuant to 18 U.S.C. section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ **Richard J. Leimbach**

Richard J. Leimbach
Vice President Finance
November 9, 2007