

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

FORM 10-Q /A  
(Amendment No.1)

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

For the quarterly period ended September 30, 2009

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number 001-31972

TELKONET, INC.

(Exact Name of Registrant as Specified in Its Charter)

Utah  
(State or Other Jurisdiction of Incorporation or Organization)

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

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

20876  
(Zip Code)

(240) 912-1800  
(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer   
(Do not check if a smaller reporting company)

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 96,563,771 shares of Common Stock (\$.001 par value) as of November 14, 2009.

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**TELKONET, INC.**  
**FORM 10-Q /A for the Quarter Ended September 30, 2009**

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## **EXPLANATORY NOTE**

This Amendment No. 1 on Form 10-Q/A (the “Amendment”) amends our quarterly report on Form 10-Q for the fiscal quarter ended September 30, 2009 as filed with the Securities and Exchange Commission on November 16, 2009 (the “Original Report”). The Company is filing this Amendment in response to comments received from the SEC. This Amendment corrects errors and provides additional disclosure information in Item 1 of Part I, Note N Discontinued Operations in the notes to the unaudited financial statements for the period ended September 30, 2009, and Item 6 of Part II as permitted by the rules and regulations of the SEC. The amendment did not have any material impact on our financial results.

For convenience and ease of reference, we are filing the quarterly report in its entirety with the applicable changes. Except for the amendment named above and the updated certifications, this Amendment continues to speak as of the date of our Original Report, and we have not updated the disclosures contained herein to reflect any events that have occurred thereafter. For a discussion of events and developments thereafter, please see our reports filed with the Securities and Exchange Commission since November 16, 2009.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

**TELKONET, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

|  | <b>(Unaudited)</b>   | <b>December</b>      |
|--|----------------------|----------------------|
|  | <b>September 30,</b> | <b>31,</b>           |
|  | <b>2009</b>          | <b>2008</b>          |
| <b>ASSETS</b>  |                      |                      |
| <b>Current assets:</b>   |                      |                      |
| Cash and cash equivalents  | \$ 38,449            | \$ 168,492           |
| Accounts receivable, net   | 687,056              | 836,336              |
| Inventories  | 1,286,296            | 1,733,940            |
| Other current assets   | 195,204              | 230,539              |
| Current assets from discontinued operations  | -                    | 476,459              |
| <b>Total current assets</b>  | <u>2,207,005</u>     | <u>3,445,766</u>     |
| <b>Property and equipment, net</b>   | <u>290,924</u>       | <u>403,593</u>       |
| <b>Other assets:</b>   |                      |                      |
| Marketable securities  | -                    | 397,403              |
| Deferred financing costs, net  | 287,178              | 432,136              |
| Goodwill and other intangible assets, net  | 14,956,212           | 15,137,469           |
| Other assets   | 8,890                | 98,807               |
| Other assets from discontinued operations  | -                    | 6,593,169            |
| <b>Total other assets</b>  | <u>15,252,280</u>    | <u>22,658,984</u>    |
| <b>Total Assets</b>  | <u>\$ 17,750,209</u> | <u>\$ 26,508,343</u> |
| <b>LIABILITIES AND EQUITY</b>  |                      |                      |
| <b>Current liabilities:</b>  |                      |                      |
| Accounts payable and accrued liabilities   | \$ 3,148,184         | \$ 2,561,213         |
| Accrued liabilities and expenses   | 1,968,910            | 1,996,044            |
| Line of credit   | 449,741              | 574,005              |
| Other current liabilities  | 141,059              | 278,033              |
| Current Liabilities from discontinued operations   | -                    | 13,450,362           |
| <b>Total current liabilities</b>   | <u>5,707,894</u>     | <u>18,859,657</u>    |
| <b>Long-term liabilities:</b>  |                      |                      |
| Convertible debentures, net of debt discounts of \$538,305 and \$825,585, respectively   | 1,067,718            | 1,311,065            |
| Derivative liability   | 1,870,113            | 2,573,126            |
| Note payable   | 300,000              | -                    |
| Deferred lease liability and other   | 50,791               | 50,791               |
| <b>Total long-term liabilities</b>   | <u>3,288,622</u>     | <u>3,934,982</u>     |
| <b>Commitments and contingencies</b>   | -                    | -                    |
| <b>Equity</b>  |                      |                      |
| Preferred stock, par value \$.001 per share; 15,000,000 shares authorized; none issued and outstanding at September 30, 2009 and December 31, 2008   | -                    | -                    |
| Common stock, par value \$.001 per share; 155,000,000 shares authorized; 96,563,771 and 87,525,495 shares issued and outstanding at September 30, 2009 and December 31, 2008, respectively | 96,564               | 87,526               |
| Additional paid-in-capital   | 119,296,304          | 118,197,450          |
| Accumulated deficit  | (110,639,175)        | (114,801,318)        |
| Accumulated comprehensive loss   | -                    | (32,750)             |
| <b>Total stockholders' equity</b>  | <u>8,753,693</u>     | <u>3,450,908</u>     |
| Non-controlling interest   | -                    | 262,795              |
| <b>Total equity</b>  | <u>8,753,693</u>     | <u>3,713,703</u>     |
| <b>Total Liabilities and Equity</b>  | <u>\$ 17,750,209</u> | <u>\$ 26,508,343</u> |

See accompanying notes to the unaudited condensed consolidated financial statements

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

|  | For The Three Months<br>Ended |                       | For The Nine Months Ended |                        |
|--|-------------------------------|-----------------------|---------------------------|------------------------|
|  | September 30,                 |                       | September 30,             |                        |
|  | 2009                          | 2008                  | 2009                      | 2008                   |
| Revenues, net:   |                               |                       |                           |                        |
| Product  | \$ 1,445,888                  | \$ 3,837,728          | \$ 5,462,955              | \$ 10,821,179          |
| Recurring  | 991,130                       | 897,482               | 2,982,384                 | 2,559,728              |
| Total Revenue  | <u>2,437,018</u>              | <u>4,735,210</u>      | <u>8,445,339</u>          | <u>13,380,907</u>      |
| Cost of Sales:   |                               |                       |                           |                        |
| Product  | 833,926                       | 2,076,776             | 2,942,748                 | 6,800,627              |
| Recurring  | <u>348,321</u>                | <u>416,723</u>        | <u>957,668</u>            | <u>1,274,786</u>       |
| Total Cost of Sales  | <u>1,182,247</u>              | <u>2,493,499</u>      | <u>3,900,416</u>          | <u>8,075,413</u>       |
| Gross Profit   | 1,254,771                     | 2,241,711             | 4,544,923                 | 5,305,494              |
| Operating Expenses:  |                               |                       |                           |                        |
| Research and Development                                       | 263,672                       | 509,418               | 761,950                   | 1,667,229              |
| Selling, General and Administrative                            | 1,732,053                     | 2,123,035             | 5,089,221                 | 7,268,375              |
| Impairment write-down in investment in affiliate               | -                             | -                     | -                         | 380,000                |
| Stock Based Compensation                                       | 65,746                        | 194,483               | 243,366                   | 704,613                |
| Depreciation and Amortization                                  | <u>86,223</u>                 | <u>103,056</u>        | <u>266,740</u>            | <u>318,210</u>         |
| Total Operating Expense  | <u>2,147,694</u>              | <u>2,929,992</u>      | <u>6,361,277</u>          | <u>10,338,427</u>      |
| Loss from Operations   | (892,923)                     | (688,281)             | (1,816,354)               | (5,032,933)            |
| Other Income (Expenses):                                       |                               |                       |                           |                        |
| Financing Expense, net   | (228,730)                     | (243,424)             | (710,266)                 | (2,191,431)            |
| Gain (Loss) on Derivative Liability                            | (650,338)                     | (576,156)             | 788,936                   | (1,594,609)            |
| Impairment of Investment in Marketable Securities              | (367,653)                     | -                     | (367,653)                 | -                      |
| (Loss) on Sale of Investment                                   | <u>-</u>                      | <u>-</u>              | <u>(29,371)</u>           | <u>-</u>               |
| Total Other Income (Expenses)                                  | <u>(1,246,721)</u>            | <u>(819,580)</u>      | <u>(318,354)</u>          | <u>(3,786,040)</u>     |
| Income (Loss) Before Provision for Income Taxes                | (2,139,644)                   | (1,507,861)           | (2,134,708)               | (8,818,973)            |
| Provision for Income Taxes                                     | <u>-</u>                      | <u>-</u>              | <u>-</u>                  | <u>-</u>               |
| Income (Loss) from Continuing Operations                       | \$ (2,139,644)                | \$ (1,507,861)        | \$ (2,134,708)            | \$ (8,818,973)         |
| Discontinued Operations  |                               |                       |                           |                        |
| Income (Loss) from Discontinued Operations                     | -                             | (1,370,896)           | (635,735)                 | (3,412,656)            |
| Gain on Deconsolidation  | <u>-</u>                      | <u>-</u>              | <u>6,932,586</u>          | <u>-</u>               |
| Net Income (Loss)  | <u>\$ (2,139,644)</u>         | <u>\$ (2,878,757)</u> | <u>\$ 4,162,143</u>       | <u>\$ (12,231,629)</u> |
| Net income (loss) per share:                                   |                               |                       |                           |                        |
| Income (loss) per share from continuing operations - basic     | <u>\$ (0.02)</u>              | <u>\$ (0.04)</u>      | <u>\$ (0.02)</u>          | <u>\$ (0.16)</u>       |
| Income (loss) per share from continuing operations - diluted   | <u>\$ (0.02)</u>              | <u>\$ (0.04)</u>      | <u>\$ (0.02)</u>          | <u>\$ (0.16)</u>       |
| Income (loss) per share from discontinued operations – basic   | <u>\$ 0.00</u>                | <u>\$ (0.02)</u>      | <u>\$ 0.07</u>            | <u>\$ (0.04)</u>       |
| Income (loss) per share from discontinued operations – diluted | <u>\$ 0.00</u>                | <u>\$ (0.02)</u>      | <u>\$ 0.07</u>            | <u>\$ (0.04)</u>       |
| Net income (loss) per share – basic                            | <u>\$ (0.02)</u>              | <u>\$ (0.04)</u>      | <u>\$ 0.04</u>            | <u>\$ (0.16)</u>       |
| Net income (loss) per share - diluted                          | <u>\$ (0.02)</u>              | <u>\$ (0.04)</u>      | <u>\$ 0.04</u>            | <u>\$ (0.16)</u>       |
| Weighted Average Common Shares Outstanding - basic             | 96,220,386                    | 81,422,404            | 93,787,069                | 76,880,047             |
| Weighted Average Common Shares Outstanding - diluted           | 96,220,386                    | 81,422,404            | 93,787,069                | 76,880,047             |
| Comprehensive Income (Loss):                                   |                               |                       |                           |                        |
| Net Income (Loss)  | \$ (2,139,644)                | \$ (2,878,757)        | \$ 4,162,143              | \$ (12,231,629)        |
| Unrecognized Gain (Loss) on Investment                         | <u>-</u>                      | <u>(1,218,100)</u>    | <u>32,750</u>             | <u>(2,776,304)</u>     |
| Comprehensive Income (Loss)                                    | <u>\$ (2,139,644)</u>         | <u>\$ (4,096,857)</u> | <u>\$ 4,194,893</u>       | <u>\$ (15,007,933)</u> |

See accompanying notes to the unaudited condensed consolidated financial statements



**TELKONET, INC.**  
**CONDENSED CONSOLIDATED STATEMENT OF EQUITY (UNAUDITED)**  
**FOR THE PERIOD FROM JANUARY 1, 2009 THROUGH SEPTEMBER 30, 2009**

|   | Preferred<br>Shares | Preferred<br>Stock<br>Amount | Common<br>Shares  | Common<br>Stock<br>Amount | Additional<br>Paid in<br>Capital | Accumulated<br>Deficit | Comprehensive<br>Income (Loss) | Noncontrolling<br>Interest | Total              |
|---|---------------------|------------------------------|-------------------|---------------------------|----------------------------------|------------------------|--------------------------------|----------------------------|--------------------|
| <b>Balance at<br/>January 1,<br/>2009</b>   |                     |                              | 87,525,495        | \$ 87,526                 | \$118,197,450                    | \$(114,801,318)        | \$ (32,750)                    | \$ 262,795                 | \$3,713,703        |
| Shares issued in<br>exchange for<br>services<br>rendered at<br>approximately<br>\$0.12 per<br>share | -                   | -                            | 83,333            | 83                        | 9,917                            | -                      | -                              | -                          | 10,000             |
| Shares issued<br>for warrants<br>exercised at<br>\$0.09 per<br>share                                | -                   | -                            | 780,000           | 780                       | 70,746                           | -                      | -                              | -                          | 71,526             |
| Shares issued in<br>exchange for<br>convertible<br>debentures                                       | -                   | -                            | 8,174,943         | 8,175                     | 714,339                          | -                      | -                              | -                          | 722,514            |
| Stock-based<br>compensation<br>expense<br>related to<br>employee<br>stock options                   | -                   | -                            | -                 | -                         | 233,366                          | -                      | -                              | -                          | 233,366            |
| Stock-based<br>compensation<br>expense<br>related to the<br>re-pricing of<br>investor<br>warrants   | -                   | -                            | -                 | -                         | 70,486                           | -                      | -                              | -                          | 70,486             |
| Unrealized<br>Gain on<br>available for<br>sale securities   | -                   | -                            | -                 | -                         | -                                | -                      | 32,750                         | -                          | 32,750             |
| Reclass of non-<br>controlling<br>interest  | -                   | -                            | -                 | -                         | -                                | -                      | -                              | (262,795)                  | (262,795)          |
| Income from<br>discontinued<br>operations   | -                   | -                            | -                 | -                         | -                                | 6,296,851              | -                              | -                          | 6,296,851          |
| Income from<br>continuing<br>operations   | -                   | -                            | -                 | -                         | -                                | (2,134,708)            | -                              | -                          | (2,134,708)        |
| <b>Balance at<br/>September<br/>30, 2009</b>  | <u>-</u>            | <u>\$ -</u>                  | <u>96,563,771</u> | <u>\$ 96,564</u>          | <u>\$119,296,304</u>             | <u>\$(110,639,175)</u> | <u>\$ -</u>                    | <u>\$ -</u>                | <u>\$8,753,693</u> |

See accompanying notes to the unaudited condensed consolidated financial statements

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

|  | For the Nine Months<br>Ended September 30, |                    |
|--|--|--------------------|
|  | 2009                                       | 2008               |
| <b>Increase (Decrease) In Cash and Equivalents</b>   |  |                    |
| <b>Cash Flows from Operating Activities:</b>   |  |                    |
| Net income (loss) attributable to common shareholders  | \$ 4,162,143                               | \$(12,231,639)     |
| Net (income) loss from discontinued operations   | (6,296,851)                                | 3,082,656          |
| Net income (loss) from continuing operations   | (2,134,708)                                | (9,148,983)        |
| Adjustments to reconcile net income (loss) from operations to cash (used in) operating activities: |  |                    |
| Amortization of debt discounts and financing costs   | 543,161                                    | 364,374            |
| Loss on sale of investment   | 29,371                                     | -                  |
| Impairment of investment in marketable securities  | 367,653                                    | -                  |
| (Gain) loss on derivative liability  | (788,936)                                  | 1,594,609          |
| Impairment write-down on fixed assets and goodwill   | -  | 710,000            |
| Stock based compensation   | 243,366                                    | 704,613            |
| Fair value of issuance of warrants and re-pricing (financing expense)                              | 70,486                                     | 1,798,662          |
| Depreciation and amortization  | 266,740                                    | 350,163            |
| Increase / decrease in:  |  |                    |
| Accounts receivable, trade and other   | 766,598                                    | 455,162            |
| Inventories  | 447,644                                    | 572,088            |
| Prepaid expenses and deposits  | 117,019                                    | 345,520            |
| Deferred revenue   | (20,536)                                   | (28,008)           |
| Other Assets   | (62,595)                                   | 157,654            |
| Accounts payable, net  | (90,088)                                   | (803,822)          |
| Accrued expenses, net  | 172,319                                    | (305,398)          |
| Cash used in continuing operations   | (72,506)                                   | (3,233,366)        |
| Cash used in discontinued operations   | (287,997)                                  | (861,542)          |
| <b>Net Cash Used In Operating Activities</b>   | <b>(360,503)</b>                           | <b>(4,094,908)</b> |
| <b>Cash Flows From Investing Activities:</b>   |  |                    |
| Purchase of property and equipment   | (2,675)                                    | (14,375)           |
| Advances to unconsolidated subsidiary  | (305,539)                                  | -                  |
| Proceeds from sale of investment   | 33,129                                     | -                  |
| Cash used in continuing operations   | (275,085)                                  | (14,375)           |
| Cash used in discontinued operations   | (5,979)                                    | (994,344)          |
| <b>Net Cash Used In Investing Activities</b>   | <b>(281,064)</b>                           | <b>(1,008,719)</b> |
| <b>Cash Flows From Financing Activities:</b>   |  |                    |
| Proceeds from issuance of convertible debentures   | -  | 3,500,000          |
| Proceeds from sale of common stock, net of costs and fees  | -  | 1,500,000          |
| Proceeds from issuance of notes payable  | 300,000                                    | 60,000             |
| Proceeds (repayments) from line of credit  | (124,264)                                  | 475,000            |
| Financing fees   | (25,000)                                   | (462,566)          |
| Repayment of notes payable   | -  | (1,500,000)        |
| Proceeds from the exercise of warrants   | 71,526                                     | -                  |
| Repayment of capital lease and other   | (4,714)                                    | (4,625)            |
| Cash provided by continuing operations   | 217,548                                    | 3,567,809          |
| Cash provided by discontinued operations   | 293,976                                    | 56,228             |
| <b>Net Cash Provided By Financing Activities</b>   | <b>511,524</b>                             | <b>3,624,037</b>   |
| Net Decrease In Cash and Equivalents   | (130,043)                                  | (1,479,590)        |
| Cash and cash equivalents at the beginning of the period   | 168,492                                    | 1,629,583          |
| <b>Cash and cash equivalents at the end of the period</b>  | <b>\$ 38,449</b>                           | <b>\$ 149,993</b>  |

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

|  | For the Nine Months Ended<br>September 30, |            |
|--|--|------------|
|  | 2009                                       | 2008       |
| <b>Supplemental Disclosures of Cash Flow Information:</b>                      |  |            |
| <b>Cash transactions:</b>  |  |            |
| Cash paid during the period for financing expenses                             | \$ 355,340                                 | \$ 257,403 |
| Income taxes paid  | -  | -          |
| <b>Non-cash transactions:</b>  |  |            |
| Stock based compensation to employees and consultants in exchange for services | \$ 243,366                                 | \$ 704,613 |
| Fair value of issuance of warrants and re-pricing (financing expense)          | 70,486                                     | 1,798,662  |
| (Gain) loss on derivative liability  | (788,936 )                                 | 1,594,609  |
| Impairment write-down on goodwill and fixed assets                             | -  | 710,000    |
| Amortization of debt discount on convertible debentures and financing costs    | 543,161                                    | 364,374    |
| Accrued interest re classified as convertible debenture principal              | 191,887                                    | -          |
| Value of common stock issued in exchange for conversion of debenture principal | 722,514                                    | 710,000    |

See accompanying notes to the unaudited condensed consolidated financial statements

**TELKONET, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**SEPTEMBER 30, 2009**  
**(UNAUDITED)**

**NOTE A-SUMMARY OF ACCOUNTING POLICIES**

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

Business and Basis of Presentation

Telkonet, Inc., formed in 1999 and incorporated under the laws of the state of Utah, has evolved into a Clean Technology company that develops and manufactures proprietary energy efficiency and SmartGrid networking technology. Prior to January 1, 2007, the Company was primarily engaged in the business of developing, producing and marketing proprietary equipment enabling the transmission of voice and data communications over a building's existing internal electrical wiring.

In January 2006, of the Company acquired 90% of Microwave Satellite Technologies, Inc. (MST), and through this subsidiary, 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). In 2009, the Company completed the deconsolidation of MST by reducing its ownership percentage and board membership. Financial statements and accompanying notes included in this report include disclosure of the results of operations for MST, for all periods presented, as discontinued operations.

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

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

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

Going Concern

The accompanying unaudited condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern. The Company has reported a net income available to common shareholders of \$4,162,143 for the nine months ended September 30, 2009. However, the Company has reported operating losses of \$1,816,354, excluding gains on derivative liabilities, impairment of marketable securities and discontinued operations, for the nine months ended September 30, 2009. In addition, the Company has reported an accumulated deficit of \$110,639,175 and a working capital deficit of \$3,500,889 as of September 30, 2009.

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

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

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Goodwill and Other Intangibles

Goodwill represents the excess of the cost of businesses acquired over fair value or net identifiable assets at the date of acquisition. Goodwill is subject to a periodic impairment assessment by applying a fair value test based upon a two-step method. The first step of the process compares the fair value of the reporting unit with the carrying value of the reporting unit, including any goodwill. The Company utilizes a discounted cash flow valuation methodology to determine the fair value of the reporting unit. If the fair value of the reporting unit exceeds the carrying amount of the reporting unit, goodwill is deemed not to be impaired in which case the second step in the process is unnecessary. If the carrying amount exceeds fair value, the Company performs the second step to measure the amount of impairment loss. Any impairment loss is measured by comparing the implied fair value of goodwill, calculated per SFAS No. 142, with the carrying amount of goodwill at the reporting unit, with the excess of the carrying amount over the fair value recognized as an impairment loss.

Fair Value of Financial Instruments

In January 2008, the Company adopted the provisions under FASB for Fair Value Measurements, which define fair value for accounting purposes, establishes a framework for measuring fair value and expands disclosure requirements regarding fair value measurements. The Company's adoption of these provisions did not have a material impact on its consolidated financial statements. Fair value is defined as an exit price, which is the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date. The degree of judgment utilized in measuring the fair value of assets and liabilities generally correlates to the level of pricing observability. Financial assets and liabilities with readily available, actively quoted prices or for which fair value can be measured from actively quoted prices in active markets generally have more pricing observability and require less judgment in measuring fair value. Conversely, financial assets and liabilities that are rarely traded or not quoted have less price observability and are generally measured at fair value using valuation models that require more judgment. These valuation techniques involve some level of management estimation and judgment, the degree of which is dependent on the price transparency of the asset, liability or market and the nature of the asset or liability. The Company has categorized its financial assets and liabilities measured at fair value into a three-level hierarchy in accordance with these provisions.

Investments

Telkonet maintained investments in two publicly-traded companies for the period ended September 30, 2009. The Company has classified these securities as available for sale. Such securities are carried at fair market value. Unrealized gains and losses on these securities, if any, are reported as accumulated other comprehensive income (loss), which is a separate component of stockholders' equity. Unrealized gains on the sale of one investment resulted in a gain of \$32,750 recorded for the nine months ended September 30, 2009 and unrealized losses of \$2,776,304 were recorded for the nine months ended September 30, 2008. Realized gains and losses and declines in value judged to be other than temporary on securities available for sale, if any, are included in operations. Realized losses of \$397,024 were recognized for the nine months ended September 30, 2009, of which, a \$29,371 loss was recorded in February 2009 for the sale of the Company's investment in Multiband, and a \$367,653 loss was recorded in September 2009 for the write-off of the Company's remaining investment in Geeks on Call America, Inc. There were no realized gains or losses for the nine months ended September 30, 2008.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

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Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with FASB's Accounting Standards Codification ("ASC") 605-10, and ASC Topic 13 guidelines that require that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) 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. The guidelines also address the accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

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

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

Reclassifications

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

Non-controlling Interest

As a result of adopting FASB ASC 810-10 Consolidations – Variable Interest Entities, on January 1, 2009, we present non-controlling interests (previously shown as minority interest) as a component of equity on our Consolidated Balance Sheets and Consolidated Statement of Equity (Deficit). The adoption of this guidance did not have any other material impact on our financial position, results of operations or cash flow.

New Accounting Pronouncements

*Accounting Standards Codification and GAAP Hierarchy* — Effective for interim and annual periods ending after September 15, 2009, the Accounting Standards Codification and related disclosure requirements issued by the FASB became the single official source of authoritative, nongovernmental GAAP. The ASC simplifies GAAP, without change, by consolidating the numerous, predecessor accounting standards and requirements into logically organized topics. All other literature not included in the ASC is non-authoritative. We adopted the ASC as of September 30, 2009, which did not have any impact on our results of operations, financial condition or cash flows as it does not represent new accounting literature or requirements. All references to pre-codified U.S. GAAP have been removed from this Form 10-Q.

*Financial Instruments* — Effective for interim and annual periods ending after June 15, 2009, GAAP established new disclosure requirements for the fair value of financial instruments in both interim and annual financial statements. Previously, the disclosure was only required annually. We adopted the new requirements as of July 4, 2009, which resulted in no change to our accounting policies, and had no effect on our results of operations, cash flows or financial position, but did result in the addition of interim disclosure of the fair values of our financial instruments.

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*Consolidation*— Effective for interim and annual periods beginning after November 15, 2009, with earlier application prohibited, GAAP amends the current accounting standards for determining which enterprise has a controlling financial interest in a VIE and amends guidance for determining whether an entity is a VIE. The new standards will also add reconsideration events for determining whether an entity is a VIE and will require ongoing reassessment of which entity is determined to be the VIE's primary beneficiary as well as enhanced disclosures about the enterprise's involvement with a VIE. We are currently assessing the future impact these new standards will have on our results of operations, financial position or cash flows.

*Transfers and Servicing* – Effective for interim and annual periods beginning after November 15, 2009, GAAP eliminates the concept of a qualifying special purpose entity, changes the requirements for derecognizing financial assets and requires additional disclosures. We are currently assessing the future impact these new standards will have on our results of operations, financial position or cash flows.

**NOTE B- INTANGIBLE ASSETS AND GOODWILL**

Total identifiable intangible assets acquired and their carrying values at December 31, 2008 are:

|  | <b>Gross<br/>Carrying<br/>Amount</b> | <b>Accumulated<br/>Amortization</b> | <b>Net</b>           | <b>Residual<br/>Value</b> | <b>Weighted<br/>Average<br/>Amortization<br/>Period<br/>(Years)</b> |
|--|--------------------------------------|-------------------------------------|----------------------|---------------------------|---|
| Amortized Identifiable Intangible Assets:      |                                      |                                     |                      |                           |   |
| Subscriber lists - EthoStream                  | \$ 2,900,000                         | \$ (432,986)                        | \$ 2,467,014         | \$ -                      | 12.0  |
| Total Amortized Identifiable Intangible Assets | 2,900,000                            | (432,986)                           | 2,467,014            | -                         | 9.6   |
| Goodwill - EthoStream                          | 8,796,439                            | (2,000,000)                         | 6,796,439            | -                         |   |
| Goodwill - SSI                                 | 5,874,016                            | -                                   | 5,874,016            | -                         |   |
| <b>Total</b>                                   | <b>\$ 17,570,455</b>                 | <b>\$ (2,432,985)</b>               | <b>\$ 15,137,469</b> | <b>\$ -</b>               |   |

Total identifiable intangible assets acquired and their carrying values at September 30, 2009 are:

|  | <b>Gross<br/>Carrying<br/>Amount</b> | <b>Accumulated<br/>Amortization</b> | <b>Net</b>           | <b>Residual<br/>Value</b> | <b>Weighted<br/>Average<br/>Amortization<br/>Period (Years)</b> |
|--|--------------------------------------|-------------------------------------|----------------------|---------------------------|---|
| Amortized Identifiable Intangible Assets:      |                                      |                                     |                      |                           |   |
| Subscriber lists - EthoStream                  | \$ 2,900,000                         | \$ (614,243)                        | \$ 2,285,757         | \$ -                      | 12.0  |
| Total Amortized Identifiable Intangible Assets | 2,900,000                            | (614,243)                           | 2,285,757            | -                         | 12.0  |
| Goodwill - EthoStream                          | 8,796,439                            | (2,000,000)                         | 6,796,439            | -                         |   |
| Goodwill - SSI                                 | 5,874,016                            | -                                   | 5,874,016            | -                         |   |
| <b>Total</b>                                   | <b>\$ 17,570,455</b>                 | <b>\$ (2,614,243)</b>               | <b>\$ 14,956,212</b> | <b>\$ -</b>               |   |

Total amortization expense charged to operations for the three and nine months ended September 30, 2009 and 2008 was \$60,424 and \$181,257, and \$60,417 and \$120,833, respectively.

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**NOTE C – ACCOUNTS RECEIVABLE**

Components of accounts receivable as of September 30, 2009 and December 31, 2008 are as follows:

|                                    | September<br>30,<br>2009 | December<br>31,<br>2008 |
|------------------------------------|--------------------------|-------------------------|
| Accounts receivable (factored)     | \$ 1,087,086             | \$ 1,961,535            |
| Advances from factor               | (342,876)                | (1,075,879)             |
| Due from factor                    | 744,210                  | 885,656                 |
| Accounts receivable (non-factored) | 85,846                   | 127,080                 |
| Allowance for doubtful accounts    | (143,000)                | (176,400)               |
| <b>Total</b>                       | <b>\$ 687,056</b>        | <b>\$ 836,336</b>       |

In February 2008, the Company entered into a factoring agreement to sell, without recourse, certain receivables to an unrelated third party financial institution in an effort to accelerate cash flow. Under the terms of the factoring agreement the maximum amount of outstanding receivables at any one time is \$2.5 million. Proceeds on the transfer reflect the face value of the account less a discount. The discount is recorded as interest expense in the Consolidated Statement of Operations in the period of the sale. Net funds received reduced accounts receivable outstanding while increasing cash. Fees paid pursuant to this arrangement are included in “Operating expenses” in the Consolidated Statement of Operations and amounted to \$156,582 for the period ended September 30, 2009. The amounts borrowed are collateralized by the outstanding accounts receivable, and are reflected as a reduction to accounts receivable in the accompanying consolidated balance sheets.

**NOTE D - INVENTORIES**

Components of inventories as of September 30, 2009 and December 31, 2008 are as follows:

|                          | September<br>30,<br>2009 | December<br>31,<br>2008 |
|--------------------------|--------------------------|-------------------------|
| Raw Materials            | \$ 737,752               | \$ 843,978              |
| Finished Goods           | 748,544                  | 1,089,962               |
| Reserve for Obsolescence | (200,000)                | (200,000)               |
| <b>Total</b>             | <b>\$ 1,286,296</b>      | <b>\$ 1,733,940</b>     |

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**NOTE E -- PROPERTY AND EQUIPMENT**

The Company's property and equipment at September 30, 2009 and December 31, 2008 consists of the following:

|  | September<br>30,<br>2009 | December 31,<br>2008 |
|--|--------------------------|----------------------|
| Telecommunications and related equipment | \$ 117,637               | \$ 117,493           |
| Development Test Equipment               | 153,484                  | 153,484              |
| Computer Software                        | 160,894                  | 160,894              |
| Leasehold Improvements                   | 228,017                  | 248,778              |
| Office Equipment                         | 371,251                  | 377,851              |
| Office Fixtures and Furniture            | 249,604                  | 265,315              |
| <b>Total</b>                             | <b>1,280,887</b>         | <b>1,328,818</b>     |
| Accumulated Depreciation                 | (989,966)                | (925,225)            |
|  | <u>\$ 290,924</u>        | <u>\$ 403,593</u>    |

Depreciation expense included as a charge to income was \$25,803 and \$90,364 and \$54,120 and \$168,911 for the three and nine months ended September 30, 2009 and 2008, respectively.

**NOTE F -- MARKETABLE SECURITIES**

Multiband Corporation

In connection with a payment of \$75,000 of accounts receivable, the Company received 30,000 shares of common stock of Multiband Corporation, a Minnesota-based communication services provider to multiple dwelling units. The Company classifies this security as available for sale, and it is carried at fair market value. The Company sold its remaining investment in Multiband and recorded a loss of \$29,371 in January 2009.

Geeks on Call America, Inc

As of September 30, 2009, the Company maintained an investment in a publicly traded company which was approximately 18% of the outstanding shares of common stock of Geeks on Call Holdings, Inc. ("GOCA"), a provider of on-site computer services to residential and commercial customers. As of December 31, 2008, the Company determined that a significant portion of this investment was permanently impaired and wrote-off \$4,098,514. Management has determined that the entire investment in GOCA is impaired and the remaining value of \$367,653 has been written off during the period ended September 30, 2009.

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**NOTE G – LINE OF CREDIT**

In September 2008, the Company entered into a two-year line of credit facility with a third party financial institution. The line of credit has an aggregate principal amount of \$1,000,000 and is secured by the Company’s inventory. The outstanding principal balance bears interest at the greater of (i) the Wall Street Journal Prime Rate plus nine (9%) percent per annum, adjusted on the date of any change in such prime or base rate, or (ii) sixteen percent (16%). Interest, computed on a 365/360 simple interest basis, and fees on the credit facility are payable monthly in arrears on the last day of each month and continuing on the last day of each month until the maturity date. The Company may prepay amounts outstanding under the credit facility in whole or in part at any time. In the event of such prepayment, the lender will be entitled to receive a prepayment fee of four percent (4.0%) of the highest aggregate loan commitment amount if prepayment occurs before the end of the first year and three percent (3.0%) if prepayment occurs thereafter. The outstanding borrowing under the agreement at September 30, 2009 was \$449,741. The Company has incurred interest expense of \$103,881 related to the line of credit for the nine months ended September 30, 2009. The Prime Rate was 3.25% at September 30, 2009.

On November 11, 2009, the Company received a notice of waiver of the “minimum cash flow to debt service ratio” and the “tangible net worth” requirements under the line of credit facility, as such terms are defined in items D(10)a and D(10)b, respectively, of the line of credit agreement. The waiver is in effect as of September 30, 2009 and continues for the 90 day period thereafter.

**NOTE H - - SENIOR CONVERTIBLE DEBENTURES**

**Senior Convertible Debenture**

A summary of convertible debentures payable at September 30, 2009 and December 31, 2008 is as follows:

|   | <b>September<br/>30,<br/>2009</b> | <b>December<br/>31,<br/>2008</b> |
|---|-----------------------------------|----------------------------------|
| Senior Convertible Debentures, accrue interest at 13% per annum and mature on May 29, 2011  | \$ 1,606,023                      | \$ 2,136,650                     |
| Debt Discount - beneficial conversion feature, net of accumulated amortization of \$514,381 and \$295,508 at September 30, 2009 and December 31, 2008, respectively.                    | (292,508)                         | (425,458)                        |
| Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of \$432,243 and \$277,913 at September 30, 2009 and December 31, 2008, respectively. | (245,797)                         | (400,127)                        |
| <b>Total</b>  | <b>\$ 1,067,718</b>               | <b>\$ 1,311,065</b>              |
| Less: current portion   | -                                 | -                                |
|   | <u><b>\$ 1,067,718</b></u>        | <u><b>\$ 1,311,065</b></u>       |

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

The Company amortized the beneficial conversion feature and the value of the attached warrants, and recorded non-cash interest expense in the amount of \$218,873 and \$154,330, respectively, and \$146,251 and \$137,545, respectively, for the nine months ended September 30, 2009, and 2008.

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

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On May 28, 2009, the Company's shareholders voted against a proposal to remove the Exchange Cap, allowing YA Global to potentially acquiring in excess of 19.99% of the outstanding shares of the Company's common stock, as of May 30, 2008, upon conversion of debentures and/or the exercise of warrants, pursuant to NYSE Amex LLC regulations. In the Agreement of Clarification, the Company agreed to seek approval of the share issuance at the 2009 annual meeting of stockholders, which was held on May 28, 2009. On May 12, 2009, YA Global met the Exchange Cap for the conversion of its debentures, and cannot receive additional shares of the Company's common stock for the conversion of debentures or exercise of warrants, under NYSE Amex rules.

At September 30, 2009, the Senior Convertible Debenture had an estimated fair value of \$1.1 million.

**Business Loan**

On September 11, 2009, the Company entered into a Loan Agreement in the aggregate principal amount of \$300,000 with the Wisconsin Department of Commerce (the "Department"). The outstanding principal balance bears interest at the annual rate of two (2.00) percent. Payment of interest and principal is to be made in the following manner: (a) payment of any and all interest that accrues from the date of disbursement commences on January 1, 2010 and continues on the first day of each consecutive month thereafter through and including December 31, 2010; (b) commencing on January 1, 2011 and continuing on the first day of each consecutive month thereafter through and including November 1, 2016, the Company shall pay equal monthly installments of \$4,426 each; followed by a final installment on December 1, 2016 which shall include all remaining principal, accrued interest and other amounts owed by the Company to the Department under the Loan Agreement. The Company may prepay amounts outstanding under the credit facility in whole or in part at any time without penalty. The credit facility is secured by the Company's assets and the proceeds from this loan will be used for the working capital requirements of the Company. The outstanding borrowing under the agreement at September 30, 2009 was \$300,000.

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

| For the twelve months ended December 31, | Amount              |
|--|---------------------|
| 2009                                     | \$ -                |
| 2010                                     | -                   |
| 2011                                     | 1,606,023           |
| 2012 and thereafter                      | 300,000             |
|  | <u>\$ 1,906,023</u> |

**NOTE I - - CAPITAL STOCK**

The Company has authorized 15,000,000 shares of preferred stock, with a par value of \$.001 per share. As of September 30, 2009 and December 31, 2008, the Company has no preferred stock issued and outstanding. The Company has authorized 155,000,000 shares of common stock, with a par value of \$.001 per share. As of September 30, 2009 and December 31, 2008, the Company has 96,563,771 and 87,525,495, respectively, shares of common stock issued and outstanding.

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

During the nine months ended September 30, 2009, the Company issued 780,000 shares of common stock at approximately \$0.09 per share to warrant holders in exchange for the exercise of their stock purchase warrants.

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

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**NOTE J - - STOCK OPTIONS AND WARRANTS**

Employee Stock Options

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

| Options Outstanding |                    |   | Options Exercisable             |                    |                                 |
|---------------------|--------------------|---|---------------------------------|--------------------|---------------------------------|
| Exercise Prices     | Number Outstanding | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| \$ 1.00 - \$1.99    | 4,417,133          | 3.93  | \$ 1.02                         | 4,273,550          | \$ 1.01                         |
| \$ 2.00 - \$2.99    | 997,500            | 5.48  | \$ 2.52                         | 957,250            | \$ 2.51                         |
| \$ 3.00 - \$3.99    | 536,250            | 6.08  | \$ 3.23                         | 413,500            | \$ 3.28                         |
| \$ 4.00 - \$4.99    | 70,000             | 5.83  | \$ 4.33                         | 58,500             | \$ 4.33                         |
| \$ 5.00 - \$5.99    | 100,000            | 5.57  | \$ 5.17                         | 88,000             | \$ 5.16                         |
|                     | <u>6,120,883</u>   | <u>4.42</u>   | <u>\$ 1.56</u>                  | <u>5,790,800</u>   | <u>\$ 1.52</u>                  |

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

|                                   | Number of Shares | Weighted Average Price Per Share |
|-----------------------------------|------------------|----------------------------------|
| Outstanding at January 1, 2008    | 8,105,429        | \$ 1.98                          |
| Granted                           | 185,000          | 1.00                             |
| Exercised                         | -                | -                                |
| Cancelled or expired              | (1,296,500)      | 2.71                             |
| Outstanding at December 31, 2008  | <u>6,993,929</u> | <u>\$ 1.82</u>                   |
| Granted                           | 320,000          | 1.00                             |
| Exercised                         | -                | -                                |
| Cancelled or expired              | (1,193,046)      | 2.91                             |
| Outstanding at September 30, 2009 | <u>6,120,883</u> | <u>\$ 1.56</u>                   |

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

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

The expected life of awards granted represents the period of time that they are expected to be outstanding. We determine the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules, exercise patterns and pre-vesting and post-vesting forfeitures. We estimate the volatility of our common stock based on the calculated historical volatility of our own common stock using the trailing 60 months of share price data prior to the date of the award. We base the risk-free interest rate used in the Black-Scholes-Merton option valuation model on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term equal to the expected life of the award. We have not paid any cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero in the Black-Scholes-Merton option valuation model. We use historical data to estimate pre-vesting option forfeitures and record share-based compensation for those awards that are expected to vest. In accordance with Share Based Payments, we adjust share-based compensation for changes to the estimate of expected equity award forfeitures based on actual forfeiture experience.

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

The total fair value of shares vested during the period ended September 30, 2009 and 2008 was \$233,366 and \$623,113, respectively.

Total stock-based compensation expense recognized in the consolidated statement of earnings for the three and nine months ended September 30, 2009 and 2008 was \$65,746 and \$243,366, and \$194,483 and \$704,613, respectively, net of tax effect. Additionally, the aggregate intrinsic value of options outstanding and unvested as of September 30, 2009 is \$0.

Non-Employee Stock Options

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

| Options Outstanding |                    |   | Options Exercisable             |                    |                                 |
|---------------------|--------------------|---|---------------------------------|--------------------|---------------------------------|
| Exercise Prices     | Number Outstanding | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| \$ 1.00             | 740,000            | 2.84  | \$ 1.00                         | 740,000            | \$ 1.00                         |

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

|                                   | Number of<br>Shares | Weighted<br>Average Price<br>Per Share |
|-----------------------------------|---------------------|--|
| Outstanding at January 1, 2008    | 1,815,937           | \$ 1.00                                |
| Granted                           | -                   | -                                      |
| Exercised                         | -                   | -                                      |
| Canceled or expired               | -                   | -                                      |
| Outstanding at December 31, 2008  | 1,815,937           | \$ 1.00                                |
| Granted                           | -                   | -                                      |
| Exercised                         | -                   | -                                      |
| Canceled or expired               | (1,075,937 )        | 1.00                                   |
| Outstanding at September 30, 2009 | <u>740,000</u>      | <u>\$ 1.00</u>                         |

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

Warrants

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

| Exercise Prices | Warrants Outstanding  |   | Weighed<br>Average<br>Exercise Price | Warrants Exercisable  |                                       |
|-----------------|-----------------------|---|--------------------------------------|-----------------------|---------------------------------------|
|                 | Number<br>Outstanding | Weighted Average<br>Remaining Contractual<br>Life (Years) |                                      | Number<br>Exercisable | Weighted<br>Average<br>Exercise Price |
| \$ 0.58         | 76,639                | 2.59  | \$ 0.58                              | 76,639                | \$ 0.58                               |
| \$ 0.60         | 800,000               | 3.85  | \$ 0.60                              | 800,000               | \$ 0.60                               |
| \$ 0.61         | 2,500,000             | 3.92  | \$ 0.61                              | 2,500,000             | \$ 0.61                               |
| \$ 2.59         | 862,452               | 2.12  | \$ 2.59                              | 862,452               | \$ 2.59                               |
| \$ 3.98         | 3,078,864             | 2.29  | \$ 3.98                              | 3,078,864             | \$ 3.98                               |
| \$ 4.17         | 359,712               | 3.06  | \$ 4.17                              | 359,712               | \$ 4.17                               |
|                 | <u>7,677,667</u>      | <u>2.97</u>   | \$ 2.35                              | <u>7,677,667</u>      | \$ 2.19                               |

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Transactions involving warrants are summarized as follows:

|                                   | Number of<br>Shares | Weighted<br>Average Price<br>Per Share |
|-----------------------------------|---------------------|--|
| Outstanding at January 1, 2008    | 7,673,627           | \$ 4.15                                |
| Issued                            | 4,164,140           | 1.31                                   |
| Exercised                         | (3,380,000)         | 0.70 *                                 |
| Canceled or expired               | -                   | -                                      |
| Outstanding at December 31, 2008  | 8,457,767           | \$ 2.19                                |
| Issued                            | -                   | -                                      |
| Exercised                         | (780,000)           | 0.09                                   |
| Canceled or expired               | -                   | -                                      |
| Outstanding at September 30, 2009 | <u>7,677,667</u>    | <u>\$ 2.35</u>                         |

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

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

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

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

In July 2009, the Company amended certain stock purchase warrants held by private placement investors to reduce the exercise price under such warrants from \$0.60 per share to approximately \$0.09 per share. The warrants entitled the holders to purchase an aggregate of up to 780,000 shares of the Company's common stock. Subsequently, these private placement investors exercised all of their warrants, and the Company has accounted for the amended warrants issued, valued at \$70,486, as financing expense using the Black-Scholes pricing model and the following assumptions: contractual term of 5 years, an average risk-free interest rate of 1.6% a dividend yield of 0% and volatility of 103%.

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**NOTE K - COMMITMENTS AND CONTINGENCIES**

Employment and Consulting Agreements

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

Litigation

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

Senior Convertible Noteholder Claim

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

Purchase Price Contingency

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

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**NOTE L- BUSINESS CONCENTRATION**

Revenue from one major customer approximated \$839,000 or 10% of total revenues for the period ended September 30, 2009. Revenue from three (3) major customers approximated \$6,782,000 or 42% of total revenues for the period ended September 30, 2008. Total accounts receivable of \$118,407, or 9% of total accounts receivable, were due from these customers as of September 30, 2009. Total accounts receivable of \$674,800, or 36% of total accounts receivable, was due from these customers as of September 30, 2008.

Purchases from one major supplier approximated \$856,000, or 61% of purchases during the period ended September 30, 2009, and \$2,014,380, or 47% of purchases, for the period ended September 30, 2008, respectively. Total accounts payable of approximately \$76,740, or 2% of total accounts payable, was due to this supplier as of September 30, 2009, and \$145,769, or 3% of total accounts payable, was due to this supplier as of September 30, 2008.

**NOTE M- FAIR VALUE MEASUREMENTS**

The financial assets of the Company measured at fair value on a recurring basis are cash equivalents, and long-term marketable securities. The Company's cash equivalents and long term marketable securities are generally classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The Company's long-term investments are classified within Level 3 of the fair value hierarchy because they are valued using unobservable inputs, due to the fact that observable inputs are not available, or situations in which there is little, if any, market activity for the asset or liability at the measurement date. The Company's derivative liabilities are classified within Level 2 of the fair value hierarchy because they are valued using inputs which are not actively observable, either directly or indirectly.

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

The following table sets forth the Company's financial instruments as of September 30, 2009 which are measured at fair value on a recurring basis by level within the fair value hierarchy. Financial instruments are classified based on the lowest level of input that is significant to the fair value measurement, (in thousands):

| (in thousands)            | Level 1       | Level 2         | Level 3         | Assets at<br>fair value |
|---------------------------|---------------|-----------------|-----------------|-------------------------|
| Cash and cash equivalents | \$ 38         | \$ -            | \$ -            | \$ 38                   |
| Long-term investments     | -             | -               | 8               | 8                       |
| <b>Total</b>              | <b>\$ 38</b>  | <b>\$ -</b>     | <b>\$ 8</b>     | <b>\$ 46</b>            |
| Derivative liabilities    | -             | 1,870           | -               | 1,870                   |
| Long-term debt            | 300           | -               | 1,068           | 1,368                   |
| <b>Total</b>              | <b>\$ 389</b> | <b>\$ 1,870</b> | <b>\$ 1,068</b> | <b>\$ 3,238</b>         |

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**NOTE N – DISCONTINUED OPERATIONS**

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

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

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

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

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

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

The following table summarizes net income from discontinued operations for the three and nine months ended September 30, 2009.

|  | Three Months Ended<br>September 30,<br>(Unaudited) |                       | Nine Months Ended<br>September 30,<br>(Unaudited) |                       |
|--|--|-----------------------|---|-----------------------|
|  | 2009   | 2008                  | 2009  | 2008                  |
| Loss from operations                       | \$ -   | \$ (1,370,896)        | \$ (635,735)                                      | \$ (3,412,656)        |
| Elimination of Liabilities, net of assets  | -  | -                     | 7,635,920   | -                     |
| Other expenses                             | -  | -                     | (67,329)  | -                     |
| Income (loss) from discontinued operations | <u>\$ -</u>  | <u>\$ (1,370,896)</u> | <u>\$ 6,932,856</u>                               | <u>\$ (3,412,656)</u> |

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**NOTE O – SUBSEQUENT EVENTS**

**In accordance with FASB ASC 855”Subsequent Events”, the Company has evaluated subsequent events through the date of the filing (November 16, 2009)**

**NYSE Amex Delisting Notice**

On November 3, 2009, Telkonet, Inc. received notice from NYSE Amex, LLC (the "Exchange") that a Listing Qualifications Panel of the Exchange’s Committee on Securities (the "Panel") had affirmed the Exchange’s Listing Qualifications Department staff’s determination to delist the Company’s common stock from the Exchange. The Exchange will file a delisting application with the Securities and Exchange Commission ("SEC") to strike the Company’s common stock from listing and registration on the Exchange, when and if authorized by the SEC. The delisting of Company’s common stock will be effective 10 days after the Exchange files a Form 25 with the SEC. The Company does not intend to appeal, or request a review of, the Panel’s decision, and thus its common stock is expected to be delisted from the Exchange. The Exchange suspended trading in the Company’s stock effective at the open of business on November 13, 2009 at which time our common stock began trading on the Over-the-Counter market’s Pink Sheets under the symbol "TKOI.PK"

The Company will be in default of the convertible debentures if its common stock is not quoted for listing on one of: (a) the American Stock Exchange, (b) New York Stock Exchange, (c) the Nasdaq Global Market, (d) the Nasdaq Capital Market, or (e) the OTC Bulletin Board (“OTCBB”) within five (5) Trading Days of the stock’s delisting. The Company is seeking to obtain a listing on the OTCBB however there can be no guarantee that the Company will be successful in obtaining a listing on the OTCBB or that it will be able to obtain such a listing within five days of the common stock’s delisting from the Exchange.

**Private Placement**

On November 16, 2009, the Company entered into definitive agreements in connection with a Regulation D private placement of 215 shares of the Company’s Series A Convertible Redeemable Preferred Stock, par value \$0.001 per share (“Series A”), and warrants (“Warrants”) to purchase an aggregate of 1,628,800 shares of the Company’s common stock, par value \$0.001 per share (the “Common Stock”). The Series A shares were sold at a price per share of \$5,000 and the Warrants have an exercise price of \$0.33, which is equal to the volume-weighted average price of a share of Common Stock measured over the 30-day period immediately preceding November 12, 2009. The Company expects to complete the private placement transaction within the next several days and expects to receive \$1,075,000 from the sale of these Series A shares and Warrants. A portion of the proceeds to be received by the Company will come from certain members of Company management in connection with the conversion of a portion of outstanding indebtedness of the Company owed to such members of management. The Company intends to use the net proceeds from the sale of the Series A shares and the Warrants for general working capital needs and may use the proceeds in the short term to repay certain outstanding indebtedness, and to pay expenses of the offering as well as other general corporate capital purposes.

Under the terms of the private placement transaction, each Series A share is convertible into approximately 13,774 shares of Common Stock at a conversion price of \$0.363 per share, which is equal to 110% of the volume-weighted average price of a share of Common Stock measured over the 30-day period immediately preceding November 12, 2009. Except as specifically provided or as otherwise required by law, the Series A shares will vote together with the Common Stock shares on an as-if-converted basis and not as a separate class. Each Series A share shall have a number of votes equal to the number of shares of Common Stock then issuable upon conversion of such shares of the Series A.

Additionally, the Company agreed with the purchasers to file a registration statement covering the resale of the shares of common stock to be acquired by the purchasers upon conversion of their Series A shares following the conclusion of a rights offering to be filed with the SEC.

**Board of Directors**

Effective November 13, 2009, Dr. Thomas M. Hall submitted his resignation as a director of the Company.

The Company’s Board of Directors elected Anthony J. Paoni as Chairman of the Board to take the position previously held by Warren V. Musser effective as of November 16, 2009.

In connection with the closing of the private placement transaction, Seth D. Blumenfeld will be resigning from the Board and Jason L. Tienor, the Company’s President and Chief Executive Officer, will fill the vacancy created by the resignation of Seth D. Blumenfeld.

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

The following discussion and analysis of the Company's financial condition and results of operations should be read in conjunction with the accompanying financial statements and related notes thereto for the quarter ended September 30, 2009 and 2008, as well as the Company's consolidated financial statements and related notes thereto and management's discussion and analysis of financial condition and results of operations in the Company's Form 10-K for the year ended December 31, 2008 filed on April 1, 2009.

### Business

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

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

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

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

On April 22, 2009, the Company completed the deconsolidation of MSTI Holdings, Inc. (MSTI). To effect the deconsolidation of MSTI, the Company was required to reduce its ownership percentage and board membership. On February 26, 2009, the Company executed a Stock Purchase Agreement pursuant to which the Company sold 2.8 million shares of MSTI common stock and following this transaction, the Company beneficially owns 49% of the issued and outstanding shares of MSTI common stock. On April 22, 2009, Warren V. Musser and Thomas C. Lynch, members of the Company's Board of Directors, submitted their resignations as directors of MSTI. As a result, the majority of MSTI's board of directors is no longer controlled by the Company. As a result of the deconsolidation, the interim financial statements have been revised to present the previously consolidated operations as discontinued operations.

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

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

## **Forward Looking Statements**

This report may contain “forward-looking statements,” which represent the Company’s expectations or beliefs, including, but not limited to, statements concerning industry performance and the Company’s results, operations, performance, financial condition, plans, growth and strategies, which include, without limitation, statements preceded or followed by or that include the words “may,” “will,” “expect,” “anticipate,” “intend,” “could,” “estimate,” or “continue” or the negative 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 “Risk Factors”, many of which are also beyond the Company’s control. You should not place undue reliance on these forward-looking statements, which speak only as of the date of this report. The Company does not undertake any obligation to update or release any revisions to these forward-looking statements to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events, except to the extent such updates and/or revisions are required by applicable law.

## **Critical Accounting Policies and Estimates**

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

### **Revenue Recognition**

For revenue from product sales, the Company recognizes revenue in accordance with FASB’s Accounting Standards Codification (“ASC”) 605-10, and ASC Topic 13 guidelines that require that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) 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. The guidelines also address the accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

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

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

## Fair Value of Financial Instruments

In January 2008, the Company adopted the provisions under FASB for Fair Value Measurements, which define fair value for accounting purposes, establishes a framework for measuring fair value and expands disclosure requirements regarding fair value measurements. The Company's adoption of these provisions did not have a material impact on its consolidated financial statements. Fair value is defined as an exit price, which is the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date. The degree of judgment utilized in measuring the fair value of assets and liabilities generally correlates to the level of pricing observability. Financial assets and liabilities with readily available, actively quoted prices or for which fair value can be measured from actively quoted prices in active markets generally have more pricing observability and require less judgment in measuring fair value. Conversely, financial assets and liabilities that are rarely traded or not quoted have less price observability and are generally measured at fair value using valuation models that require more judgment. These valuation techniques involve some level of management estimation and judgment, the degree of which is dependent on the price transparency of the asset, liability or market and the nature of the asset or liability. The Company has categorized its financial assets and liabilities measured at fair value into a three-level hierarchy in accordance with these provisions.

## New Accounting Pronouncements

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

## Revenues

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

|           | Three Months Ended  |      |                     |      |                       |      |
|-----------|---------------------|------|---------------------|------|-----------------------|------|
|           | September 30, 2009  |      | September 30, 2008  |      | Variance              |      |
| Product   | \$ 1,445,888        | 59%  | \$ 3,837,728        | 81%  | \$ (2,391,840)        | -62% |
| Recurring | 991,130             | 41%  | 897,482             | 19%  | 93,648                | 10%  |
| Total     | <u>\$ 2,437,018</u> | 100% | <u>\$ 4,735,210</u> | 100% | <u>\$ (2,298,192)</u> | -49% |

  

|           | Nine months Ended   |      |                      |      |                       |      |
|-----------|---------------------|------|----------------------|------|-----------------------|------|
|           | September 30, 2009  |      | September 30, 2008   |      | Variance              |      |
| Product   | \$ 5,462,955        | 65%  | \$ 10,821,179        | 81%  | \$ (5,358,224)        | -50% |
| Recurring | 2,982,384           | 35%  | 2,559,728            | 19%  | 422,656               | 17%  |
| Total     | <u>\$ 8,445,339</u> | 100% | <u>\$ 13,380,907</u> | 100% | <u>\$ (4,935,568)</u> | -37% |

### Product revenue

Product revenue principally arises from the sale and installation of SmartGrid and broadband networking equipment, including Telkonet SmartEnergy™ products, Telkonet Series 5™ products and the Telkonet iWire System™. Telkonet markets and sells to hospitality, education, healthcare and government markets. The Telkonet Series 5™ and the Telkonet iWire System™ consist of the Telkonet Gateways, Telkonet Extenders, the patented Telkonet Coupler, and Telkonet iBridges. The Telkonet SmartEnergy™ product suite consists of thermostats, sensors and controllers.

For the three and nine months ended September 30, 2009, product revenue decreased by 62% and 50%, respectively, when compared to the prior year periods, primarily due to the prior year rollout of an energy management contract with a national hotel operator, which accounted for 16% and 34% of product revenue for the three and nine months ended September 30, 2008. Product revenue for the three and nine months ended September 30, 2009 includes approximately \$0.9 million and \$3.6 million, respectively, attributed to the sale of energy management products, and approximately \$400,000 and \$1.5 million, respectively, from the sales of broadband networking products and services to the hospitality market. In addition, product revenues for the three and nine months ended September 30, 2009 were down overall due to the impact of the current economy, which has continued to cause delays in planned opportunities with new and existing customers. Quarter over quarter revenue has decreased by approximately 22% and management does not believe that product revenues will significantly increase in the fourth quarter 2009 due to seasonality of the hospitality market segment, which accounts for the majority of our near-term revenue.

### Recurring Revenue

Recurring revenue includes approximately 2,500 hotels in our broadband network portfolio. We currently support over 200,000 HSIA rooms, with over 2 million monthly users. For the three and nine months ended September 30, 2009, recurring revenue increased by 10% and 17%, respectively, when compared to the prior year periods. We anticipate growth to our subscriber base as we deploy additional sites under contract and increase Telkonet's strategic franchise and group alliances through the Ethostream brand.

### Cost of Sales

|           | Three Months Ended  |     |                     |     |                       |      |
|-----------|---------------------|-----|---------------------|-----|-----------------------|------|
|           | September 30, 2009  |     | September 30, 2008  |     | Variance              |      |
| Product   | \$ 833,926          | 58% | \$ 2,076,775        | 54% | \$ (1,242,849)        | -60% |
| Recurring | 348,321             | 35% | 416,723             | 46% | (68,402)              | -16% |
| Total     | <u>\$ 1,182,247</u> | 49% | <u>\$ 2,493,498</u> | 53% | <u>\$ (1,311,251)</u> | -53% |

  

|           | Nine months Ended   |     |                     |     |                       |      |
|-----------|---------------------|-----|---------------------|-----|-----------------------|------|
|           | September 30, 2009  |     | September 30, 2008  |     | Variance              |      |
| Product   | \$ 2,942,748        | 54% | \$ 6,800,627        | 63% | \$ (3,857,879)        | -57% |
| Recurring | 957,668             | 32% | 1,274,786           | 50% | (317,118)             | -25% |
| Total     | <u>\$ 3,900,416</u> | 46% | <u>\$ 8,075,413</u> | 60% | <u>\$ (4,174,997)</u> | -52% |

### Product Costs

Product costs include equipment and installation labor related to the sale of Telkonet SmartEnergy™ products, Telkonet Series 5™ products and the Telkonet iWire System™. For the three and nine months ended September 30, 2009, product costs decreased by 60% and 57%, respectively, when compared to the prior year periods, primarily in connection with the decreased sales in the current year periods. However, product costs increased as a percentage of revenue for the three months ended September 30, 2009, when compared to the prior year period because of increased contract labor costs. For the nine months ended September 30, 2009, product revenue decreased as a percentage of revenue when compared to the prior year periods, which reflects the consolidation of operations in the Milwaukee, WI operations center.

### Recurring Costs

For the three and nine months ended September 30, 2009, recurring costs decreased by 16% and 25%, respectively, when compared to the prior year periods, primarily due to the increase in efficiency in providing support services to EthoStream's customers through the Milwaukee, WI operations center.

### Gross Profit

|           | September 30, 2009  |     | Three Months Ended<br>September 30, 2008 |     | Variance            |      |
|-----------|---------------------|-----|--|-----|---------------------|------|
|           |                     |     |  |     |                     |      |
| Product   | \$ 611,962          | 42% | \$ 1,760,952                             | 46% | \$ (1,148,991)      | -65% |
| Recurring | 642,809             | 65% | 480,759                                  | 54% | 162,050             | 34%  |
| Total     | <u>\$ 1,254,771</u> | 51% | <u>\$ 2,241,711</u>                      | 47% | <u>\$ (986,941)</u> | -44% |

  

|           | September 30, 2009  |     | Nine months Ended<br>September 30, 2008 |     | Variance            |      |
|-----------|---------------------|-----|---|-----|---------------------|------|
|           |                     |     |   |     |                     |      |
| Product   | \$ 2,520,207        | 46% | \$ 4,020,552                            | 37% | \$ (1,500,345)      | -37% |
| Recurring | 2,024,716           | 68% | 1,284,942                               | 50% | 739,774             | 58%  |
| Total     | <u>\$ 4,544,923</u> | 54% | <u>\$ 5,304,495</u>                     | 40% | <u>\$ (760,571)</u> | -14% |

### Product Gross Profit

Gross profit margins for the three and nine months ended September 30, 2009 decreased from 46% to 42%, respectively, and increased from 37% to 46% when compared to the prior year periods. We expect to maintain our product gross profit margins between 45% to 50% on our sales of energy management products and services, to hospitality, utility and government market customers.

### *Recurring Gross Profit*

Gross profit margins associated with recurring revenue were 65% and 68% for the three and nine months ended September 30, 2009 respectively. The centralized remote monitoring and management platform and internal call support center has provided the platform to increase and maintain healthy profit margins on recurring revenue.

### **Operating Expenses**

|       | Three Months Ended    |                       |                     |      |
|-------|-----------------------|-----------------------|---------------------|------|
|       | September 30,<br>2009 | September 30,<br>2008 | Variance            |      |
| Total | <u>\$ 2,147,694</u>   | <u>\$ 2,929,992</u>   | <u>\$ (782,298)</u> | -27% |

  

|       | Nine months Ended     |                       |                       |      |
|-------|-----------------------|-----------------------|-----------------------|------|
|       | September 30,<br>2009 | September 30,<br>2008 | Variance              |      |
| Total | <u>\$ 6,361,277</u>   | <u>\$ 10,338,427</u>  | <u>\$ (3,977,150)</u> | -38% |

During the three and nine months ended September 30, 2009, operating expenses decreased by 27% and 38%, respectively, when compared to the prior year periods. This decrease is primarily related to the overall reduction in operating expenses beginning in 2008 in connection with the corporate restructuring, and the reduction of research and development and overhead staffing at the corporate headquarters office. We do not anticipate any significant changes to operating expenses for the remainder of 2009.

### **Research and Development**

|       | Three Months Ended    |                       |                     |      |
|-------|-----------------------|-----------------------|---------------------|------|
|       | September 30,<br>2009 | September 30,<br>2008 | Variance            |      |
| Total | <u>\$ 263,672</u>     | <u>\$ 509,418</u>     | <u>\$ (245,746)</u> | -48% |

  

|       | Nine months Ended     |                       |                     |      |
|-------|-----------------------|-----------------------|---------------------|------|
|       | September 30,<br>2009 | September 30,<br>2008 | Variance            |      |
| Total | <u>\$ 761,950</u>     | <u>\$ 1,667,229</u>   | <u>\$ (905,279)</u> | -54% |

Telkonet's research and development costs related to both present and future products are expensed in the period incurred. Total expenses decreased for the three and nine months ended September 30, 2009 by approximately \$246,000, or 48%, and \$905,000, or 54%, respectively. The Research and Development costs are associated with the development of the Telkonet Series 5™ product suite and the integration of new applications to the Telkonet iWire System™, and the development of next generation Telkonet SmartEnergy™ (TSE) and Networked Telkonet SmartEnergy™ (NTSE) products. The Company expects to maintain the current cost structure for research and development in 2009.

**Selling, General and Administrative Expenses**

|       | Three Months Ended    |                       |              | Variance |
|-------|-----------------------|-----------------------|--------------|----------|
|       | September 30,<br>2009 | September 30,<br>2008 |              |          |
| Total | \$ 1,732,053          | \$ 2,123,035          | \$ (390,982) | -18%     |

|       | Three Months Ended    |                       |                | Variance |
|-------|-----------------------|-----------------------|----------------|----------|
|       | September 30,<br>2009 | September 30,<br>2008 |                |          |
| Total | \$ 5,089,221          | \$ 7,268,375          | \$ (2,179,154) | -30%     |

During the three and nine months ended September 30, 2009, selling, general and administrative expenses decreased over the comparable prior year periods by approximately 18% and 30%, respectively. This decrease when compared to the prior year periods is primarily the result of the efficiencies in the organization resulting in reduced salary and related costs by \$200,000 and \$989,000, respectively, as well as other significant reductions in sales and marketing expenses of \$183,000 and \$635,000, respectively, professional fees of \$3,800 and \$231,000, office expenses of \$31,000 and \$126,000, and travel costs of \$81,000 and \$236,000. We do not expect to significantly increase our selling, general and administrative expenses in 2009, except as necessary to meet future growth opportunities.

**Discontinued Operations**

We had net income from discontinued operations of \$6,296,851, or \$0.07 per share, for the nine months ended September 30, 2009, compared to net loss from discontinued operations of \$(3,412,656), or \$(0.04) per share, for the nine months ended September 30, 2008. Net income from discontinued operations for the nine months ended September 30, 2009 includes the gain on deconsolidation of \$6,932,586, offset by MSTI's net loss of \$635,735 for the nine months ended September 30, 2009.

**Backlog**

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

## **Liquidity and Capital Resources**

### *Working Capital*

Our working capital decreased by \$1,060,900 during the nine months ended September 30, 2009 from a working capital deficit of \$2,439,988 at December 31, 2008 to a working capital deficit of \$3,500,889 at September 30, 2009, excluding working capital attributed to discontinued operations. The decrease in working capital for the nine months ended September 30, 2009 is due to a combination of factors, of which the significant factors include:

- Advances to our former subsidiary of approximately \$305,000;
- Net repayments on our line of credit of approximately \$124,000; and
- Working capital decreases related to our loss from continuing operations.

### *Business Loan*

On September 11, 2009, the Company entered into a Loan Agreement in the aggregate principal amount of \$300,000 with the Wisconsin Department of Commerce (the "Department"). The outstanding principal balance bears interest at the annual rate of two (2.00) percent. Payment of interest and principal is to be made in the following manner: (a) payment of any and all interest that accrues from the date of disbursement commences on January 1, 2010 and continues on the first day of each consecutive month thereafter through and including December 31, 2010; (b) commencing on January 1, 2011 and continuing on the first day of each consecutive month thereafter through and including November 1, 2016, the Company shall pay equal monthly installments of \$4,426 each; followed by a final installment on December 1, 2016 which shall include all remaining principal, accrued interest and other amounts owed by the Company to the Department under the Loan Agreement. The Company may prepay amounts outstanding under the credit facility in whole or in part at any time without penalty. The credit facility is secured by the Company's assets and the proceeds from this loan will be used for the working capital requirements of the Company. The outstanding borrowing under the agreement at September 30, 2009 was \$300,000.

### *Line of Credit*

In September 2008, the Company entered into a two-year line of credit facility with a third party financial institution. The line of credit has an aggregate principal amount of \$1,000,000 and is secured by the Company's inventory. The outstanding principal balance bears interest at the greater of (i) the Wall Street Journal Prime Rate plus nine (9%) percent per annum, adjusted on the date of any change in such prime or base rate, or (ii) sixteen percent (16%). Interest, computed on a 365/360 simple interest basis, and fees on the credit facility are payable monthly in arrears on the last day of each month and continuing on the last day of each month until the maturity date. The Company may prepay amounts outstanding under the credit facility in whole or in part at any time. In the event of such prepayment, the lender will be entitled to receive a prepayment fee of four percent (4.0%) of the highest aggregate loan commitment amount if prepayment occurs before the end of the first year and three percent (3.0%) if prepayment occurs thereafter. The outstanding borrowing under the agreement at September 30, 2009 was \$449,741. The Company has incurred interest expense of \$103,881 related to the line of credit for the nine months ended September 30, 2009. The Prime Rate was 3.25% at September 30, 2009.

On November 11, 2009, the Company received a notice of waiver of the "minimum cash flow to debt service ratio" and the "tangible net worth" requirements under the line of credit facility, as such terms are defined in items D(10)a and D(10)b, respectively, of the line of credit agreement. The waiver is in effect as of September 30, 2009 and continues for the 90 day period thereafter.

### *Convertible Debenture*

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

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

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

On May 28, 2009, the Company's shareholders voted against a proposal to remove the Exchange Cap, to allow YA Global to potentially acquiring in excess of 19.99% of the outstanding shares of the Company's common stock, as of May 30, 2008, upon conversion of debentures and/or the exercise of warrants, pursuant to NYSE Amex LLC regulations. In the Agreement of Clarification, the Company agreed to seek approval of the share issuance at the 2009 annual meeting of stockholders, which was held on May 28, 2009. On May 12, 2009, YA Global met the Exchange Cap for the conversion of its debentures, and cannot receive additional shares of the Company's common stock for the conversion of debentures or exercise of warrants, under NYSE Amex rules.

### *Senior Note Payable*

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

### *Acquisition of Microwave Satellite Technologies, Inc. (MSTI)*

On January 31, 2006, the Company acquired a 90% interest in MSTI from Frank Matarazzo, the sole stockholder of MSTI in exchange for \$1.8 million in cash and 1.6 million unregistered shares of the Company's common stock for an aggregate purchase price of \$9,000,000. The cash portion of the purchase price was paid in two installments, \$900,000 at closing and \$900,000 in February 2007. The stock portion is payable from shares held in escrow, 400,000 shares of which were paid at closing and the remaining 1,200,000 reserve shares, which shall be issued based on the achievement of 3,300 video and data subscribers over a three year period from the closing (later extended to July 2009 pursuant to a May 2008 agreement between the parties). As of August 14, 2009, the Company has issued 800,000 shares of the reserve shares. The escrow agreement terminated on July 31, 2009.

#### *Acquisition of Smart Systems International (SSI)*

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

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

#### *Acquisition of Ethostream, LLC*

On March 15, 2007, the Company acquired 100% of the outstanding membership units of Ethostream, LLC, a network solutions integration company that offers installation, sales and service to the hospitality industry. The purchase price of \$11,756,097 was comprised of \$2.0 million in cash and 3,459,609 shares of the Company's common stock. The entire stock portion of the purchase price was deposited into escrow upon closing to satisfy certain potential indemnification obligations of the sellers under the purchase agreement. The shares held in escrow are distributable over the three years following the closing.

#### *Proceeds from the issuance of common stock*

During the nine months ended September 30, 2009, the Company received \$71,526 from the exercise of investor stock purchase warrants.

#### *Cashflow analysis*

Cash used in continuing operations was \$72,506 during the nine months ended September 30, 2009 compared to cash used in continuing operations of \$3,233,366 during the prior year period. For the remainder of the year ended December 31, 2009, our primary capital needs are for operating expenses, including funds to support our business strategy, which primarily includes working capital necessary to fund inventory purchases, and reducing our trade payables.

The Company utilized cash for investing activities from continuing operations of \$275,085 and \$14,375 during the nine months ended September 30, 2009, and 2008, respectively. During the nine months ended September 30, 2009, these activities involved intercompany loans to MSTI of approximately \$305,000, which was partially offset by the sale of the Company's remaining investment in Multiband for proceeds of \$33,129. During the nine months ended September 30, 2008, these expenditures were primarily due to the purchase of computer and related equipment.

The Company had cash from financing activities from continuing operations of \$217,548 and \$3,567,809 during the nine months ended September 30, 2009 and 2008, respectively. During the nine months ended September 30, 2009, cash from financing activities was provided by a \$300,000 business loan from the Wisconsin Department of Commerce, which was partially offset by net cash used of \$124,000 for the repayment of our working capital line of credit used for inventory purchases, and \$25,000 for the payment of financing costs related to the accounts receivable factoring program. During the nine months ended September 30, 2008, the financing activities involved the sale of 2.5 million shares of common stock at \$0.60 per share for a total of \$1,500,000, in February 2008, the proceeds of which were used to repay the outstanding principal amount on the GRQ Note. Additionally, the Company sold debentures for gross proceeds of \$3,500,000 in May 2008 and July 2008, and the Company received a \$400,000 loan from a board member, which was offset by \$462,511 in financing costs.

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

Our registered independent certified public accountants have stated in their report dated April 1, 2009, that we have incurred operating losses in the past years, and that we are dependent upon management's ability to develop profitable operations. These factors, among others, may raise substantial doubt about our ability to continue as a going concern.

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

While the Company has been able to manage its working capital needs with the current credit facilities, additional financing is required in order to meet its current and projected cash flow requirements from operations. Additional investments are being sought, but we cannot guarantee that we will be able to obtain such investments. Financing transactions may include the issuance of equity or debt securities, obtaining credit facilities, or other financing mechanisms. However, the trading price of our common stock and the downturn in the U.S. stock and debt markets could make it more difficult to obtain financing through the issuance of equity or debt securities. Even if we are able to raise the funds required, it is possible that we could incur unexpected costs and expenses, fail to collect significant amounts owed to us, or experience unexpected cash requirements that would force us to seek alternative financing. Further, if we issue additional equity or debt securities, stockholders may experience additional dilution or the new equity securities may have rights, preferences or privileges senior to those of existing holders of our common stock. If additional financing is not available or is not available on acceptable terms, we will have to curtail our operations.

In addition to working capital, a portion of the proceeds from a new financing will be used to retire the Company's current convertible debenture and inventory line of credit facilities. The Company cannot predict whether this new financing will be in the form of equity or debt. The Company may not be able to obtain the necessary additional capital on a timely basis, on acceptable terms, or at all, in which case the Company may be unable to implement its current plans to retire the convertible debenture and line of credit facilities. Each of the convertible debenture and line of credit facilities contain provisions for the payment of a pre-payment fee in connection with a prepayment. The line of credit facility provides for a prepayment fee of four percent (4.0%) of the highest aggregate loan commitment amount if prepayment occurs before the end of the first year and three percent (3.0%) if prepayment occurs after the end of the first year. The convertible debenture provides for a prepayment fee equal to 15% of the principal amount of the Debentures being redeemed. It is the Company's intention to negotiate its obligation to pay such fees and/or the reduction of such fees. However, there can be no guarantee that it will be successful in achieving such a reduction.

### **Inflation**

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

### **Off-Balance Sheet Arrangements**

The Company does not maintain off-balance sheet arrangements nor does it participate in any non-exchange traded contracts requiring fair value accounting treatment.

### **Acquisition or Disposition of Property and Equipment**

During the nine months ended September 30, 2009, fixed assets and cost of equipment under operating leases decreased by \$3,925, primarily from the transfer and disposal of computer equipment and peripherals used in day-to-day operations, net of equipment purchases. The Company does not anticipate the sale or purchase of any significant property, plant or equipment during the next twelve months, other than computer equipment and peripherals to be used in the Company's day-to-day operations.

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

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

### **Number of Employees**

As of November 1, 2009, the Company had 88 full time employees.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

#### *Short Term Investments*

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

#### *Marketable Securities*

Telkonet maintained investments in two publicly-traded companies for the period ended September 30, 2009. The Company has classified these securities as available for sale. Such securities are carried at fair market value. Unrealized gains and losses on these securities, if any, are reported as accumulated other comprehensive income (loss), which is a separate component of stockholders' equity. Unrealized gains on the sale of one investment resulted in a gain of \$32,750 recorded for the period ended September 30, 2009 and unrealized losses of \$1,558,204 were recorded for the period ended September 30, 2008. Realized gains and losses and declines in value judged to be other than temporary on securities available for sale, if any, are included in operations. Realized losses of \$29,371 and \$367,653 were recorded for the sale of the Company's investment in Multiband, and the write-off of the remaining investment in Geeks on Call America, Inc. There were no realized gains or losses for the period ended September 30, 2008.

#### *Investments in Privately Held Companies*

We have invested in a privately held company, which is in the startup or development stage. This investment is inherently risky because the market for the products of this company is developing and may never materialize. As a result, we could lose our entire initial investment in this company. In addition, we could also be required to hold our investment indefinitely, since there is presently no public market in the securities of this company and none is expected to develop. This investment is carried at cost, which as of November 1, 2009 was \$8,000 and recorded in other assets in the Consolidated Balance Sheet.

### **Item 4. Controls and Procedures.**

As of September 30, 2009, the Company performed an evaluation, under the supervision and with the participation of management, including the Chief Executive Officer and Chief Financial Officer (Principal Accounting Officer), of the effectiveness of the design and operation of its disclosure controls and procedures as defined in Rules 13a - 15(e) or 15d - 15(e) promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based on that evaluation and due to the lack of segregation of duties and failure to implement accounting controls of acquired businesses, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were ineffective as of the end of the period covered by this report. During the period ended September 30, 2009, there was no change in the Company's internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings.

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

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

### Item 1A. Risk Factors.

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

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

Since inception through September 30, 2009, the Company has incurred cumulative losses of \$(110,639,175) and has never generated enough funds through operations to support its business. Additional capital may be required in order to provide working capital requirements for the next twelve months.

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

We have goodwill totaling approximately \$12.7 million at September 30, 2009 resulting from recent and past acquisitions. We evaluate this goodwill for impairment based on the fair value of the operating business units to which this goodwill relates at least once a year. This estimated fair value could change if we are unable to achieve operating results at the levels that have been forecasted, the market valuation of those business units decreases based on transactions involving similar companies, or there is a permanent, negative change in the market demand for the services offered by the business units. These changes could result in an impairment of the existing goodwill balance that could require a material non-cash charge to our results of operations.

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

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

*Following delisting from NYSE Amex LLC (the "Exchange"), our common stock will be listed for trading on the Over-the-counter Bulletin Board.*

On May 18, 2009, we received a letter from the Exchange notifying us that we are out of compliance with the Exchange's continued listing standards related to the impairment of our existing financial condition. In the opinion of the Exchange, our historical losses in relation to our overall operations and existing financial resources has caused our financial condition to become so impaired that it appears questionable as to whether we are able to continue operations and/or meet our obligations as they mature. On June 25, 2009 we submitted a plan to the Exchange advising of the actions we had taken, and planned to take, that would bring us into compliance with the applicable listing standards within the six month cure period. On August 27, 2009, we were notified of the Exchange's intention to delist our common stock because our plan did not reasonably demonstrate the ability to regain compliance with the continued listing standards of the Exchange. On November 3, 2009, the Company received notice from the Exchange informing it that the Hearing Panel had confirmed the Staff's recommendation that the Company's common stock be delisted from the Exchange. After considering the costs to the Company of compliance with the continued listing requirements of the Exchange and other factors, the Company determined that it was not in the best interests of the Company and its shareholders to appeal the delisting of the Company's securities from the Exchange and approved the voluntary delisting of the securities. The Company intends to promptly file a Form 25 with the Securities and Exchange Commission ("SEC") and anticipates that the delisting will be effective 10 days after the date of filing of the Form 25. Upon delisting from the Exchange, the Company intends to have its common stock quoted on the OTC Bulletin Board ("OTCBB"). This could adversely affect the market price and liquidity of our common stock, which would make it more difficult for us to raise additional capital.

**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.**

| <b>Exhibit Number</b> | <b>Description Of Document</b>  |
|-----------------------|---|
| 2.1                   | MST Stock Purchase Agreement and Amendment (incorporated by reference to our 8-K filed on February 2, 2006)   |
| 2.2                   | Asset Purchase Agreement by and between Telkonet, Inc. and Smart Systems International, dated as of February 23, 2007 (incorporated by reference to our Form 8-K filed on March 2, 2007)                                      |
| 2.3                   | Unit Purchase Agreement by and among Telkonet, Inc., Ethostream, LLC and the members of Ethostream, LLC dated as of March 15, 2007 (incorporated by reference to our Form 8-K filed on March 16, 2007)                        |
| 3.1                   | Articles of Incorporation of the Registrant (incorporated by reference to our Form 8-K (No. 000-27305), filed on August 30, 2000 and our Form S-8 (No. 333-47986), filed on October 16, 2000)                                 |
| 3.2                   | Amendment to Articles of Incorporation (incorporated by reference to our Form 10-Q (No. 001-31972), filed August 11, 2008)  |
| 3.3                   | Amendment to Articles of Incorporation (incorporated by reference to our Form 10-Q (No. 001-31972), filed August 14, 2009)  |
| 3.4                   | Bylaws of the Registrant (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)   |
| 4.1                   | Form of Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K (No. 001-31972) filed on May 12, 2008)  |
| 4.2                   | Form of Convertible Debenture (incorporated by reference to our Form 8-K (No. 001-31972) filed on June 5, 2008)   |
| 4.3                   | Form of Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K (No. 001-31972) filed on June 5, 2008)  |
| 4.4                   | Promissory Note in Favor of Thermo Credit, LLC (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 10, 2008)  |
| 4.5                   | Promissory Note in Favor of the Wisconsin Department of Commerce (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 17, 2009)  |
| 10.1                  | Amended and Restated Telkonet, Inc. Incentive Stock Option Plan (incorporated by reference to our Registration Statement on Form S-8 (No. 333-412), filed on April 17, 2002)  |
| 10.2                  | Employment Agreement by and between Telkonet, Inc. and Frank T. Matarazzo, dated as of February 1, 2006 (incorporated by reference to our Form 10-K (No. 001-31972), filed March 16, 2006)                                    |
| 10.3                  | Settlement Agreement by and among Telkonet, Inc. and Kings Road Investments Ltd., dated as of August 14, 2006 (incorporated by reference to our Form 8-K (No. 001-31972), filed on August 16, 2006)                           |
| 10.4                  | Settlement Agreement by and among Telkonet, Inc. and Portside Growth & Opportunity Fund, dated as of August 14, 2006 (incorporated by reference to our Form 8-K (No. 001-31972), filed on August 16, 2006)                    |
| 10.5                  | Employment Agreement by and between Telkonet, Inc. and Jason Tienor, dated as of March 15, 2007 (incorporated by reference to our Form 10-K (No. 001-31972), filed March 16, 2007)  |
| 10.6                  | Employment Agreement by and between Telkonet, Inc. and Jeff Sobieski, dated as of March 15, 2007 (incorporated by reference to our Form 10-K (No. 001-31972), filed March 16, 2007)   |
| 10.7                  | Securities Purchase Agreement, dated May 30, 2008, by and between Telkonet, Inc. and YA Global Investments LP (incorporated by reference to our Current Report on Form 8-K filed on June 5, 2008)                             |
| 10.8                  | Registration Rights Agreement, dated May 30, 2008, by and between Telkonet, Inc. and YA Global Investments LP (incorporated by reference to our Current Report on Form 8-K filed on June 5, 2008)                             |
| 10.9                  | Security Agreement, dated May 30, 2008, by and between Telkonet, Inc. and YA Global Investments LP (incorporated by reference to our Current Report on Form 8-K filed on June 5, 2008)  |
| 10.10                 | Commercial Business Loan Agreement, dated September 9, 2008, by and between Telkonet, Inc. and Thermo Credit, LLC (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 10, 2008)                     |
| 10.11                 | Loan Agreement, dated September 11, 2009, by and between Telkonet, Inc. and the Wisconsin Department of Commerce (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 17, 2009)                      |
| 10.12                 | General Business Security Agreement, dated September 11, 2009, by and between Telkonet, Inc. and the Wisconsin Department of Commerce (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 17, 2009) |
| 31.1                  | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Jason L. Tienor  |
| 31.2                  | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Richard J. Leimbach  |
| 32.1                  | Certification of Jason L. Tienor pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002   |
| 32.2                  | Certification of Richard J. Leimbach pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002   |

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Telkonet, Inc.  
(Registrant)

Date: December 11 , 2009

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

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



CERTIFICATIONS

I, Jason L. Tienor, certify that:

1. I have reviewed this quarterly report on Form 10-Q/A 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: December 11, 2009

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

CERTIFICATIONS

I, Richard J. Leimbach, certify that:

1. I have reviewed this quarterly report on Form 10-Q/A 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: December 11, 2009

By: /s/ Richard J. Leimbach  
Richard J. Leimbach  
Chief Financial Officer

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/A for the period ending September 30, 2009 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Jason L. Tienor, 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/ Jason L. Tienor  
Jason L. Tienor  
Chief Executive Officer  
December 11, 2009

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/A for the period ending September 30, 2009 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Richard J. Leimbach, Chief Financial 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/ Richard J. Leimbach  
Richard J. Leimbach  
Chief Financial Officer  
December 11, 2009