

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

FORM 10-Q

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

For the quarterly period ended September 30, 2019

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.)

20800 Swenson Drive, Suite 175, Waukesha, WI
(Address of Principal Executive Offices)

53186
(Zip Code)

(414) 302-2299
(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
None	None	None

Securities registered pursuant to Section 12(g) of the Act: Common Stock, \$0.001 par value

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer
Non-accelerated filer
Emerging growth company

Accelerated filer
Smaller reporting company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The number of shares outstanding of the registrant's common stock, par value \$0.001 per share, as of October 31, 2019 is 135,633,350.

TELKONET, INC.
FORM 10-Q for the Nine Months Ended September 30, 2019

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TELKONET, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	September 30, 2019	December 31, 2018
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 3,484,114	\$ 4,678,891
Accounts receivable, net	2,079,998	1,081,291
Inventories	1,367,580	1,790,919
Contract assets	423,303	314,749
Prepaid expenses	373,043	577,386
Income taxes receivable	25,336	19,695
Total current assets	<u>7,753,374</u>	<u>8,462,931</u>
Property and equipment, net	201,857	247,289
Other assets:		
Deposits	17,130	17,130
Operating lease right of use assets	930,684	–
Total other assets	<u>947,814</u>	<u>17,130</u>
Total Assets	<u>\$ 8,903,045</u>	<u>\$ 8,727,350</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,004,599	\$ 408,045
Accrued liabilities	622,737	656,611
Line of credit	909,423	121,474
Contract liabilities – current	998,458	1,070,502
Operating lease liabilities – current	221,920	–
Total current liabilities	<u>3,757,137</u>	<u>2,256,632</u>
Long-term liabilities:		
Contract liabilities – long-term	122,517	162,121
Operating lease liabilities – long-term	794,273	–
Deferred lease liability – long-term	–	71,877
Total long-term liabilities	<u>916,790</u>	<u>233,998</u>
Total liabilities	<u>\$ 4,673,927</u>	<u>\$ 2,490,630</u>
Commitments and contingencies		
Stockholders' Equity		
Series A, par value \$.001 per share; 215 shares issued, 185 shares outstanding at September 30, 2019 and December 31, 2018, preference in liquidation of \$1,655,535 and \$1,600,168 as of September 30, 2019 and December 31, 2018, respectively	1,340,566	1,340,566
Series B, par value \$.001 per share; 538 shares issued, 52 shares outstanding at September 30, 2019 and December 31, 2018, preference in liquidation of \$450,655 and \$435,081 as of September 30, 2019 and December 31, 2018, respectively	362,059	362,059
Common stock, par value \$.001 per share; 190,000,000 shares authorized; 135,633,350 and 134,793,211 shares issued and outstanding at September 30, 2019 and December 31, 2018, respectively	135,632	134,792
Additional paid-in-capital	127,680,315	127,570,709
Accumulated deficit	(125,289,454)	(123,171,406)
Total stockholders' equity	<u>4,229,118</u>	<u>6,236,720</u>
Total Liabilities and Stockholders' Equity	<u>\$ 8,903,045</u>	<u>\$ 8,727,350</u>

See accompanying notes to the unaudited condensed consolidated financial statements

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Revenues, net:				
Product	\$ 1,995,788	\$ 1,319,046	\$ 7,963,349	\$ 5,643,509
Recurring	202,855	144,970	568,531	399,865
Total Net Revenue	<u>2,198,643</u>	<u>1,464,016</u>	<u>8,531,880</u>	<u>6,043,374</u>
Cost of Sales:				
Product	1,259,151	881,444	5,026,815	3,252,409
Recurring	74,437	68,467	237,551	194,947
Total Cost of Sales	<u>1,333,588</u>	<u>949,911</u>	<u>5,264,366</u>	<u>3,447,356</u>
Gross Profit	865,055	514,105	3,267,514	2,596,018
Operating Expenses:				
Research and development	448,690	539,652	1,360,986	1,410,287
Selling, general and administrative	1,137,084	1,248,204	3,936,851	3,816,210
Depreciation and amortization	16,775	16,797	50,750	50,340
Total Operating Expenses	<u>1,602,549</u>	<u>1,804,653</u>	<u>5,348,587</u>	<u>5,276,837</u>
Operating Loss	<u>(737,494)</u>	<u>(1,290,548)</u>	<u>(2,081,073)</u>	<u>(2,680,819)</u>
Other Income (Expenses):				
Gain on fixed assets	150	–	150	–
Interest income (expense), net	(16,525)	9,540	(37,125)	11,063
Total Other Income (Expense)	<u>(16,375)</u>	<u>9,540</u>	<u>(36,975)</u>	<u>11,063</u>
Loss before Provision for Income Taxes	(753,869)	(1,281,008)	(2,118,048)	(2,669,756)
Provision for Income Taxes	–	–	–	2,000
Net Loss Attributable to Common Stockholders	<u>\$ (753,869)</u>	<u>\$ (1,281,008)</u>	<u>\$ (2,118,048)</u>	<u>\$ (2,671,756)</u>
Net Loss per Common Share:				
Basic – net loss attributable to common stockholders	<u>\$ (0.01)</u>	<u>\$ (0.01)</u>	<u>\$ (0.02)</u>	<u>\$ (0.02)</u>
Diluted – net loss attributable to common stockholders	<u>\$ (0.01)</u>	<u>\$ (0.01)</u>	<u>\$ (0.02)</u>	<u>\$ (0.02)</u>
Weighted Average Common Shares Outstanding – basic	135,331,951	133,989,919	134,937,277	133,892,730
Weighted Average Common Shares Outstanding – diluted	135,331,951	134,238,181	134,937,277	133,892,730

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)
NINE MONTHS ENDED SEPTEMBER 30, 2018

	Series A Preferred Stock Shares	Series A Preferred Stock Amount	Series B Preferred Stock Shares	Series B Preferred Stock Amount	Common Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Equity
Balance at January 1, 2018	185	\$ 1,340,566	52	\$ 362,059	133,695,111	\$ 133,695	\$ 127,421,402	\$ (119,724,656)	\$ 9,533,066
January 1, 2018, Cumulative effect of a change in accounting principle related to ASC 606, net of tax	-	-	-	-	-	-	-	(430,000)	(430,000)
Shares issued to directors	-	-	-	-	294,808	294	35,706	-	36,000
Stock-based compensation expense related to employee stock options	-	-	-	-	-	-	1,531	-	1,531
Net loss	-	-	-	-	-	-	-	(1,184,166)	(1,184,166)
Balance at March 31, 2018	185	\$ 1,340,566	52	\$ 362,059	133,989,919	\$ 133,989	\$ 127,458,639	\$ (121,338,822)	\$ 7,956,431
Stock-based compensation expense related to employee stock options	-	-	-	-	-	-	1,530	-	1,530
Net loss	-	-	-	-	-	-	-	(206,582)	(206,582)
Balance at June 30, 2018	185	\$ 1,340,566	52	\$ 362,059	133,989,919	\$ 133,989	\$ 127,460,169	\$ (121,545,404)	\$ 7,751,379
Shares issued to directors	-	-	-	-	546,988	547	71,453	-	72,000
Stock-based compensation expense related to employee stock options	-	-	-	-	-	-	1,529	-	1,529
Net loss	-	-	-	-	-	-	-	(1,281,008)	(1,281,008)
Balance at September 30, 2018	185	\$ 1,340,566	52	\$ 362,059	134,536,907	\$ 134,536	\$ 127,533,151	\$ (122,826,412)	\$ 6,543,900

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)
NINE MONTHS ENDED SEPTEMBER 30, 2019

	Series A Preferred Stock Shares	Series A Preferred Stock Amount	Series B Preferred Stock Shares	Series B Preferred Stock Amount	Common Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Equity
Balance at January 1, 2019	185	\$ 1,340,566	52	\$ 362,059	134,793,211	\$ 134,792	\$ 127,570,709	\$ (123,171,406)	\$ 6,236,720
Shares issued to directors	–	–	–	–	292,308	294	35,708	–	36,002
Stock-based compensation expense related to employee stock options	–	–	–	–	–	–	1,815	–	1,815
Net loss attributable to common stockholders	–	–	–	–	–	–	–	(845,604)	(845,604)
Balance at March 31, 2019	185	\$ 1,340,566	52	\$ 362,059	135,085,519	\$ 135,086	\$ 127,608,232	\$ (124,017,010)	\$ 5,428,933
Shares issued to directors	–	–	–	–	246,432	245	35,753	–	35,998
Stock-based compensation expense related to employee stock options	–	–	–	–	–	–	1,816	–	1,816
Net loss attributable to common stockholders	–	–	–	–	–	–	–	(518,575)	(518,575)
Balance at June 30, 2019	185	\$ 1,340,566	52	\$ 362,059	135,331,951	\$ 135,331	\$ 127,645,801	\$ (124,535,585)	\$ 4,948,172
Shares issued to directors	–	–	–	–	301,399	301	32,699	–	33,000
Stock-based compensation expense related to employee stock options	–	–	–	–	–	–	1,815	–	1,815
Net loss attributable to common stockholders	–	–	–	–	–	–	–	(753,869)	(753,869)
Balance at September 30, 2019	185	\$ 1,340,566	52	\$ 362,059	135,633,350	\$ 135,632	\$ 127,680,315	\$ (125,289,454)	\$ 4,229,118

See accompanying notes to the unaudited condensed consolidated financial statements

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

	For the Nine Months Ended	
	September 30,	
	2019	2018
Cash Flows from Operating Activities:		
Net loss	\$ (2,118,048)	\$ (2,671,756)
Adjustments to reconcile net loss to cash used in operating activities:		
Stock-based compensation expense related to employee stock options	5,446	4,590
Stock issued to directors as compensation	105,000	108,000
Depreciation and amortization	50,750	50,339
Provision for doubtful accounts, net of recoveries	(7,241)	101,917
Reserve for inventory obsolescence	189,539	(15,394)
Noncash operating lease expense	178,426	-
Changes in operating assets and liabilities:		
Accounts receivable	(991,466)	285,330
Inventories	233,800	(615,055)
Prepaid expenses and other current assets	204,343	(515,403)
Accounts payable	596,554	(335,056)
Accrued liabilities and expenses	(33,874)	297,803
Contract liability	(111,648)	(370,209)
Contract assets	(108,554)	(7,292)
Operating lease liability	(164,794)	-
Income tax receivable	(5,641)	(10,018)
Deferred lease liability	-	17,893
Net Cash Used In Operating Activities	(1,977,408)	(3,674,311)
Cash Flows From Investing Activities:		
Purchase of property and equipment	(5,318)	(7,492)
Net Cash Used In Investing Activities	(5,318)	(7,492)
Cash Flows From Financing Activities:		
Proceeds from line of credit	9,079,000	1,100,000
Payments on line of credit	(8,291,051)	(1,526,481)
Net Cash Provided (Used) In Financing Activities	787,949	(426,481)
Net decrease in cash and cash equivalents	(1,194,777)	(4,108,284)
Cash and cash equivalents at the beginning of the period	4,678,891	9,195,595
Cash and cash equivalents at the end of the period	\$ 3,484,114	\$ 5,087,311

See accompanying notes to the unaudited condensed consolidated financial statements

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

	Nine Months Ended	
	September 30,	
	2019	2018
Supplemental Disclosures of Cash Flow Information:		
Cash transactions:		
Cash paid during the period for interest	\$ 60,580	\$ 21,430

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2019
(UNAUDITED)

NOTE A – BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

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

General

The accompanying unaudited condensed consolidated financial statements of Telkonet, Inc. (the “Company”, “Telkonet”) have been prepared in accordance with Rule S-X of the Securities and Exchange Commission (the “SEC”) and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. However, the results from operations for the nine months ended September 30, 2019, are not necessarily indicative of the results that may be expected for the year ending December 31, 2019. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated December 31, 2018 financial statements and footnotes thereto included in the Company's Form 10-K filed with the SEC.

Business and Basis of Presentation

Telkonet, Inc. (the “Company”, “Telkonet”), formed in 1999 and incorporated under the laws of the state of Utah, is the creator of the EcoSmart Platform of intelligent automation solutions designed to optimize energy efficiency, comfort and analytics in support of the emerging Internet of Things (“IoT”).

In 2007, the Company acquired substantially all of the assets of Smart Systems International (“SSI”), which was a provider of energy management products and solutions to customers in the United States and Canada and the precursor to the Company's EcoSmart platform. The EcoSmart platform provides comprehensive savings, management reporting, analytics and virtual engineering of a customer's portfolio and/or property's room-by-room energy consumption. Telkonet has deployed more than a half million intelligent devices worldwide in properties within the hospitality, military, educational, healthcare and other commercial markets. The EcoSmart platform is recognized as a solution for reducing energy consumption, operational costs and carbon footprints, and eliminating the need for new energy generation in these marketplaces – all whilst improving occupant comfort and convenience.

The condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Telkonet Communications, Inc. We currently operate in a single reportable business segment.

Going Concern and Management's Plan

The accompanying financial statements have been prepared on a going concern basis which assumes the Company will be able to realize its assets and discharge its liabilities in the normal course of business for the foreseeable future and, thus, do not include any adjustments relating to the recoverability and classification of assets and liabilities that may be necessary if the Company is unable to continue as a going concern.

Since inception through September 30, 2019, we have incurred cumulative losses of \$125,289,454 and have never generated enough funds through operations to support our business. For the nine-month period ended September 30, 2019, we had an operating cash flow deficit of \$1,977,408 from operations. The Company's ability to continue as a going concern is dependent upon generating profitable operations in the future and obtaining the necessary financing to meet its obligations and repay its liabilities arising from normal business operations when they come due. There can be no assurance that the Company will be able to secure such financing at commercially reasonable terms, if at all. If cash resources become insufficient to meet the Company's ongoing obligations, the Company will be required to scale back or discontinue portions of its operations or discontinue operations entirely, whereby, the Company's shareholders may lose some or all of their investment.

In June 2018, the Company's Board engaged an investment bank to identify strategic alternatives to maximize shareholder value, including but not limited to, a sale of the Company, an investment in the Company, a merger or other business combination, a sale of all or substantially all assets or a strategic joint venture. At November 14, 2019, no definitive alternatives had been identified.

During the quarter ended September 30, 2019, the Company began initiating a number of cost elimination and liquidity management actions, including, reviewing opportunities to decrease spend with third party consultants and providers, strategically reviewing whether or not to fill employee positions in the event of vacancies, and implementing sales campaigns to sell slow-moving inventory and reducing existing inventory volumes. Management expects these actions will continue to reduce operating losses. The full impact of these actions is not expected to be reflected in the Company's financial statements in the next twelve months. There is no guarantee these actions, nor any other actions identified, will yield profitable operations in the foreseeable future.

At September 30, 2019, the Company had \$3,484,114 of cash and approximately \$742,000 of availability on its credit facility. The Company currently expects to draw on these cash reserves and utilize the credit facility to finance its near term working capital needs. It expects to continue to incur operating losses and negative operating cash flows for one year beyond the date of these financial statements. Accordingly, and in light of the Company's historic and continuing losses, there is substantial doubt about the Company's ability to continue as a going concern.

Income (Loss) per Common Share

The Company computes earnings per share under ASC 260-10, "Earnings Per Share". Basic net income (loss) per common share is computed using the weighted average shares outstanding. Diluted net income (loss) per common share is computed using the treasury stock method, which assumes that the proceeds to be received on exercise of outstanding stock options and warrants are used to repurchase shares of the Company at the average market price of the common shares for the year. Dilutive common stock equivalents consist of shares issuable upon the exercise of the Company's outstanding stock options and warrants. For the nine months ended September 30, 2019 and 2018, there were 3,599,793 and 3,557,399 shares of common stock underlying options and warrants excluded due to these instruments being anti-dilutive, respectively.

Use of Estimates

The preparation of financial statements in conformity with United States of America ("U.S.") generally accepted accounting principles ("GAAP") requires management to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Estimates are used when accounting for items and matters such as revenue recognition and allowances for uncollectible accounts receivable, inventory obsolescence, depreciation and amortization, long-lived assets, taxes, related valuation allowance and income tax provisions, stock-based compensation, and contingencies. The Company believes that the estimates, judgments and assumptions are reasonable, based on information available at the time they are made. Actual results may differ from those estimates.

Income Taxes

The Company accounts for income taxes in accordance with ASC 740-10 "Income Taxes." Under this method, deferred income taxes (when required) are provided based on the difference between the financial reporting and income tax bases of assets and liabilities and net operating losses at the statutory rates enacted for future periods. The Company has a policy of establishing a valuation allowance when it is more likely than not that the Company will not realize the benefits of its deferred income tax assets in the future.

The Company adopted ASC 740-10-25, which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. ASC 740-10-25 also provides guidance on de-recognition, classification, treatment of interest and penalties, and disclosure of such positions.

Revenue from Contracts with Customers

Identify the customer contracts

The Company accounts for a customer contract under ASC 606 when the contract is legally enforceable. A contract is legally enforceable when all of the following criteria are met: (1) the contract has been approved by the Company and the customer and both parties are committed to perform their respective obligations, (2) the Company can identify each party's rights regarding goods or services transferred, (3) the Company can identify payment terms for goods or services transferred, (4) the contract has commercial substance, and (5) collectability of all the consideration to which the Company is entitled in exchange for the goods or services transferred is probable.

A contract does not exist if each party to the contract has the unilateral right to terminate a wholly unperformed contract without compensating the other party (or parties). Nearly all of the Company's contracts do not contain such mutual termination rights for convenience. All contracts are in written form.

Identify the performance obligations

The Company will enter into product only contracts that contain a single performance obligation related to the transfer of EcoSmart products to a customer.

The Company will also enter into certain customer contracts that encompass product and installation services, referred to as "turnkey" solutions. These contracts ultimately provide the customer with a solution that enhances the functionality of the customer's existing equipment. For this reason, the Company has determined that the product and installation services are not separately identifiable performance obligations, but in essence represent one, combined performance obligation ("turnkey").

The Company also offers technical phone support services to customers. This service is considered a separate performance obligation.

Determine the transaction price

The Company generally enters into contracts containing fixed prices. It is not customary for the Company to include contract terms that would result in variable consideration. In the rare situation that a contract does include this type of provision, it is not expected to result in a material adjustment to the transaction price. The Company regularly extends pricing discounts; however, they are negotiated up front and adjust the fixed transaction price set out in the contract.

Customer contracts will typically contain upfront deposits that will be applied against future invoices, as well as customer retainage. The intent of any required deposit or retainage is to ensure that the obligations of either party are honored and follow customary industry practices. In addition, the Company will typically be paid in advance at the beginning of any support contracts, consistent with industry practices. None of these payment provisions are intended to represent significant implicit financing. The Company's standard payment terms are thirty days from invoice date. Products are fully refundable when returned in their original packaging without damage or defacing less a restocking fee. Historical returns have shown to be immaterial. The Company offers a standard one-year assurance warranty. However customers can purchase an extended warranty. Under the new standard, extended warranties are accounted for as a service warranty, requiring the revenue to be recognized over the extended service periods. Contracts involving an extended warranty are immaterial and will continue to be combined with technical phone support services revenue and recognized on a straight-line basis over the term of the contract.

Allocate the transaction price to the performance obligations

Revenues from customer contracts are allocated to the separate performance obligations based on their relative stand-alone selling price ("SSP") at contract inception. The SSP is the price at which the Company would sell a promised good or service separately. The best evidence of an SSP is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. However, turnkey solutions are sold for a broad range of amounts resulting from, but not limited to, tiered discounting for value added resellers ("VAR") based upon committed volumes and other economic factors. Due to the high variability of our pricing, the Company cannot establish a reliable SSP using observable data. Accordingly, the Company uses the residual approach to allocate the transaction price to performance obligations related to its turnkey solutions. When support services are not included within the turnkey solution, the residual method is not utilized and no allocation of the transaction price to the performance obligation is necessary.

All support service agreements, whether single or multi-year terms, automatically renew for one-year terms at a suggested retail price ("SRP"). Support service renewals are consistently priced and therefore would support the use of SRP as the best estimate of an SSP for such performance obligations.

Revenue Recognition

The Company recognizes revenues from product only sales at a point in time, when control over the product has transferred to the customer. As the Company's principal terms of sale are FOB shipping point, the Company primarily transfers control and records revenue for product only sales upon shipment.

A typical turnkey project involves the installation and integration of 200-300 rooms in a customer-controlled facility and usually takes sixty days to complete. Since control over goods and services transfers to a customer once a room is installed, the Company recognizes revenue for turnkey solutions over time. The Company uses an outputs measure based on the number of rooms installed to recognize revenues from turnkey solutions.

Revenues from support services are recognized over time, in even daily increments over the term of the contract, and are presented as "Recurring Revenue" in the Statement of Operations.

Contract liabilities include deferrals for the monthly support service fees. Long-term contract liabilities represent support service fees that will be recognized as revenue after September 30, 2020.

Contract Fulfillment Cost

The Company recognizes related costs of the contract over time in relation to the revenue recognized. Costs included within the projects relate to the cost of the material, direct labor and costs of outside services utilized to complete projects. These are represented as "Contract assets" in the condensed consolidated balance sheets.

Guarantees and Product Warranties

The Company records a liability for potential warranty claims in cost of sales at the time of sale. The amount of the liability is based on the trend in the historical ratio of claims to sales, the historical length of time between the sale and resulting warranty claim, new product introductions and other factors. The products sold are generally covered by a warranty for a period of one year. In the event the Company determines that its current or future product repair and replacement costs exceed its estimates, an adjustment to these reserves would be charged to earnings in the period such determination is made. For the nine months ended September 30, 2019 and the year ended December 31, 2018, the Company experienced returns of approximately 1% to 2% of materials included in the cost of sales. As of September 30, 2019 and December 31, 2018, the Company recorded warranty liabilities in the amount of \$30,314 and \$46,103, respectively, using this experience factor range.

Product warranties for the nine months ended September 30, 2019 and the year ended December 31, 2018 are as follows:

	September 30, 2019	December 31, 2018
Beginning balance	\$ 46,103	\$ 59,892
Warranty claims incurred	(36,373)	(28,000)
Provision charged to expense	20,584	14,211
Ending balance	<u>\$ 30,314</u>	<u>\$ 46,103</u>

NOTE B – NEW ACCOUNTING PRONOUNCEMENTS

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. ASU 2016-13 provides guidance for estimating credit losses on certain types of financial instruments, including trade receivables, by introducing an approach based on expected losses. The expected loss approach will require entities to incorporate considerations of historical information, current information and reasonable and supportable forecasts. ASU 2016-13 also amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The guidance is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The guidance requires a modified retrospective transition method and early adoption is permitted. The Company does not expect the adoption of ASU 2016-13 to have a material impact on its consolidated financial statements.

Management has evaluated other recently issued accounting pronouncements and does not believe that any of these pronouncements will have a significant impact on our consolidated financial statements and related disclosures.

Accounting Standards Recently Adopted

Effective January 1, 2019, the Company has adopted ASU 2016-02, Leases (“ASU 2016-02”), subsequently amended in 2018 by ASU 2018-10, ASU 2018-11 and ASU 2018-20 and codified in ASC 842, Leases (“ASC 842”). ASC 842 is effective for annual periods beginning after December 15, 2018 and interim periods thereafter. Earlier application was permitted, however the Company did not elect to do so. ASC 842 supersedes current lease guidance in ASC 840 and requires a lessee to recognize a right-of-use asset and a corresponding lease liability for substantially all leases. The lease liability will be equal to the present value of the remaining lease payments while the right-of-use asset will be similarly calculated and then adjusted for initial direct costs. In addition, ASC 842 expands the disclosure requirements to increase the transparency and comparability of the amount, timing and uncertainty of cash flows arising from leases.

We chose to elect available practical expedients permitted under the guidance, which among other items, allowed the Company to carry forward its historical lease classification to not reassess leases for the definition of lease under the new standard, and to not reassess initial direct costs for existing leases. Refer below for practical expedient package adopted:

- Whether expired or existing contracts contain leases under the new definition of the lease;
- Lease classification for expired or existing leases; and
- Whether previously capitalized initial direct costs would qualify for capitalization under ASC 842.

Upon the adoption of ASC 842, we have elected to not recognize a right-of-use asset and related lease liability for leases with an initial term of 12 months or less as an accounting policy choice and elected to account for lease and non-lease components as a single lease component.

The Company elected to utilize the new alternative transition approach introduced by ASU 2018-11, under which the standard is adopted and measured from the first date of the fiscal year under adoption, in this case January 1, 2019. Comparative periods are presented in accordance with Topic 840 and do not include any retrospective adjustments to comparative periods to reflect the adoption of Topic 842.

As of September 30, 2019, \$0.9 million was included in total other assets, \$0.2 million in total current liabilities, and \$0.8 million in total long-term liabilities. There was no impact on our Condensed Consolidated Statements of Operations. Refer to Note K for further discussion.

NOTE C– REVENUE

The following table presents the Company's product and recurring revenues disaggregated by industry for the three months ended September 30, 2019.

	Hospitality	Education	Multiple Dwelling Units	Government	Total
Product	\$ 1,764,778	\$ 155,354	\$ 59,661	\$ 15,995	\$ 1,995,788
Recurring	149,868	51,321	1,666	–	202,855
	<u>\$ 1,914,646</u>	<u>\$ 206,675</u>	<u>\$ 61,327</u>	<u>\$ 15,995</u>	<u>\$ 2,198,643</u>

The following table presents the Company's product and recurring revenues disaggregated by industry for the nine months ended September 30, 2019.

	Hospitality	Education	Multiple Dwelling Units	Government	Total
Product	\$ 5,786,068	\$ 863,507	\$ 371,711	\$ 942,063	\$ 7,963,349
Recurring	455,364	92,370	20,797	–	568,531
	<u>\$ 6,241,432</u>	<u>\$ 955,877</u>	<u>\$ 392,508</u>	<u>\$ 942,063</u>	<u>\$ 8,531,880</u>

The following table presents the Company's product and recurring revenues disaggregated by industry for the three months ended September 30, 2018.

	Hospitality	Education	Multiple Dwelling Units	Government	Total
Product	\$ 1,222,543	\$ (4,159)	\$ 100,604	\$ 58	\$ 1,319,046
Recurring	103,157	40,344	1,469	–	144,970
	<u>\$ 1,325,700</u>	<u>\$ 36,185</u>	<u>\$ 102,073</u>	<u>\$ 58</u>	<u>\$ 1,464,016</u>

The following table presents the Company's product and recurring revenues disaggregated by industry for the nine months ended September 30, 2018.

	Hospitality	Education	Multiple Dwelling Units	Government	Total
Product	\$ 4,755,219	\$ 647,079	\$ 166,454	\$ 74,757	\$ 5,643,509
Recurring	330,652	58,449	10,764	–	399,865
	<u>\$ 5,085,871</u>	<u>\$ 705,528</u>	<u>\$ 177,218</u>	<u>\$ 74,757</u>	<u>\$ 6,043,374</u>

Sales taxes and other usage-based taxes are excluded from revenues.

Remaining performance obligations

As of September 30, 2019, the aggregate amount of the transaction price allocated to remaining performance obligations was approximately \$0.8 million. Except for support services, the Company expects to recognize 100% of the remaining performance obligations over the next six months.

Contract assets and liabilities

	September 30, 2019	December 31, 2018	Variance
Contract assets	\$ 423,303	\$ 314,749	\$ 108,554
Contract liabilities	1,120,975	1,232,623	(111,648)
Net contract liabilities	<u>\$ 697,672</u>	<u>\$ 917,874</u>	<u>\$ (220,202)</u>

Contracts are billed in accordance with the terms and conditions, either at periodic intervals or upon substantial completion. This can result in billings occurring subsequent to revenue recognition, resulting in contract assets. Contract assets are presented as current assets in the Condensed Consolidated Balance Sheet. There were \$0.3 million of costs incurred to fulfill contracts in the closing balance of contract assets.

Often, the Company will require customers to pay a deposit upon contract signing that will be applied against work performed or products shipped. In addition, the Company will often invoice the full term of support at the start of the support period. Billings that occur prior to revenue recognition result in contract liabilities. The change in the contract liability balance during the nine month period ended September 30, 2019 is the result of cash payments received and billing in advance of satisfying performance obligations.

NOTE D – ACCOUNTS RECEIVABLE

Components of accounts receivable as of September 30, 2019 and December 31, 2018 are as follows:

	September 30, 2019	December 31, 2018
Accounts receivable	\$ 2,102,246	\$ 1,146,832
Allowance for doubtful accounts	(22,248)	(65,541)
Accounts receivable, net	<u>\$ 2,079,998</u>	<u>\$ 1,081,291</u>

NOTE E – ACCRUED LIABILITIES AND EXPENSES

Accrued liabilities and expenses at September 30, 2019 and December 31, 2018 are as follows

	September 30, 2019	December 31, 2018
Accrued payroll and payroll taxes	\$ 291,918	\$ 241,253
Accrued expenses	252,961	239,793
Accrued professional	5,187	86,062
Accrued sales taxes, penalties, and interest	42,357	43,400
Product warranties	30,314	46,103
Total accrued liabilities	<u>\$ 622,737</u>	<u>\$ 656,611</u>

NOTE F – DEBT**Revolving Credit Facility**

The Company is a party to a loan and security agreement (the “Heritage Bank Loan Agreement”), with Heritage Bank of Commerce, a California state chartered bank (“Heritage Bank”), governing a revolving credit facility in a principal amount not to exceed \$2,000,000 (the “Credit Facility”). Availability of borrowings under the Credit Facility is subject to a borrowing base calculation based on the Company’s eligible accounts receivable and eligible inventory each multiplied by an applicable advance rate, with an overall limitation tied to the Company’s eligible accounts receivable. The Heritage Bank Loan Agreement is available for working capital and other general business purposes. The outstanding principal balance of the Credit Facility bears interest at the Prime Rate plus 3.00%, which was 8.00% at September 30, 2019 and 8.50% at December 31, 2018. On October 9, 2014, as part of the Heritage Bank Loan Agreement, Heritage Bank was granted a warrant to purchase 250,000 shares of Telkonet common stock, for further information on the accounting for warrants, refer to Note I. The warrant has an exercise price of \$0.20 and expires October 9, 2021. On November 6, 2019, the eleventh amendment to the Credit Facility was executed to extend the maturity date to September 30, 2021, unless earlier accelerated under the terms of the Heritage Bank Loan Agreement, and eliminate the maximum EBITDA loss covenant. The eleventh amendment was effective as of September 30, 2019.

The Heritage Bank Loan Agreement contains covenants that place restrictions on, among other things, the incurrence of debt, granting of liens and sale of assets. The Heritage Bank Loan Agreement also contains financial covenants. As discussed above, the EBITDA loss covenant was eliminated in the eleventh amendment to the Credit Facility. The sole financial covenants are a minimum asset coverage ratio and a minimum unrestricted cash balance of \$2 million, both of which are measured at the end of each month. A violation of any of these covenants could result in an event of default under the Heritage Bank Loan Agreement. Upon the occurrence of such an event of default or certain other customary events of defaults, payment of any outstanding amounts under the Credit Facility may be accelerated and Heritage Bank’s commitment to extend credit under the Heritage Bank Loan Agreement may be terminated. The Heritage Bank Loan Agreement contains other representations and warranties, covenants, and other provisions customary to transactions of this nature.

The outstanding balance on the Credit Facility was \$909,423 and \$121,474 at September 30, 2019 and December 31, 2018 and the remaining available borrowing capacity was approximately \$742,000 and \$499,000, respectively. As of September 30, 2019, the Company was in compliance with all financial covenants.

NOTE G – PREFERRED STOCK

Preferred stock carries certain preference rights as detailed in the Company’s Amended and Restated Articles of Incorporation related to both the payment of dividends and as to payments upon liquidation in preference to any other class or series of capital stock of the Company. As of September 30, 2019, the liquidation preference of the preferred stock is based on the following order: first, Series B with a preference value of \$450,655, which includes cumulative accrued unpaid dividends of \$190,655, and second, Series A with a preference value of \$1,655,535, which includes cumulative accrued unpaid dividends of \$730,535. As of December 31, 2018, the liquidation preference of the preferred stock is based on the following order: first, Series B with a preference value of \$435,081, which includes cumulative accrued unpaid dividends of \$175,081, and second, Series A with a preference value of \$1,600,168, which includes cumulative accrued unpaid dividends of \$675,168.

NOTE H – CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock (designated and undesignated), with a par value of \$.001 per share. The Company has designated 215 shares as Series A preferred stock and 538 shares as Series B preferred stock. At September 30, 2019 and December 31, 2018, there were 185 shares of Series A and 52 shares of Series B outstanding.

The Company has authorized 190,000,000 shares of common stock with a par value of \$.001 per share. As of September 30, 2019 and December 31, 2018 the Company had 135,633,350 and 134,793,211 common shares issued and outstanding, respectively.

NOTE I – STOCK OPTIONS AND WARRANTS

Employee Stock Options

The Company maintains an equity incentive plan, (the “Plan”). The Plan was established in 2010 as an incentive plan for officers, employees, non-employee directors, prospective employees and other key persons. It is anticipated that providing such persons with a direct stake in the Company’s welfare will assure a better alignment of their interests with those of the Company and its stockholders.

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 the Plan as of September 30, 2019.

Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price	
\$0.01 - \$0.15	2,000,000	7.26	\$ 0.14	2,000,000	\$ 0.14	
\$0.16 - \$0.99	1,349,793	4.09	0.18	1,190,059	0.18	
	<u>3,349,793</u>	5.98	\$ 0.16	<u>3,190,059</u>	\$ 0.16	

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

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2018	4,376,474	\$ 0.18
Granted	67,394	0.14
Exercised	-	-
Cancelled or expired	(1,094,075)	0.17
Outstanding at December 31, 2018	3,349,793	\$ 0.16
Granted	-	-
Exercised	-	-
Cancelled or expired	-	-
Outstanding at September 30, 2019	3,349,793	\$ 0.16

During the nine months ended September 30, 2019, no options were granted, exercised, cancelled or expired. For the nine months ended September 30, 2018, no options were granted or exercised and there were 1,094,075 options that were cancelled or expired. Total stock-based compensation expense in connection with options granted to employees recognized in the condensed consolidated statements of operations for the three months ended September 30, 2019 and 2018 was \$1,815 and \$1,530, respectively. Total stock-based compensation expense in connection with options granted to employees recognized in the condensed consolidated statements of operations for the nine months ended September 30, 2019 was \$5,446, and \$4,590, 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.

Warrants Outstanding			Warrants Exercisable		
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 0.20	250,000	2.02	\$ 0.20	250,000	\$ 0.20

Transactions involving warrants are summarized as follows:

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2018	250,000	\$ 0.20
Issued	—	—
Exercised	—	—
Cancelled or expired	—	—
Outstanding at December 31, 2018	250,000	\$ 0.20
Issued	—	—
Exercised	—	—
Cancelled or expired	—	—
Outstanding at September 30, 2019	250,000	\$ 0.20

There were no warrants granted, exercised, cancelled or forfeited during the nine months ended September 30, 2019 and 2018.

NOTE J – RELATED PARTY TRANSACTIONS

During the nine months ended September 30, 2019 and during the year ended December 31, 2018, the Company agreed to issue common stock in the amount of \$105,000 and \$144,000, respectively, and pay cash consideration of \$5,000 and \$0, respectively, to the Company’s non-employee directors as compensation for their attendance and participation in the Company’s Board of Director and committee meetings.

NOTE K – COMMITMENTS AND CONTINGENCIES

Leases

On January 1, 2019 the Company adopted ASC Topic 842 “Leases” (“ASC 842”), which supersedes ASC Topic 840 “Leases” (“ASC 840”), using the alternative transition method of adoption. Under this method of adoption, the Company has recognized and measured all leases that exist as at January 1, 2019 (the effective date) using a modified retrospective transition approach. Comparative periods are presented in accordance with Topic 840 and do not include any retrospective adjustments to comparative periods to reflect the adoption of Topic 842. Any cumulative-effect adjustments to retained earnings is recognized as of January 1, 2019. Upon adoption, we recognized our leases with greater than one year in duration on the balance sheet as right-of-use assets and lease liabilities. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Classification is based on criteria that are largely similar to those applied in prior lease accounting, but without explicit lines. We have made certain assumptions in judgments when applying ASC 842. Those judgments of most significance are as follows:

- We elected the package of practical expedients available for transition which allow us to not reassess the following:
 - o Whether expired or existing contracts contain leases under the new definition of the lease;
 - o Lease classification for expired or existing leases; and
 - o Whether previously capitalized initial direct costs would qualify for capitalization under ASC 842.

- We did not elect to use hindsight for transition when considering judgments and estimates such as assessments of lessee options to extend or terminate a lease or purchase the underlying asset.
- For all asset classes, we elected to not recognize a right-of-use asset and lease liability for leases with a term of 12 months or less.
- For all asset classes, we elected to not separate non-lease components from lease components to which they relate and have accounted for the combined lease and non-lease components as a single lease component.

We determine if an arrangement is a lease at inception. Operating leases are included in our consolidated balance sheet as right-of-use assets, operating lease liabilities - current and operating lease liabilities – long term. Upon adoption, the Company determined there were no financing leases. Our current operating leases are for facilities and office equipment. Our leases may contain renewal options; however, we do not recognize right-of-use assets or lease liabilities for renewal periods unless it is determined that we are reasonably certain of renewing the lease at inception or when a triggering event occurs. Some of our lease agreements may contain rent escalation clauses, rent holidays, capital improvement funding, or other lease concessions. We recognize our minimum rental expense on a straight-line basis based on the fixed components of a lease arrangement. Payments are set on a pre-determined schedule within each lease agreement. We amortize this expense over the term of the lease beginning with the date of the standard adoption for current leases and beginning with the date of initial possession, which is the date we enter the leased space and begin to make improvements in the preparation for its intended use, for future leases. Variable lease components represent amounts that are not fixed in nature and are not tied to an index or rate, and are recognized as incurred. Variable lease components consist primarily of common area maintenance, taxes and insurance.

The Company does not, upon adoption of ASC 842, control a specific space or underlying asset used in providing a service by a third-party service provider, under any third party service agreements. There are no such arrangements that meet the definition under ASC 842.

In determining our right-of-use assets and lease liabilities, we apply a discount rate to the minimum lease payments within each lease agreement. ASC 842 requires us to use the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term, an amount equal to the lease payments in a similar economic environment. When we cannot readily determine the discount rate implicit in the lease agreement, we utilize our current borrowing rate on our outstanding line of credit. The Company's line of credit utilizes market rates to assess an interest rate. Refer to Note F for further discussion.

We lease certain property under non-cancelable operating leases, primarily facilities. The impact of the adoption of ASC 842 at January 1, 2019 created a right-of-use asset of \$1,042,004, lease liability of \$1,095,761 and unwound the \$71,877 balance of the deferred lease liability account.

The components of lease expense for the nine months ended September 30, 2019 were as follows:

Operating lease expense:	
Operating lease cost - fixed	\$ 170,562
Variable lease cost	<u>97,903</u>
Total operating lease cost	<u>\$ 268,465</u>

Other information related to leases as of September 30, 2019 was as follows:

Operating lease liability - current	\$	221,920
Operating lease liability - long-term	\$	794,273
Operating cash outflows from operating leases	\$	164,794
Weighted-average remaining lease term of operating leases		5.9 years
Weighted-average discount rate of operating leases		8.5%

Future annual minimum operating lease payments as of September 30, 2019 were as follows:

2019 (excluding the nine months ended September 30, 2019)	\$	55,003
2020		223,835
2021		242,299
2022		195,176
2023		193,169
2024 and thereafter		384,119
Total minimum lease payments	\$	1,293,601
Less imputed interest		(277,408)
Total	\$	<u>1,016,193</u>

Future annual minimum lease payments under non-cancelable leases as of December 31, 2018 prior to our adoption of ASU 2016-02, Leases (Topic 842) are as follows:

2019	\$	211,448
2020		223,417
2021		242,785
2022		195,176
2023		193,168
2024 and thereafter		380,714
Total	\$	<u>1,446,708</u>

Rental expenses charged to operations for the three months ended September 30, 2019 and 2018 were \$87,633 and \$84,620, respectively. Rental expenses charged to operations for the nine months ended September 30, 2019 and 2018 were \$268,465 and \$255,568, respectively.

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.

Sales Tax

The following table sets forth the change in the sales tax accrual as of September 30, 2019 and December 31, 2018:

	September 30, 2019	December 31, 2018
Balance, beginning of year	\$ 43,400	\$ 83,282
Sales tax collected	138,527	101,145
Provisions	(6,437)	30,465
Interest and penalties	-	-
Payments	(133,133)	(171,492)
Balance, end of period	<u>\$ 42,357</u>	<u>\$ 43,400</u>

NOTE L – BUSINESS CONCENTRATION

For the nine months ended September 30, 2019, three customers represented 16%, 16%, and 12% of total net revenues. For the nine months ended September 30, 2018, no single customer represented 10% or more of total net revenues. As of September 30, 2019, two customers represented 28% and 14% of the Company's net accounts receivable. As of December 31, 2018, two customers represented 29% and 11% of the Company's net accounts receivable.

Purchases from one supplier approximated \$2,522,000, or 84%, of purchases for the nine months ended September 30, 2019 and \$3,261,000, or 90%, of purchases for the nine months ended September 30, 2018. The amount due to this supplier, net of deposits paid, was approximately \$353,000 as of September 30, 2019. Deposits paid to this supplier exceeded the total due by approximately \$320,000 as of December 31, 2018.

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 condensed consolidated financial statements and related notes thereto for the three and nine months ended September 30, 2019, 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, 2018, filed with the US Securities and Exchange Commission (the “SEC”) on April 1, 2019.

Business

Telkonet, Inc. (the “Company”, “Telkonet”), formed in 1999 and incorporated under the laws of the state of Utah, is the creator of the EcoSmart Platform of intelligent automation solutions designed to optimize energy efficiency, comfort and analytics in support of the emerging Internet of Things (“IoT”). We currently operate in a single reportable business segment.

The Company’s direct sales effort targets the hospitality, education, commercial, utility and government/military markets. Taking advantage of legislation, including the Energy Independence and Security Act of 2007, or EISA, the Energy Policy Act of 2005, and the American Recovery and Reinvestment Act the Company is focusing its sales efforts in areas with available public funding and incentives, such as rebate programs offered by utilities for efficiency upgrades. Through the Company’s proprietary platform, technology and partnerships with energy efficiency providers, the Company’s management intends to position the Company as a leading provider of energy management solutions.

Forward-Looking Statements

In accordance with the Private Securities Litigation Reform Act of 1995, the Company can obtain a “safe-harbor” for forward-looking statements by identifying those statements and by accompanying those statements with cautionary statements which identify factors that could cause actual results to differ materially from those in the forward-looking statements. Accordingly, the following “Management’s Discussion and Analysis of Financial Condition and Results of Operations” may contain certain forward-looking statements regarding strategic growth initiatives, growth opportunities and management’s expectations regarding orders and financial results for the remainder of 2019 and future periods. These forward-looking statements are based on current expectations and current assumptions which management believes are reasonable. However, these statements involve risks and uncertainties that could cause actual results to differ materially from any future results encompassed within the forward-looking statements. Factors that could cause or contribute to such differences include those risks affecting the Company’s business as described in the Company’s filings with the SEC, including the current reports on Form 8-K, which factors are incorporated herein by reference. The Company expressly disclaims a duty to provide updates to forward-looking statements, whether as a result of new information, future events or other occurrences.

Critical Accounting Policies and Estimates and New Accounting Pronouncements

Please refer to the Company’s Form 10-K filed April 1, 2019 for critical accounting policies and estimates. For information regarding recent accounting pronouncements and their effect on the Company, see “New Accounting Pronouncements” in Note B of the Notes to Unaudited Condensed Consolidated Financial Statements contained herein.

Revenues

The tables below outline product versus recurring revenues, along with respective percentages for the comparable periods:

	Three Months Ended					
	September 30, 2019		September 30, 2018		Variance	
Product	\$ 1,995,788	91%	\$ 1,319,046	90%	\$ 676,742	51%
Recurring	202,855	9%	144,970	10%	57,885	40%
Total	<u>\$ 2,198,643</u>	100%	<u>\$ 1,464,016</u>	100%	<u>\$ 734,627</u>	50%

	Nine Months Ended					
	September 30, 2019		September 30, 2018		Variance	
Product	\$ 7,963,349	93%	\$ 5,643,509	93%	\$ 2,319,840	41%
Recurring	568,531	7%	399,865	7%	168,666	42%
Total	<u>\$ 8,531,880</u>	100%	<u>\$ 6,043,374</u>	100%	<u>\$ 2,488,506</u>	41%

Product Revenue

Product revenue principally arises from the sale and installation of the EcoSmart energy management platform. The EcoSmart Suite of products consists of thermostats, sensors, controllers, wireless networking products, switches, outlets and a control platform.

For the three and nine months ended September 30, 2019, product revenue increased by 51% or \$0.68 million and 41% or \$2.32 million, respectively, when compared to the prior year. Increases are primarily attributable to volume generated from value added resellers and distribution partners. Beginning in the third quarter of 2019, the Company began implementing portfolio pricing increases, which are expected to positively impact product revenue.

For the three months ended September 30, 2019, the majority of the increase in product revenues over the prior year period was due to hospitality revenues increasing \$0.54 million to \$1.76 million and education revenues increasing \$0.16 million to \$0.16 million. For the three months ended September 30, 2019, actual product revenues increased by \$1.12 million while installation revenues decreased by \$0.46 million.

For the nine months ended September 30, 2019, the increase in product revenues over the prior year period was due to hospitality revenues increasing \$1.03 million to \$5.79 million, government revenues increasing \$0.87 million to \$0.94 million, and education and MDU revenues both increasing \$0.21 to \$0.86 million and \$0.37 million, respectively. For the nine months ended September 30, 2019, actual product revenues increased by \$3.18 million while installation revenues decreased by \$0.75 million.

Product revenues derived from value added resellers and distribution partners were \$1.88 million for the three months ended September 30, 2019, an increase of 102% compared to the prior year period. Product revenues derived from value added resellers and distribution partners were \$6.36 million for the nine months ended September 30, 2019, an increase of 39% compared to the prior year period.

Backlogs were approximately \$3.60 million and \$4.00 million at the beginning of the three and nine month periods ended September 30, 2019. The Company ended the third quarter with a backlog of approximately \$3.60 million.

Recurring Revenue

Recurring revenue is attributed to our call center support services. The Company recognizes revenue ratably over the service period for monthly support revenues and defers revenue for annual support services over the term of the service period. Recurring revenue consists of Telkonet's EcoCare service and support program.

For the three and nine months ended September 30, 2019, recurring revenue increased by 40% and 42%, respectively, when compared to the prior year period. Increases were related to increased unit sales with call center support services included.

Cost of Sales

The tables below outline product versus recurring cost of sales, along with respective percentages of revenue for the comparable periods:

	September 30, 2019		Three Months Ended September 30, 2018		Variance	
Product	\$ 1,259,151	63%	\$ 881,444	67%	\$ 377,707	43%
Recurring	74,437	37%	68,467	47%	5,970	9%
Total	<u>\$ 1,333,588</u>	61%	<u>\$ 949,911</u>	65%	<u>\$ 383,677</u>	40%

	September 30, 2019		Nine Months Ended September 30, 2018		Variance	
Product	\$ 5,026,815	63%	\$ 3,252,409	58%	\$ 1,774,406	55%
Recurring	237,551	42%	194,947	49%	42,604	22%
Total	<u>\$ 5,264,366</u>	62%	<u>\$ 3,447,356</u>	57%	<u>\$ 1,817,010</u>	53%

Costs of Product Sales

Costs of product revenue include materials and installation labor related to EcoSmart technology. For the three and nine months ended September 30, 2019, product costs increased by 43% and 55%, respectively, compared to the prior year periods.

For the three month comparison, the variance was primarily attributable to an increase of \$0.28 million in material costs, an increase of \$0.03 million in logistical expenses, inclusive of import tariffs and an increase of \$0.04 million to the inventory obsolescence reserve. Material costs as a percentage of product revenues were 39% for the three months ended September 30, 2019, a decrease of 14%, compared to the prior year period as a result of a formal pricing increase implemented during the three months ended September 30, 2019 and changes in the product and customer mix.

For the nine month comparison, the variance was primarily attributable to an increase of \$1.03 million in material costs, an increase of \$0.43 million in logistical expenses, inclusive of import tariffs and an increase of \$0.26 million in the use of installation subcontractors. Material costs as a percentage of product revenues were 42% for the nine months ended September 30, 2019, a decrease of 6%, compared to the prior year period.

Costs of Recurring Revenue

Recurring costs are comprised primarily of call center support labor. For the three and nine months ended September 30, 2019, recurring costs increased by 9% and 22%, respectively, when compared to the prior year periods. These variances were primarily due to increases in salary and recruiting efforts offset by a decrease in temporary staffing.

Gross Profit

The tables below outline product versus recurring gross profit, along with respective gross profit percentages for the comparable periods:

	September 30, 2019		Three Months Ended September 30, 2018		Variance	
Product	\$ 736,637	37%	\$ 437,602	33%	\$ 299,035	68%
Recurring	128,418	63%	76,503	53%	51,915	68%
Total	<u>\$ 865,055</u>	39%	<u>\$ 514,105</u>	35%	<u>\$ 350,950</u>	68%

	September 30, 2019		Nine Months Ended September 30, 2018		Variance	
Product	\$ 2,936,534	37%	\$ 2,391,100	42%	\$ 545,434	23%
Recurring	330,980	58%	204,918	51%	126,062	62%
Total	<u>\$ 3,267,514</u>	38%	<u>\$ 2,596,018</u>	43%	<u>\$ 671,496</u>	26%

Gross Profit on Product Revenue

Gross profit for the three and nine months ended September 30, 2019 increased 68% and 23%, respectively, when compared to the prior year periods.

For the three months ended September 30, 2019, the actual gross profit percentage increased 4% to 37%. Contributing to the increase was a decrease in material costs as a percentage of product revenues, partially offset by increased logistical expenses, inclusive of import tariffs and the inventory obsolescence reserve. Tariffs imposed on Chinese imports resulted in an adverse impact of approximately 7% on the actual gross profit percentage for the three months ended September 30, 2019.

For the nine months ended September 30, 2019, the actual gross profit percentage decreased 5% to 37%. Contributing to the decrease were increases in logistical expenses and the use of installation subcontractors, partially offset by a decrease in material costs as a percentage of product revenues. Tariffs imposed on Chinese imports resulted in an adverse impact of approximately 7% on the actual gross profit percentage for the nine months ended September 30, 2019.

Gross Profit on Recurring Revenue

Gross profit for the three and nine months ended September 30, 2019 increased 68% and 62%, respectively, when compared to the prior year periods. Increases were related to increased unit sales with call center support services.

For the three months ended September 30, 2019, the actual gross profit percentage increased 10% to 63% when compared to the prior year period. For the nine months ended September 30, 2019, the actual gross profit percentage increased 7% to 58% when compared to the prior year period.

Operating Expenses

The tables below outline operating expenses for the comparable periods, along with percentage change:

	Three Months Ended September 30,			Variance
	2019	2018		
Total	<u>\$ 1,602,549</u>	<u>\$ 1,804,653</u>	<u>\$ (202,104)</u>	(11%)

	Nine Months Ended September 30,			Variance
	2019	2018		
Total	<u>\$ 5,348,587</u>	<u>\$ 5,276,837</u>	<u>\$ 71,750</u>	1%

During the three and nine months ended September 30, 2019, operating expenses decreased by 11% and increased by 1%, respectively, when compared to the prior year periods as outlined below.

Research and Development

	Three Months Ended September 30,			Variance
	2019	2018		
Total	<u>\$ 448,690</u>	<u>\$ 539,652</u>	<u>\$ (90,962)</u>	(17%)

	Nine Months Ended September 30,			Variance
	2019	2018		
Total	<u>\$ 1,360,986</u>	<u>\$ 1,410,287</u>	<u>\$ (49,301)</u>	(3%)

Research and development costs are related to both present and future products and are expensed in the period incurred. Current research and development costs are associated with product development and integration. During the three and nine months ended September 30, 2019, research and development costs decreased by 17% and 3%, respectively, when compared to the prior year periods. For the three month comparison, the variance is attributable to a decrease in expenses incurred with third-party consultants. For the nine month comparison the variance is attributable to decreases in expenses incurred with third-party consultants and salary expense, partially offset by increases in travel and certification expenses.

Selling, General and Administrative Expenses

	Three Months Ended September 30,			Variance
	2019	2018		
Total	<u>\$ 1,137,084</u>	<u>\$ 1,248,204</u>	<u>\$ (111,120)</u>	(9%)

	Nine Months Ended September 30,			Variance
	2019	2018		
Total	<u>\$ 3,936,851</u>	<u>\$ 3,816,210</u>	<u>\$ 120,641</u>	3%

During the three and nine months ended September 30, 2019, selling, general and administrative expenses decreased by 9% and increased 3% over the prior year periods, respectively. For the three month comparison, the variance is attributable to a \$0.13 million decrease in bad debt reserve and \$0.06 million decrease in software consulting services, partially offset by a \$0.02 million increase in audit fees and a \$0.05 million increase in commission expenses. For the nine month comparison, the variance is attributable to a \$0.12 million increase in sales commissions, a \$0.12 million increase in audit and legal fees offset by a \$0.11 million decrease to the bad debt reserve.

EBITDA from Operations

Management believes that certain non-GAAP financial measures may be useful to investors in certain instances to provide additional meaningful comparisons between current results and results in prior operating periods. Adjusted earnings before interest, taxes, depreciation and amortization (“Adjusted EBITDA”) is a metric used by management and frequently used by the financial community. Adjusted EBITDA provides insight into an organization’s operating trends and facilitates comparisons between peer companies, since interest, taxes, depreciation and amortization can differ greatly between organizations as a result of differing capital structures and tax strategies. Adjusted EBITDA is one of the measures used for determining our debt covenant compliance. Adjusted EBITDA excludes certain items that are unusual in nature or not comparable from period to period. While management believes that non-GAAP measurements are useful supplemental information, such adjusted results are not intended to replace our GAAP financial results. Adjusted EBITDA is not, and should not be considered, an alternative to net income (loss), income (loss) from operations, or any other measure for determining operating performance of liquidity, as determined under accounting principles generally accepted in the United States (GAAP). In assessing the overall health of its business for the three and nine months ended September 30, 2019 and 2018, the Company excluded items in the following general category described below:

Stock-based compensation: The Company believes that because of the variety of equity awards used by companies, varying methodologies for determining stock-based compensation and the assumptions and estimates involved in those determinations, the exclusion of non-cash stock-based compensation expense related to employee stock options enhances the ability of management and investors to understand the impact of non-cash stock-based compensation on our operating results. Further, the Company believes that excluding stock-based compensation expense related to employee stock options allows for a more transparent comparison of its financial results to the previous period.

**RECONCILIATION OF NET LOSS FROM
OPERATIONS TO ADJUSTED EBITDA
(Unaudited)**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2019	2018	2019	2018
Net loss from operations	\$ (753,869)	\$ (1,281,008)	\$ (2,118,048)	\$ (2,671,756)
Gain on sale of fixed assets	(150)	—	(150)	—
Interest (income) expense, net	16,525	(9,540)	37,125	(11,063)
Provision for income taxes	—	—	—	2,000
Depreciation and amortization	16,775	16,797	50,750	50,340
EBITDA	(720,719)	(1,273,751)	(2,030,323)	(2,630,479)
Adjustments:				
Stock-based compensation	1,815	1,530	5,446	4,590
Adjusted EBITDA	<u>\$ (718,904)</u>	<u>\$ (1,272,221)</u>	<u>\$ (2,024,877)</u>	<u>\$ (2,625,889)</u>

Liquidity and Capital Resources

For the nine-month period ended September 30, 2019, the Company reported a net loss of \$2,118,048 and had cash used in operating activities of \$1,977,408 and ended the period with an accumulated deficit of \$125,289,454 and total current assets in excess of current liabilities of \$3,997,628. At September 30, 2019, the Company had \$3,484,114 of cash and approximately \$742,000 of availability on its credit facility. The credit facility is a \$2,000,000 line of credit, which is subject to a borrowing base calculation based on the Company's eligible accounts receivable and eligible inventory each multiplied by an applicable advance rate, with an overall limitation tied to the Company's eligible accounts receivable. As of September 30, 2019, we had borrowing capacity of \$2,000,000, an outstanding balance of \$909,423 and approximately \$742,000 of availability on the credit facility. During the twelve-month period between January 1, 2018 and December 31, 2018, the Company's cash balance decreased from \$8,385,595 to \$4,678,891, or approximately \$309,000 per month. In comparison, during the nine-month period between January 1, 2019 and September 30, 2019, the Company's cash balance decreased from \$4,678,891 to \$3,484,114, or approximately \$133,000 per month. This improvement is the result of improved revenues and cost management efforts.

Since inception, the Company has incurred operating losses and has reported negative cash flows from operating activities. Since 2012, the Company has made significant investments in the engineering, development and marketing of an intelligent automation platform, including but not limited to, hardware and software enhancements, support services and applications. The funding for these development efforts has contributed to the ongoing operating losses and use of cash. Operating losses have been financed by debt and equity transactions, credit facility capacity, the sale of a wholly-owned subsidiary and management of working capital levels. The report from our independent registered public accounting firm on our consolidated financial statements for the year ended December 31, 2018 stated there is substantial doubt about our ability to continue as a going concern.

The Company's ability to continue as a going concern is dependent upon generating profitable operations in the future and/or securing the necessary financing to meet its obligations and repay its liabilities arising from normal business operations when they come due. There can be no assurance that the Company will be able to secure such financing at commercially reasonable terms, if at all. If cash resources become insufficient to meet the Company's ongoing obligations, the Company will be required to scale back or discontinue portions of its operations or discontinue operations entirely, whereby, the Company's shareholders may lose some or all of their investment.

In June 2018, the Company's Board engaged an investment bank to identify strategic alternatives to maximize shareholder value, including but not limited to, a sale of the Company, an investment in the Company, a merger or other business combination, a sale of all or substantially all assets or a strategic joint venture. At November 14, 2019, no definitive alternatives had been identified.

During the quarter ended September 30, 2019, the Company began initiating a number of cost elimination and liquidity management actions, including, reviewing opportunities to decrease spend with third party consultants and providers, strategically reviewing whether or not to fill employee positions in the event of vacancies, and implementing sales campaigns to sell slow-moving inventory and reducing existing inventory volumes. Management expects these actions will continue to reduce operating losses. The full impact of these actions is not expected to be reflected in the Company's financial statements in the next twelve months. There is no guarantee these actions, nor any other actions identified, will yield profitable operations in the foreseeable future.

The Company expects to draw on its' cash reserves and utilize the credit facility to the extent availability exists to finance its near term working capital needs. We expect to continue to incur operating losses and negative operating cash flows for one year beyond the date of these financial statements. Accordingly, and in light of the Company's historic and continuing losses, there is substantial doubt about the Company's ability to continue as a going concern.

Working Capital

Working capital (current assets in excess of current liabilities) from operations decreased by \$2,210,062 during the nine months ended September 30, 2019 from working capital of \$6,206,299 at December 31, 2018 to working capital of \$3,996,237 at September 30, 2019.

Revolving Credit Facility

The Company is a party to a loan and security agreement (the "Heritage Bank Loan Agreement"), with Heritage Bank of Commerce, a California state chartered bank ("Heritage Bank"), governing a revolving credit facility in a principal amount not to exceed \$2,000,000 (the "Credit Facility"). Availability of borrowings under the Credit Facility is subject to a borrowing base calculation based on the Company's eligible accounts receivable and eligible inventory each multiplied by an applicable advance rate, with an overall limitation tied to the Company's eligible accounts receivable. The Heritage Bank Loan Agreement is available for working capital and other general business purposes. The outstanding principal balance of the Credit Facility bears interest at the Prime Rate plus 3.00%, which was 8.00% at September 30, 2019 and 8.50% at December 31, 2018. On October 9, 2014, as part of the Heritage Bank Loan Agreement, Heritage Bank was granted a warrant to purchase 250,000 shares of Telkonet common stock, for further information on the accounting for warrants, refer to Note I. The warrant has an exercise price of \$0.20 and expires October 9, 2021. On November 6, 2019, the eleventh amendment to the Credit Facility was executed to extend the maturity date to September 30, 2021, unless earlier accelerated under the terms of the Heritage Bank Loan Agreement, and eliminate the maximum EBITDA loss covenant. The eleventh amendment was effective as of September 30, 2019.

The Heritage Bank Loan Agreement contains covenants that place restrictions on, among other things, the incurrence of debt, granting of liens and sale of assets. The Heritage Bank Loan Agreement also contains financial covenants. As discussed above, the EBITDA loss covenant was eliminated in the eleventh amendment to the Credit Facility. The sole financial covenants are a minimum asset coverage ratio and a minimum unrestricted cash balance of \$2 million, both of which are measured at the end of each month. A violation of any of these covenants could result in an event of default under the Heritage Bank Loan Agreement. Upon the occurrence of such an event of default or certain other customary events of defaults, payment of any outstanding amounts under the Credit Facility may be accelerated and Heritage Bank's commitment to extend credit under the Heritage Bank Loan Agreement may be terminated. The Heritage Bank Loan Agreement contains other representations and warranties, covenants, and other provisions customary to transactions of this nature.

The outstanding balance on the Credit Facility was \$909,423 and \$121,474 at September 30, 2019 and December 31, 2018 and the remaining available borrowing capacity was approximately \$742,000 and \$499,000, respectively. As of September 30, 2019, the Company was in compliance with all financial covenants.

Cash Flow Analysis

Cash used in operations was \$1,977,408 and \$3,674,311 during the nine months ended September 30, 2019 and 2018, respectively. As of September 30, 2019, our primary capital needs included costs incurred to increase energy management sales, inventory procurement, and managing current liabilities. The working capital changes during the nine months ended September 30, 2019 were primarily related to an approximate \$991,000 increase in accounts receivable, \$112,000 decrease in contract liabilities, \$108,000 increase in contract assets, partially offset by a \$596,000 increase in accounts payable, a \$234,000 decrease in inventory, and a \$204,000 decrease in prepaid and other current assets. The working capital changes during the nine months ended September 30, 2018 were primarily related to an approximate \$615,000 increase in inventories, a \$515,000 increase in prepaid expense and other current assets, a \$370,000 decrease in contract liabilities, a \$335,000 decrease in accounts payable, partially offset by a \$298,000 increase in other accrued expenses, and a \$285,000 decrease in accounts receivable. The increase in accounts receivable is primarily the result of revenue growth and invoice timing as opposed to collection difficulties. We purchase inventory based on forecasts and orders, and when those forecasts and orders change, the amount of inventory may also fluctuate. Accounts payable fluctuates with changes in inventory levels, volume of inventory purchases, and negotiated supplier and vendor terms.

Cash used in investing activities was \$5,318, and \$7,492 during the nine months ended September 30, 2019 and 2018, respectively. During the nine months ended September 30, 2019, the cash used by investing activities reflects a decrease of \$5,318 associated with the purchase of property and equipment. During the nine months ended September 30, 2018, the cash used by investing activities reflects a decrease of \$7,492 associated with the purchase of property and equipment.

Cash provided from financing activities was \$787,949 compared to cash used of \$426,481 during the nine months ended September 30, 2019 and 2018, respectively. Proceeds borrowed from the line of credit were \$9,079,000 and cash used for payments on the line of credit were \$8,291,051 during the nine months ended September 30, 2019. Proceeds borrowed from the line of credit were \$1,100,000 and cash used for payments on the line of credit were \$1,526,481 during the nine months ended September 30, 2018.

We are working to manage our current liabilities while we continue to make changes in operations to improve our cash flow and liquidity position.

Management expects that global economic conditions, in particular the decreasing price of energy, the adverse impact of tariffs and competition will continue to present a challenging operating environment through 2019; therefore working capital management will continue to be a high priority for 2019. The Company's estimated cash requirements for our operations for the next 12 months is not anticipated to differ significantly from our present cash requirements for our operations.

Off-Balance Sheet Arrangements

The Company has no material off-balance sheet arrangements.

Acquisition or Disposition of Property and Equipment

The Company does not anticipate significant purchases of property or equipment during the next twelve months. The Waukesha, Wisconsin lease may require additional furniture, shelving, computer equipment and peripherals to be used in the Company's day-to-day operations.

Item 4. Controls and Procedures.

Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that material information required to be disclosed in our periodic reports filed under the Securities Exchange Act of 1934, as amended (the "Exchange Act") is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms and to ensure that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer as appropriate, to allow timely decisions regarding required disclosure. The Company's Chief Executive Officer and Chief Financial Officer each evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act) as of September 30, 2019. Based on these evaluations, the Chief Executive Officer and the Chief Financial Officer concluded that our disclosure controls and procedures required by paragraph (b) of Rule 13a-15 and 15d-15 were not effective as of September 30, 2019 as a result of the material weaknesses discussed below.

Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rule 13a-15(f) under the Exchange Act. The Company's internal control over financial reporting is designed to provide reasonable assurances regarding the reliability of financial reporting and the preparation of the financial statements of the Company in accordance with U.S. generally accepted accounting principles, or GAAP. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

With the participation of our Chief Executive Officer, our management conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2018 based on the framework in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on our evaluation and the material weaknesses described below, management concluded that the Company did not maintain effective internal control over financial reporting as of December 31, 2018 based on the COSO framework criteria.

As previously disclosed in Item 9A of our Annual Report on Form 10-K for the year ended December 31, 2018, our management did not properly design or maintain effective controls over the control environment and monitoring components of COSO. We did not have a sufficient complement of accounting and financial personnel with an appropriate level of knowledge to address technical accounting and financial reporting matters in accordance with generally accepted accounting principles and the Company's overall financial reporting requirements. We also lack sufficient information technology resources to address our IT general control environment requirements. The failures within the control environment and monitoring components contributed to the following control activity level material weaknesses:

- Revenues – We did not properly design or maintain effective controls over the recording of revenue recognition for contracts whose performance obligations are fulfilled over time.
- Financial Statement Close and Reporting – We did not properly design or maintain effective controls over the period end financial close and reporting process. Specifically, we lacked control over the review of account reconciliations, journal entries, identification of related party transactions, and reporting of our financial results and disclosures.
- Information Technology – We did not properly design or maintain effective controls to prevent unauthorized access to certain systems, programs and data, and provide for periodic review and monitoring of access and changes in programs, including review of security logs and analysis of segregation of duties conflicts.
- Segregation of Duties – We did not maintain adequate segregation of duties within the Company's business processes, financial applications, and IT systems. Specifically, we did not have appropriate controls in place to adequately assess the segregation of job responsibilities and system user access for initiating, authorizing, and recording transactions.

These control deficiencies could result in a misstatement of account balances resulting in a more than remote likelihood that a material misstatement to our financial statements may not be prevented or detected on a timely basis. Accordingly, we have determined that these control deficiencies as described above constitute material weaknesses.

We are reviewing actions to remediate the identified material weaknesses. As we continue to evaluate and work to improve our internal controls over financial reporting, our senior management may determine to take additional measures to address deficiencies or modify the remediation efforts. Until the remediation efforts that our senior management identifies as necessary, are completed, tested and determined effective, the material weaknesses described above will continue to exist. At present, the Company does not expect to hire additional personnel to remediate these control deficiencies in the near future.

In light of these material weaknesses, we performed additional analyses and procedures in order to conclude that our consolidated financial statements (i) as of and for the year ended December 31, 2018 and 2017 included in the Annual Report on Form 10-K and (ii) as of September 30, 2019 and 2018 included in this Form 10-Q were fairly stated in accordance with GAAP. Notwithstanding the identified material weaknesses, our management has concluded that (i) the audited condensed consolidated financial statements included in the Annual Report on Form 10-K for the year ended December 31, 2018 and (ii) the unaudited condensed consolidated financial statements included in this quarterly filing fairly represent in all material respects our financial position, results of operations, cash flows and changes in stockholders' equity as of and for the periods presented in accordance with U.S. GAAP.

Under applicable Securities Law, the Company is not required to obtain an attestation report from the Company's independent registered public accounting firm regarding internal control over financial reporting, and accordingly, such an attestation has not been obtained or included in the Annual Report on Form 10-K for the year ended December 31, 2018.

Changes in Internal Controls

Other than the material weaknesses discussed above, during the quarter ended September 30, 2019, there have been no changes in our internal control over financial reporting that have materially affected or are reasonably likely to materially affect our internal controls over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

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.

Item 1A. Risk Factors.

There were no material changes during the quarter to the Risk Factors disclosed in Item 1A – “Risk Factors” in our annual report on Form 10-K for the year ended December 31, 2018.

Item 6. Exhibits.

Exhibit Number	Description Of Document
10.1	Eleventh Amendment to Loan and Security Agreement entered into as of November 6, 2019, by and among Telkonet, Inc. and Heritage Bank of Commerce (incorporated by reference to our Form 8-K (File No. 000-31972) filed on November 7, 2019)
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 E. Mushrush
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 E. Mushrush pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Schema Document
101.CAL	XBRL Calculation Linkbase Document
101.DEF	XBRL Definition Linkbase Document
101.LAB	XBRL Label Linkbase Document
101.PRE	XBRL Presentation Linkbase Document

SIGNATURES

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

Telkonet, Inc.
Registrant

Date: November 14, 2019

By: /s/ Jason L. Tienor
Jason L. Tienor
Chief Executive Officer
(principal executive officer)

Date: November 14, 2019

By: /s/ Richard E. Mushrush
Richard E. Mushrush
Chief Financial Officer
(principal financial officer)

CERTIFICATIONS

Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Jason L. Tienor, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Telkonet, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer 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 (the registrant's fourth fiscal quarter in the case of an annual report) 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 and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2019

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

CERTIFICATIONS

Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Richard E. Mushrush certify that:

1. I have reviewed this quarterly report on Form 10-Q of Telkonet, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer 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 (the registrant's fourth fiscal quarter in the case of an annual report) 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 and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 14, 2019

By: /s/ Richard E. Mushrush
Richard E. Mushrush
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 for the period ended September 30, 2019 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Jason L. Tienor, Chief Executive Officer of the Company, 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.

This certification is being provided pursuant to 18 U.S.C. Section 1350 and is not to be deemed a part of the Report, nor is it to be deemed to be "filed" for any purpose whatsoever.

/s/ Jason L. Tienor
Jason L. Tienor
Chief Executive Officer
November 14, 2019

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

In connection with the Quarterly Report of Telkonet, Inc. (the "Company") on Form 10-Q for the period ended September 30, 2019 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Richard E. Mushrush, Chief Financial Officer of the Company, 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.

This certification is being provided pursuant to 18 U.S.C. Section 1350 and is not to be deemed a part of the Report, nor is it to be deemed to be "filed" for any purpose whatsoever.

/s/ Richard E. Mushrush
Richard E. Mushrush
Chief Financial Officer
November 14, 2019