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, 2017

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	87-0627421
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
20800 Swenson Drive, Suite 175, Waukesha, WI	53186
(Address of Principal Executive Offices)	(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the 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 and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, 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 ☐	Accelerated filer ☐
Non-accelerated filer ☐ (Do not check if a smaller reporting company)	Smaller reporting company ☒
Emerging growth 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, 2017 is 133,440,111.

TELKONET, INC.
FORM 10-Q for the Nine Months Ended September 30, 2017

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TELKONET, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	September 30, 2017	December 31, 2016
ASSETS		
Current assets:		
Cash and cash equivalents	$ 8,959,229	$ 791,858
Restricted cash on deposit	800,000	–
Accounts receivable, net	1,769,221	1,403,772
Inventories	1,082,289	777,202
Prepaid expenses and other current assets	260,269	205,328
Current assets of discontinued operations	–	7,149,971
Total current assets	12,871,008	10,328,131
Property and equipment, net	318,767	143,907
Other assets:		
Deposits	17,130	–
Total other assets	17,130	–
Total Assets	$ 13,206,905	$ 10,472,038
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,137,632	$ 765,617
Accrued liabilities and expenses	1,094,054	925,581
Related party payable	–	97,127
Line of credit	79,953	1,062,129
Deferred revenues - current	444,110	184,793
Deferred lease liability – current	–	3,942
Customer deposits	215,576	165,830
Income taxes payable	85,884	–
Deferred income taxes	–	933,433
Current liabilities of discontinued operations	–	869,604
Total current liabilities	3,057,209	5,008,056
Long-term liabilities:		
Deferred revenue - long term	190,896	120,421
Deferred lease liability - long term	40,508	23,761
Total long-term liabilities	231,404	144,182
Commitments and contingencies		
Stockholders' Equity		
Series A, par value $.001 per share; 215 shares issued, 185 shares outstanding at September 30, 2017 and December 31, 2016, preference in liquidation of $1,507,481 and $1,452,114 as of September 30, 2017 and December 31, 2016, respectively	1,340,566	1,340,566
Series B, par value $.001 per share; 538 shares issued, 52 shares outstanding at September 30, 2017 and December 31, 2016, preference in liquidation of $409,009 and $393,435 as of September 30, 2017 and December 31, 2016, respectively	362,059	362,059
Common stock, par value $.001 per share; 190,000,000 shares authorized; 133,440,111 and 132,774,475 shares issued and outstanding at September 30, 2017 and December 31, 2016 , respectively	133,440	132,774
Additional paid-in-capital	127,383,314	126,955,435
Accumulated deficit	(119,301,087)	(123,471,034)
Total stockholders' equity	9,918,292	5,319,800
Total Liabilities and Stockholders' Equity	$ 13,206,905	$ 10,472,038

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,	
	2017	**2016**	**2017**	**2016**
Revenues, net:				
Product	$ 1,904,571	$ 1,360,887	$ 5,728,878	$ 6,356,437
Recurring	131,665	143,028	344,708	340,412
Total Net Revenue	2,036,236	1,503,915	6,073,586	6,696,849
Cost of Sales:				
Product	1,160,019	770,830	3,233,978	3,194,094
Recurring	55,702	36,618	118,347	92,324
Total Cost of Sales	1,215,721	807,448	3,352,325	3,286,418
Gross Profit	820,515	696,467	2,721,261	3,410,431
Operating Expenses:				
Research and development	500,656	429,622	1,323,669	1,321,007
Selling, general and administrative	1,188,905	1,432,489	4,396,667	5,012,249
Depreciation and amortization	14,616	8,382	34,405	24,366
Total Operating Expenses	1,704,177	1,870,493	5,754,741	6,357,622
Operating Loss	(883,662)	(1,174,026)	(3,033,480)	(2,947,191)
Other Income (Expenses):				
Interest income (expense), net	8,722	(15,482)	2,797	(45,308)
Total Other Income (Expense)	8,722	(15,482)	2,797	(45,308)
Loss from Continuing Operations before Provision (Benefit) for Income Taxes	(874,940)	(1,189,508)	(3,030,683)	(2,992,499)
Provision (Benefit) for Income Taxes	(3,600)	2,575	4,301	3,200
Net loss from continuing operations	(871,340)	(1,192,083)	(3,034,984)	(2,995,699)
Discontinued Operations:				
Gain from sale of discontinued operations (net of tax)	218,000	–	6,602,871	–
Income from discontinued operations (net of tax)	11,403	798,887	602,060	2,050,998
Net income (loss) attributable to common stockholders	$ (641,937)	$ (393,196)	$ 4,169,947	$ (944,701)
Net income (loss) per common share:				
Basic - continuing operations	$ (0.01)	$ (0.01)	$ (0.02)	$ (0.02)
Basic - discontinued operations	$ 0.00	$ 0.01	$ 0.05	$ 0.02
Basic – net income (loss) attributable to common stockholders	$ (0.01)	$ (0.00)	$ 0.03	$ (0.00)
Diluted - continuing operations	$ (0.01)	$ (0.01)	$ (0.02)	$ (0.02)
Diluted - discontinued operations	$ 0.00	$ 0.01	$ 0.05	$ 0.02
Diluted – net income (loss) attributable to common stockholders	$ (0.01)	$ (0.00)	$ 0.03	$ (0.00)
Weighted Average Common Shares Outstanding – basic	133,231,367	132,314,049	133,007,830	130,399,390
Weighted Average Common Shares Outstanding – diluted	133,231,367	132,314,049	133,405,096	130,399,390

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)
NINE MONTHS FROM JANUARY 1, 2017 THROUGH SEPTEMBER 30, 2017

	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, 2017	185	$1,340,566	52	$362,059	132,774,475	$132,774	$126,955,435	$(123,471,034)	$ 5,319,800
Shares issued to directors	–	–	–	–	665,636	666	107,334	–	108,000
Stock-based compensation expense related to employee stock options	–	–	–	–	–	–	320,545	–	320,545
Net income	–	–	–	–	–	–	–	4,169,947	4,169,947
Balance at September 30, 2017	185	$1,340,566	52	$362,059	133,440,111	$133,440	$127,383,314	$(119,301,087)	$ 9,918,292

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,	
	2017	2016
Cash Flows from Operating Activities:		
Net income (loss)	$ 4,169,947	$ (944,701)
Less: Net income from discontinued operations	(602,060)	(2,050,998)
Gain on sale of discontinued operations	(6,602,871)	–
Net loss from continuing operations	(3,034,984)	(2,995,699)
Adjustments to reconcile net loss from continuing operations to cash used in operating activities of continuing operations:		
Stock-based compensation expense	320,545	10,204
Stock issued to directors as compensation	108,000	36,000
Amortization of deferred financing costs	–	14,210
Depreciation	34,405	24,366
Provision for doubtful accounts, net of recoveries	15,013	7,047
Related party payable	–	161,075
Changes in operating assets and liabilities:		
Accounts receivable	(380,462)	468,589
Inventories	(305,087)	(410,202)
Prepaid expenses and other current assets	(54,941)	60,271
Deposits and other long term assets	(17,130)	23,871
Accounts payable	305,322	(535,016)
Accrued liabilities and expenses	168,473	299,919
Deferred revenue	329,792	56,825
Related party payable	(97,127)	(15,928)
Customer deposits	49,746	27,985
Income taxes payable	85,884	–
Deferred lease liability	12,805	(1,818)
Net Cash Used In Operating Activities of Continuing Operations	(2,459,746)	(2,768,301)
Net Cash Provided By Operating Activities of Discontinued Operations	517,242	2,023,820
Net Cash Used In Operating Activities	(1,942,504)	(744,481)
Cash Flows From Investing Activities:		
Purchase of property and equipment	(142,572)	(33,629)
Net proceeds from sale of subsidiary	12,034,623	–
Change in restricted cash	(800,000)	31,277
Net Cash Provided By (Used In) Investing Activities of Continuing Operations	11,092,051	(2,352)
Cash Flows From Financing Activities:		
Payments on notes payable	–	(79,864)
Proceeds from exercise of warrants	–	677,501
Proceeds from line of credit	3,572,500	4,327,068
Payments on line of credit	(4,554,676)	(4,217,068)
Net Cash (Used In) Provided By Financing Activities of Continuing Operations	(982,176)	707,637
Net increase (decrease) in cash and cash equivalents	8,167,371	(39,196)
Cash and cash equivalents at the beginning of the period	791,858	951,249
Cash and cash equivalents at the end of the period	$ 8,959,229	$ 912,053

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,	
	2017	**2016**
Supplemental Disclosures of Cash Flow Information:		
Cash transactions:		
Cash paid during the period for interest	$ 11,485	$ 30,980
Cash paid during the period for income taxes, net of refunds	58,551	–
Schedule of Non-Cash Investing Activities:		
Unpaid purchases of property and equipment included in accounts payable	$ 66,693	–

See accompanying notes to the unaudited condensed consolidated financial statements

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, 2017, are not necessarily indicative of the results that may be expected for the year ending December 31, 2017. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated December 31, 2016 financial statements and footnotes thereto included in the Company's Form 10-K filed with the SEC.

Business and Basis of Presentation

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 rapidly being recognized as a leading solution for reducing energy consumption, operational costs and carbon footprints, and eliminating the need for new energy generation in these marketplaces – all while improving occupant comfort and convenience.

On March 28, 2017, the Company, and the Company's wholly-owned subsidiary, EthoStream LLC, a Wisconsin limited liability company ("EthoStream"), entered into an Asset Purchase Agreement (the "Purchase Agreement") with DCI-Design Communications LLC ("DCI"), a Delaware limited liability company, whereby DCI would acquire all of the assets and certain liabilities of EthoStream for a base purchase price of $12,750,000. The Purchase Agreement provided that proceeds of $900,000 were to be withheld from the $12,750,000 base purchase price and placed into an escrow account to support potential indemnification obligations of up to $800,000 and net working capital adjustments of up to $100,000. Another $93,000 is classified in other current assets as a net working capital receivable. The escrow amount, net of potential claims, will be fully released after an escrow period not to exceed 12 months after closing. The assets included, among other items, certain inventory, contracts and intellectual property. DCI acquired only the liabilities provided for in the Purchase Agreement. On March 29, 2017, pursuant to the terms and the conditions of the Purchase Agreement, the Company closed on the sale. The income from discontinued operations (net of tax) represents the activity of EthoStream from January 1, 2017 through the date of the sale on March 28, 2017. The gain from sale of discontinued operations (net of tax) represents the gain recognized from the EthoStream selling price that was in excess of the assets sold to DCI and liabilities assumed by DCI on March 28, 2017. On September 27, 2017, the Company reached a final settlement with DCI on net working capital as set forth in the Purchase Agreement. On September 29, 2017, the Company received $100,000 from the escrow account for the portion of the escrow account set aside for net working capital adjustments and cash proceeds of $311,000 from DCI in the settlement of net working capital adjustments. The net working capital receivable of $93,000 in other current assets was applied against the cash proceeds of $311,000 received on September 29, 2017 resulting in a gain from sale of discontinued operations of $218,000 recognized during the three months ended September 30, 2017.

The condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Telkonet Communications, Inc., and EthoStream. The current and prior period accounts of Ethostream have been classified as discontinued operations on the condensed consolidated balance sheet, the condensed consolidated statement of operations and the condensed consolidated statement of cash flows. All significant intercompany balances and transactions have been eliminated in consolidation.

Unless otherwise noted, all financial information in the consolidated financial statement footnotes reflect the Company's results from continuing operations.

Liquidity and Financial Condition

The Company reported a net loss of $3,034,984 from continuing operations for the nine months ended September 30, 2017, had cash used in operating activities from continuing operations of $2,459,746 and had an accumulated deficit of $119,301,087. Since inception, the Company's primary sources of ongoing liquidity for operations have come through private and public offerings of equity securities, and the issuance of various debt instruments, asset-based lending and the sale of assets.

On March 29, 2017, an amendment to the revolving credit facility with Heritage Bank of Commerce, a California state chartered bank ("Heritage Bank"), was executed to amend certain terms of the Loan and Security Agreement (the "Heritage Bank Loan Agreement") following the sale of certain assets of the Company's wholly-owned subsidiary, EthoStream. Heritage Bank amended the EBITDA compliance measurement.

On October 23, 2017, an amendment to the revolving credit facility with Heritage Bank was executed to amend certain terms of the Heritage Bank Loan Agreement. Among the terms of the amendment was that if the Company deviates from its projected EBITDA for the quarters ended September 30, 2017 or December 31, 2017, the Company will be deemed to be in compliance as of the measurement date if the Company's unrestricted cash maintained at Heritage Bank is in excess of $5,000,000. The amendment also extends the revolving credit facility's maturity date by one year to September 30, 2019.

The outstanding balance of the revolving credit facility was $79,953 as of September 30, 2017 and the remaining available borrowing capacity was approximately $1,304,000. As of September 30, 2017, the Company was in compliance with all financial covenants.

On March 28, 2017, the Company and EthoStream, entered into the Purchase Agreement with DCI whereby DCI acquired all of the assets and certain liabilities of EthoStream for a base purchase price of $12,750,000, subject to an adjustment based on the net working capital of EthoStream on the closing date of the sale transaction. The Company's liquidity for the remainder of 2017 remains strong due to the net proceeds received from the sale of EthoStream.

Restricted Cash on Deposit

The restricted cash on deposit of $800,000 as of September 30, 2017 reflects amounts placed into an escrow account to support potential indemnification obligations associated with the sale of the Company's wholly-owned subsidiary, EthoStream. The escrow amount, net of potential claims, would be fully released after an escrow period not to exceed 12 months from the transaction closing on March 29, 2017. On September 29, 2017, the Company received $100,000 from the escrow account for the portion of the escrow account set aside for net working capital adjustments.

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 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, 2017 and 2016, there were 5,621,800 and 2,240,225 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 and related valuation allowance, 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 derecognition, classification, treatment of interest and penalties, and disclosure of such positions.

Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with ASC 605-10, “Revenue Recognition” and ASC 605-10-S99 guidelines that require that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectability is reasonably assured. Determination of criteria (3) and (4) are based on management’s judgments regarding the fixed nature of the selling prices of the products delivered and the collectability of those amounts. Assuming all conditions for revenue recognition have been satisfied, product revenue is recognized when products are shipped and installation revenue is recognized when the services are completed. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. The guidelines also address the accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

Multiple-Element Arrangements ("MEAs"): The Company accounts for contracts that have both product and installation under the MEAs guidance in ASC 605-25. Arrangements under such contracts may include multiple deliverables consisting of a combination of equipment and services. The deliverables included in the MEAs are separated into more than one unit of accounting when (i) the delivered equipment has value to the customer on a stand-alone basis, and (ii) delivery of the undelivered service element(s) is probable and substantially in the Company's control. Arrangement consideration is then allocated to each unit, delivered or undelivered, based on the relative selling price of each unit of accounting based first on vendor-specific objective evidence ("VSOE") if it exists, second on third-party evidence ("TPE") if it exists and on estimated selling price ("ESP") if neither VSOE or TPE exist.

- VSOE – In most instances, products are sold separately in stand-alone arrangements. Services are also sold separately through renewals of contracts with varying periods. The Company determines VSOE based on pricing and discounting practices for the specific product or service when sold separately, considering geographical, customer, and other economic or marketing variables, as well as renewal rates or stand-alone prices for the service element(s).

- TPE – If the Company cannot establish VSOE of selling price for a specific product or service included in a multiple-element arrangement, the Company uses third-party evidence of selling price. The Company determines TPE based on sales of a comparable amount of similar product or service offered by multiple third parties considering the degree of customization and similarity of product or service sold.

- ESP – The estimated selling price represents the price at which the Company would sell a product or service if it were sold on a stand-alone basis. When neither VSOE nor TPE exists for all elements, the Company determines ESP for the arrangement element based on sales, cost and margin analysis, as well as other inputs based on the Company's pricing practices. Adjustments for other market and Company-specific factors are made as deemed necessary in determining ESP.

Under the estimated selling price method, revenue is recognized in MEAs based on estimated selling prices for all of the elements in the arrangement, assuming all other conditions for revenue recognition have been satisfied. To determine the estimated selling price, the Company establishes the selling price for its products and installation services using the Company's established pricing guidelines, and the proceeds are allocated between the elements and the arrangement.

When MEAs include an element of customer training, the Company determined it is not essential to the functionality, efficiency or effectiveness of the MEA due to its perfunctory nature in relation to the entire arrangement. Therefore the Company has concluded that this obligation is inconsequential and perfunctory. As such, for MEAs that include training, customer acceptance of said training is not deemed necessary in order to record the related revenue, but is recorded when the installation deliverable is fulfilled. Historically, training revenues have not been significant.

The Company provides call center support services to properties installed by the Company. The Company receives monthly service fees from such properties for its services. The Company recognizes the service fee ratably over the term of the contract. The prices for these services are fixed and determinable prior to delivery of the service. The fair value of these services is known due to objective and reliable evidence from standalone executed contracts. The Company reports such revenues as recurring revenues. Deferred revenue includes deferrals for the monthly support service fees. Long-term deferred revenue represents support service fees to be earned or provided beginning after September 30, 2018. Revenue recognized that has not yet been billed to a customer results in an asset as of the end of the period. As of September 30, 2017 and December 31, 2016, there was $68,855 and $193,400 recorded within accounts receivable, respectively, related to revenue recognized that has not yet been billed.

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, 2017 and the year ended December 31, 2016, the Company experienced returns of approximately 1.0% to 2.5% of materials included in the cost of sales. As of September 30, 2017 and December 31, 2016, the Company recorded warranty liabilities in the amount of $77,810 and $95,540, respectively, using this experience factor range.

Product warranties for the nine months ended September 30, 2017 and the year ended December 31, 2016 are as follows:

	September 30, 2017	December 31, 2016
Beginning balance	$ 95,540	$ 66,555
Warranty claims incurred	(48,767)	(115,120)
Provision charged to expense	31,037	144,105
Ending balance	$ 77,810	$ 95,540

Reclassifications

Certain amounts on the condensed consolidated balance sheets as of December 31, 2016 and statements of cash flows have been reclassified to conform to the current year presentation. The Company reclassified $106,743 from current assets of discontinued operations to cash and cash equivalents for certain EthoStream assets not sold to DCI on March 28, 2017. The Company reclassified $150,936 from current liabilities of discontinued operations to accrued liabilities and expenses for certain EthoStream liabilities not assumed by DCI on March 28, 2017. The reclassifications were not material and had no effect on the Company's total current assets, current liabilities or stockholders' equity as of December 31, 2016.

NOTE B – NEW ACCOUNTING PRONOUNCEMENTS

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (ASU 2014-09), which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP. The guidance for this standard was initially effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period, however in August 2015 the FASB delayed the effective date of the standard for one full year. Companies will adopt the standard using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a modified retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). The Company expects to adopt ASU 2014-09 as of January 1, 2018 with a cumulative effect adjustment to opening retained earnings, if necessary, under the modified retrospective approach. The Company has developed a project plan for the implementation of the new standard including a review of all revenue streams to identify any differences in the performance obligations, timing, measurement or presentation of revenue recognition. The Company's implementation of this ASU includes the evaluation of its customer agreements to identify terms or conditions that could be considered a performance obligation such that, if material to the terms of the contract, consideration would be allocated to the performance obligation and could accelerate or defer the timing of recognizing revenue. The Company also continues to evaluate the presentation of its principal versus agent arrangements. The Company's evaluation of its revenue streams and the treatment under the new guidance on the timing of revenue recognition and the allocation of revenue to the Company's goods and services is in process and any effect cannot be determined at this time.

In February 2016, the FASB issued ASU No. 2016-02, Leases ("ASU 2016-02"). The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the statement of operations. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is currently evaluating the impact of its pending adoption of ASU 2016-02 on its consolidated financial statements. Upon adoption, the Company expects that the ROU asset and lease liability will be recognized in the balance sheets in amounts that will be material.

In August 2016, the FASB issued ASU No. 2016-15, Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). The new standard provides guidance on the classification of certain transactions in the statement of cash flows, such as contingent consideration payments made in connection with a business combination and debt prepayment or extinguishment costs. ASU 2016-15 is effective for fiscal years beginning after December 15, 2017, including interim periods within that fiscal year. When adopted, the new guidance will be applied retrospectively. The Company is currently evaluating the impact of its pending adoption of ASU 2016-15 on its consolidated financial statements.

In May 2017, the FASB issued ASU 2017-09, Compensation — Stock Compensation — Scope of Modification Accounting ("ASU 2017-09"), which provides guidance about the types of changes to terms or conditions of a share-based payment award that would require an entity to apply modification accounting. The new guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The amendments in this update should be applied prospectively to an award modified on or after the adoption date.

NOTE C– ACCOUNTS RECEIVABLE

Components of accounts receivable as of September 30, 2017 and December 31, 2016 are as follows:

	September 30, 2017	December 31, 2016
Accounts receivable	$ 1,781,394	$ 1,438,345
Allowance for doubtful accounts	(12,173)	(34,573)
Accounts receivable, net	$ 1,769,221	$ 1,403,772

NOTE D – ACCRUED LIABILITIES AND EXPENSES

Accrued liabilities and expenses at September 30, 2017 and December 31, 2016 are as follows**:**

	September 30, 2017	December 31, 2016
Accrued liabilities and expenses	$ 589,288	$ 223,011
Accrued payroll and payroll taxes	354,293	331,908
Accrued sales taxes, penalties, and interest	72,331	274,869
Accrued interest	332	253
Product warranties	77,810	95,540
Total accrued liabilities and expenses	$ 1,094,054	$ 925,581

NOTE E – DEBT

Kross Promissory Note

On August 4, 2016, the Board of Directors authorized the Company to reimburse Peter T. Kross ("Mr. Kross") $161,075 for expenses incurred related to his successful contested proxy. Effective June 27, 2016, Mr. Kross became a director of the Company and is considered a related party. On August 30, 2016, Mr. Kross accepted an unsecured promissory note ("Kross Note") for $161,075 from the Company. The outstanding principal balance bore interest at the annual rate of 3.00%. Payment of interest and principal began on September 1, 2016 and continued monthly on the first day of each month thereafter through and including June 1, 2017. The Company was required to pay equal monthly installments of $16,330 which included all remaining principal and accrued interest owed by the Company to Mr. Kross under the Kross Note. The Company could prepay in advance any unpaid principal or interest due under the Kross Note without premium or penalty. The principal balance of the Kross Note as of September 30, 2017 and December 31, 2016 was zero and $97,127, respectively.

Revolving Credit Facility

On September 30, 2014, the Company and its wholly-owned subsidiary, EthoStream, as co-borrowers (collectively, the "Borrowers"), entered into a loan and security agreement (the "Heritage Bank Loan Agreement"), with Heritage Bank of Commerce, a California state chartered bank ("Heritage Bank"), governing a new revolving credit facility in a principal amount not to exceed $2,000,000 (the "Credit Facility"). Availability of borrowings under the Credit Facility from time to time 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 7.25% at September 30, 2017 and 6.75% at December 31, 2016. 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. The warrant has an exercise price of $0.20 and expires October 9, 2021. On February 17, 2016, an amendment to the Credit Facility was executed extending the maturity date to September 30, 2018, unless earlier accelerated under the terms of the Heritage Bank Loan Agreement.

The Heritage Bank Loan Agreement also contains financial covenants that place restrictions on, among other things, the incurrence of debt, granting of liens and sale of assets. The Heritage Bank Loan Agreement and amendments also contain financial covenants that require the Borrowers to maintain a minimum EBITDA level, measured quarterly, a minimum asset coverage ratio, measured monthly and minimum cash account balances. 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. As of September 30, 2017, the Company was in compliance with all financial covenants. The outstanding balance on the Credit Facility was $79,953 and $1,062,129 at September 30, 2017 and December 31, 2016, respectively. The remaining available borrowing capacity was approximately $1,304,000 and $107,000 at September 30, 2017 and December 31, 2016, respectively.

On March 28, 2017, the Company and the Company's wholly-owned subsidiary, EthoStream, entered into an Asset Purchase Agreement with DCI-Design Communications LLC ("DCI"), whereby DCI would acquire all of the assets and certain liabilities of EthoStream. Heritage Bank had provided the Company with its consent to the sale transaction. Upon closing of the sale transaction on March 29, 2017, the entire balance outstanding on the Credit Facility was repaid. On March 29, 2017 an amendment to the Credit Facility was executed amending the quarterly and year to date EBITDA compliance measurements for 2017.

On August 29, 2017, an amendment to the Credit Facility with Heritage Bank was executed to amend certain terms of the Heritage Bank Loan Agreement allowing for the issuance of corporate credit cards providing credit not to exceed $100,000. The Borrower may request credit advances in an aggregate outstanding amount not to exceed the borrowing limits set forth in the amendment.

On October 23, 2017, an amendment to the revolving credit facility with Heritage Bank was executed to amend certain terms of the Heritage Bank Loan Agreement. Among the terms of the amendment was that if the Company deviates from its projected EBITDA for the quarters ended September 30, 2017 or December 31, 2017, the Company will be deemed to be in compliance as of the measurement date if the Company's unrestricted cash maintained at Heritage Bank is in excess of $5,000,000. The amendment also extends the revolving credit facility's maturity date by one year to September 30, 2019.

NOTE F – PREFERRED STOCK

<u>Series A</u>

The Company has designated 215 shares of preferred stock as Series A Preferred Stock ("Series A"). Each share of Series A is convertible, at the option of the holder thereof, at any time, into shares of the Company's common stock at a conversion price of $0.363 per share. On November 16, 2009, the Company sold 215 shares of Series A with attached warrants to purchase an aggregate of 1,628,800 shares of the Company's common stock at $0.33 per share. The Series A shares were sold at a price per share of $5,000 and each Series A share is convertible into approximately 13,774 shares of common stock at a conversion price of $0.363 per share. The Company received $1,075,000 from the sale of the Series A shares. In prior years, 30 of the preferred shares issued on November 16, 2009 were converted to shares of the Company's common stock. In a prior year, the redemption feature available to the Series A holders expired.

<u>Series B</u>

The Company has designated 538 shares of preferred stock as Series B Preferred Stock ("Series B"). Each share of Series B is convertible, at the option of the holder thereof, at any time, into shares of the Company's common stock at a conversion price of $0.13 per share. On August 4, 2010, the Company sold 267 shares of Series B with attached warrants to purchase an aggregate of 5,134,626 shares of the Company's common stock at $0.13 per share. The Series B shares were sold at a price per share of $5,000 and each Series B share was convertible into approximately 38,461 shares of common stock at a conversion price of $0.13 per share. The Company received $1,335,000 from the sale of the Series B shares on August 4, 2010. On April 8, 2011, the Company sold 271 additional shares of Series B with attached warrants to purchase an aggregate of 5,211,542 shares of the Company's common stock at $0.13 per share. The Series B shares were sold at a price per share of $5,000 and each Series B share was convertible into approximately 38,461 shares of common stock at a conversion price of $0.13 per share. The Company received $1,355,000 from the sale of the Series B shares on April 8, 2011. In prior years, 486 of the preferred shares issued on August 4, 2010 and April 8, 2011 were converted to shares of the Company's common stock. In a prior year, the redemption feature available to the Series B holders expired.

Preferred stock carries certain preference rights as detailed in the Company's Amended 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, 2017, the liquidation preference of the preferred stock is based on the following order: first, Series B with a preference value of $409,009, which includes cumulative accrued unpaid dividends of $149,009, and second, Series A with a preference value of $1,507,481, which includes cumulative accrued unpaid dividends of $582,481. As of December 31, 2016, the liquidation preference of the preferred stock is based on the following order: first, Series B with a preference value of $393,435, which includes cumulative accrued unpaid dividends of $133,435, and second, Series A with a preference value of $1,452,114, which includes cumulative accrued unpaid dividends of $527,114.

NOTE G – 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. As of September 30, 2017 and December 31, 2016, 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, 2017 and December 31, 2016 the Company had 133,440,111 and 132,774,475 common shares issued and outstanding.

During the nine months ended September 30, 2016, 5,211,542 warrants were exercised for an aggregate of 5,211,542 shares of the Company's common stock at $0.13 per share. These warrants were originally granted to shareholders of the April 8, 2011 Series B preferred stock issuance.

During the nine months ended September 30, 2016, 3 shares of Series B preferred stock were converted to, in aggregate, 115,385 shares of common stock.

NOTE H – 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, 2017.

	Options Outstanding			Options Exercisable	
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 0.01 - $0.15	3,075,000	6.19	$ 0.14	3,075,000	$ 0.14
$ 0.16 - $0.99	2,476,800	3.44	0.18	2,246,800	0.18
	5,551,800	4.97	$ 0.16	5,321,800	$ 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, 2016	1,825,225	$ 0.28
Granted	1,300,000	0.17
Exercised	–	–
Cancelled or expired	(292,500)	0.69
Outstanding at December 31, 2016	2,832,725	$ 0.18
Granted	3,000,000	0.14
Exercised	–	–
Cancelled or expired	(280,925)	0.17
Outstanding at September 30, 2017	5,551,800	$ 0.16

The expected life of awards granted represents the period of time that they are expected to be outstanding. The Company determines the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules, exercise patterns and pre-vesting and post-vesting forfeitures. The Company estimates the volatility of the Company's common stock based on the calculated historical volatility of the Company's own common stock using the trailing 24 months of share price data prior to the date of the award. The Company bases the risk-free interest rate used in the Black-Scholes option valuation model on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term equal to the expected life of the award. The Company has not paid any cash dividends on the Company's common stock and does not anticipate paying any cash dividends in the foreseeable future. Consequently, the Company uses an expected dividend yield of zero in the Black-Scholes option valuation model. The Company uses historical data to estimate pre-vesting option forfeitures and record share-based compensation for those awards that are expected to vest. In accordance with ASC 718-10, the Company adjusts share-based compensation for changes to the estimate of expected equity award forfeitures based on actual forfeiture experience.

There were 3,000,000 and zero options granted and zero options exercised during the nine months ended September 30, 2017 and 2016, respectively. Total stock-based compensation expense in connection with options granted to employees recognized in the condensed consolidated statements of operations for the three and nine months ended September 30, 2017 and 2016 was $2,343 and $2,703, respectively, and $320,545 and $10,204, 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
$ 0.18	50,000	0.16	$ 0.18	50,000	$ 0.18
0.20	250,000	4.02	0.20	250,000	0.20
	300,000	3.38	$ 0.20	300,000	$ 0.20

Transactions involving warrants are summarized as follows:

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2016	5,638,410	$ 0.20
Issued	–	–
Exercised	(5,211,542)	0.13
Cancelled or expired	(126,868)	3.00
Outstanding at December 31, 2016	300,000	0.20
Issued	–	–
Exercised	–	–
Cancelled or expired	–	–
Outstanding at September 30, 2017	300,000	$ 0.20

There were no warrants granted, exercised, cancelled or forfeited during the nine months ended September 30, 2017 and no warrants granted, 5,211,542 warrants exercised and 126,868 cancelled or forfeited during the nine months ended September 30, 2016, respectively.

NOTE I – RELATED PARTY TRANSACTIONS

On August 4, 2016, the Board of Directors authorized the Company to reimburse Peter T. Kross ("Mr. Kross") $161,075 for expenses incurred related to his successful contested proxy. Effective June 27, 2016, Mr. Kross became a director of the Company and is considered a related party. On August 30, 2016, Mr. Kross accepted an unsecured promissory note ("Kross Note") for $161,075 from the Company. The outstanding principal balance bore interest at the annual rate of 3.00%. Payment of interest and principal began on September 1, 2016 and continued monthly on the first day of each month thereafter through and including June 1, 2017. The Company was required to pay equal monthly installments of $16,330 which included all remaining principal and accrued interest owed by the Company to Mr. Kross under the Kross Note. The Company could prepay in advance any unpaid principal or interest due under the Kross Note without premium or penalty. The principal balance of the Kross Note as of September 30, 2017 and December 31, 2016 was zero and $97,127, respectively.

During the nine months ended September 30, 2017, the Company issued common stock in the amount of $108,000 to the Company's non-employee directors as compensation for their attendance and participation in the Company's Board of Director and committee meetings.

On July 1, 2016, each newly elected Board of Director member, Mr. Kross, Mr. Blatt and Mr. Byrnes were granted 100,000 stock options pursuant to the Company's Board of Director compensation plan. These options have an expiration period of ten years, vest quarterly over five years and have an exercise price of $0.19.

Upon execution of their employment agreements during the nine months ended September 30, 2017, each of Messrs. Tienor, Sobieski and Koch, were granted 1,000,000 stock options at fair market value and all were scheduled to vest over a three year period. However, pursuant to the terms of the employment agreements, the stock options vested immediately upon the sale of the Company's subsidiary, EthoStream, in March 2017.

During the nine months ended September 30, 2017, Messrs. Tienor, Sobieski and Koch, earned a bonus of $29,250 contingent on the sale and sale price amount of Ethostream.

From time to time the Company may receive advances from certain of its officers in the form of salary deferment or cash advances to meet short term working capital needs. These advances may not have formal repayment terms or arrangements. As of September 30, 2017 and December 31, 2016, there were no such arrangements.

NOTE J – COMMITMENTS AND CONTINGENCIES

Office Lease Obligations

In October 2013, the Company entered into a lease agreement for 6,362 square feet of commercial office space in Waukesha, Wisconsin for its corporate headquarters. The Waukesha lease would have expired in April 2021, but was subsequently amended and extended through April 2026. On April 7, 2017 the Company executed an amendment to its' existing lease in Waukesha, Wisconsin to expand another 3,982 square feet, bringing the total leased space to 10,344 square feet. In addition, the lease term was extended from May 1, 2021 to April 30, 2026. The commencement date for this amendment was July 15, 2017.

In January 2016, the Company entered into a lease agreement for 2,237 square feet of commercial office space in Germantown, Maryland for its Maryland employees. The Germantown lease was set to expire at the end of January 2017. In December 2016, the Company entered into a first amendment to the lease agreement extending the lease through the end of January 2018.

In May 2017, the Company entered into a lease agreement for 5,838 square feet of floor space in Waukesha, Wisconsin for its inventory warehousing operations. The Waukesha lease expires in May 2027.

Commitments for minimum rentals under non-cancelable leases as of September 30, 2017 are as follows:

2017 (remainder of)	$	43,738
2018		153,063
2019		154,496
2020		164,903
2021		182,512
2022 and thereafter		764,024
Total	$	1,462,736

Rental expenses charged to continuing operations for the three and nine months ended September 30, 2017 and 2016 was $86,649 and $42,271 and $200,816 and $127,537, 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

During 2012, the Company engaged a sales tax consultant to assist in determining the extent of its potential sales tax exposure. Based upon this analysis, management determined the Company had probable exposure for certain unpaid obligations, including interest and penalty, of approximately $1,100,000 including and prior to the year ended December 31, 2011. The Company has approximately $72,000 and $275,000 accrued as of September 30, 2017 and December 31, 2016, respectively.

During the year ended December 31, 2016, the State of Wisconsin performed a sales and use tax audit covering the period from January 1, 2012 through December 31, 2015. The audit resulted in approximately $120,000 in additional use tax and interest. As of September 30, 2017, the Company paid in full the additional use tax liability and interest associated with the sales and use tax audit.

Prior to 2017, the Company successfully executed and paid in full VDAs in thirty six states totaling approximately $765,000 and is current with the subsequent filing requirements.

The following table sets forth the change in the sales tax accrual as of September 30, 2017 and December 31, 2016:

	September 30, 2017	December 31, 2016
Balance, beginning of year	$ 274,869	$ 229,768
Sales tax collected	235,091	452,016
Provisions (reversals)	(52,000)	151,000
Interest and penalties	-	(3,017)
Payments	(385,629)	(554,898)
Balance, end of period	$ 72,331	$ 274,869

NOTE K – BUSINESS CONCENTRATION

For the nine months ended September 30, 2017 and 2016, no single customer represented 10% or more of total net revenues. As of September 30, 2017, one customer accounted for approximately 10% of the Company's net accounts receivable. As of December 31, 2016, two customers accounted for approximately 24% of the Company's net accounts receivable.

Purchases from one supplier approximated $2,122,000, or 86%, of purchases for the nine months ended September 30, 2017 and $1,907,000, or 77%, of purchases for the nine months ended September 30, 2016. Total due to this supplier, net of deposits, was approximately $525,858 as of September 30, 2017, and $45,037 as of December 31, 2016.

NOTE L – DISCONTINUED OPERATIONS

In October of 2016, the Company, under the direction and authority of the Board of Directors, committed to a plan to offer for sale EthoStream, the Company's wholly–owned High-Speed Internet Access ("HSIA") subsidiary. As a result of this decision to sell EthoStream, the operating results of EthoStream as of and for the year ended December 31, 2016 were reclassified as discontinued operations and as assets and liabilities held for sale in the consolidated financial statements as detailed in the table below. During the nine months ended September 30, 2017, the Company, and EthoStream, entered into an Asset Purchase Agreement (the "Purchase Agreement") with DCI-Design Communications LLC ("DCI"), a Delaware limited liability company, whereby DCI acquired all of the assets and certain liabilities of EthoStream for a base purchase price of $12,750,000. The Purchase Agreement includes that proceeds of $900,000 are to be withheld from the $12,750,000 base purchase price and placed into an escrow account to support potential indemnification obligations of up to $800,000 and net working capital adjustments of up to $100,000. The escrow amount, net of potential claims, would be fully released after an escrow period not to exceed 12 months after closing. Another $93,000 is classified in other current assets as a net working capital receivable. The assets included, among other items, certain inventory, contracts and intellectual property. DCI acquired only the liabilities provided for in the Purchase Agreement. On March 29, 2017, pursuant to the terms and the conditions of the Purchase Agreement, the Company closed on the sale.

On September 27, 2017, the Company reached a final settlement with DCI on net working capital as set forth in the Purchase Agreement. On September 29, 2017, the Company received $100,000 from the escrow account for the portion of the escrow account set aside for net working capital adjustments and cash proceeds of $311,000 from DCI in the settlement of net working capital adjustments. The net working capital receivable of $93,000 in other current assets was applied against the cash proceeds of $311,000 received on September 29, 2017 resulting in a gain from sale of discontinued operations of $218,000 recognized during the three months ended September 30, 2017.

The following table summarizes the balance sheet information for discontinued operations.

	September 30, 2017	December 31, 2016
Accounts receivable, net	$ –	$ 456,478
Inventories	–	350,506
Other current assets	–	12,980
Other asset – goodwill	–	5,796,430
Other asset – intangible asset, net	–	533,577
Current assets of discontinued operations	–	7,149,971
Accounts payable	–	465,346
Accrued liabilities and expenses	–	90,187
Deferred revenues	–	37,509
Customer deposits	–	200,466
Deferred lease liability	–	76,096
Current liabilities of discontinued operations	–	869,604
Net assets of discontinued operations	$ –	$ 6,280,367

The following table summarizes the statements of operations information for discontinued operations.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Revenues, net:				
Product	$ –	$ 995,425	$ 653,839	$ 2,749,001
Recurring	–	1,038,585	925,837	2,985,550
Total Net Revenue	–	2,034,010	1,579,676	5,734,551
Cost of Sales:				
Product	(11,600)	565,276	403,004	1,753,994
Recurring	–	242,678	209,868	697,541
Total Cost of Sales	(11,600)	807,954	612,872	2,451,535
Gross Profit	11,600	1,226,056	966,804	3,283,016
Operating Expenses:				
Selling, general and administrative	197	315,437	252,307	896,385
Depreciation and amortization	–	60,420	60,420	181,697
Total Operating Expenses	197	375,857	312,727	1,078,082
Income from Discontinued Operations before Provision for Income Taxes	11,403	850,199	654,077	2,204,934
Provision for Income Taxes	–	51,312	52,017	153,936
Income from Discontinued Operations (net of tax)	$ 11,403	$ 798,887	$ 602,060	$ 2,050,998

The consolidated statements of cash flows do not present the cash flows from discontinued operations for investing activities or financing activities because there were no investing or financing activities associated with the discontinued operations in three and nine months ended September 30, 2017 and 2016.

NOTE M - SUBSEQUENT EVENT

On October 24, 2017, the Company announced a share repurchase program authorized by its Board of Directors. The share repurchase program does not obligate the Company to acquire any specific number of shares, but authorizes the Company to repurchase up to ten million shares of the Company’s common stock. Under the program, shares may be repurchased in privately negotiated and/or open market transactions. The program does not have a specific expiration date and may be suspended or discontinued at any time. As of the date of this filing, no shares have been repurchased under the program.

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, 2017, 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, 2016, filed with the U.S. Securities and Exchange Commission (the "SEC") on April 3, 2017.

Business

Telkonet, Inc. (the "Company", "Telkonet", "we", "our"), 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 October of 2016, the Company, under the direction and authority of the Board of Directors, committed to a plan to offer for sale EthoStream LLC ("EthoStream"), its wholly-owned High-Speed Internet Access ("HSIA") subsidiary. The sale will enable the Company to focus on its higher growth potential EcoSmart Platform line. As a result of this decision to sell EthoStream, the operating results of EthoStream for the three and nine months ended September 30, 2017 and 2016 have been reclassified as discontinued operations in the condensed consolidated statement of operations and as assets and liabilities of discontinued operations in the condensed consolidated balance sheet for the year ended December 31, 2016. The transaction closed on March 29, 2017.

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 2017 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

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires the Company to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. On an ongoing basis, the Company evaluates significant estimates used in preparing its condensed consolidated financial statements including those related to revenue recognition and allowances for uncollectible accounts receivable, inventory obsolescence, depreciation and amortization, long-lived asset valuations, impairment assessments, taxes and related valuation allowance, income tax provisions, stock-based compensation, and contingencies. The Company bases its estimates on historical experience, underlying run rates and various other assumptions that the Company believes to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results could differ from these estimates. The following are critical judgments, assumptions, and estimates used in the preparation of the condensed consolidated financial statements.

Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with ASC 605-10, "Revenue Recognition" and ASC 605-10-S99 guidelines that require that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectability is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the selling prices of the products delivered and the collectability of those amounts. Assuming all conditions for revenue recognition have been satisfied, product revenue is recognized when products are shipped and installation revenue is recognized when the services are completed. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. The guidelines also address the accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

Multiple-Element Arrangements ("MEAs"): The Company accounts for contracts that have both product and installation under the MEAs guidance in ASC 605-25. Arrangements under such contracts may include multiple deliverables consisting of a combination of equipment and services. The deliverables included in the MEAs are separated into more than one unit of accounting when (i) the delivered equipment has value to the customer on a stand-alone basis, and (ii) delivery of the undelivered service element(s) is probable and substantially in the Company's control. Arrangement consideration is then allocated to each unit, delivered or undelivered, based on the relative selling price of each unit of accounting based first on vendor-specific objective evidence ("VSOE") if it exists, second on third-party evidence ("TPE") if it exists and on estimated selling price ("ESP") if neither VSOE or TPE exist.

- VSOE – In most instances, products are sold separately in stand-alone arrangements. Services are also sold separately through renewals of contracts with varying periods. The Company determines VSOE based on pricing and discounting practices for the specific product or service when sold separately, considering geographical, customer, and other economic or marketing variables, as well as renewal rates or stand-alone prices for the service element(s).

- TPE – If the Company cannot establish VSOE of selling price for a specific product or service included in a multiple-element arrangement, the Company uses third-party evidence of selling price. The Company determines TPE based on sales of a comparable amount of similar product or service offered by multiple third parties considering the degree of customization and similarity of product or service sold.

- ESP – The estimated selling price represents the price at which the Company would sell a product or service if it were sold on a stand-alone basis. When neither VSOE nor TPE exists for all elements, the Company determines ESP for the arrangement element based on sales, cost and margin analysis, as well as other inputs based on the Company's pricing practices. Adjustments for other market and Company-specific factors are made as deemed necessary in determining ESP.

Under the estimated selling price method, revenue is recognized in MEAs based on estimated selling prices for all of the elements in the arrangement, assuming all other conditions for revenue recognition have been satisfied. To determine the estimated selling price, the Company establishes the selling price for its products and installation services using the Company's established pricing guidelines, and the proceeds are allocated between the elements and the arrangement.

When MEAs include an element of customer training, the Company determined it is not essential to the functionality, efficiency or effectiveness of the MEA due to its perfunctory nature in relation to the entire arrangement. Therefore the Company has concluded that this obligation is inconsequential and perfunctory. As such, for MEAs that include training, customer acceptance of said training is not deemed necessary in order to record the related revenue, but is recorded when the installation deliverable is fulfilled. Historically, training revenues have not been significant.

The Company provides call center support services to properties installed by the Company. The Company receives monthly service fees from such properties for its services. The Company recognizes the service fee ratably over the term of the contract. The prices for these services are fixed and determinable prior to delivery of the service. The fair value of these services is known due to objective and reliable evidence from standalone executed contracts. The Company reports such revenues as recurring revenues. Deferred revenue includes deferrals for the monthly support service fees. Long-term deferred revenue represents support service fees to be earned or provided beginning after September 30, 2018. Revenue recognized that has not yet been billed to a customer results in an asset as of the end of the period. As of September 30, 2017 and December 31, 2016, there was $68,855 and $193,400 recorded within accounts receivable, respectively, related to revenue recognized that has not yet been billed.

New Accounting Pronouncements

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 table below outlines product versus recurring revenues for comparable periods:

	Three Months Ended								
	September 30, 2017			September 30, 2016			Variance		
Product	$	1,904,571	94%	$	1,360,887	90%	$	543,684	40%
Recurring		131,665	6%		143,028	10%		(11,363)	-8%
Total	$	2,036,326	100%	$	1,503,915	100%	$	532,321	35%

	Nine Months Ended								
	September 30, 2017			September 30, 2016			Variance		
Product	$	5,728,878	94%	$	6,356,437	95%	$	(627,559)	-10%
Recurring		344,708	6%		340,412	5%		4,296	1%
Total	$	6,073,586	100%	$	6,696,849	100%	$	(623,263)	-9%

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 months ended September 30, 2017, product revenue increased by 40% or $0.5 million and for the nine months ended September 30, 2017, product revenue decreased 10% or $0.6 million. For the three months ended September 30, 2017, the hospitality market comprised $1.3 million of product sales for the three months ended September 30, 2017, a $0.1 million decrease from the prior year period. The education market sales for the three months ended September 30, 2017 increased $0.3 million to $0.4 million from $0.1 million for the prior year period. The Multiple Dwelling Unit ("MDU") market increased $0.2 million from $0.0 million during the three months ended September 30, 2016. The hospitality market sales for the nine months ended September 30, 2017 decreased $0.7 million to $4.2 million from $4.9 million for the prior year period. The education market sales for the nine months ended September 30, 2017 increased $0.1 million to $1.0 million from $0.9 million for the prior year period and the Commercial and MDU market sales for the nine months ended September 30, 2017 remained at $0.5 million for the nine months ended September 30, 2017 and 2016. The Company's distribution channels through resellers and value added distribution partners decreased from $3.1 million for the nine months ended September 30, 2016 to $2.8 million at September 30, 2017.

Recurring Revenue

Recurring revenue is attributed to our call center support services. The Company recognizes revenue ratably over the service month 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, 2017, recurring revenue decreased by 8% and increased by 1%, respectively, when compared to the prior year period.

Cost of Sales

	Three Months Ended					
	September 30, 2017		September 30, 2016		Variance	
Product	$ 1,160,019	61%	$ 770,830	57%	$ 389,189	50%
Recurring	55,702	42%	36,618	26%	19,084	52%
Total	$ 1,215,721	60%	$ 807,448	54%	$ 408,273	51%

	Nine Months Ended					
	September 30, 2017		September 30, 2016		Variance	
Product	$ 3,233,978	56%	$ 3,194,094	50%	$ 39,884	1%
Recurring	118,347	34%	92,324	27%	26,023	28%
Total	$ 3,352,325	55%	$ 3,286,418	49%	$ 65,907	2%

Costs of Product Revenue

Costs of product revenue include equipment and installation labor related to EcoSmart technology. For the three and nine months ended September 30, 2017, product costs increased by 50% and 1%, respectively, compared to the prior year periods. For the three month comparison, the materials costs as a percentage of product sales increased 2% to 45% for the three month ended September 30, 2017 from 43% for the three months ended September 30, 2016. The cost of materials increased $0.15 million, freight and warranty expense increased $0.04 million and inventory adjustments increased $0.08 million. For the three months ended September 30, 2017, the Company's increased use of outside contractors for installations resulted in a $0.19 million variance in contractor services costs, consequently, salary, benefits and travel costs related to installations decreased by $0.07 million.

For the nine month comparison, the use of outside contractors for installations resulted in a $0.20 million decrease in salary, wages and travel expense. These decreases were offset by a $0.16 million adjustment in inventory costs, a $0.03 million increase in freight costs, a $0.03 million increase in outside services and a $0.02 million increase in parts and supplies and warranty expense.

Costs of Recurring Revenue

Recurring costs are comprised of labor and telecommunication services for our customer service department. For the three and nine months ended September 30, 2017, recurring costs increased by 52% and 28%, respectively, when compared to the prior year periods. The three and nine month variances are the result of a $0.02 million and a $0.03 million increase in salary and benefit costs for the period ended September 30, 2017. The Company added a support services supervisor.

Gross Profit

	Three Months Ended					
	September 30, 2017		September 30, 2016		Variance	
Product	$ 744,552	39%	$ 590,057	43%	$ 154,495	26%
Recurring	75,963	58%	106,410	74%	(30,447)	-29%
Total	$ 820,515	40%	$ 696,467	46%	$ 124,048	18%

	Nine Months Ended					
	September 30, 2017		September 30, 2016		Variance	
Product	$ 2,494,900	44%	$ 3,162,343	50%	$ (667,443)	-21%
Recurring	226,361	66%	248,088	73%	(21,727)	-9%
Total	$ 2,721,261	45%	$ 3,410,431	51%	$ (689,170)	-20%

Gross Profit on Product Revenue

Gross profit for the three and nine months ended September 30, 2017 increased by 26% and decreased by 21%, respectively, when compared to the prior year periods. For the three months ended September 30, 2017, the actual gross profit percentage declined to 39% from 43%. The majority of the variance was due to an approximate increase of 20% for outside services. For the nine months ended September 30, 2017, the actual gross profit percentage declined to 44% from 50%. Material costs as a percentage of sales increased 3% for the nine months ended September 30, 2017 when compared to the prior year period. The inventory valuation adjustment variance of $0.16 million during the nine months ended September 30, 2017 when compared to the prior year period also contributed to gross profit decline.

Gross Profit on Recurring Revenue

The gross profit associated with recurring revenue decreased by 29% and 9%, respectively, for the three and nine months ended September 30, 2017 when compared to the prior year periods. For the three months ended September 30, 2017, the actual gross profit percentage decreased 16% compared to the prior year period, from 74% to 58%. The primary reason was a manager was added to the Company's support department, increasing wages and benefits. For the nine months ended September 30, 2017, the actual gross profit percentage decreased 7% compared to the prior year period, from 73% to 66%.

Operating Expenses

	Three Months Ended September 30,			
	2017	2016	Variance	
Total	$ 1,704,177	$ 1,870,493	$ (166,316)	-9%

	Nine Months Ended September 30,			
	2017	2016	Variance	
Total	$ 5,754,741	$ 6,357,622	$ (602,881)	-9%

During the three and nine months ended September 30, 2017, operating expenses decreased by 9% when compared to the prior year periods as outlined below.

Research and Development

	Three Months Ended September 30			
	2017	2016	Variance	
Total	$ 500,656	$ 429,622	$ 71,034	17%
	Nine Months Ended September 30,			
	2017	2016	Variance	
Total	$ 1,323,669	$ 1,321,007	$ 2,662	0%

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, 2017, research and development costs increased by 17% and 0%, respectively, when compared to the prior year periods. For the three month comparison, the variance is due to an approximate $0.04 million increase in expenditures for consulting, a $0.01 increase in personnel recruiting and an increase of $0.02 million for salary and benefits. For the nine month comparison, overall expense remained unchanged however there were changes within the research and development category. For the nine months ended September 30, 2017, a $0.06 million decrease was the result of retooling charges related to new product development for the prior year period. This was offset by a $0.04 million increase in consulting and a $0.02 million increase for new product certification expenses for the nine months ended September 30, 2017.

Selling, General and Administrative Expenses

	Three Months Ended September 30,			
	2017	2016	Variance	
Total	$ 1,188,905	$ 1,432,489	$ (243,584)	-17%
	Nine Months Ended September 30,			
	2017	2016	Variance	
Total	$ 4,396,667	$ 5,012,249	$ (615,582)	-12%

During the three and nine months ended September 30, 2017, selling, general and administrative expenses decreased over the prior year periods by 17% and 12%, respectively. For the three month comparison, due to the sale of EthoStream, the Company was able to decrease executive, accounting and sales salaries, wages and benefits by $0.20 million. A $0.07 million decrease was a result of a refund received from a utility. The Company had a $0.09 million decrease in sales and use tax, the result of a $0.10 million State of Wisconsin audit assessment during 2016 as well as a $0.06 million decrease in bad debt expense, the result of a collection previously reserved. These decreases were offset by increases for legal expense of $0.03 million, hardware/software expenses of $0.06 million, marketing and trade show expense of $0.05 million, rent expense of $0.04 million and commissions of $0.02 million.

For the nine month comparison, $0.29 million of the variance is attributed to the costs associated with the contested 2016 proxy contest as discussed in detail in the June 30, 2017 Form 10-Q as well as an additional $0.10 million in public company fees in 2016. Due to the sale of EthoStream, the Company was able to decrease temporary staffing, executive, accounting and sales salaries, wages and benefits of $0.61 million, $0.11 million for sales and use tax, related to the State of Wisconsin audit discussed above, a utility refund of $0.07 million, $0.03 million for director fees, $0.04 million for insurance expense. These reductions in expense were offset by an increase in stock option expense of $0.31 million, marketing and trade show expenses of $0.14 million, rent expense of $0.07 million, commissions of $0.02 million and hardware/software costs of $0.05 million.

Income from Discontinued Operations, Net of Tax

	Three Months Ended September 30,			
	2017	2016	Variance	
Total	$ 11,403	$ 798,887	$ (787,484)	-99%

	Nine Months Ended September 30,			
	2017	2016	Variance	
Total	$ 602,060	$ 2,050,998	$ (1,448,938)	-71%

Income from discontinued operations decreased $0.79 million or 99% and $1.45 million or 71% for the three and nine months ended September 30, 2017 over the prior year periods. On March 29, 2017, pursuant to the terms and the conditions of the Purchase Agreement, the Company closed on the sale of EthoStream. The income from discontinued operations (net of tax) represents the activity of EthoStream from January 1, 2017 through the date of the sale on March 28, 2017. After March 28, 2017, certain liabilities retained by the Company will be adjusted in future periods as these liability balances are paid.

EBITDA from Continuing 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, 2017 and 2016, 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 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 allows for a more transparent comparison of its financial results to the previous period.

- Bonuses paid to executives upon sale of discontinued operations: The Company does not consider the bonuses of $87,750 associated with the sale of EthoStream to be indicative of current or future operating performance. Therefore, the Company does not consider the inclusion of these costs helpful in assessing its current financial performance compared to the previous year.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2017	2016	2017	2016
Net loss from continuing operations	$ (871,340)	$ (1,192,083)	$ (3,034,984)	$ (2,995,699)
Interest (income) expense, net	(8,722)	15,482	(2,797)	45,308
Provision (benefit) for income taxes	(3,600)	2,575	4,301	3,200
Depreciation and amortization	14,616	8,382	34,405	24,366
EBITDA – continuing operations	(869,046)	(1,165,644)	(2,999,075)	(2,922,825)
Adjustments:				
Stock-based compensation	2,343	2,703	320,545	10,204
Bonuses paid to executives upon sale of discontinued operations	–	–	87,750	–
Adjusted EBITDA	$ (866,703)	$ (1,162,941)	$ (2,590,780)	$ (2,912,621)

Liquidity and Capital Resources

The Company has financed its operations since inception primarily through private and public offerings of the Company's equity securities, the issuance of various debt instruments and asset based lending, and the sale of assets.

Working Capital

Working capital (current assets in excess of current liabilities) from continuing operations increased by $9,840,658 during the nine months ended September 30, 2017 from working capital deficit of $26,859 at December 31, 2016 to working capital of $9,813,799 at September 30, 2017.

Kross Promissory Note

On August 4, 2016, the Board of Directors authorized the Company to reimburse Peter T. Kross ("Mr. Kross") $161,075 for expenses incurred related to his successful contested proxy. Effective June 27, 2016, Mr. Kross became a director of the Company and is considered a related party. On August 30, 2016, Mr. Kross accepted an unsecured promissory note ("Kross Note") for $161,075 from the Company. The outstanding principal balance bore interest at the annual rate of 3.00%. Payment of interest and principal began on September 1, 2016 and continued monthly on the first day of each month thereafter through and including June 1, 2017. The Company was required to pay equal monthly installments of $16,330 which included all remaining principal and accrued interest owed by the Company to Mr. Kross under the Kross Note. The Company could prepay in advance any unpaid principal or interest due under the Kross Note without premium or penalty. The principal balance of the Kross Note as of September 30, 2017 and December 31, 2016 was zero and $97,127, respectively.

Revolving Credit Facility

On September 30, 2014, the Company and its wholly-owned subsidiary, EthoStream, as co-borrowers (collectively, the "Borrowers"), entered into a loan and security agreement (the "Heritage Bank Loan Agreement"), with Heritage Bank of Commerce, a California state chartered bank ("Heritage Bank"), governing a new revolving credit facility in a principal amount not to exceed $2,000,000 (the "Credit Facility"). Availability of borrowings under the Credit Facility from time to time 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 7.25% at September 30, 2017 and 6.75% at December 31, 2016. 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. The warrant has an exercise price of $0.20 and expires October 9, 2021. On February 17, 2016, an amendment to the Credit Facility was executed extending the maturity date to September 30, 2018, unless earlier accelerated under the terms of the Heritage Bank Loan Agreement.

The Heritage Bank Loan Agreement also contains financial 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 that require the Borrowers to maintain a minimum EBITDA level, measured quarterly, and a minimum asset coverage ratio, measured monthly. 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 of the revolving credit facility was $79,953 as of September 30, 2017 and the remaining available borrowing capacity was approximately $1,304,000. As of September 30, 2017, the Company was in compliance with all financial covenants.

On March 28, 2017, the Company and the Company's wholly-owned subsidiary, EthoStream, entered into an Asset Purchase Agreement with DCI-Design Communications LLC ("DCI"), whereby DCI acquired all of the assets and certain liabilities of EthoStream. Heritage Bank provided the Company with its consent to the sale transaction. Upon closing of the sale transaction on March 29, 2017, the entire balance outstanding on the Credit Facility was repaid. On March 29, 2017 an amendment to the Credit Facility was executed amending the quarterly and year to date EBITDA compliance measurements for 2017.

On August 29, 2017, an amendment to the Credit Facility with Heritage Bank was executed to amend certain terms of the Heritage Bank Loan Agreement allowing for the issuance of corporate credit cards providing credit not to exceed $100,000. The Borrower may request credit advances in an aggregate outstanding amount not to exceed the borrowing limits set forth in the amendment.

On October 23, 2017, an amendment to the revolving credit facility with Heritage Bank was executed to amend certain terms of the Heritage Bank Loan Agreement. Among the terms of the amendment was that if the Company deviates from its projected EBITDA for the quarters ended September 30, 2017 or December 31, 2017, the Company will be deemed to be in compliance as of the measurement date if the Company's unrestricted cash maintained at Heritage Bank is in excess of $5,000,000. The amendment also extends the revolving credit facility's maturity date by one year to September 30, 2019.

Cash Flow Analysis

Cash used in continuing operations was $2,459,746 and $2,768,301 during the nine months ended September 30, 2017 and 2016, respectively. As of September 30, 2017, 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, 2017 were primarily related to an approximate $380,500 increase in accounts receivable, a $305,000 increase in inventory, a $305,000 increase in accounts payable, a $330,000 increase in deferred revenue and a $168,000 increase in accrued liabilities and expenses. The working capital changes during the nine months ended September 30, 2016 were primarily related to an approximately $469,000 decrease in accounts receivable, a $410,000 increase in inventory, a $535,000 decrease in accounts payable and a $300,000 increase in accrued liabilities and expenses. Accounts receivable fluctuates based on the negotiated billing terms with customers and collections. 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 provided by investing activities was $11,092,051 during the nine months ended September 30, 2017 and cash used in investing activities was $2,352 during the nine months ended September 30, 2016, respectively. During the nine months ended September 30, 2017, the cash provided by investing activities reflects the proceeds less adjustments associated with the sale of the assets and certain liabilities assumed of the Company's wholly-owned subsidiary, EthoStream and a decrease of $142,572 associated with the purchase of computer equipment and furniture, fixtures and equipment. Due to the sale of EthoStream, the Company extended the Waukesha lease, as discussed in Note J, and refurbished the corporate office to accommodate employee's previously working at the Milwaukee operations office. During the nine months ended September 30, 2016, the Company purchased $33,629 of computer equipment and had $31,277 of restricted cash related to a bonding requirement released.

Cash used in financing activities was $982,176 and cash provided by financing activities was $707,637 during the nine months ended September 30, 2017 and 2016, respectively. The Heritage Bank Loan Agreement for the Company's line of credit included the Company and EthoStream as co borrowers. Upon closing the EthoStream sale transaction on March 29, 2017, the entire balance outstanding on the Credit Facility, $1,062,129, was repaid and a net balance of $79,953 was subsequently borrowed during the three months ended September 30, 2017. During the nine months ended September 30, 2016, 5,211,542 warrants were exercised for an aggregate of 5,211,542 shares of the Company's common stock at $0.13 per share. These warrants were originally granted to shareholders of the April 8, 2011 Series B preferred stock issuance. Total proceeds received were $677,501. Cash used in financing activities to repay indebtedness was $79,864 and net cash paid on the line of credit was $110,000 during the nine months ended September 30, 2016.

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, along with competition will continue to present a challenging operating environment through 2017; therefore working capital management will continue to be a high priority for 2017. 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 anticipate significant purchases of property or equipment during the next twelve months. The amended and expanded Waukesha, Wisconsin lease requires furniture, shelving, computer equipment and peripherals to be used in the Company's day-to-day operations.

Item 4. Controls and Procedures.

As of September 30, 2017, the Company performed an evaluation, under the supervision and with the participation of management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures. Management has identified control deficiencies regarding the lack of segregation of duties due to the limited size of the Company's accounting department, a failure to implement adequate internal control over financial reporting including in our IT general control environment, and the need for a stronger internal control environment particularly in our financial reporting and close process. We lack sufficient personnel resources and technical accounting and reporting expertise to appropriately address certain accounting and financial reporting matters in accordance with generally accepted accounting principles. We did not have an adequate process or appropriate controls in place to support the accurate reporting of our financial results and disclosures on our Form 10-Q. Management of the Company believes that these material weaknesses are due to the small size of the Company's accounting staff. The small size of the Company's accounting staff may prevent adequate controls in the future, such as segregation of duties, due to the cost/benefit of such remediation. The Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were ineffective as of the end of the period covered by this report.

During the nine months ended September 30, 2017, there were no changes in the Company's internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the Company's internal control 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 have been no material changes to risk factors previously disclosed in our annual report on Form 10-K for the year ended December 31, 2016 in response to Item 1A of Form 10-K.

Item 6. Exhibits.

Exhibit Number	Description Of Document
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, 2017	By: /s/ Jason L. Tienor Jason L. Tienor Chief Executive Officer (principal executive officer)
Date: November 14, 2017	By: /s/ Richard E. Mushrush Richard E. Mushrush Chief Financial Officer (principal financial officer)

EXHIBIT 31.1

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 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, 2017

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

EXHIBIT 31.2

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 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, 2017

By: /s/ Richard E. Mushrush
Richard E. Mushrush
Chief Financial Officer

EXHIBIT 32.1

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, 2017 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, 2017

EXHIBIT 32.2

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, 2017 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, 2017