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 June 30, 2013

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.)
10200 Innovation Drive, Suite 300, Milwaukee, WI	53226
(Address of Principal Executive Offices)	(Zip Code)

(414) 223-0473
(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 or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐	Accelerated filer ☐
Non-accelerated filer ☐ (Do not check if a smaller reporting company)	Smaller reporting company ☒

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

The number of shares outstanding of the registrant's common stock, par value $0.001 per share, as of August 1, 2013 is 114,526,073.

TELKONET, INC.
FORM 10-Q for the Three and Six Months Ended June 30, 2013

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TELKONET, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	June 30, 2013	December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$ 715,116	$ 1,163,758
Restricted cash on deposit	382,000	–
Accounts receivable, net	2,401,093	3,026,107
Inventories	913,786	654,912
Prepaid expenses	112,822	189,879
Total current assets	4,524,817	5,034,656
Property and equipment, net	46,524	35,898
Other assets:		
Goodwill	8,570,446	8,570,446
Intangible assets, net	1,379,457	1,500,297
Deposits	34,238	34,238
Total other assets	9,984,141	10,104,981
Total Assets	$ 14,555,482	$ 15,175,535
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,954,338	$ 1,967,030
Notes payable – current	259,129	74,611
Accrued liabilities and expenses	2,055,167	2,342,047
Deferred revenues	438,656	117,556
Customer deposits	525,744	118,763
Total current liabilities	5,233,034	4,620,007
Long-term liabilities:		
Deferred lease liability	133,062	133,609
Notes payable – long term	529,232	813,928
Total long-term liabilities	662,294	947,537
Redeemable preferred stock:		
15,000,000 shares authorized, par value $.001 per share		
Series A; 215 shares issued, 185 shares outstanding at June 30, 2013 and December 31, 2012, respectively, preference in liquidation of $1,192,512 and $1,176,076 as of June 30, 2013 and December 31, 2012, respectively	1,093,289	1,041,837
Series B; 538 shares issued, 483 and 493 shares outstanding at June 30, 2013 and December 31, 2012, respectively, preference in liquidation of $2,903,019 and $2,884,833 as of June 30, 2013 and December 31, 2012, respectively	2,423,186	2,223,752
Total redeemable preferred stock	3,516,475	3,265,589
Commitments and contingencies		
Stockholders' Equity		
Common stock, par value $.001 per share; 190,000,000 shares authorized; 108,487,616 and 108,103,001 shares issued and outstanding at June 30, 2013 and December 31, 2012, respectively	108,488	108,103
Additional paid-in-capital	124,022,663	124,188,415
Accumulated deficit	(118,987,472)	(117,954,116)
Total stockholders' equity	5,143,679	6,342,402
Total Liabilities and Stockholders' Equity	$ 14,555,482	$ 15,175,535

See accompanying notes to the unaudited condensed consolidated financial statements

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	**2012**	**2013**	**2012**
Revenues, net:				
Product	$ 2,659,751	$ 2,401,683	$ 4,825,251	$ 3,319,612
Recurring	935,745	1,060,228	1,897,879	2,070,900
Total Net Revenue	3,595,496	3,461,911	6,723,130	5,390,512
Cost of Sales:				
Product	1,848,081	1,201,855	3,277,627	1,802,664
Recurring	270,517	276,815	536,680	566,724
Total Cost of Sales	2,118,598	1,478,670	3,814,307	2,369,388
Gross Profit	1,476,898	1,983,241	2,908,823	3,021,124
Operating Expenses:				
Research and development	287,291	250,501	589,433	481,065
Selling, general and administrative	1,806,351	1,495,927	3,266,944	2,927,708
Depreciation and amortization	64,729	61,478	128,847	134,076
Total Operating Expenses	2,158,371	1,807,906	3,985,224	3,542,849
Income (Loss) from Operations	(681,473)	175,335	(1,076,401)	(521,725)
Other Income (Expenses):				
Interest income (expense), net	18,061	(33,559)	1,423	(65,323)
Gain on sale of product line	41,902	15,408	41,902	15,408
Total Other Income (Expense)	59,963	(18,151)	43,325	(49,915)
Income (Loss) Before Provision for Income Taxes	(621,510)	157,184	(1,033,076)	(571,640)
Provision for Income Taxes	–	–	280	–
Net Income (Loss)	(621,510)	157,184	(1,033,356)	(571,640)
Accretion of preferred dividends and discount	(127,989)	(224,113)	(300,886)	(414,866)
Net loss attributable to common stockholders	$ (749,499)	$ (66,929)	$ (1,334,242)	$ (986,506)
Net loss per common share:				
Net loss attributable to common stockholders per common share – basic	$ 0.00	$ 0.00	$ (0.01)	$ (0.01)
Net loss attributable to common stockholders per common share – diluted	$ 0.00	$ 0.00	$ (0.01)	$ (0.01)
Weighted Average Common Shares Outstanding – basic	108,179,079	104,518,000	108,141,250	104,434,663
Weighted Average Common Shares Outstanding – diluted	108,179,079	104,518,000	108,141,250	104,434,663

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)
SIX MONTHS FROM JANUARY 1, 2013 THROUGH JUNE 30, 2013

	Common Shares	Common Stock Amount	Additional Paid-in-Capital	Accumulated Deficit	Total Stockholders' Equity
Balance at January 1, 2013	108,103,001	$ 108,103	$ 124,188,415	$ (117,954,116)	$ 6,342,402
Stock-based compensation expense related to employee stock options	–	–	85,519	–	85,519
Shares issued on conversion of preferred stock at approximately $0.13 per share	384,615	385	49,615	–	50,000
Accretion of redeemable preferred stock discount	–	–	(216,264)	–	(216,264)
Accretion of redeemable preferred stock dividends	–	–	(84,622)	–	(84,622)
Net loss				(1,033,356)	(1,033,356)
Balance at June 30, 2013	108,487,616	$ 108,488	$ 124,022,663	$ (118,987,472)	$ 5,413,679

See accompanying notes to the unaudited condensed consolidated financial statements

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

	Six Months Ended June 30, 2013	Six Months Ended June 30, 2012
Cash Flows from Operating Activities:		
Net loss	$ (1,033,356)	$ (571,640)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Gain on sale of product line	(41,902)	(15,408)
Stock-based compensation expense	85,519	174,669
Depreciation	8,007	13,236
Amortization	120,840	120,840
Provision for doubtful accounts	64,543	11,850
Changes in assets and liabilities:		
Accounts receivable	560,471	(116,646)
Inventories	(258,874)	(350,612)
Prepaid expenses	77,057	26,039
Accounts payable	(12,692)	173,548
Accrued liabilities and expenses	(286,880)	272,040
Deferred revenue	321,100	51,243
Customer deposits	406,981	55,691
Deferred lease liability	(547)	10,682
Net Cash Provided By (Used In) Operating Activities	10,267	(144,468)
Cash Flows From Investing Activities:		
Purchase of property and equipment	(18,633)	(34,119)
Deposit of restricted cash	(382,000)	–
Net Cash Used In Investing Activities	(400,633)	(34,119)
Cash Flows From Financing Activities:		
Payments on note payable	(58,276)	(36,878)
Net Cash Used In Financing Activities	(58,276)	(36,878)
Net decrease in cash and cash equivalents	(448,642)	(215,465)
Cash and cash equivalents at the beginning of the period	1,163,758	961,091
Cash and cash equivalents at the end of the period	$ 715,116	$ 745,626

See accompanying notes to the unaudited condensed consolidated financial statements

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

	Six Months Ended June 30,	
	2013	**2012**
Supplemental Disclosures of Cash Flow Information:		
Cash transactions:		
Cash paid during the period for interest expense	$ 9,194	$ 3,395
Non-cash transactions:		
Accretion of discount on redeemable preferred stock	$ 216,264	$ 279,582
Accretion of dividends on redeemable preferred stock	84,622	135,284
Conversion of preferred stock to common stock	50,000	–

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") 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 three and six months ended June 30, 2013, are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated December 31, 2012 financial statements and footnotes thereto included in the Company's Form 10-K filed with the SEC.

Business and Basis of Presentation

Telkonet, Inc., formed in 1999 and incorporated under the laws of the state of Utah, is made up of two synergistic business divisions, EcoSmart Energy Management Technology and EthoStream High Speed Internet Access (HSIA) Network. Prior to January 1, 2007, the Company was primarily engaged in the business of developing, producing and marketing proprietary equipment enabling the transmission of voice and data communications over a building's internal electrical wiring.

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

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

In March 2011, the Company sold all its Series 5 PLC power line carrier product line and related assets to Wisconsin-based Dynamic Ratings, Inc. under an Asset Purchase Agreement.

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

Going Concern

The accompanying condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern. The Company reported a net loss of $1,033,356 for the six months ended June 30, 2013, and has an accumulated deficit of $118,987,472 and total current liabilities in excess of current assets of $708,217 as of June 30, 2013.

Although we had net income for the year ended December 31, 2012 and positive cash flows from operations for the six months ended June 30, 2013, these results have not been achieved on a consistent basis. Our ability to continue as a going concern is subject to our ability to consistently generate a profit and positive operating cash flows and/or obtain necessary funding from outside sources, including by the sale of our securities or assets, or obtaining loans from financial institutions, where possible. We may also experience net operating losses in the future and the uncertainty regarding contingent liabilities cast doubt on our ability to satisfy such liabilities and the Company cannot make any representations for fiscal 2013 and beyond. The accompanying condensed consolidated financial statements do not include any adjustments that might result from the outcome of these uncertainties.

The Company believes that anticipated cash flows from operations may be insufficient to satisfy its ongoing capital requirements for at least the next 12 months. In May 2013, the Company entered into a Revolving Credit Facility, the principal not to exceed $2,000,000. This credit facility is available for working capital and other lawful business purposes. The Company's borrowing base at June 30, 2013 was $530,813 and the outstanding balance was $0. Management believes that the Company will be able to generate additional revenues and continued positive cash flows that will allow the Company to continue as a going concern.

Restricted Cash on Deposit

During 2012, the Company was awarded a contract with a bonding requirement. The Company satisfied this requirement during the six months ended June 30, 2013, with cash collateral supported by an irrevocable standby letter of credit in the amount of $382,000 which expires September 30, 2013. The amount is presented as restricted cash on deposit on the condensed consolidated balance sheets.

Goodwill and Other Intangibles

In accordance with the accounting guidance on goodwill and other intangible assets, we perform an annual impairment test of goodwill and other tangible assets at our reporting unit level, or more frequently if events or circumstances change that would more likely than not reduce the fair value of our reporting units below their carrying value. Amortization is recorded for other intangible assets with determinable lives using the straight line method over the 12 year estimated useful life. Goodwill is subject to a periodic impairment assessment by applying a fair value test based upon a two-step method. The first step of the process compares the fair value of the reporting unit with the carrying value of the reporting unit, including any goodwill. We utilize a discounted cash flow valuation methodology to determine the fair value of the reporting unit. This approach is developed from management's forecasted cash flow data. If the fair value of the reporting unit exceeds the carrying amount of the reporting unit, goodwill is deemed not to be impaired. If the carrying amount exceeds fair value, we calculate an impairment loss. Any impairment loss is measured by comparing the implied fair value of goodwill to the carrying amount of goodwill at the reporting unit, with the excess of the carrying amount over the fair value recognized as an impairment loss.

Long-Lived Assets

We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable in accordance with ASC 360-10 "Impairment and Disposal of Long-Lived Assets". Recoverability is measured by comparison of the carrying amount to the future net cash flows which the assets are expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the projected future cash flows arising from the asset determined by management to be commensurate with the risk inherent to our current business model.

Income (Loss) per Common Share

The Company computes net income (loss) per share under ASC 260-10, "Earnings Per Share". Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of shares outstanding of common stock. Diluted income (loss) per share is computed using the weighted average number of common and common stock equivalent shares outstanding during the year. Dilutive common stock equivalents consist of shares issuable upon the exercise of the Company's outstanding stock options and warrants. As a result of the losses in the periods ended June 30, 2013 and 2012, there were 11,402,512 and 15,077,652 shares of common stock underlying options and warrants excluded, respectively, as their inclusion would have been anti-dilutive.

Estimates

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

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, accounting in interim periods and disclosure and transition related to the uncertainty in these income tax positions.

Revenue Recognition

For revenue from product sales, we recognize revenue in accordance with ASC 605-10, "Revenue Recognition" and ASC Topic 13 guidelines that require that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) 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. 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 large contracts that have both product and installation under the MEAs guidance in ASC 605. The Company believes the volume of these large contracts will continue to increase. Arrangements under such contracts may include multiple deliverables, 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 our control. Arrangement consideration is then allocated to each unit, delivered or undelivered, based on the relative selling price ("RSP") 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. We determine VSOE based on its 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 we cannot establish VSOE of selling price for a specific product or service included in a multiple-element arrangement, we use third-party evidence of selling price. We determine TPE based on sales of 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 we would sell a product or service if it were sold on a stand-alone basis. When neither VSOE nor TPE exists for all elements, we determine ESP for the arrangement element based on sales, cost and margin analysis, as well as other inputs based on our pricing practices. Adjustments for other market and Company-specific factors are made as deemed necessary in determining ESP.

When MEAs include an element of customer training, it is not essential to the functionality, efficiency or effectiveness of the MEA. 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.

We provide call center support services to properties installed by us and also to properties installed by other providers. In addition, we provide the property with the portal to access the Internet. We receive monthly service fees from such properties for our services and Internet access. We recognize 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 contracts and standalone sales. We report such revenues as recurring revenues.

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 six months ended June 30, 2013 and the year ended December 31, 2012, the Company experienced returns of approximately 1% to 4% of material's included in the cost of sales. As of June 30, 2013 and December 31, 2012, the Company recorded warranty liabilities in the amount of $77,443 and $69,743, respectively.

Product warranties for the six months ended June 30, 2013 and the year ended December 31, 2012 are as follows:

	June 30, 2013	December 31, 2012
Beginning balance	$ 69,743	$ 104,423
Warranty claims incurred	(4,429)	(66,278)
Provision charged to expense	12,129	31,598
Ending balance	$ 77,443	$ 69,743

Stock-Based Compensation

We account for our stock based awards in accordance with ASC 718-10, "Compensation", which requires a fair value measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors, including employee stock options and restricted stock awards. We estimate the fair value of stock options granted using the Black-Scholes valuation model. This model requires us to make estimates and assumptions including, among other things, estimates regarding the length of time an employee will hold vested stock options before exercising them, the estimated volatility of our common stock price and the number of options that may be forfeited prior to vesting. The fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. Changes in these estimates and assumptions can materially affect the determination of the fair value of stock-based compensation and consequently, the related amount recognized in our condensed consolidated statements of operations.

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. For 2013 and prior years, expected stock price volatility is based on the historical volatility of the Company's stock for the related vesting periods.

Stock-based compensation expense in connection with options granted to employees for the three and six months ended June 30, 2013 and 2012 was $83,496 and $97,504, and $85,519 and $103,669, respectively.

Deferred Lease Liability

Rent expense is recorded on a straight-line basis over the term of the lease. Rent escalations and rent abatement periods during the term of the lease create a deferred lease liability which represents the excess of cumulative rent expense recorded to date over the actual rent paid to date.

Lease Abandonment

On July 15, 2011, the Company executed a sublease agreement for approximately 12,000 square feet of commercial office space in Germantown, Maryland. Because we no longer have access to this subleased space, we recorded a charge of $59,937 in accrued liabilities and expenses related to this abandonment during 2011. On June 27, 2012 the subtenant exercised the option to extend the expiration of the term of the sublease from January 31, 2013 to December 31, 2015 and we recorded an additional charge of $132,174. The remaining liability at June 30, 2013 was $113,169 and at December 31, 2012 was $135,975.

NOTE B – NEW ACCOUNTING PRONOUNCEMENTS

There were no recent pronouncements that have had or may have a significant effect on our financial statements. We do not discuss recent pronouncements that are not anticipated to have an impact on or are unrelated to our financial condition, results of operations or related disclosures.

NOTE C – INTANGIBLE ASSETS AND GOODWILL

Total identifiable intangible assets acquired and their carrying values at June 30, 2013 are:

	Cost	Accumulated Amortization	Carrying Value	Weighted Average Amortization Period (Years)
Amortized Identifiable Intangible Assets:				
Subscriber lists – EthoStream	$ 2,900,000	$ (1,520,543)	$ 1,379,457	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(1,520,543)	1,379,457	
Goodwill – EthoStream	5,796,430	–	5,796,430	
Goodwill – SSI	2,774,016	–	2,774,016	
Total Goodwill	8,570,446	–	8,570,446	
Total	$ 11,470,446	$ (1,520,543)	$ 9,949,903	

Total identifiable intangible assets acquired and their carrying values at December 31, 2012 are:

	Cost	Accumulated Amortization	Accumulated Impairment	Carrying Value	Weighted Average Amortization Period (Years)
Amortized Identifiable Intangible Assets:					
Subscriber lists – EthoStream	$ 2,900,000	$ (1,399,703)	$ –	$ 1,500,297	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(1,399,703)	–	1,500,297	
Goodwill – EthoStream	8,796,430	–	(3,000,000)	5,796,430	
Goodwill – SSI	5,874,016	–	(3,100,000)	2,774,016	
Total Goodwill	14,670,446		(6,100,000)	8,570,446	
Total	$ 17,570,446	$ (1,399,703)	$ (6,100,000)	$ 10,070,743	

Total amortization expense charged to operations for each of the three and six months ended June 30, 2013 and 2012 was $60,420 and $120,840.

Estimated future amortization expense as of June 30, 2013 is as follows:

Remainder of 2013	$ 120,840
2014	241,680
2015	241,680
2016	241,680
2017	241,680
2018 and after	291,897
Total	$ 1,379,457

The Company does not amortize goodwill. The Company recorded goodwill in the amount of $14,670,446 as a result of the acquisitions of EthoStream and SSI during the year ended December 31, 2007. The Company evaluates goodwill for impairment based on the fair value of the operating business units to which this goodwill relates at least once a year. We utilize a discounted cash flow valuation methodology (income approach) to determine the fair value of the reporting unit. Since acquisition, the Company has written off $3,000,000 and $3,100,000 of goodwill for Ethostream and Smart Systems International, respectively.

NOTE D – ACCOUNTS RECEIVABLE

Components of accounts receivable as of June 30, 2013 and December 31, 2012 are as follows:

	June 30, 2013	December 31, 2012
Accounts receivable	$ 2,435,702	$ 3,096,914
Allowance for doubtful accounts	(34,609)	(70,807)
Accounts receivable, net	$ 2,401,093	$ 3,026,107

NOTE E – INVENTORIES

Components of inventories as of June 30, 2013 and December 31, 2012 are as follows:

	June 30, 2013	December 31, 2012
Merchandise purchased for resale	$ 1,008,086	$ 768,812
Reserve for obsolescence	(94,300)	(113,900)
Inventory, net	$ 913,786	$ 654,912

NOTE F – ACCRUED LIABILITIES AND EXPENSES

Accrued liabilities and expenses at June 30, 2013 and December 31, 2012 are as follows**:**

	June 30, 2013	December 31, 2012
Accrued liabilities and expenses	$ 489,847	$ 717,731
Accrued payroll and payroll taxes	383,370	345,384
Accrued sales taxes, penalties, and interest	1,101,163	1,188,136
Accrued interest	3,344	21,053
Product warranties	77,443	69,743
Total	$ 2,055,167	$ 2,342,047

NOTE G – LONG TERM DEBT

On September 11, 2009, the Company entered into a Loan Agreement in the aggregate principal amount of $300,000 with the Wisconsin Department of Commerce (the "Department"). The outstanding principal balance bears interest at the annual rate of 2%. Payment of interest and principal is to be made in the following manner: (a) payment of any and all interest that accrues from the date of disbursement commenced on January 1, 2010 and continued on the first day of each consecutive month thereafter through and including December 31, 2010; (b) commencing on January 1, 2011 and continuing on the first day of each consecutive month thereafter through and including November 1, 2016, the Company shall pay equal monthly installments of $4,426 each; followed by a final installment on December 1, 2016 which shall include all remaining principal, accrued interest and other amounts owed by the Company to the Department under the Loan Agreement. The Company may prepay amounts outstanding under the credit facility in whole or in part at any time without penalty. The Loan Agreement is secured by substantially all of the Company's assets and the proceeds from this loan were used for the working capital requirements of the Company. The Loan Agreement contains covenants which require, among other things, that the Company shall keep and maintain 75 existing full-time positions and create and fill 35 additional full-time positions in Milwaukee, Wisconsin by December 31, 2012. On June 18, 2012, the Department agreed to waive all penalties associated with the Company's noncompliance with this covenant. The outstanding borrowings under the agreement as of June 30, 2013 and December 31, 2012 were $179,328 and $203,947, respectively.

Promissory Note

On March 4, 2011, the Company sold all its Series 5 PLC product line assets to Wisconsin-based Dynamic Ratings, Inc. ("Purchaser") under an Asset Purchase Agreement ("APA"). Per the APA, the Company signed an unsecured Promissory Note (the "Note") due to purchaser in the aggregate principal amount of $700,000. The outstanding principal balance bears interest at the annual rate of 6% and was originally due on March 31, 2014. The Note may be prepaid in whole or in part, without penalty at any time. The Note contains certain earn-out provisions that encompass both the Company's and Purchaser's revenue volumes. Amounts earned under the earn-out provisions were applied against the Note on June 30, 2012 and June 30, 2013. For the periods ended June 30, 2013 and June 30, 2012, the non-cash reduction of principal calculated under these provisions and applied to the Note was $41,902 and $15,408, respectively. Payments not made when due, by maturity acceleration or otherwise, shall bear interest at the rate of 12% per annum from the date due until fully paid. Effective April 30, 2013, Purchaser approved an amendment to certain terms of the Note. Telkonet commenced a monthly payment of principal and interest of $20,000 to be applied against the outstanding balance starting May 1, 2013. The interest rate remains unchanged at 6% and the maturity date was extended to January 1, 2016. The outstanding principal balance of the Note as of June 30, 2013 and December 31, 2012 was $609,033 and $684,592, respectively.

Revolving Credit Facility

On May 31, 2013, the Company entered into a Revolving Credit Facility (the "Agreement") with Bridge Bank, NA, (the "Bank") in a principal amount not to exceed $2,000,000. The Agreement is subject to a borrowing base that is equal to the sum of 80% of the Company's eligible accounts receivable and 25% of the eligible inventory. The Agreement is available for working capital and other lawful general corporate purposes. The outstanding principal balance of the facility bears interest at Prime Rate plus 2.75%. The Company's borrowing base at June 30, 2013 was $530,813 and the outstanding balance was $0.

Aggregate annual future maturities of long-term debt as of June 30, 2013 are as follows:

Years ended December 31,		Amount
2013 (remainder of)	$	127,888
2014		265,985
2015		280,295
2016		114,193
		788,361
Less: Current portion		(259,129)
Notes payable long term	$	529,232

NOTE H – REDEEMABLE PREFERRED STOCK

Series A

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 our Common Stock at an initial conversion price of $0.363 per share. In the event of a change of control (as defined in the purchase agreement with respect to the Series A), or at the holder's option, on November 19, 2014 and for a period of 180 days thereafter, provided that at least 50% of the shares of Series A issued on the Series A Original Issue Date remain outstanding as of November 19, 2014, and the holders of at least a majority of the then outstanding shares of Series A provide written notice requesting redemption of all shares of Series A, we are required to redeem the Series A for the purchase price plus any accrued but unpaid dividends. The Series A accrues dividends at an annual rate of 8% of the original purchase price, payable only when, as, and if declared by our Board of Directors.

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. Since the Series A may ultimately be redeemable at the option of the holder, the carrying value of the preferred stock, net of discount and including accumulated dividends, has been classified as redeemable preferred stock on the condensed consolidated balance sheets.

A portion of the proceeds were allocated to the warrants based on their relative fair value, which totaled $287,106 using the Black Scholes option pricing model. Further, the Company attributed a beneficial conversion feature of $70,922 to the Series A preferred shares based upon the difference between the effective conversion price of those shares and the closing price of the Company's common stock on the date of issuance. The assumptions used in the Black-Scholes model were as follows: (1) dividend yield of 0%; (2) expected volatility of 123%, (3) weighted average risk-free interest rate of 2.2%, (4) expected term of 5 years, and (5) estimated fair value of Telkonet common stock of $0.24 per share. The expected term of the warrants represents the estimated period of time until exercise and is based on historical experience of similar awards and giving consideration to the contractual terms. The amounts attributable to the warrants and beneficial conversion feature, aggregating $358,028, were recorded as a discount and deducted from the face value of the preferred stock. The discount is being amortized over the period from issuance to November 19, 2014 (the initial redemption date) as a charge to additional paid-in capital (since there is a deficit in retained earnings).

The charge to additional paid in capital for amortization of Series A discount and costs for the three and six months ended June 30, 2013 and 2012 was $17,508 and $21,697 and $35,016 and $39,598, respectively.

For the three and six months ended June 30, 2013 and 2012, we have accrued dividends for Series A in the amount of $ (1,817) and $18,454 and $16,436 and $36,908, respectively, and cumulative accrued dividends of $267,512 and $213,756, respectively. The accrued dividends have been charged to additional paid-in capital (since there is a deficit in retained earnings) and the net unpaid accrued dividends been added to the carrying value of the preferred stock.

Series B

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 our Common Stock at an initial conversion price of $0.13 per share. In the event of a change of control (as defined in the purchase agreement with respect to the Series B), or at the holder's option, on November 19, 2014 and for a period of 180 days thereafter, provided that at least 50% of the shares of Series B issued on the Series B Original Issue Date remain outstanding as of November 19, 2014, and the holders of at least a majority of the then outstanding shares of Series B provide written notice requesting redemption of all shares of Series B, we are required to redeem the Series B for the purchase price plus any accrued but unpaid dividends. The Series B accrues dividends at an annual rate of 8% of the original purchase price, payable only when, as, and if declared by our Board of Directors.

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 is 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. Since the Series B may ultimately be redeemable at the option of the holder, the carrying value of the preferred stock, net of discount and including accumulated dividends, has been classified as redeemable preferred stock on the condensed consolidated balance sheets.

A portion of the proceeds was allocated to the warrants based on their relative fair value, which totaled $394,350 using the Black-Scholes option pricing model. Further, the Company attributed a beneficial conversion feature of $394,350 to the Series B preferred shares based upon the difference between the effective conversion price of those shares and the closing price of the Company's common stock on the date of issuance. The assumptions used in the Black-Scholes model were as follows: (1) dividend yield of 0%; (2) expected volatility of 123%, (3) weighted average risk-free interest rate of 1.76%, (4) expected term of approximately 4 years, and (5) estimated fair value of Telkonet common stock of $0.109 per share. The expected term of the warrants represents the estimated period of time until exercise and is based on historical experience of similar awards and giving consideration to the contractual terms. The amounts attributable to the warrants and beneficial conversion feature, aggregating $788,700, were recorded as a discount and deducted from the face value of the preferred stock. The discount is being amortized over the period from issuance to November 19, 2014 (the initial redemption date) as a charge to additional paid-in capital (since there is a deficit in retained earnings).

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 is 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. Since the Series B shares may ultimately be redeemable at the option of the holder, the carrying value of the Series B shares, net of discount and including accumulated dividends, has been classified as redeemable preferred stock on the condensed consolidated balance sheet.

A portion of the proceeds were allocated to the warrants based on their relative fair value, which totaled $427,895 using the Black-Scholes option pricing model. Further, the Company attributed a beneficial conversion feature of $427,895 to the Series B shares based upon the difference between the effective conversion price of those shares and the closing price of the Company's common stock on the date of issuance. The assumptions used in the Black-Scholes model are as follows: (1) dividend yield of 0%; (2) expected volatility of 129%, (3) weighted average risk-free interest rate of 0.26%, (4) expected life of approximately 3.5 years, and (5) estimated fair value of Telkonet common stock of $0.12 per share. The expected term of the warrants represents the estimated period of time until exercise and is based on historical experience of similar awards and giving consideration to the contractual terms. The amounts attributable to the warrants and beneficial conversion feature, aggregating $855,790, have been recorded as a discount and deducted from the face value of the Series B shares. The discount is being amortized over the period from issuance to November 19, 2014 (the initial redemption date) as a charge to additional paid-in capital (since there is a deficit in retained earnings).

The charge to additional paid in capital for amortization of Series B discount and costs for the three and six months ended June 30, 2013 and 2012 was $92,760 and $134,774 and $181,248 and $239,984, respectively.

For the three and six months ended June 30, 2013 and 2012, we have accrued dividends for Series B in the amount of $19,538 and $49,188 and $68,186 and $98,376, respectively, and cumulative accrued dividends of $488,019 and $320,373 as of June 30 2013 and 2012, respectively. The accrued dividends have been charged to additional paid-in capital (since there is a deficit in retained earnings) and the net unpaid accrued dividends been added to the carrying value of the preferred stock.

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. Liquidation preference of the preferred stock is based on the following order: first, Series B with a preference value of $2,903,019 and second, Series A with a preference value of $1,192,512. Both series of preferred stock are equal in their dividend preference over common stock.

NOTE I – CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock (designated and undesignated), with a par value of $.001 per share. As of June 30, 2013 and December 31, 2012 the Company had 215 and 538 shares of preferred stock issued and 185 and 185 and 483 and 493 shares outstanding, designated Series A and B preferred stock, respectively.

The Company has authorized 190,000,000 shares of common stock with a par value of $.001 per share. As of June 30, 2013 and December 31, 2012 the Company had 108,487,616 and 108,103,001 common shares issued and outstanding, respectively.

During the three months ended June 30, 2013, 10 shares of Series B redeemable preferred stock were converted to 384,615 shares of common stock.

During the six months ended June 30, 2012, the Company issued 431,721 shares of common stock to directors and management for services performed through June 30, 2012. These shares were valued at $71,000, which approximated the fair value of the shares when they were issued.

NOTE J – 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.

	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	175,000	4.32	$ 0.14	175,000	$ 0.14
$0.16 - $0.99	1,420,225	9.23	0.18	1,165,225	0.18
$1.00 - $5.99	190,000	2.28	3.14	190,000	3.14
	1,785,225	8.01	$ 0.49	1,530,225	$ 0.54

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

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2012	685,000	$ 1.45
Granted	915,642	0.19
Exercised	–	–
Cancelled or expired	(320,000)	1.16
Outstanding at December 31, 2012	1,280,642	$ 0.62
Granted	504,583	0.18
Exercised	–	–
Cancelled or expired	–	–
Outstanding at June 30, 2013	1,785,225	$ 0.49

The expected life of awards granted represents the period of time that they are expected to be outstanding. We determine the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules, exercise patterns and pre-vesting and post-vesting forfeitures. We estimate the volatility of our common stock based on the calculated historical volatility of our own common stock using the trailing 24 months of share price data prior to the date of the award. We base 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. We have not paid any cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero in the Black-Scholes option valuation model. We use historical data to estimate pre-vesting option forfeitures and record share-based compensation for those awards that are expected to vest. In accordance with ASC 718-10, we adjust share-based compensation for changes to the estimate of expected equity award forfeitures based on actual forfeiture experience.

There were 504,583 and 615,642 options granted and no options exercised during the six months ended June 30, 2013 and 2012, 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 six months ended June 30, 2013 and 2012 was $83,496 and $97,504 and $85,519 and $103,669, respectively.

Warrants

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

	Warrants Outstanding			Warrants Exercisable	
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 0.13	7,439,240	2.62	$ 0.13	7,439,240	$ 0.13
0.33	1,628,800	1.39	0.33	1,628,800	0.33
3.00	549,247	1.93	3.00	549,247	3.00
	9,617,287	2.38	$ 0.32	9,617,287	$ 0.32

Transactions involving warrants are summarized as follows:

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2012	14,921,920	$ 0.50
Issued	–	–
Exercised	(3,115,390)	0.13
Canceled or expired	(976,114)	2.20
Outstanding at December 31, 2012	10,830,416	0.45
Issued	–	–
Exercised	–	–
Canceled or expired	(1,213,129)	1.42
Outstanding at June 30, 2013	9,617,287	$ 0.32

The Company did not issue any warrants during the six month periods ended June 30, 2013 and 2012.

NOTE K – COMMITMENTS AND CONTINGENCIES

Office Lease Obligations

The Company presently leases approximately 14,000 square feet of office space in Milwaukee, Wisconsin for its corporate headquarters. The Milwaukee lease expires in March 2020.

The Company presently leases 16,416 square feet of commercial office space in Germantown, Maryland. The lease commitments expire in December 2015. On July 15, 2011, Telkonet executed a sublease agreement for 11,626 square feet of the office space in Germantown, Maryland. On June 27, 2012 the subtenant exercised the option to extend the expiration of the term of the sublease from January 31, 2013 to December 31, 2015.

Commitments for minimum rentals under non-cancelable leases at June 30, 2013 are as follows:

2013 (remainder of)	$ 188,878
2014	414,267
2015	426,399
2016	169,155
2017	174,099
2018 and thereafter	410,184
Total	$ 1,782,982

Expected rent payments to be received under the sublease agreement at June 30, 2013 are as follows:

2013 (remainder of)	$ 66,280
2014	134,872
2015	138,919
Total	$ 340,071

Rental expenses charged to operations for the three and six months ended June 30, 2013 and 2012 were $129,320 and $128,919 and $267,295 and $261,959, respectively. Rental income received for the three and six months ended June 30, 2013 and 2012 was $32,332 and $31,389 and $64,664 and $62,778, respectively.

Employment Agreements

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

Jason L. Tienor, President and Chief Executive Officer, is employed pursuant to an employment agreement dated May 1, 2013. Mr. Tienor's employment agreement has a term of two years, which may be extended by mutual agreement of the parties, and provides, among other things, for an annual base salary of $206,000 per year and bonuses and benefits based on our internal policies and participation in our incentive and benefit plans.

Jeffrey J. Sobieski, Chief Operating Officer, is employed pursuant to an employment agreement dated May 1, 2013. Mr. Sobieski's employment agreement has a term of two years, which may be extended by mutual agreement of the parties, and provides for a base salary of $195,700 per year and bonuses and benefits based upon our internal policies and participation in our incentive and benefit plans.

Gerrit J. Reinders, Executive Vice President-Global Sales and Marketing, is employed pursuant to an employment agreement, dated May 1, 2013. Mr. Reinder's employment agreement is for a term expiring on May 1, 2014, is renewable at the agreement of the parties and provides for a base salary of at least $154,500 per year.

In addition to the foregoing, stock options are periodically granted to employees under the Company's 2010 Equity Incentive Plan at the discretion of the Compensation Committee of the Board of Directors. Executives of the Company are eligible to receive stock option grants, based upon individual performance and the performance of the Company as a whole.

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.

Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc.

On July 1, 2008, Linksmart Wireless Technology, LLC, or Linksmart, filed a civil lawsuit in the Eastern District of Texas against EthoStream, LLC, our wholly-owned subsidiary and 22 other defendants (*Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc., et al*, U.S. District Court, for the Eastern District of Texas, Marshall Division, No. 2:08-cv-00264). This lawsuit alleges that the defendants' services infringe a wireless network security patent held by Linksmart. Linksmart seeks a permanent injunction enjoining the defendants from infringing, inducing the infringement of, or contributing to the infringement of its patent, an award of damages and attorney's fees.

Defendant Ramada Worldwide, Inc. provided us with notice of the suit and demanded that we defend and indemnify it pursuant to a vendor direct supplier agreement between EthoStream and WWC Supplier Services, Inc., a Ramada affiliate (wherein we agreed to indemnify, defend and hold only Ethostream supported Ramada properties harmless from and against claims of infringement). After a review of that agreement, it was determined that EthoStream owes the duty to defend and indemnify with respect to services provided by Telkonet to Ramada and it has assumed Ramada's defense.

The parties in the lawsuit agreed to and the Court ordered a stay of the litigation pending the conclusion of a reexamination proceeding in the U.S. Patent and Trademark Office relating to the patent involved in the lawsuit. The case was reopened in early 2012 based on the expectation that a reexamination certificate would be issued by the Patent Office. The reexamination certificate has been issued. After the case resumed, the parties agreed to a "transfer" of the case from the Eastern District of Texas to the Central District of California. To accomplish the "transfer," with the agreement of the parties, the Texas case was dismissed and a new action was filed in California on April 5, 2012. (*Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc., et al*, U.S. District Court, for the Central District of California, Southern Division, No. SACV 12-522-JST). The parties have answered the complaint filed in the new action and the court has set the litigation calendar with trial set for June 2014. Management is presently unable to predict the ultimate resolution of this matter.

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 $1,101,000 accrued as of June 30, 2013. The Company continues to manage the liability by establishing voluntary disclosure agreements ("VDAs") with applicable states, which establishes a maximum look-back period and payment arrangements. However, if the aforementioned methods prove unsuccessful and the Company is examined or challenged by taxing authorities, there exists possible exposure of an additional $620,000, not including any applicable interest and penalties.

During 2012, the Company successfully executed, and paid in full, VDAs in five states totaling approximately $23,000 and is current with the subsequent filing requirements. It has submitted VDAs with an additional twenty-seven states and awaits notification of acceptance. Two states offer no voluntarily disclosure program. The Company also confirmed that one customer had self-assessed, further reducing our liability and expense associated with that liability by approximately $151,000.

During the six months ended June 30, 2013, the Company successfully executed and paid in full four states totaling approximately $27,000. In addition, the Company executed VDAs with two other states and has established payment plan agreements with these states.

The following table sets forth the change in the sales tax accrual as of June 30, 2013 and December 31, 2012:

	June 30, 2013	December 31, 2012
Balance, beginning of year	$ 1,188,133	$ 1,068,314
Collections	190,664	277,374
Provisions	(118,913)	(119,255)
Interest and penalties	7,342	32,696
Payments	(166,063)	(70,996)
Balance, end of period	$ 1,101,163	$ 1,188,133

NOTE L – BUSINESS CONCENTRATION

For the six months ended June 30, 2013 and 2012, no single customer represented 10% or more of total net revenues.

Purchases from two major suppliers approximated $1,235,063, or 62%, of purchases, and $964,632, or 70%, of purchases, for the six months ended June 30, 2013 and 2012, respectively. Total due to these suppliers, net of deposits, was approximately $455,000 as of June 30, 2013, and $1,744 as of June 30, 2012.

NOTE M – SUBSEQUENT EVENT

From July 17, 2013 through July 26, 2013, 157 shares of Series B redeemable preferred shares were converted to 6,038,457 shares of common stock.

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 six months ended June 30, 2013, 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, 2012, filed April 1, 2013.

Business

Telkonet, Inc., formed in 1999 and incorporated under the laws of the state of Utah, is made up of two synergistic business divisions, EcoSmart Energy Management Technology and EthoStream High Speed Internet Access (HSIA) Network.

Our EcoSmart Suite of products (which include Telkonet's legacy "SmartEnergy" products) provides comprehensive savings, management and reporting of a building's room-by-room energy consumption. Telkonet's energy management products are currently installed in over 200,000 rooms in properties within the hospitality, military, educational and healthcare markets. The EcoSmart technology platform is rapidly being recognized as a leading solution-provider for reducing energy consumption, carbon footprints and eliminating the need for new energy generation in these marketplaces – all while improving occupant comfort and convenience.

Controlling energy consumption can make a significant impact on a property owner's bottom line, as heating, ventilation and air conditioning ("HVAC") costs represent a substantial portion of a facility's overall utility bill. Hospitality is a key market for Telkonet. According to the EPA EnergySTAR for Hospitality analysis, the median hotel uses approximately 70,000 Btu/ft2 from all energy sources. Since fewer than 20% of the hotels in North America have an energy management system, there is considerable opportunity to assist those lodging facilities that are more energy intensive than necessary. With approximately 47,000 hotels in the USA alone, the market size is substantial.

Telkonet's EthoStream is one of the largest public High-Speed Internet Access ("HSIA") providers in the world, providing services to more than 5.1 million users monthly across a network of greater than 2,300 locations. With a wide range of product and service offerings and one of the most comprehensive management platforms available for HSIA networks, EthoStream offers solutions for any public access location.

Our direct sales efforts target 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 we've focused our sales efforts in areas with available public funding and incentives, such as rebate programs offered by utilities for efficiency upgrades. Through our proprietary platform, technology and partnerships with energy efficiency providers, we intend to position our Company as a leading provider of energy management solutions.

Telkonet's Series 5 Smart Grid networking technology allows commercial, industrial and consumer users to connect intelligent devices to a communications network using the existing low voltage electrical grid. Series 5 technology uses power line communications, or PLC, technology to transform existing electrical infrastructure into a communications backbone. Operating at 200 Mbps, the PLC platform offers a secure alternative in grid communications, transforming a traditional electrical distribution system into a "smart grid" that delivers electricity in a manner that can save energy, reduce cost and increase reliability.

On March 4, 2011, the Company sold its Series 5 PLC product line and related business assets to Dynamic Ratings, Inc. ("Dynamic Ratings"). The sales price was $1,000,000 in cash. In connection with the sale, Dynamic Ratings lent $700,000 to the Company in the form of a 6% promissory note dated March 4, 2011. Concurrently with the sale, the Company entered into a Distributorship Agreement and a Consulting Agreement with Dynamic Ratings. Under the Distributorship Agreement, the Company was designated as a distributor of the Series 5 product to non-utility markets and will receive preferred pricing for purchases of Series 5 product. Under the Consulting Agreement, the Company agreed to provide Dynamic Ratings with ongoing transition assistance and consulting services for the Series 5 product. The Distributorship Agreement and the Consulting Agreement have initial terms that expire on March 31, 2013 and March 31, 2014, respectively. Proceeds payable to the Company under the Distributorship Agreement and the Consulting Agreement for a stated period of time will be applied against the outstanding accrued interest and principal balance of the Promissory Note.

Forward Looking Statements

In accordance with the Private Securities Litigation Reform Act of 1995, we 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 2013 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 us to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. On an ongoing basis, we evaluate significant estimates used in preparing our condensed consolidated financial statements including those related to revenue recognition, uncollectible accounts receivable, guarantees and product warranties, stock-based compensation, potential impairment of goodwill and other long-lived assets, contingent liabilities and business combinations. We base our estimates on historical experience, underlying run rates and various other assumptions that we believe to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results could differ from these estimates. The following are critical judgments, assumptions, and estimates used in the preparation of the condensed consolidated financial statements.

Revenue Recognition

For revenue from product sales, we recognize revenue in accordance with ASC 605-10, and ASC Topic 13 guidelines that require that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) 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. 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 large contracts that have both product and installation under the MEAs guidance in ASC 605. The Company believes the volume of these large contracts will continue to increase. Arrangements under such contracts may include multiple deliverables, 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 our control. Arrangement consideration is then allocated to each unit, delivered or undelivered, based on the relative selling price (“RSP”) 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. We determine VSOE based on its 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 we cannot establish VSOE of selling price for a specific product or service included in a multiple-element arrangement, we use third-party evidence of selling price. We determine TPE based on sales of 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 we would sell a product or service if it were sold on a stand-alone basis. When neither VSOE nor TPE exists for all elements, we determine ESP for the arrangement element based on sales, cost and margin analysis, as well as other inputs based on our pricing practices. Adjustments for other market and Company-specific factors are made as deemed necessary in determining ESP.

When MEAs include an element of customer training, it is not essential to the functionality, efficiency or effectiveness of the MEA. 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.

We provide call center support services to properties installed by us and also to properties installed by other providers. In addition, we provide the property with the portal to access the Internet. We receive monthly service fees from such properties for our services and Internet access. We recognize 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 contracts and standalone sales. We report such revenues as recurring revenues.

Total revenues do not include sales tax as we consider ourselves a pass through conduit for collection and remitting sales tax.

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								
	June 30, 2013			June 30, 2012			Variance		
Product	$	2,659,751	74%	$	2,401,683	69%	$	258,068	11%
Recurring		935,745	26%		1,060,228	31%		(124,483)	-12%
Total	$	3,595,496	100%	$	3,461,911	100%	$	133,585	4%

	Six Months Ended								
	June 30, 2013			June 30, 2012			Variance		
Product	$	4,825,251	72%	$	3,319,612	62%	$	1,505,639	45%
Recurring		1,897,879	28%		2,070,900	38%		(173,021)	-8%
Total	$	6,723,130	100%	$	5,390,512	100%	$	1,332,618	25%

Product Revenue

Product revenue principally arises from the sale and installation of EcoSmart Suite of products, SmartGrid and High Speed Internet Access equipment. These include TSE, Telkonet Series 5, Telkonet iWire, and wireless networking products. We market and sell to the hospitality, education, healthcare and government/military markets. The Telkonet Series 5 and the Telkonet iWire products consist of the Telkonet Gateways, Telkonet Extenders, the patented Telkonet Coupler, and Telkonet iBridges. The EcoSmart Suite of products consists of thermostats, sensors, controllers, wireless networking products switches, outlets and a control platform. The HSIA product suite consists of gateway servers, switches and access points.

For the three and six months ended June 30, 2013, product revenue increased by 11% and 45% respectively, when compared to the prior year periods. Product revenue in 2013 includes approximately $2.2 million attributed to the sale and installation of energy management products, and approximately $2.6 million for the sale and installation of HSIA products. The increase in product revenue can be attributed to management's commitment of resources to sales and marketing efforts and personnel.

Recurring Revenue

Recurring revenue is primarily attributed to recurring 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. The recurring revenue consists primarily of HSIA support services and advertising revenue. Advertising revenue is based on impression-based statistics for a given period from customer site visits to the Company's login portal page under the terms of advertising agreements entered into with third-parties. A component of our recurring revenue is derived from fees, less payback costs, associated with approximately 1% of our hospitality customers who do not internally manage guest-related, internet transactions.

Recurring revenue includes approximately 2,300 hotels in our broadband network portfolio. We currently support approximately 234,000 HSIA rooms. For the three and six months ended June 30, 2013, recurring revenue decreased by 12% and 8% when compared to the prior year periods. The decrease of recurring revenue was attributed to a decrease in advertising revenue and management's decision not to pursue renewing customer accounts with lower profit margins.

Cost of Sales

	Three Months Ended					
	June 30, 2013		June 30, 2012		Variance	
Product	$ 1,848,081	69%	$ 1,201,855	50%	$ 646,226	54%
Recurring	270,517	29%	276,815	26%	(6,298)	-2%
Total	$ 2,118,598	59%	$ 1,478,670	43%	$ 639,928	43%

	Six Months Ended					
	June 30, 2013		June 30, 2012		Variance	
Product	$ 3,277,627	68%	$ 1,802,664	54%	$ 1,474,963	82%
Recurring	536,680	28%	566,724	27%	(30,044)	-5%
Total	$ 3,814,307	57%	$ 2,369,388	44%	$ 1,444,919	61%

Product Costs

Costs of product sales include equipment and installation labor related to the sale of SmartGrid and broadband networking equipment, including EcoSmart technology and Telkonet iWire. For the three and six months ended June 30, 2013, product costs as a percentage of sales increased by 54% and 82% when compared to the prior year periods. The variances were attributed to the increase in product sales, increased travel expenses and subcontractor services associated with the installations.

Recurring Costs

Recurring costs are comprised of labor and telecommunication services for our Customer Service department. For the three and six months ended June 30, 2013, recurring costs decreased by 2% and 5% when compared to the prior year period. The variance is attributed to the decrease in Internet Service Provider costs associated with recurring sales.

Gross Profit

	Three Months Ended					
	June 30, 2013		June 30, 2012		Variance	
Product	$ 811,670	31%	$ 1,199,828	50%	$ (388,158)	-32%
Recurring	665,228	71%	783,413	74%	(118,185)	-15%
Total	$ 1,476,898	41%	$ 1,983,241	57%	$ (506,343)	-26%

	Six Months Ended					
	June 30, 2013		June 30, 2012		Variance	
Product	$ 1,547,624	32%	$ 1,516,948	46%	$ 30,676	2%
Recurring	1,361,199	72%	1,504,176	73%	(142,977)	-10%
Total	$ 2,908,823	43%	$ 3,021,124	56%	$ (112,301)	-4%

Product Gross Profit

The gross profit on product revenue for the three months ended June 30, 2013 decreased by 32% when compared to the prior year period. The variance was a result of increased cost of installations on energy management and HSIA sales. The gross profit on product revenue for the six months ended June 30, 2013 increased by 2% when compared to the prior year period. The variance was a result of increased product sales on energy management and HSIA sales.

Recurring Gross Profit

Our gross profit associated with recurring revenue decreased by 15% and 10% for the three and six months ended June 30, 2013. The decrease was mainly due to a decrease in advertising revenue which yields higher gross profit margins.

Operating Expenses

	Three Months Ended June 30,						
	2013		2012		Variance		
Total	$	2,158,371	$	1,807,906	$	350,465	19%

	Six Months Ended June 30,						
	2013		2012		Variance		
Total	$	3,985,224	$	3,542,849	$	442,375	12%

During the three and six months ended June 30, 2013, operating expenses increased by 19% and 12% when compared to the prior year periods. The increase is the result of executive bonuses, continuing development of our EcoSmart Suite product line and additional sales and marketing staff.

Research and Development

	Three Months Ended June 30,						
	2013		2012		Variance		
Total	$	287,291	$	250,501	$	36,790	15%

	Six Months Ended June 30,						
	2013		2012		Variance		
Total	$	589,433	$	481,065	$	108,368	23%

Our research and development costs related to both present and future products are expensed in the period incurred. Current research and development costs are associated with product development and integration. During the three and six months ended June 30, 2013, research and development costs increased 15% and 23% when compared to the prior year periods. The increase is due to additional expenditures for salaries, consulting, test equipment and tooling.

Selling, General and Administrative Expenses

	Three Months Ended June 30,						
	2013		2012		Variance		
Total	$	1,806,351	$	1,495,927	$	310,424	21%

	Six Months Ended June 30,						
	2013		2012		Variance		
Total	$	3,266,944	$	2,927,708	$	339,236	12%

During the three and six months ended June 30, 2013, selling, general and administrative expenses increased over the comparable prior year periods by 21% and 12%. The increase is primarily the result of expenditures for sales personnel, travel and consulting fees.

Liquidity and Capital Resources

We have financed our operations since inception primarily through private and public offerings of our equity securities, the issuance of various debt instruments and asset based lending, and cash generated from operations.

Working Capital

Our working capital decreased by $1,122,866 during the six months ended June 30, 2013 from working capital (current assets in excess of current liabilities) of $414,649 at December 31, 2012 to a working capital deficit (current liabilities in excess of current assets) of $708,217 at June 30, 2013.

Business Loan

On September 11, 2009, the Company entered into a Loan Agreement in the aggregate principal amount of $300,000 with the Wisconsin Department of Commerce (the "Department"). The outstanding principal balance bears interest at the annual rate of 2%. Payment of interest and principal is to be made in the following manner: (a) payment of any and all interest that accrues from the date of disbursement commenced on January 1, 2010 and continued on the first day of each consecutive month thereafter through and including December 31, 2010; (b) commencing on January 1, 2011 and continuing on the first day of each consecutive month thereafter through and including November 1, 2016, the Company shall pay equal monthly installments of $4,426 each; followed by a final installment on December 1, 2016 which shall include all remaining principal, accrued interest and other amounts owed by the Company to the Department under the Loan Agreement. The Company may prepay amounts outstanding under the credit facility in whole or in part at any time without penalty. The Loan Agreement is secured by substantially all of the Company's assets and the proceeds from this loan were used for the working capital requirements of the Company. The Loan Agreement contains covenants which require, among other things, that the Company shall keep and maintain 75 existing full-time positions and create and fill 35 additional full-time positions in Milwaukee, Wisconsin by December 31, 2012. On June 18, 2012, the Department agreed to waive all penalties associated with the Company's noncompliance with this covenant. The outstanding borrowings under the agreement as of June 30, 2013 and December 31, 2012 were $179,328 and $203,947, respectively.

Promissory Note

On March 4, 2011, the Company sold all its Series 5 PLC product line assets to Wisconsin-based Dynamic Ratings, Inc. ("Purchaser") under an Asset Purchase Agreement ("APA"). Per the APA, the Company signed an unsecured Promissory Note (the "Note") due to Purchaser in the aggregate principal amount of $700,000. The outstanding principal balance bears interest at the annual rate of 6% and was originally due on March 31, 2014. The Note may be prepaid in whole or in part, without penalty at any time. The Note contains certain earn-out provisions that encompass both the Company's and Purchaser's revenue volumes. Amounts earned under the earn-out provisions were applied against the Note on June 30, 2012 and June 30, 2013. For the periods ended June 30, 2013 and June 30, 2012, the non-cash reduction of principal calculated under these provisions and applied to the Note was $41,902 and $15,408, respectively. Payments not made when due, by maturity acceleration or otherwise, shall bear interest at the rate of 12% per annum from the date due until fully paid. Effective April 30, 2013, Purchaser approved an amendment to certain terms of the Note. Telkonet commenced a monthly payment of principal and interest of $20,000 to be applied against the outstanding balance starting May 1, 2013. The interest rate remains unchanged at 6% and the maturity date was extended to January 1, 2016. The outstanding borrowings under the Note as of June 30, 2013 and December 31, 2012 were $609,033 and $684,592, respectively.

Revolving Credit Facility

On May 31, 2013, the Company entered into a Revolving Credit Facility (the "Agreement") with Bridge Bank, NA, in a principal amount not to exceed $2,000,000. The Agreement is subject to a borrowing base that is equal to the sum of 80% of the Company's eligible accounts receivable and 25% of the eligible inventory. The Agreement is available for working capital and other lawful general corporate purposes. The outstanding principal balance of the facility bears interest at Prime Rate plus 2.75%. The Company's borrowing base at June 30, 2013 was $530,813 and the outstanding balance was $0.

Cash Flow Analysis

Cash provided by continuing operations was $10,267 during the six months ended June 30, 2013 and cash used in continuing operations was $144,468 during the six months ended June 30, 2012. As of June 30, 2013, our primary capital needs included business strategy execution, inventory procurement and managing current liabilities.

Cash used in investing activities from continuing operations was $400,633 and $34,119 during the six months ended June 30, 2013 and 2012, respectively. During the year ended December 31, 2012, the Company was awarded a contract that required a bonding requirement. During the six months ended June 30, 2013, the Company satisfied this requirement with cash collateral supported by an irrevocable standby letter of credit in the amount of $382,000.

Cash used in financing activities to repay indebtedness was $58,276 and $36,878 during the six months ended June 30, 2013 and 2012, respectively.

Our independent registered public accountants report on our consolidated financial statements for the year ended December 31, 2012 includes an explanatory paragraph relating to our ability to continue as a going concern. We have incurred operating losses in past years and are dependent upon our ability to develop profitable operations and/or obtain necessary funding from outside sources, including by the sale of our securities, or obtaining loans from financial institutions, where possible. These factors, among others, raise doubt about our ability to continue as a going concern and may also affect our ability to obtain financing in the future.

Management expects that global economic conditions will continue to present a challenging operating environment through 2013; therefore working capital management will continue to be a high priority for the remainder of 2013.

The Company continues to manage its sales tax liability of approximately $1,101,000 by establishing voluntary disclosure agreements ("VDAs") with the applicable states, which establishes a maximum look-back period and payment arrangements. However, if the aforementioned methods prove unsuccessful and the Company is examined or challenged by taxing authorities, there exists possible exposure of an additional $620,000 in sales tax liability, not including any applicable interest and penalties.

During 2012, the Company successfully executed, and paid in full, VDAs in five states totaling approximately $23,000 and is current with the subsequent filing requirements. We have submitted VDAs with an additional twenty-seven states and await notification of acceptance. Two states offer no voluntarily disclosure program. The Company also confirmed that one customer had self-assessed, further reducing our liability and expense associated with that liability by approximately $151,000.

During the six months ended June 30, 2013, the Company successfully executed and paid in full four states totaling approximately $27,000. In addition, the Company executed VDAs with two other states and has set up payment plan agreements with these states.

Off-Balance Sheet Arrangements

The Company has no material, off-balance sheet arrangements.

Acquisition or Disposition of Property and Equipment

During the six months ended June 30, 2013, the Company had $18,633 of expenditures for equipment. The Company does not anticipate any significant purchases of property or equipment during the next twelve months, other than computer equipment and peripherals to be used in the Company's day-to-day operations.

We presently lease two commercial office spaces in Germantown, Maryland totaling, in the aggregate, 16,400 square feet. Both leases expire in December 2015. On July 15, 2011, Telkonet executed a sublease agreement for 11,626 square feet of its space located in Germantown, Maryland. On June 27, 2012 the subtenant exercised its option to extend the expiration of the term of the sublease from January 31, 2013 to December 31, 2015.

Item 4. Controls and Procedures.

As of June 30, 2013, 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. Due to the lack of a segregation of duties and failure to implement accounting controls, 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 three months ended June 30, 2013, 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.

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.

Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc.

On July 1, 2008, Linksmart Wireless Technology, LLC, or Linksmart, filed a civil lawsuit in the Eastern District of Texas against EthoStream, LLC, our wholly-owned subsidiary and 22 other defendants (*Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc., et al*, U.S. District Court, for the Eastern District of Texas, Marshall Division, No. 2:08-cv-00264). This lawsuit alleges that the defendants' services infringe a wireless network security patent held by Linksmart. Linksmart seeks a permanent injunction enjoining the defendants from infringing, inducing the infringement of, or contributing to the infringement of its patent, an award of damages and attorney's fees.

Defendant Ramada Worldwide, Inc. provided us with notice of the suit and demanded that we defend and indemnify it pursuant to a vendor direct supplier agreement between EthoStream and WWC Supplier Services, Inc., a Ramada affiliate (wherein we agreed to indemnify, defend and hold only Ethostream supported Ramada properties harmless from and against claims of infringement). After a review of that agreement, it was determined that EthoStream owes the duty to defend and indemnify with respect to services provided by Telkonet to Ramada and it has assumed Ramada's defense.

The parties in the lawsuit agreed to and the Court ordered a stay of the litigation pending the conclusion of a reexamination proceeding in the U.S. Patent and Trademark Office relating to the patent involved in the lawsuit. The case was reopened in early 2012 based on the expectation that a reexamination certificate would be issued by the Patent Office. The reexamination certificate has been issued. After the case resumed, the parties agreed to a "transfer" of the case from the Eastern District of Texas to the Central District of California. To accomplish the "transfer," with the agreement of the parties, the Texas case was dismissed and a new action was filed in California on April 5, 2012. (*Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc., et al*, U.S. District Court, for the Central District of California, Southern Division, No. SACV 12-522-JST). The parties have answered the complaint filed in the new action and the court has set the litigation calendar with trial set for June 2014. Management presently is unable to predict the ultimate resolution of this matter.

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, 2012 in response to Item 1A of Form 10-K.

Item 6. Exhibits.

Exhibit Number	Description Of Document
4.1	Amendment to Promissory Note between Dynamic Ratings, Inc. and Telkonet, Inc., effective as of April 30, 2013
10.2	Employment Agreement, effective as of May 1, 2013, by and between Telkonet, Inc. and Jason L. Tienor, incorporated by reference to the Company's current report on Form 8-K dated May 14, 2013
10.3	Employment Agreement, effective as of May 1, 2013, by and between Telkonet, Inc. and Jeff J. Sobieski, incorporated by reference to the Company's current report on Form 8-K dated May 14, 2013
10.4	Employment Agreement, effective as of May 1, 2013, by and between Telkonet, Inc. and Richard E. Mushrush, incorporated by reference to the Company's current report on Form 8-K dated May 14, 2013
10.5	Employment Agreement, effective as of May 1, 2013, by and between Telkonet, Inc. and Matthew P. Koch, incorporated by reference to the Company's current report on Form 8-K dated May 14, 2013
10.6	Employment Agreement, effective as of May 1, 2013, by and between Telkonet, Inc. and Gerrit J. Reinders, incorporated by reference to the Company's current report on Form 8-K dated May 14, 2013
10.7	Business Financing Agreement, effective as of May 31, 2013, between Telkonet, Inc. and Bridge Bank, N.A. incorporated by reference to the Company's current report on Form 8-K filed June 6, 2013
10.8	Intellectual Property Security Agreement between Telkonet, Inc. and Bridge Bank, N.A. incorporated by reference to the Company's current report on Form 8-K dated June 06, 2013
10.9	Bond Letter Agreement between Telkonet, Inc. and William Davis dated July 05, 2013
10.10	Bond Letter Agreement between Telkonet, Inc. and Jason Tienor dated July 08, 2013
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: August 14, 2013	By: /s/ Jason L. Tienor Jason L. Tienor Chief Executive Officer (principal executive officer)
Date: August 14, 2013	By: /s/ Richard E. Mushrush Richard E. Mushrush Chief Financial Officer (principal financial officer)

EXHIBIT 4.1

FIRST AMENDMENT TO PROMISSORY NOTE

THIS FIRST AMENDMENT TO PROMISSORY NOTE is effective ·as of the 30th day of April, 2013, by and among **TELKONET, INC.** (the "Company") and **DYNAMIC RATINGS, INC.** ("Holder").

RECITALS

A. The Company executed a certain promissory note in the principal amount of $700,000.00, payable to Holder, dated March 4, 2011 (the "Promissory Note"), in connection with Holder's acquisition of substantially all of the Company's assets under a certain Asset Purchase Agreement dated March 4, 2011 (the "APA").

B. The Company desires to, and Holder agrees to, amend the terms of the Promissory Note subject to the terms and conditions set forth below.

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are acknowledged, the parties agree as follows:

1. The last sentence of Section 1 of the Promissory Note is hereby deleted and replaced with the following: "Unless sooner paid, the outstanding principal balance of this Note, together with all accrued and unpaid interest, shall be payable in full on January 1, 2016 (the "Maturity Date")."

2. Section 2 of the Promissory Note is hereby amended by adding the following at the end of such Section:

   Notwithstanding the foregoing, any payment due hereunder that is prohibited by the Senior Lender (as defined below) pursuant to the terms of the Subordination Agreement (as defined below) shall not bear interest at the foregoing default rate until the expiration of any standstill period provided for in the Subordination Agreement. For purposes of this Note, "Senior Lender" shall mean Bridge Bank and "Subordination Agreement" shall mean that certain Subordination Agreement to be entered into between the Holder and the Senior Lender on or about the date hereof. Nothing contained herein is intended or shall be construed to; in any way, impact or limit Holder's right to declare the entire balance of principal and accrued interest to be payable immediately as provided for in the Promissory Note.

3. Section 3 of the Promissory Note is hereby amended by amending subsection (b) as follows:

   (b) Payment due on April 30, 2013, calculated in an amount equal to the Sales Incentive described in Section 2.4 of the Purchase Agreement, and the Consulting Compensation described in Section 2.5 of the Purchase Agreement, from April 1, 2012 through March 31, 2013, Holder shall apply the Sales Incentive and the Consulting Compensation amounts to the payment due on April 30, 2013.

In addition, Section 3 of the Promissory Note is further amended to add subsection (c) which shall read as follows:

(c) Monthly payments in the amount of $20,000.00 commencing on May 1, 2,913 and continuing on the 1st day of each month thereafter in accordance with the amortization schedule attached hereto as Schedule 1.

4. The Promissory Note is amended by adding Schedule I thereto in the form Schedule I attached to this Amendment.

5. Except as modified by this Amendment, all of the other terms of the Promissory Note shall remain unchanged and in full force and effect.

IN WITNESS WHEREOF, the parties have executed this First Amendment to Promissory Note effective as of the day and year first set forth above.

HOLDER: DYNAMIC RATINGS, INC.	TELKONET, INC.
By: /s/ Tony Pink Name: Tony Pink Its: GM/COO	By: /s/ Jason L. Tienor Name: Jason L. Tienor Its: Chief Executive Officer

Schedule 1

Amortization Schedule

Loan Amortization Schedule

Compound Period: Monthly

Nominal Annual Rate: 6.000%

CASH FLOW DATA

	Event	Date	Amount	Number	Period	End Date
1	Loan	04/01/2013	642,690.7	1		
				1		
2	Payment	05/01/2013	20,000.00	32	Monthly	12/01/2015
3	Payment	01/01/2016	62,040.08	1		

AMORTIZATION SCHEDULE- Normal Amortization

	Date	Payment	Interest	Principal	Balance
Loan	04/01/2013				642,690.71
1	05/01/2013	20,000.00	3,213.45	16,786.55	625,904.16
2	06/01/2013	20,000.00	3,129.52	16,870.48	609,033.68
3	07/01/2013	20,000.00	3,045.17	16,954.83	592,078.85
4	08/01/2013	20,000.00	2,960.39	17,039.61	575,039.24
5	09/01/2013	20,000.00	2,875.20	17,124.80	557,914.44
6	10/01/2013	20,000.00	2,789.57	17,210.43	540,704.01
7	11/01/2013	20,000.00	2,703.52	17,296.48	523,407.53
8	12/01/2013	20,000.00	2,617.04	17,382.96	506,024.57
2013 Totals		160,000.00	23,333.86	136,666.14	
9	01/01/2014	20,000.00	2,530.12	17,469.88	488,554.69
10	02/01/2014	20,000.00	2,442.77	17,557.23	470,997.46
11	03/01/2014	20,000.00	2,354.99	17,645.01	453,352.45
12	04/01/2014	20,000.00	2,266.76	17,733.24	435,619.21
13	05/01/2014	20,000.00	2,178.10	17,821.90	417,797.31
14	06/01/2014	20,000.00	2,088.99	17,911.01	399,886.30
15	07/01/2014	20,000.00	1,999.43	1.8,000.57	381,885.73
16	08/01/2014	20,000.00	1,909.43	18,090.57	363,795.16
17	09/01/2014	20,000.00	1,818.98	18,181.02	345,614.14
18	10/01/2014	20,000.00	1,728.07	18,271.93	327,342.21
19	11/01/2014	20,000.00	1,636.71	18,363.29	308,978.92
20	12/01/2014	20,000.00	1,544.89	18,455.11	290,523.81

	Date	Payment	Interest	Principal	Balance
2014 Totals		240,000.00	24,499.24	215,500.76	
21	01/01/2015	20,000.00	1,452.62	18,547.38	271,976.43
22	02/01/2015	20,000.00	1,359.88	18,640.12	253,336.31
23	03/01/2015	20,000.00	1,266.68	18,733.32	234,602.99
24	04/01/2015	20,000.00	1,173.01	18,826.99	215,776.00
25	05/01/2015	20,000.00	1,078.88	18,921.12	196,854.88
26	06/01/2015	20,000.00	984.27	19,015.73	177,839.15
27	07/01/2015	20,000.00	889.20	19,110.80	158,728.35
28	08/01/2015	20,000.00	793.64	19,206.36	139,521.99
29	09/01/2015	20,000.00	697.61	19,302.39	120,219.60
30	10/01/2015	20,000.00	601.10	19,398.90	100,820.70
31	11/01/2015	20,000.00	504.10	19,495.90	81,324.80
32	12/01/2015	20,000.00	406.62	19,593.38	61,731.42
2015 Totals		240,000.00	11,207.61	228,792.39	
33	01/01/2016	62,040.08	308.66	61,731.42	0.00
2016 Totals		62,040.08	308.66	61,731.42	
Grand Totals		702,040.08	59,349.37	642,690.71	

EXHIBIT 10.9

telkonet

William H.Davis
29 Glen Green
Winchester, MA 01890

Reference is made to that certain General Indemnity Agreement dated as of June_, 2013 (the "Indemnification Agreement", a copy of which is attached to this letter agreement) pursuant to which you ("you" or the "Indemnitor") have agreed to indemnify and hold harmless Philadelphia Indemnity Insurance Company and certain of its affiliated and related entities (collectively, the "Surety") for certain Losses (as defined in the Indemnification Agreement) incurred by the Surety for the benefit of Telkonet, Inc. (the "Company"), and to post collateral for such purposes (collectively, the "Indemnification Obligations"). The purpose of this letter is to set forth the understanding between you and the Company regarding the consideration to be paid to you in exchange for your assumption of the Indemnification Obligations pursuant to the Indemnification Agreement. With the foregoing as background, the Company and the Indemnitor agree as follows:

As consideration for the assumption of the Indemnification Obligations by the Indemnitor, the Company hereby agrees to compensate the Indemnitor in the amount of Twenty Thousand Dollars ($20,000), grossed up to accommodate the Indemnitor's 2013 federal income tax rate ("taxes') and subject to ordinary tax withholdings (if applicable) (the "Consideration Payment"). The Consideration Payment, less taxes, will be paid by the Company to the Indemnitor by check within thirty (30) days following delivery to the Company by the Indemnitor of a fully executed copy of this letter agreement Taxes will be paid once the applicable rate is confirmed in 2014.

Neither party may assign or transfer its rights or obligations under this letter agreement without the prior written consent of the other party. This letter agreement may be executed in counterparts, which shall be read together and construed as but one in the same instrument This letter agreement shall be governed by, construed and enforced in accordance with the internal laws of Wisconsin and the parties hereto expressly consent to the jurisdiction and venue of the State and Federal courts in Wisconsin for purposes of enforcement of this letter agreement This letter agreement shall be binding upon and shall inure·to the benefit of the parties hereto and their respective heirs, successors, permitted assigns and legal representatives.

This letter agreement represents the entire agreement between the parties hereto with respect to the subject matter hereof. All prior discussions and negotiations, agreements and understandings between the parties whether oral or written, are superseded by this letter agreement. The terms of this letter agreement may or may not be altered, waived, modified or discharged except by an express declaration in writing signed on behalf of the parties hereto.

Accepted and agreed to this 5th day of July, 2013.

/s/ William H. Davis	/s/ signature
William H. Davis	By: Telkonet, Inc. (Title)

EXHIBIT 10.10

telkonet

Jason L. Tienor
1031 Fieldridge Ct.
Waukesha, WI 53188

Reference is made to that certain General Indemnity Agreement dated as of June__, 2013 (the "Indemnification Agreement", a copy of which is attached to this letter agreement) pursuant to which you ("you" or the "Indemnitor") have agreed to indemnify and hold harmless Philadelphia Indemnity Insurance Company and certain of its affiliated and related entities (collectively, the "Surety") for certain Losses (as defined in the Indemnification Agreement) incurred by the Surety for the benefit of Telkonet, Inc. (the "Company"), and to post collateral for such purposes (collectively, the "Indemnification Obligations"). The purpose of this letter is to set forth the understanding between you and the Company regarding the consideration to be paid to you in exchange for your assumption of the Indemnification Obligations pursuant to the Indemnification Agreement. With the foregoing as background, the Company and the Indemnitor agree as follows:

As consideration for the assumption of the Indemnification Obligations by the Indemnitor, the Company hereby agrees to compensate the Indemnitor in the amount of Twenty Thousand Dollars ($20,000), grossed up to accommodate the Indemnitor's 2013 federal income tax rate ("taxes') and subject to ordinary tax withholdings (if applicable) (the "Consideration Payment"). The Consideration Payment, less taxes, will be paid by the Company to the Indemnitor by check within thirty (30) days following delivery to the Company by the Indemnitor of a fully executed copy of this letter agreement. Taxes will be paid once the applicable rate is confirmed in 2014.

Neither party may assign or transfer its rights or obligations under this letter agreement without the prior written consent of the other party. This letter agreement may be executed in counterparts, which shall be read together and construed as but one in the same instrument. This letter agreement shall be governed by, construed and enforced in accordance with the internal laws of Wisconsin and the parties hereto expressly consent to the jurisdiction and venue of the State and Federal courts in Wisconsin for purposes of enforcement of this letter agreement. This letter agreement shall be binding upon and shall inure to the benefit of the parties hereto and their respective heirs, successors, permitted assigns and legal representatives.

This letter agreement represents the entire agreement between the parties hereto with respect to the subject matter hereof. All prior discussions and negotiations, agreements and understandings between the parties whether oral or written, are superseded by this letter agreement. The terms of this letter agreement may or may not be altered, waived, modified or discharged except by an express declaration in writing signed on behalf of the parties hereto.

Accepted and agreed to this 5th day of July, 2013.

/s/ Jason L. Tienor	/s/ signature
Jason L. Tienor	By: Telkonet, Inc. (Title)

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: August 14, 2013

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: August 14, 2013

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 **June 30, 2013** 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
August 14, 2013

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 **June 30, 2013** 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
August 14, 2013