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

FORM 10-Q

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

For the quarterly period ended September 30, 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 (State or Other Jurisdiction of Incorporation or Organization)	87-0627421 (I.R.S. Employer Identification No.)
10200 Innovation Drive, Suite 300, Milwaukee, WI (Address of Principal Executive Offices)	53226 (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 October 31, 2013 is 125,035,612.

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

Index

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TELKONET, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	September 30, 2013	December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$ 799,473	$ 1,163,758
Restricted cash on deposit	382,000	–
Accounts receivable, net	1,768,505	3,026,107
Inventories	861,843	654,912
Prepaid expenses	88,490	189,879
Total current assets	3,900,311	5,034,656
Property and equipment, net	42,213	35,898
Other assets:		
Goodwill	8,570,446	8,570,446
Intangible assets, net	1,319,037	1,500,297
Deposits	34,238	34,238
Total other assets	9,923,721	10,104,981
Total Assets	$ 13,866,245	$ 15,175,535
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,678,567	$ 1,967,030
Notes payable – current	262,532	74,611
Accrued liabilities and expenses	2,182,107	2,342,047
Deferred revenues	207,390	117,556
Customer deposits	466,698	118,763
Total current liabilities	4,797,294	4,620,007
Long-term liabilities:		
Deferred lease liability	131,991	133,609
Notes payable – long term	462,308	813,928
Deferred income taxes	292,953	–
Total long-term liabilities	887,252	947,537
Redeemable preferred stock:		
15,000,000 shares authorized, par value $.001 per share		
Series A; 215 shares issued, 185 shares outstanding at September 30, 2013 and December 31, 2012, respectively, preference in liquidation of $1,211,172 and $1,176,076 as of September 30, 2013 and December 31, 2012, respectively	1,129,457	1,041,837
Series B; 538 shares issued, 55 and 493 shares outstanding at September 30, 2013 and December 31, 2012, respectively, preference in liquidation of $344,453 and $2,884,833 as of September 30, 2013 and December 31, 2012, respectively	311,491	2,223,752
Total redeemable preferred stock	1,440,948	3,265,589
Commitments and contingencies		
Stockholders' Equity		
Common stock, par value $.001 per share; 190,000,000 shares authorized; 125,035,612 and 108,103,001 shares issued and outstanding at September 30, 2013 and December 31, 2012, respectively	125,035	108,103
Additional paid-in-capital	126,083,666	124,188,415
Accumulated deficit	(119,467,950)	(117,954,116)
Total stockholders' equity	6,740,751	6,342,402
Total Liabilities and Stockholders' Equity	$ 13,866,245	$ 15,175,535

See accompanying notes to the unaudited condensed consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	**2012**	**2013**	**2012**
Revenues, net:				
Product	$ 2,606,464	$ 2,161,753	$ 7,431,715	$ 5,481,365
Recurring	901,321	1,127,025	2,799,200	3,197,925
Total Net Revenue	3,507,785	3,288,778	10,230,915	8,679,290
Cost of Sales:				
Product	1,469,104	1,166,848	4,746,731	2,969,512
Recurring	263,068	292,264	799,748	858,988
Total Cost of Sales	1,732,172	1,459,112	5,546,479	3,828,500
Gross Profit	1,775,613	1,829,666	4,684,436	4,850,790
Operating Expenses:				
Research and development	306,559	251,089	895,992	732,154
Selling, general and administrative	1,578,464	1,009,814	4,845,408	3,937,522
Depreciation and amortization	64,731	63,265	193,578	197,341
Total Operating Expenses	1,949,754	1,324,168	5,934,978	4,867,017
Income (Loss) from Operations	(174,141)	505,498	(1,250,542)	(16,227)
Other Income (Expenses):				
Interest income (expense), net	(11,401)	7,712	(9,978)	(57,611)
Gain on sale of product line	–	–	41,902	15,408
Total Other Income (Expense)	(11,401)	7,712	31,924	(42,203)
Income (Loss) Before Provision for Income Taxes	(185,542)	513,210	(1,218,618)	(58,430)
Provision for Income Taxes	294,936	–	295,216	–
Net Income (Loss)	(480,478)	513,210	(1,513,834)	(58,430)
Accretion of preferred dividends and discount	(556,351)	(308,386)	(857,237)	(723,252)
Net income (loss) attributable to common stockholders	$ (1,036,829)	$ 204,824	$ (2,371,071)	$ (781,682)
Net loss per common share:				
Net loss attributable to common stockholders per common share – basic	$ (0.01)	$ 0.00	$ (0.02)	$ 0.00
Net loss attributable to common stockholders per common share – diluted	$ (0.01)	$ 0.00	$ (0.02)	$ 0.00
Weighted Average Common Shares Outstanding – basic	117,150,713	106,153,192	111,177,407	105,011,687
Weighted Average Common Shares Outstanding – diluted	117,150,713	107,611,189	111,177,407	105,011,687

See accompanying notes to the unaudited condensed consolidated financial statements.

TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)
NINE MONTHS FROM JANUARY 1, 2013 THROUGH SEPTEMBER 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	–	–	87,542	–	87,542
Shares issued on conversion of preferred stock at approximately $0.13 per share	16,846,139	16, 846	2,665,032	–	2,681,878
Shares issued for cashless Series B warrants exercised	86,472	86	(86)	–	–
Accretion of redeemable preferred stock discount	–	–	(680,643)	–	(680,643)
Accretion of redeemable preferred stock dividends	–	–	(176,594)	–	(176,594)
Net loss				(1,513,834)	(1,513,834)
Balance at September 30, 2013	125,035,612	$ 125,035	$ 126,083,666	$ (119,467,950)	$ 6,740,751

See accompanying notes to the unaudited condensed consolidated financial statements.

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

	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Cash Flows from Operating Activities:		
Net loss	$ (1,513,834)	$ (58,430)
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	87,542	206,928
Depreciation	12,318	16,081
Amortization	181,260	181,260
Provision for doubtful accounts	61,606	(14,525)
Deferred income taxes	292,953	–
Changes in assets and liabilities:		
Accounts receivable	1,195,996	(600,489)
Inventories	(206,931)	(447,736)
Prepaid expenses	101,389	(24,027)
Accounts payable	(288,463)	211,281
Accrued liabilities and expenses	(159,940)	84,040
Deferred revenue	89,834	116,006
Customer deposits	347,935	119,994
Deferred lease liability	(1,618)	13,290
Net Cash Provided By (Used In) Operating Activities	158,145	(211,735)
Cash Flows From Investing Activities:		
Purchase of property and equipment	(18,633)	(38,114)
Deposit of restricted cash	(382,000)	–
Net Cash Used In Investing Activities	(400,633)	(38,114)
Cash Flows From Financing Activities:		
Payments on note payable	(121,797)	(49,035)
Proceeds from exercise of warrants	–	405,000
Net Cash (Used In) Provided By Financing Activities	(121,797)	355,965
Net (decrease) increase in cash and cash equivalents	(364,285)	106,116
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	$ 799,473	$ 1,067,207

See accompanying notes to the unaudited condensed consolidated financial statements.

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

	Nine Months Ended September 30,	
	2013	**2012**
Supplemental Disclosures of Cash Flow Information:		
Cash transactions:		
Cash paid during the period for interest expense	$ 20,622	$ 4,889
Non-cash transactions:		
Accretion of discount on redeemable preferred stock	$ 680,643	$ 519,578
Accretion of dividends on redeemable preferred stock	176,594	203,674
Conversion of preferred stock to common stock	2,681,878	–

See accompanying notes to the unaudited condensed consolidated financial statements.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2013
(UNAUDITED)

NOTE A – BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

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

General

The accompanying unaudited condensed consolidated financial statements of Telkonet, Inc. (the "Company") 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 nine months ended September 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 $1,513,834 for the nine months ended September 30, 2013, and has an accumulated deficit of $119,467,950 and total current liabilities in excess of current assets of $896,983 as of September 30, 2013.

Although we had net income for the year ended December 31, 2012 and positive cash flows from operations for the nine months ended September 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.

Anticipated cash flows from operations may be insufficient to satisfy the Company's 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 September 30, 2013 was $1,063,000 and the outstanding balance was zero. As of September 30, 2013, the Company was in violation of a financial performance covenant. The Bank has chosen not to exercise any default provisions as of November 14, 2013.

Restricted Cash on Deposit

During 2012, the Company was awarded a contract with a bonding requirement. The Company satisfied this requirement during the nine months ended September 30, 2013, with cash collateral supported by an irrevocable standby letter of credit in the amount of $382,000 which expires September 30, 2014, however, the Company can be released prior to expiration if the Company has satisfied all obligations. 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 September 30, 2013 and 2012, there were 11,095,139 and 11,601,002 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 contracts that have both product and installation under the MEAs guidance in ASC 605. The Company believes the volume of these contracts will continue to increase. Arrangements under such contracts 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 element has value to the customer on a stand-alone basis, and (ii) delivery of the undelivered 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 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 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 nine months ended September 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 September 30, 2013 and December 31, 2012, the Company recorded warranty liabilities in the amount of $84,943 and $69,743, respectively.

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

	September 30, 2013	December 31, 2012
Beginning balance	$ 69,743	$ 104,423
Warranty claims incurred	(5,926)	(66,278)
Provision charged to expense	21,126	31,598
Ending balance	$ 84,943	$ 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 nine months ended September 30, 2013 and 2012 was $2,023 and $1,259, and $87,542 and $104,928, 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 September 30, 2013 was $102,413 and at December 31, 2012 was $135,975.

NOTE B – NEW ACCOUNTING PRONOUNCEMENTS

In July 2013, the Financial Accounting Standards Board ("FASB") issued ASU No. 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (a consensus of the FASB Emerging Issues Task Force), which applies to the presentation of unrecognized tax benefits as a liability on the balance sheet when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose. This ASU is effective prospectively for fiscal years (and interim reporting periods within those years) beginning after December 15, 2013. The Company is currently reviewing the provisions of this ASU but does not expect it to have a material effect on the Company's financial condition, results of operations, and cash flows.

NOTE C – INTANGIBLE ASSETS AND GOODWILL

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

	Cost	Accumulated Amortization	Carrying Value	Weighted Average Amortization Period (Years)
Amortized Identifiable Intangible Assets:				
Subscriber lists – EthoStream	$ 2,900,000	$ (1,580,963)	$ 1,319,037	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(1,580,963)	1,319,037	
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	$ (1,580,963)	$ 9,889,483	

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

	Original 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 nine months ended September 30, 2013 and 2012 was $60,420 and $181,260.

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

Remainder of 2013	$ 60,420
2014	241,680
2015	241,680
2016	241,680
2017	241,680
2018 and after	291,897
Total	$ 1,319,037

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 reporting 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 September 30, 2013 and December 31, 2012 are as follows:

	September 30, 2013	December 31, 2012
Accounts receivable	$ 1,805,086	$ 3,096,914
Allowance for doubtful accounts	(36,581)	(70,807)
Accounts receivable, net	$ 1,768,505	$ 3,026,107

NOTE E – INVENTORIES

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

	September 30, 2013	December 31, 2012
Merchandise purchased for resale	$ 934,793	$ 768,812
Reserve for obsolescence	(72,950)	(113,900)
Inventory, net	$ 861,843	$ 654,912

NOTE F – ACCRUED LIABILITIES AND EXPENSES

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

	September 30, 2013	December 31, 2012
Accrued liabilities and expenses	$ 654,003	$ 717,731
Accrued payroll and payroll taxes	361,891	345,384
Accrued sales taxes, penalties, and interest	1,078,203	1,188,136
Accrued interest	3,067	21,053
Product warranties	84,943	69,743
Total	$ 2,182,107	$ 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 required, among other things, that the Company 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 September 30, 2013 and December 31, 2012 were $166,926 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 September 30, 2013 and December 31, 2012 was $557,914 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. On August 1, 2013 the Agreement was modified to include the eligible receivables and the eligible inventory of Ethostream. 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 September 30, 2013 was $1,063,000 and the outstanding balance was zero. As of September 30, 2013, the Company was in violation of a financial performance covenant. The Bank has chosen not to exercise any default provisions as of November 14, 2013.

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

Years ended December 31,		Amount
2013 (remainder of)	$	64,367
2014		265,985
2015		280,295
2016		114,193
		724,840
Less: Current portion		(262,532)
Notes payable long term	$	462,308

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 nine months ended September 30, 2013 and 2012 was $17,508 and $17,508 and $52,524 and $57,106, respectively.

For the three and nine months ended September 30, 2013 and 2012, we have accrued dividends for Series A in the amount of $18,660 and $18,660 and $35,096 and $55,568, respectively, and cumulative accrued dividends of $286,172 and $232,416, 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. During the nine-months ended September 30, 2013, shareholders converted 167 redeemable preferred shares issued on August 4, 2010, to, in aggregate, 6,423,072 shares of common stock.

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). During the nine-months ended September 30, 2013, the remaining portion of the discount of approximately $123,100 was accelerated and recognized immediately as a charge to additional paid-in capital and accretion of preferred stock discounts for the 167 redeemable preferred shares converted to common stock.

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. During the nine-month period ended September 30, 2013, all 271 of the redeemable preferred shares issued on April 8, 2011, were converted to, in aggregate, 10,423,067 shares of common stock.

As a result of the Series B conversions during the nine months ended September 30, 2013, fewer than 50% of the Series B shares issued on the Series B Original Issuance Date remain outstanding, and the balance of the outstanding Series B shares will not become redeemable at the option of the holders.

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). During the nine-months ended September 30, 2013, the remaining discount of approximately $261,300 was accelerated and recognized immediately as a charge to additional paid-in capital and accretion of preferred stock discounts upon the 271 redeemable preferred shares converted to common stock.

The charge to additional paid in capital for amortization of Series B discount and costs for the three and nine months ended September 30, 2013 and 2012 was $446,871 and $222,488 and $628,119 and $462,472, respectively.

For the three and nine months ended September 30, 2013 and 2012, we have accrued dividends for Series B in the amount of $73,312 and $49,730 and $141,498 and $148,106, respectively, and cumulative accrued dividends of $69,453 and $370,103 as of September 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. During the three-months and nine-months ended September 30, 2013, accrued dividends in the amount of $491,878 were written down and credited back to additional paid-in capital upon the redeemable preferred share conversions to common 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 $334,453 and second, Series A with a preference value of $1,211,172. 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. The Company has designated 215 shares as Series A preferred stock and 538 shares as Series B preferred stock. At each of September 30, 2013 and December 31, 2012, there were 185 shares of Series A outstanding. At September 30, 2013 and December 31, 2012, there were 55 and 493 shares of Series B outstanding, respectively.

The Company has authorized 190,000,000 shares of common stock with a par value of $.001 per share. As of September 30, 2013 and December 31, 2012 the Company had 125,035,612 and 108,103,001 common shares issued and outstanding, respectively.

During the nine months ended September 30, 2013, 438 shares of Series B redeemable preferred stock were converted to, in aggregate, 16,846,139 shares of common stock.

During the nine months ended September 30, 2013, 86,472 warrants were exercised to an equal number of common shares. These warrants were originally granted to the Company's placement agent in lieu of cash compensation for services performed or financing expenses in connection with the placement of the April 2011 Series B convertible preferred stock issuance.

During the nine months ended September 30, 2012, the Company issued 638,104 shares of common stock to directors and management for services performed through September 30, 2012. These shares were valued at $102,000, 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	4.07	$ 0.14	175,000	$ 0.14
$ 0.16 - $0.99	1,420,225	8.98	0.18	1,180,225	0.18
$ 1.00 - $5.99	140,000	2.70	3.29	140,000	3.29
	1,735,225	7.98	$ 0.47	1,495,225	$ 0.47

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	(50,000)	2.69
Outstanding at September 30, 2013	1,735,225	$ 0.47

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 nine months ended September 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 nine months ended September 30, 2013 and 2012 was $2,023 and $1,259 and $87,542 and $104,928, respectively.

Warrants

The following table summarizes the changes in warrants outstanding and the related prices for the shares of the Company's common stock issued to non-employees of the Company.

	Warrants Outstanding			Warrants Exercisable	
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 0.13	7,230,778	2.37	$ 0.13	7,230,778	$ 0.13
0.33	1,628,800	1.13	0.33	1,628,800	0.33
3.00	500,336	1.86	3.00	500,336	3.00
	9,359,914	2.12	$ 0.32	9,359,914	$ 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	(86,472)	0.13
Canceled or expired	(1,384,030)	1.36
Outstanding at September 30, 2013	9,359,914	$ 0.32

The Company did not issue any warrants during the nine month periods ended September 30, 2013 and 2012. During the period ended September 30, 2013, 86,472 warrants were exercised. These warrants were originally granted to the Company's placement agent in lieu of cash compensation for services performed or financing expenses in connection with the placement of convertible preferred stock.

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 September 30, 2013 are as follows:

2013 (remainder of)	$ 100,977
2014	414,267
2015	426,399
2016	169,155
2017	174,099
2018 and thereafter	410,184
Total	$ 1,695,081

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

2013 (remainder of)	$	33,302
2014		134,872
2015		138,919
Total	$	307,093

Rental expenses charged to operations for the three and nine months ended September 30, 2013 and 2012 were $129,320 and $145,605 and $403,100 and $407,564, respectively. Rental income received for the three and nine months ended September 30, 2013 and 2012 was $33,145 and $32,180 and $97,809 and $94,958, 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).

On October 1, 2013, the Company entered into a settlement agreement with Linksmart. The Company has agreed to pay $115,000, payable in twelve installments of $9,583 due on the first of each month beginning October 1, 2013, which has been accrued by the Company in accrued liabilities and expenses as of September 30, 2013.

<u>**Sales Tax**</u>

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 $1,078,000 accrued as of September 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 nine months ended September 30, 2013, the Company successfully executed and paid in full eight states totaling approximately $72,000. 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 September 30, 2013 and December 31, 2012:

	September 30, 2013	December 31, 2012
Balance, beginning of year	$ 1,188,133	$ 1,068,314
Collections	299,614	277,374
Provisions	(120,923)	(119,255)
Interest and penalties	7,342	32,696
Payments	(295,963)	(70,996)
Balance, end of period	$ 1,078,203	$ 1,188,133

NOTE L – BUSINESS CONCENTRATION

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

Purchases from two major suppliers approximated $1,878,397, or 67%, of purchases, and $1,624,639, or 71%, of purchases, for the nine months ended September 30, 2013 and 2012, respectively. Total due to these suppliers, net of deposits, was approximately $286,724 as of September 30, 2013, and $152,099 as of September 30, 2012.

NOTE M – SUBSEQUENT EVENT

On October 7, 2013 the Company entered into a commercial office lease agreement. The 87 month lease, anticipated to begin December 1, 2013 or the day following the date of substantial completion of the renovations, whichever is later, provides for the lease by the Company of approximately 6,362 square feet of office space in Waukesha, Wisconsin. The initial base rent is approximately $6,097 per month and the total minimum rental commitment under this lease is anticipated to be approximately $627,956.

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

The following discussion and analysis of the Company's financial condition and results of operations should be read in conjunction with the accompanying condensed consolidated financial statements and related notes thereto for the three and nine months ended September 30, 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 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 contracts that have both product and installation under the MEAs guidance in ASC 605. The Company believes the volume of these contracts will continue to increase. Arrangements under such contracts 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 element has value to the customer on a stand-alone basis, and (ii) delivery of the undelivered 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 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					
	September 30, 2013		September 30, 2012		Variance	
Product	$ 2,606,464	74%	$ 2,161,753	66%	$ 444,711	21%
Recurring	901,321	26%	1,127,025	34%	(225,704)	-20%
Total	$ 3,507,785	100%	$ 3,288,778	100%	$ 219,007	7%

	Nine Months Ended					
	September 30, 2013		September 30, 2012		Variance	
Product	$ 7,431,715	73%	$ 5,481,365	63%	$ 1,950,350	36%
Recurring	2,799,200	27%	3,197,925	37%	(398,725)	-12%
Total	$ 10,230,915	100%	$ 8,679,290	100%	$ 1,551,625	18%

Product Revenue

Product revenue principally arises from the sale and installation of EcoSmart Suite of products, SmartGrid and HS IA 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 nine months ended September 30, 2013, product revenue increased by 21% and 36% respectively, when compared to the prior year periods. Product revenue in 2013 includes approximately $3.5 million attributed to the sale, installation of energy management products, and approximately $3.7 million for the sale and installation of HSIA products and $0.2 million of Telkonet Series 5 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 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 nine months ended September 30, 2013, recurring revenue decreased by 20% and 12% 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					
	September 30, 2013		September 30, 2012		Variance	
Product	$ 1,469,104	56%	$ 1,166,848	54%	$ 302,256	26%
Recurring	263,068	29%	292,264	26%	(29,196)	-10%
Total	$ 1,732,172	49%	$ 1,459,112	44%	$ 273,060	19%

	Nine Months Ended					
	September 30, 2013		September 30, 2012		Variance	
Product	$ 4,746,731	64%	$ 2,969,512	53%	$ 1,777,219	60%
Recurring	799,748	29%	858,988	27%	(59,240)	-7%
Total	$ 5,546,479	54%	$ 3,828,500	44%	$ 1,717,979	45%

Costs of Product Sales

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 nine months ended September 30, 2013, product costs as a percentage of sales increased by 26% and 60% when compared to the prior year periods. The variances were attributed to costs associated with the increase in product sales, materials, travel expenses and subcontractor services and salaries associated with the installations.

Costs of Recurring Revenue

Recurring costs are comprised of labor and telecommunication services for our Customer Service department. For the three and nine months ended September 30, 2013, recurring costs decreased by 10% and 7% 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					
	September 30, 2013		September 30, 2012		Variance	
Product	$ 1,137,360	44%	$ 994,905	46%	$ 142,445	14%
Recurring	638,253	71%	834,761	74%	(196,508)	-24%
Total	$ 1,775,613	51%	$ 1,829,666	56%	$ (54,053)	-3%

	Nine Months Ended					
	September 30, 2013		September 30, 2012		Variance	
Product	$ 2,684,984	36%	$ 2,511,853	46%	$ 173,131	7%
Recurring	1,999,452	71%	2,338,937	73%	(339,485)	-15%
Total	$ 4,684,436	46%	$ 4,850,790	56%	$ (166,354)	-3%

Gross Profit on Product Revenue

The gross profit on product revenue for the three months ended September 30, 2013 increased by 14% when compared to the prior year period. The variance was a result of increased installations on energy management and HSIA sales. The gross profit on product revenue for the nine months ended September 30, 2013 increased by 7% when compared to the prior year period. The variance was a result of increased product sales on energy management and HSIA sales.

Gross Profit on Recurring Revenue

Our gross profit associated with recurring revenue decreased by 24% and 15% for the three and nine months ended September 30, 2013. The decrease was mainly due to a decrease in advertising revenue which yields higher gross profit margins as well as management's decision to pursue renewing customer accounts with lower profit margins.

Operating Expenses

	Three Months Ended September 30,			
	2013	2012	Variance	
Total	$ 1,949,754	$ 1,324,168	$ 625,586	47%

	Nine Months Ended September 30,			
	2013	2012	Variance	
Total	$ 5,934,978	$ 4,867,017	$ 1,067,961	22%

During the three and nine months ended September 30, 2013, operating expenses increased by 47% and 22% when compared to the prior year periods. The increase is the result of legal expenses associated with the Linksmart settlement, executive bonuses, continuing development of our EcoSmart Suite product line and additional sales and marketing staff.

Research and Development

	Three Months Ended September 30,			
	2013	2012	Variance	
Total	$ 306,559	$ 251,089	$ 55,470	22%

	Nine Months Ended September 30,			
	2013	2012	Variance	
Total	$ 895,992	$ 732,154	$ 163,838	22%

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 nine months ended September 30, 2013, research and development costs increased 22% 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 September 30,			
	2013	2012	Variance	
Total	$ 1,578,464	$ 1,009,814	$ 568,650	56%

	Nine Months Ended September 30,			
	2013	2012	Variance	
Total	$ 4,845,408	$ 3,937,522	$ 907,886	23%

During the three and nine months ended September 30, 2013, selling, general and administrative expenses increased over the comparable prior year periods by 56% and 23%. The increase is primarily the result of expenditures for legal, sales personnel, travel, consulting fees and costs associated with sales initiatives.

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 $1,311,632 during the nine months ended September 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 $896,983 at September 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 required, among other things, that the Company 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 September 30, 2013 and December 31, 2012 were $166,926 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 September 30, 2013 and December 31, 2012 were $557,914 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. On August 1, 2013 the Agreement was modified to include the eligible receivables and the eligible inventory of Ethostream. 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 September 30, 2013 was $1,063,000 and the outstanding balance was zero. As of September 30, 2013, the Company was in violation of a financial performance covenant. The Bank has chosen not to exercise any default provisions as of November 14, 2013.

Cash Flow Analysis

Cash provided by continuing operations was $158,145 during the nine months ended September 30, 2013 and cash used in continuing operations was $211,735 during the nine months ended September 30, 2012. As of September 30, 2013, our primary capital needs included business strategy execution, inventory procurement and managing current liabilities.

Cash used in investing activities was $400,633 and $38,114 during the nine months ended September 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 nine months ended September 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 $121,797 during the nine months ended September 30, 2013 and cash provided by financing activities was $355,965 during the nine months ended September 30, 2012.

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 $1,078,000 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 nine months ended September 30, 2013, the Company successfully executed and paid in full eight states totaling approximately $72,000. 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 nine months ended September 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 September 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 September 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).

On October 1, 2013, the Company entered into a settlement agreement with Linksmart. The Company has agreed to pay $115,000, payable in twelve installments of $9,583 due on the first of each month beginning October 1, 2013, which has been accrued by the Company in accrued liabilities and expenses as of September 30, 2013.

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 5. Other Information

At the July 12, 2013 continuation of the Company's 2013 Annual Meeting of Shareholders, a majority of votes cast on the shareholder advisory vote on the frequency of the advisory vote on compensation of the Company's named executive officers were voted in favor of a frequency of one year. In light of this result and in keeping with the Board of Directors' recommendation on the proposal, the Company intends to conduct an advisory vote on compensation of the Company's named executive officers on an annual basis until the next required vote on the frequency of shareholder votes on executive compensation. The Company is required to hold votes on frequency every six years.

Item 6. Exhibits.

Exhibit Number	Description Of Document
10.1	Amendment to Business Finance Agreement, effective as of August 1, 2013
32.1	Certification of Jason L. Tienor pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Richard E. Mushrush pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Schema Document
101.CAL	XBRL Calculation Linkbase Document
101.DEF	XBRL Definition Linkbase Document
101.LAB	XBRL Label Linkbase Document
101.PRE	XBRL Presentation Linkbase Document

SIGNATURES

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

	Telkonet, Inc. Registrant
Date: November 14, 2013	By: /s/ Jason L. Tienor Jason L. Tienor Chief Executive Officer (principal executive officer)
Date: November 14, 2013	By: /s/ Richard E. Mushrush Richard E. Mushrush Chief Financial Officer (principal financial officer)

EXHIBIT 10.1

BUSINESS FINANCING MODIFICATION AGREEMENT

This Business Financing Modification Agreement is entered into as of August 1, 2013, by and between Telkonet, Inc. (the "Borrower") and Bridge Bank, National Association ("Lender").

1 . DESCRIPTION OF EXISTING INDEBTEDNESS: Among other indebtedness which may be owing by Borrower to Lender, Borrower is indebted to Lender pursuant to, among other documents, a Business Financing Agreement, dated May 31, 2013, by and between Borrower and Lender, as may be amended from time to time (the "Business Financing Agreement"). Capitalized terms used without definition herein shall have the meanings assigned to them in the Business Financing Agreement.

Hereinafter, all indebtedness owing by Borrower to Lender shall be referred to as the "Indebtedness" and the Business Financing Agreement and any and all other documents executed by Borrower in favor of Lender shall be referred to as the "Existing Documents."

2. DESCRIPTION OF CHANGE IN TERMS.

A. Modification(s) to Business Financing Agreement:

1) The following definition in Section 12.1 entitled "Definitions" is amended to read as follows:

"**Advance Rate**" means 80% in case of the Eligible Receivables (except for Receivables from the Account Debtor EthoStream), or 75% in case of the Eligible Receivables from the Account Debtor EthoStream, and 25% in the case of the Eligible Inventory, or in each case, such greater or lesser percentage as Lender may from time to time establish in its sole discretion upon notice to Borrower.

2) Clauses (n) and (o) under the defined term "Eligible Receivable" in Section 12.1 entitled "Definitions is hereby amended to read as follows:

(n) The Receivable is otherwise acceptable to Lender.

3 . CONSISTENT CHANGES. The Existing Documents are each hereby amended wherever necessary to reflect the changes described above.

4. **INTENTIONALLY OMITTED**.

5. NO DEFENSES OF BORROWER/GENERAL RELEASE. Borrower agrees that, as of this date, it has no defenses against the obligations to pay any amounts under the Indebtedness. Each of Borrower and Guarantor (each, a "Releasing Party") acknowledges that Lender would not enter into this Business Financing Modification Agreement without Releasing Party's assurance that it has no claims against Lender or any of Lender's officers, directors, employees or agents. Except for the obligations arising hereafter under this Business Financing Modification Agreement, each Releasing Party releases Lender, and each of Lender's and entity's officers, directors and employees from any known or unknown claims that Releasing Party now has against Lender of any nature, including any claims that Releasing Party, its successors, counsel, and advisors may in the future discover they would have now had if they had known facts not now known to them, whether· founded in contract, in tort or pursuant to any other theory of liability, including but not limited to any claims arising out of or related to the Agreement or the transactions contemplated thereby. Releasing Party waives the provisions of California Civil Code section 1542, which states:

A GENERAL RELEASE DOES NOT EXTEND TO CLAIMS WHICH THE CREDITOR DOES NOT KNOW OR SUSPECT TO EXIST IN HIS OR HER FAVOR AT THE TIME OF EXECUTING THE RELEASE, WHICH IF KNOWN BY HIM OR HER, MUST HAVE MATERIALLY AFFECTED HIS OR HER SETTLEMENT WITH THE DEBTOR.

The provisions, waivers and releases set forth in this section are binding upon each Releasing Party and its shareholders, agents, employees, assigns and successors in interest. The provisions, waivers and releases of this section shall inure to the benefit of Lender and its agents, employees, officers, directors, assigns and successors in interest. The provisions of this section. shall survive payment in full of the Obligations, full performance of all the terms of this Business Financing Modification Agreement and the Agreement, and/or Lender's actions to exercise any remedy available under the Agreement or otherwise.

6 . CONTINUING VALIDITY. Borrower understands and agrees that in modifying the existing Indebtedness, Lender is relying upon Borrower's representations, warranties, and agreements, as set forth in the Existing Documents. Except as expressly modified pursuant to this Business Financing Modification Agreement, the terns of the Existing Documents remain unchanged and in full force and effect. Lender's agreement to modifications to the existing Indebtedness pursuant to this Business Financing Modification Agreement in no way shall obligate Lender to make any future modifications to the Indebtedness. Nothing in this Business Financing Modification Agreement shall constitute a satisfaction of the Indebtedness. It is the intention of Lender and Borrower to retain as liable parties all makers and endorsers of Existing Documents, unless the party is expressly released by Lender in writing. No maker, endorser, or guarantor will be released by virtue of this Business Financing Modification Agreement. The terms of this paragraph apply not only to this Business Financing Modification Agreement, but also to any subsequent Business Financing modification agreements.

7. INTENTIONALLY OMITTED.

8 . NOTICE OF FINAL AGREEMENT. BY SIGNING THIS DOCUMENT EACH PARTY REPRESENTS AND AGREES THAT: (A) THIS WRITTEN AGREEMENT REPRESENTS THE FINAL AGREEMENT BETWEEN THE PARTIES, (B) THERE ARE NO UNWRITTEN ORAL AGREEMENTS BETWEEN THE PARTIES, AND (C) THIS WRITTEN AGREEMENT MAY NOT BE CONTRADICTED BY EVIDENCE OF ANY PRIOR, CONTEMPORANEOUS, OR SUBSEQUENT ORAL AGREEMENTS OR UNDERSTANDINGS OF THE PARTIES.

9 . COUNTER SIGNATURE. This Business Financing Modification Agreement shall become effective only when executed by Lender, Borrower, and Guarantor.

BORROWER:

TELKONET, INC.

By: ______________________

Name: Jason L Tienor

Title: CEO

LENDER:

BRIDGE BANK, NATIONAL ASSOCIATION

By: ______________________

Name: [illegible]

Title: SVP

EXHIBIT 31.1
CERTIFICATIONS

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

I, Jason L. Tienor, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Telkonet, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

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

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

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

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

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

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

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

Date: November 14, 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: November 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 **September 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
November 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 **September 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
November 14, 2013