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, 2020

OR

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

For the transition period from __________ to __________.

Commission file number 001-31972

TELKONET, INC.
(Exact name of Registrant as specified in its charter)

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

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

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

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

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

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

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

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

Large accelerated filer ☐
Accelerated filer ☐
Non-accelerated filer ☒
Smaller reporting company ☒
Emerging growth company ☐

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

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

The number of shares outstanding of the registrant's common stock, par value $0.001 per share, as of October 31, 2020 is 136,311,335.

TELKONET, INC.
FORM 10Q
September 30, 2020

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TELKONET, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	September 30, 2020	December 31, 2019
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,858,879	$ 3,300,600
Accounts receivable, net	1,582,921	2,283,587
Inventories, net	1,468,228	1,373,074
Contract assets	45,879	188,120
Prepaid expenses	247,736	251,619
Income taxes receivable	85,377	85,070
Total current assets	6,289,020	7,482,070
Property and equipment, net	142,329	186,525
Other assets:		
Deposits	7,000	17,130
Operating lease right of use assets	777,052	892,170
Deferred tax asset	28,021	28,021
Total other assets	812,073	937,321
Total Assets	$ 7,243,422	$ 8,605,916
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,194,500	$ 1,265,560
Accrued liabilities	803,176	527,826
Line of credit	65,317	624,347
Contract liabilities – current	620,847	653,053
Operating lease liabilities – current	237,048	223,835
Note Payable – current	913,063	–
Total current liabilities	3,833,951	3,294,621
Long-term liabilities:		
Contract liabilities – long-term	86,907	111,131
Accrued royalties – long-term	500,000	–
Operating lease liabilities – long-term	636,622	758,315
Total long-term liabilities	1,223,529	869,446
Total liabilities	$ 5,057,480	$ 4,164,067
Commitments and contingencies		
Stockholders' Equity		
Preferred stock Series A, par value $.001 per share; 215 shares authorized, 185 shares outstanding at September 30, 2020 and December 31, 2019, preference in liquidation of $1,729,763 and $1,674,195 as of September 30, 2020 and December 31, 2019, respectively.	1,340,566	1,340,566
Preferred stock Series B, par value $.001 per share; 567 shares authorized, 52 shares outstanding at September 30, 2020 and December 31, 2019, preference in liquidation of 471,533 and $455,904 as of September 30, 2020 and December 31, 2019, respectively.	362,059	362,059
Common stock, par value $.001 per share; 190,000,000 shares authorized; 136,311,335 and 135,990,491 shares issued and outstanding at September 30, 2020 and December 31, 2019, respectively.	136,311	135,990
Additional paid-in-capital	127,731,898	127,708,773
Accumulated deficit	(127,384,892)	(125,105,539)
Total stockholders' equity	2,185,942	4,441,849
Total Liabilities and Stockholders' Equity	$ 7,243,422	$ 8,605,916

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,	
	2020	2019	2020	2019
Revenues, net:				
Product	$ 2,050,170	$ 1,995,788	$ 4,762,802	$ 7,963,349
Recurring	189,801	202,855	562,274	568,531
Total Net Revenue	2,239,971	2,198,643	5,325,076	8,531,880
Cost of Sales:				
Product	1,131,205	1,259,151	2,933,679	5,026,815
Recurring	16,468	74,437	65,037	237,551
Total Cost of Sales	1,147,673	1,333,588	2,998,716	5,264,366
Gross Profit	1,092,298	865,055	2,326,360	3,267,514
Operating Expenses:				
Research and development	231,088	448,690	892,179	1,360,986
Selling, general and administrative	1,518,915	1,137,084	3,646,246	3,936,851
Depreciation and amortization	14,658	16,775	44,196	50,750
Total Operating Expenses	1,764,661	1,602,549	4,582,621	5,348,587
Operating Loss	(672,363)	(737,494)	(2,256,261)	(2,081,073)
Other Expenses:				
Gain on fixed assets	–	150	–	150
Interest expense, net	(4,392)	(16,525)	(19,976)	(37,125)
Total Other Expense	(4,392)	(16,375)	(19,976)	(36,975)
Loss before Provision for Income Taxes	(676,755)	(753,869)	(2,276,237)	(2,118,048)
Income Tax Provision	–	–	3,116	–
Net Loss Attributable to Common Stockholders	$ (676,755)	$ (753,869)	$ (2,279,353)	$ (2,118,048)
Net Loss per Common Share:				
Basic – net loss attributable to common stockholders	$ (0.01)	$ (0.01)	$ (0.02)	$ (0.02)
Diluted – net loss attributable to common stockholders	$ (0.01)	$ (0.01)	$ (0.02)	$ (0.02)
Weighted Average Common Shares Outstanding – basic	136,311,335	135,331,951	136,061,140	134,937,277
Weighted Average Common Shares Outstanding – diluted	136,311,335	135,331,951	136,061,140	134,937,277

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)
JANUARY 1, 2019 THROUGH SEPTEMBER 30, 2019

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

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)
JANUARY 1, 2020 THROUGH SEPTEMBER 30, 2020

	Series A Preferred Stock Shares	Series A Preferred Stock Amount	Series B Preferred Stock Shares	Series B Preferred Stock Amount	Common Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Equity
Balance at January 1, 2020	185	$ 1,340,566	52	$ 362,059	135,990,491	$ 135,990	$ 127,708,773	$ (125,105,539)	$ 4,441,849
Shares issued to directors	–	–	–	–	320,844	321	17,679	–	18,000
Stock-based compensation expense related to employee stock options	–	–	–	–	–	–	1,815	–	1,815
Net loss attributable to common stockholders	–	–	–	–	–	–	–	(652,501)	(652,501)
Balance at March 31, 2020	185	$ 1,340,566	52	$ 362,059	136,311,335	$ 136,311	$ 127,728,267	$ (125,758,040)	$ 3,809,163
Shares issued to directors	–	–	–	–	–	–	–	–	–
Stock-based compensation expense related to employee stock options	–	–	–	–	–	–	1,816	–	1,816
Net loss attributable to common stockholders	–	–	–	–	–	–	–	(950,097)	(950,097)
Balance at June 30, 2020	185	$ 1,340,566	52	$ 362,059	136,311,335	$ 136,311	$ 127,730,083	$ (126,708,137)	$ 2,860,882
Shares issued to directors	–	–	–	–	–	–	–	–	–
Stock-based compensation expense related to employee stock options	–	–	–	–	–	–	1,815	–	1,815
Net loss attributable to common stockholders	–	–	–	–	–	–	–	(676,755)	(676,755)
Balance at September 30, 2020	185	$ 1,340,566	52	$ 362,059	136,311,335	$ 136,311	$ 127,731,898	$ (127,384,892)	$ 2,185,942

See accompanying notes to the unaudited condensed consolidated financial statements

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

	For the Nine Months Ended September 30,	
	2020	**2019**
Cash Flows from Operating Activities:		
Net loss	$ (2,279,353)	$ (2,118,048)
Adjustments to reconcile net loss to cash used in operating activities:		
Stock-based compensation expense related to employee stock options	5,446	5,446
Stock issued to directors as compensation	18,000	105,000
Depreciation and amortization	44,196	50,750
Noncash operating lease expense	173,556	178,426
Changes in operating assets and liabilities:		
Accounts receivable, net	700,666	(998,707)
Inventories, net	(95,154)	423,339
Prepaid expenses	3,883	204,343
Deposits	10,130	–
Accounts payable	(71,060)	596,554
Accrued royalties – long-term	500,000	–
Accrued liabilities and expenses	275,350	(33,874)
Contract liabilities	(56,430)	(111,648)
Contract assets	142,241	(108,554)
Operating lease liabilities	(166,918)	(164,794)
Income taxes receivable	(307)	(5,641)
Net Cash Used In Operating Activities	(795,754)	(1,977,408)
Cash Flows From Investing Activities:		
Purchase of property and equipment	–	(5,318)
Net Cash Used In Investing Activities	–	(5,318)
Cash Flows From Financing Activities:		
Proceeds from note payable	913,063	–
Proceeds from line of credit	5,425,000	9,079,000
Payments on line of credit	(5,984,030)	(8,291,051)
Net Cash Provided By Financing Activities	354,033	787,949
Net decrease in cash and cash equivalents	(441,721)	(1,194,777)
Cash, cash equivalents at the beginning of the period	3,300,600	4,678,891
Cash and cash equivalents at the end of the period	$ 2,858,879	$ 3,484,114

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,	
	2020	**2019**
Supplemental Disclosures of Cash Flow Information:		
Cash transactions:		
Cash paid during the period for interest	$ 28,137	$ 60,580

See accompanying notes to the unaudited condensed consolidated financial statements

NOTE A – BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

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

General

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

In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. However, the results from operations for the nine months ended September 30, 2020, are not necessarily indicative of the results that may be expected for the year ending December 31, 2020. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated December 31, 2019 financial statements and footnotes thereto included in the Company's Form 10-K filed with the SEC.

Business and Basis of Presentation

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

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

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

Going Concern and Management's Plan

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

Since inception through September 30, 2020, we have incurred cumulative losses of $127,384,892 and have never generated enough cash through operations to support our business. For the nine-month period ended September 30, 2020, we had a cash flow deficit from operations of $795,754. The Company has made significant investments in the engineering, development and marketing of an intelligent automation platform, including but not limited to, hardware and software enhancements, support services and applications. The funding for these development efforts has contributed to, and continues to contribute to, the ongoing operating losses and use of cash. Operating losses have been financed by debt and equity transactions, Credit Facility capacity, the sale of a wholly-owned subsidiary, and management of working capital levels. The report from our previous independent registered public accounting firm on our consolidated financial statements for the year ended December 31, 2019 stated there is substantial doubt about our ability to continue as a going concern. The Company's ability to continue as a going concern is dependent upon generating profitable operations in the future and obtaining the necessary financing to meet its obligations and repay its liabilities arising from normal business operations when they come due.

The Company's operations and financial results have also been impacted by the COVID-19 pandemic. Both the health and economic aspects of the COVID-19 pandemic are highly fluid and the future course of each is uncertain. We cannot predict whether the outbreak of COVID-19 will be effectively contained on a sustained basis. Depending on the length and severity of the COVID-19 pandemic, the demand for our products, our customers' ability to meet payment obligations to the Company, our supply chain and production capabilities, and our workforces' ability to deliver our products and services could be impacted. Management is actively monitoring the impact of the global situation on the Company's financial condition, liquidity, operations, suppliers, industry, and workforce. While we expect this disruption to continue to have a material adverse impact on our results of operations, financial condition cash flows, and liquidity, the Company is unable to reasonably determine the full extent of the impact at this time.

The Company's sales and gross profits have decreased significantly resulting from a contraction in commercial demand for our products, a lower revenue conversion rate in our existing pipeline and significant one-off transactions from customers in 2019 that have not been, and are not expected to be, repeated in 2020. Due to travel restrictions, social distancing and shelter at home edicts, the hospitality industry, our largest market that generally accounts for a majority of our revenue, has suffered as much as any. According to data from STR and Tourism Economics, full recovery in U.S. hotel demand and room revenue remains unlikely until 2023 and 2024, respectively. [1] For the remainder of 2020, Ernst & Young estimates that international travel is likely to contract anywhere between 58% to 78% for the year.[2]

In addition, the Company is currently in discussions related to the settlement of a patent infringement lawsuit (the Sipco Lawsuit). See the "Litigation" section in Note I – Commitments and Contingencies for a discussion of the Sipco Lawsuit. Based on these discussions, the Company determined the likelihood of a settlement to be probable, and as a result, as of September 30, 2020, the Company recorded, as its best estimate, a current liability of $100,000 included in Accrued liabilities and a non-current liability of $500,000 included in Accrued royalties – long-term of the Condensed Consolidated Balance Sheet for settlement-related costs. The corresponding expense is recorded in the Selling, general and administrative line of the Condensed Consolidated Statements of Operations. The payment of such estimated settlement-related royalty fees is expected to have a material and adverse impact on the Company's results of operations and liquidity. There is, however, no assurance that the Sipco Lawsuit will be settled, and if settled, the amount of any costs.

The Company has taken, and is continuing to take, a number of actions to preserve cash. These actions include suspending the use of engineering consultants and cancelling all non-essential travel and the Company's attendance at tradeshows (implemented prior to applicable government stay-at-home orders being put in place). In early April of 2020, management made the decision to furlough certain employees, instituted pay cuts for certain other employees and suspended the Company's 401(k) match through the end of 2020. With the receipt of the PPP Loan (discussed below), the Company was able to bring back the furloughed employees, restore payroll to prior levels and delay suspension of the 401(k) match. However, the pandemic continued to impact the Company's operations and financial results, and consequently, in late June of 2020 management once again made the decision to furlough certain employees, instituted pay cuts for certain other employees and suspended the Company's 401(k) match through the end of 2020. The furloughs and pay cuts continued through September 2020, at which time management determined it was necessary to discontinue the furloughs and pay cuts in order to retain necessary personnel for the Company's ongoing operations.

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[1] Fox, Jena Tesse. "Hotel Data Conference: Sluggish recovery for U.S. hotels."*Hotel Management* September 2020: 10.

[2] Fox, Jena Tesse. "WTTC, EY take in-depth look at the path to tourism recovery."*Hotel Management* August 2020: 9.

The more recent actions described above are in addition to the cost elimination and liquidity management actions that the Company began implementing in the second half of 2019, including reviewing opportunities to decrease spend with third party consultants and providers, strategically reviewing whether or not to fill employee positions in the event of vacancies, and implementing sales campaigns to sell slow-moving inventory and reduce existing inventory volumes. There is no guarantee, however, that these actions, nor any other actions identified, will yield profitable operations in the foreseeable future.

In addition to the actions noted above, on April 21, 2020, the Company entered into an unsecured promissory note, dated April 17, 2020 ("the PPP Loan"), with Heritage Bank of Commerce, a California state chartered bank ("Heritage Bank") for a $913,063 loan under the Paycheck Protection Program ("PPP"). See Note G – Debt for a summary of the terms of the PPP and the PPP Loan, including eligibility for forgiveness.

The Company also has a $2 million revolving credit facility with Heritage Bank (the "Credit Facility"), which is secured by all of the Company's assets. The Company is currently in compliance with the financial covenants in the loan agreement for the Credit Facility. However, based on the Company's current level of operations and forecasted cash flow analysis for the twelve-month period subsequent to the date of this filing, without further cost cutting measures, working capital management, and/or enhanced revenues, the Company believes it is reasonably likely that it will breach the covenant to maintain a minimum unrestricted cash balance of $2 million at some time during 2021. Violation of any covenant under the Credit Facility provides Heritage Bank with the option to accelerate repayment of amounts borrowed, terminate its commitment to extend further credit, and foreclose on the Company's assets. A default under the Credit Facility would also result in a cross-default under the Company's PPP Loan with Heritage Bank, in which case Heritage Bank could require immediate repayment of all amounts due under the PPP Loan. As of September 30, 2020, the outstanding balance on the Credit Facility was $65,317 and the PPP Loan had a balance of $913,063.

The Company plans to discuss the possibility of a waiver or a change to the financial covenant with Heritage Bank in the near term. Any covenant waiver or amendment could lead to increased costs, increased interest rates, additional restrictive covenants, and other lender protections. There is no assurance, however, that the Company will be able to obtain a covenant waiver or amendment, in which case Heritage Bank could immediately declare all amounts due under both the Credit Facility and the PPP Loan, terminate the Credit Facility, and foreclose on the Company's assets. Currently, the Company has sufficient cash balances to pay the amounts due under the Credit Facility and the PPP Loan, and the Company plans to submit an application for forgiveness of the PPP Loan. However, depending on the timing of a default and the Company's ongoing use of cash reserves and the Credit Facility to finance its near-term working capital needs, there is no assurance that at the time of a default that the Company would have sufficient cash balances to pay the amounts due at such time. There is also no assurance that the Company will obtain forgiveness of the PPP Loan in whole or in part. The Company may also seek additional financing from alternative sources, but there is no assurance that such financing will be available at commercially reasonable terms, if at all.

The Company currently expects to draw on its cash reserves and utilize the Credit Facility to finance its near-term working capital needs. It expects to continue to incur operating losses and negative operating cash flows for at least one year beyond the date of these financial statements. The Credit Facility provides the Company with needed liquidity to assist in meeting its obligations. However, as discussed above, without further cost cutting measures, working capital management, and/or enhanced revenues, the Company believes it is reasonably likely that it will breach a financial covenant under the Credit Facility at some time during 2021, in which case, without a waiver or amendment, the Credit Facility could be terminated, and without additional financing, the Company may be unable to meet its obligations or fund its operations within the next twelve months. The Company's Board also continues to consider strategic alternatives to maximize shareholder value, including but not limited to, a sale of the Company, an investment in the Company, a merger or other business combination, a sale of all or substantially all assets or a strategic joint venture. However, these actions are not solely within the control of the Company.

If cash resources become insufficient to meet the Company's ongoing obligations, the Company may be required to scale back or discontinue portions of its operations or discontinue operations entirely, pursue a sale of the Company or its assets at a price that may result in a significant or complete loss on investment for its shareholders, file for bankruptcy or seek other protection from creditors, or liquidate all its assets. In addition, if the Company defaults under the Credit Facility and is unable to pay the outstanding balance, Heritage Bank could foreclose on the Company's assets. The Company's shareholders may lose some or all of their investment as a result of any of these outcomes. Accordingly, and in light of the Company's historic losses, there is substantial doubt about the Company's ability to continue as a going concern.

Income (Loss) per Common Share

The Company computes earnings per share under ASC 260-10, "Earnings Per Share". Basic net income (loss) per common share is computed using the weighted average shares outstanding. Diluted net income (loss) per common share is computed using the treasury stock method, which assumes that the proceeds to be received on exercise of outstanding stock options and warrants are used to repurchase shares of the Company at the average market price of the common shares for the year. Dilutive common stock equivalents consist of shares issuable upon the exercise of the Company's outstanding stock options and warrants. For both the nine months ended September 30, 2020 and 2019, there were 3,599,793 shares of common stock underlying options and warrants excluded due to these instruments being anti-dilutive.

Shares used in the calculation of diluted EPS are summarized below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
Weighted average common shares outstanding – basic	136,311,335	135,331,951	136,061,140	134,937,277
Dilutive effect of stock options	–	–	–	–
Weighted average common shares outstanding – diluted	136,311,335	135,331,951	136,061,140	134,937,277

Use of Estimates

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

Income Taxes

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

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

Revenue from Contracts with Customers

Accounting Standards Codification Topic 606, Revenue from Contracts with Customers ("ASC 606, the Standard") supersedes nearly all legacy revenue recognition guidance. ASC 606, the Standard outlines a comprehensive five-step revenue recognition model based on the principle that an entity should recognize revenue based on when it satisfies its performance obligations by transferring control of promised goods or services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for said goods or services.

Identify the customer contracts

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

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

Identify the performance obligations

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

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

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

Determine the transaction price

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

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

Allocate the transaction price to the performance obligations

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

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

Revenue Recognition

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

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

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

Contracts are billed in accordance with the terms and conditions, either at periodic intervals or upon substantial completion. This can result in billing occurring subsequent to revenue recognition, resulting in contract assets. Contract assets are presented as current assets in the Condensed Consolidated Balance Sheet.

Contract liabilities include deferrals for the monthly support service fees. Long-term contract liabilities represent support service fees that will be recognized as revenue after September 30, 2021.

Contract Completion Cost

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

Sales Taxes

Unless provided with a resale or tax exemption certificate, the Company assesses and collects sales tax on sales transactions and records the amount as a liability. It is recognized as a liability until remitted to the applicable state. Total revenues do not include sales tax as the Company is considered a pass through conduit for collecting and remitting sales taxes.

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, 2020 and the year ended December 31, 2019, the Company experienced returns of approximately 1% to 3% of materials included in the cost of sales. As of September 30, 2020 and December 31, 2019, the Company recorded warranty liabilities in the amount of $48,222 and $58,791, respectively, using this experience factor range.

Product warranties for the nine months ended September 30, 2020 and the year ended December 31, 2019 are as follows:

	September 30, 2020	December 31, 2019
Beginning balance	$ 58,791	$ 46,103
Warranty claims incurred	(14,580)	(66,803)
Provision charged to expense	4,011	79,491
Ending balance	$ 48,222	$ 58,791

Advertising

The Company follows the policy of charging the costs of advertising to expenses as incurred. During the three months ended September 30, 2020 and 2019, the Company incurred advertising costs of $1,153 and $11,257, respectively. During the nine months ended September 30, 2020 and 2019, the Company incurred advertising costs of $8,315 and $47,399, respectively.

Research and Development

The Company accounts for research and development costs in accordance with the ASC 730-10, "Research and Development". Under ASC 730-10, all research and development costs must be charged to expense as incurred. Accordingly, internal research and development costs are expensed as incurred. Third-party research and development costs are expensed when the contracted work has been performed or as milestone results have been achieved. Company-sponsored research and development costs related to both present and future products are expensed in the period incurred. Total expenditures on research and product development for the three months ended September 30, 2020 and 2019 were $231,088 and $448,690, respectively. Research and product development expenditures for the nine months ended September 30, 2020 and 2019 were $892,179 and $1,360,986, respectively.

Stock-Based Compensation

The Company accounts for stock-based awards in accordance with ASC 718-10, "Share-Based Compensation", which requires a fair value measurement and recognition of compensation expense for all share-based payment awards made to the Company's employees and directors, including employee stock options and restricted stock awards. The Company estimates the fair value of stock options granted using the Black-Scholes valuation model. This model requires the Company 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 the Company's common stock price and the number of options that will 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 the Company's 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. The expected stock price volatility is based on the historical volatility of the Company's stock for the related expected term.

Total stock-based compensation expense in connection with options granted to employees recognized in the condensed consolidated statements of stockholders' equity was $1,815 for both the three months ended September 30, 2020 and 2019. Total stock-based compensation expense in connection with options granted to employees was $5,446 for both the nine months ended September 30, 2020 and 2019.

NOTE B – NEW ACCOUNTING PRONOUNCEMENTS

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. ASU 2016-13 provides guidance for estimating credit losses on certain types of financial instruments, including trade receivables, by introducing an approach based on expected losses. The expected loss approach will require entities to incorporate considerations of historical information, current information and reasonable and supportable forecasts. ASU 2016-13 also amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The guidance requires a modified retrospective transition method and early adoption is permitted. In November 2019, FASB issued ASU No. 2019-10, Financial Instruments – Credit Losses, Derivatives and Hedging, and Leases ("ASU 2019-10"), which defers the adoption of ASU 2016-13 for smaller reporting companies until January 1, 2023. The Company will continue to evaluate the impact of ASU 2016-13 on its consolidated financial statements.

In August 2018, the FASB issued ASU 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement. This guidance modifies, removes, and adds certain disclosure requirements on fair value measurements. This ASU is effective for annual periods beginning after December 15, 2019, including interim periods therein. The adoption of this guidance did not have a material impact on the Company's consolidated financial statements.

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

NOTE C – REVENUE

The following table presents the Company's product and recurring revenues disaggregated by industry for the three months ended September 30, 2020.

	Hospitality	Education	Multiple Dwelling Units	Government	Total
Product	$ 1,890,086	$ 61,779	$ 2,083	$ 96,222	$ 2,050,170
Recurring	116,292	72,059	1,450	–	189,801
	$ 2,006,378	$ 133,838	$ 3,533	$ 96,222	$ 2,239,971

The following table presents the Company's product and recurring revenues disaggregated by industry for the nine months ended September 30, 2020.

	Hospitality	Education	Multiple Dwelling Units	Government	Total
Product	$ 4,072,147	$ 383,944	$ 132,353	$ 174,358	$ 4,762,802
Recurring	432,214	112,422	17,638	–	562,274
	$ 4,504,361	$ 496,366	$ 149,991	$ 174,358	$ 5,325,076

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

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

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

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

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

Remaining performance obligations

As of September 30, 2020, the aggregate amount of the transaction price allocated to remaining performance obligations was approximately $0.87 million. Except for support services, the Company expects to recognize 100% of the remaining performance obligations over the next six months.

Contract assets and liabilities

	September 30, 2020	December 31, 2019
Contract assets	$ 45,879	$ 188,120
Contract liabilities	707,754	764,184
Net contract liabilities	$ 661,875	$ 576,064

Contracts are billed in accordance with the terms and conditions, either at periodic intervals or upon substantial completion. This can result in billings occurring subsequent to revenue recognition, resulting in contract assets. Contract assets are presented as current assets in the Condensed Consolidated Balance Sheet.

Often, the Company will require customers to pay a deposit upon contract signing that will be applied against work performed or products shipped. In addition, the Company will often invoice the full term of support at the start of the support period. Billings that occur prior to revenue recognition result in contract liabilities. The change in the contract liability balance during the nine-month period ended September 30, 2020 is the result of cash payments received and billing in advance of satisfying performance obligations.

Contract costs

Costs to complete a turnkey contract primarily relate to the materials cost and direct labor and are recognized proportionately as the performance obligation is satisfied. The Company will defer costs to complete a contract when materials have shipped (and control over the materials has transferred to the customer), but an insignificant amount of rooms have been installed. The Company will recognize any deferred costs in proportion to revenues recognized from the related turnkey contract. The Company does not expect deferred contract costs to be long-lived since a typical turnkey project takes sixty days to complete. Deferred contract costs are generally presented as other current assets in the condensed consolidated balance sheets.

The Company incurs incremental costs to obtain a contract in the form of sales commissions. These costs, whether related to performance obligations that extend beyond twelve months or not, are immaterial and will continue to be recognized in the period incurred within selling, general and administrative expenses.

NOTE D – ACCOUNTS RECEIVABLE

Components of accounts receivable as of September 30, 2020 and December 31, 2019 are as follows:

	September 30, 2020	December 31, 2019
Accounts receivable	$ 1,625,628	$ 2,338,626
Allowance for doubtful accounts	(42,707)	(55,039)
Accounts receivable, net	$ 1,582,921	$ 2,283,587

NOTE E – INVENTORIES

Components of inventories as of September 30, 2020 and December 31, 2019 are as follows:

	September 30, 2020	December 31, 2019
Product purchased for resale	$ 1,881,264	$ 1,613,733
Reserve for obsolescence	(413,036)	(240,659)
Inventory, net	$ 1,468,228	$ 1,373,074

NOTE F – ACCRUED LIABILITIES AND EXPENSES

Accrued liabilities at September 30, 2020 and December 31, 2019 are as follows:

	September 30, 2020	December 31, 2019
Accrued liabilities and expenses	$ 434,473	$ 214,925
Accrued payroll and payroll taxes	302,973	227,153
Accrued sales taxes, penalties, and interest	17,508	26,957
Product warranties	48,222	58,791
Total accrued liabilities and expenses	$ 803,176	$ 527,826

NOTE G – DEBT

Revolving Credit Facility

On September 30, 2014, the Company entered into a loan and security agreement (the "Heritage Bank Loan Agreement") with Heritage Bank of Commerce, a California state chartered bank ("Heritage Bank"), governing a revolving credit facility in a principal amount not to exceed $2,000,000 (the "Credit Facility"). Availability of borrowings under the Credit Facility is subject to a borrowing base calculation based on the Company's eligible accounts receivable and eligible inventory each multiplied by an applicable advance rate, with an overall limitation tied to the Company's eligible accounts receivable. The Credit Facility is secured by all of the Company's assets. The Credit Facility is available for working capital and other general business purposes.

The outstanding principal balance of the Credit Facility bears interest at the Prime Rate plus 3.00%, which was 6.25% at September 30, 2020 and 7.75% December 31, 2019. On October 9, 2014, as part of the Heritage Bank Loan Agreement, Heritage Bank was granted a warrant to purchase 250,000 shares of Telkonet common stock. The warrant has an exercise price of $0.20 and expires October 9, 2021. On November 6, 2019, the eleventh amendment to the Credit Facility was executed to extend the maturity date of the Credit Facility to September 30, 2021, unless earlier accelerated under the terms of the Heritage Bank Loan Agreement, and eliminate the maximum EBITDA loss covenant. The eleventh amendment was effective as of September 30, 2019.

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

The outstanding balance on the Credit Facility was $65,317 and $624,347 at September 30, 2020 and December 31, 2019, respectively, and the remaining available borrowing capacity was approximately $963,000 and $424,000, respectively. As of September 30, 2020, the Company was in compliance with all financial covenants.

See the "Going Concern and Management's Plan" section in Note A – Basis of Presentation and Significant Accounting Policies for a discussion of a potential default under the Credit Facility.

Paycheck Protection Program

On April 21, 2020, the Company entered into an unsecured promissory note, dated as of April 17, 2020 ("the PPP Loan"), with Heritage Bank under the PPP administered by the United States SBA and authorized by the Keeping American Workers Employed and Paid Act, which is part of the CARES Act, enacted on March 27, 2020. The principal amount of the PPP Loan is $913,063. The PPP Loan bears interest of 1.0% per annum and was disbursed on April 21, 2020.

The PPP Loan has a maturity date of April 21, 2022. No payments of principal or interest are required during the first six months, but interest accrues during this period. The PPP Flexibility Act (discussed below) extended the six-month loan payment deferral period. After the deferral period, monthly payments of principal and interest are required and continue until maturity with respect to any portion of the PPP Loan not forgiven, as discussed below. The PPP Loan may be prepaid, in full or in part, at any time prior to maturity with no prepayment penalties. The note contains events of default and other provisions customary for a loan of this type.

Under the terms of the PPP, the Company can apply for, and be granted, forgiveness for all or a portion of the PPP Loan. Such forgiveness will be determined, subject to limitations and ongoing rulemaking by the SBA, based on the use of loan proceeds for eligible purposes, including payroll costs, mortgage interest, rent, utility costs and the maintenance of employee and compensation levels. Prior to the enactment of the PPP Flexibility Act, at least 75% of such forgiven amounts must be used for eligible payroll costs. The amount of loan forgiveness will be reduced if the Company terminates employees or reduces salaries during the eight-week period following the date the proceeds are disbursed, and if it is not eligible to claim any of the safe harbors or exemptions.

On June 5, 2020, the PPP Flexibility Act of 2020 was signed into law. It amended the CARES Act and eased rules on how and when recipients can use loans and still be eligible for forgiveness. The PPP Flexibility Act changed many aspects of the PPP, including: (1) extending the covered period for loan forgiveness purposes from eight weeks to the earlier of 24 weeks from the loan origination date or December 31, 2020; (2) lowering the amount required to be spent on payroll costs from 75% to 60% of the loan principal; (3) extending the loan maturity period from two years to five years for PPP loans made on or after June 5, 2020; and (4) revising the loan payment deferral period until the date when the amount of loan forgiveness is determined and remitted to the lender. For PPP recipients who do not apply for forgiveness, the loan payment deferral period expires ten months after the applicable forgiveness period ends. No assurance is provided that the Company will obtain forgiveness of the PPP Loan in whole or in part.

The outstanding balance was $913,063 at September 30, 2020.

See the "Going Concern and Management's Plan" section in Note A – Basis of Presentation and Significant Accounting Policies for a discussion of a potential default under the PPP Loan.

NOTE H – CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock, with a par value of $.001 per share. The Company has authorized 215 shares as Series A preferred stock and 567 shares as Series B preferred stock. At September 30, 2020 and December 31, 2019, there were 185 shares of preferred stock Series A and 52 shares of preferred stock Series B outstanding.

The Company has authorized 190,000,000 shares of common stock with a par value of $.001 per share. As of September 30, 2020 and December 31, 2019, the Company had 136,311,335 and 135,990,491 shares of common stock issued and outstanding, respectively.

During the nine months ended September 30, 2020 and 2019, the Company issued 320,844 and 840,139 shares of common stock, respectively, to directors for services performed during the nine months ended September 30, 2020 and 2019, respectively. These shares were valued at $18,000 and $105,000, respectively, which approximated the fair value of the shares when they were issued.

During the nine months ended September 30, 2020 and 2019, no warrants were exercised and no shares of Series A or B preferred stock were converted to shares of common stock.

NOTE I – COMMITMENTS AND CONTINGENCIES

Office Leases Obligations

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

In January 2016, the Company entered into a lease agreement for 2,237 square feet of commercial office space in Germantown, Maryland for its Maryland employees. The Germantown lease, as amended, was set to expire at the end of January 2018. In November 2017, the Company entered into a second amendment to the lease agreement extending the lease through the end of January 2019. In November 2018, the Company entered into a third amendment to the lease agreement extending the lease through the end of January 2022.

In May 2017, the Company entered into a lease agreement for 5,838 square feet of floor space in Waukesha, Wisconsin for its inventory warehousing operations. The Waukesha lease expires in May 2024.

The Company determines if an arrangement is a lease at inception. This determination generally depends on whether the arrangement conveys to the Company the right to control the use of an explicitly or implicitly identified fixed asset for a period of time in exchange for consideration. Control of an underlying asset is conveyed to the Company if the Company obtains the rights to direct the use of and to obtain substantially all of the economic benefits from using the underlying asset. The Company does not separate non-lease components from lease components to which they relate and accounts for the combined lease and non-lease components as a single lease component.

Operating leases are included in our condensed consolidated balance sheet as right-of-use assets, operating lease liabilities – current and operating lease liabilities – long-term. We do not recognize a right-of-use asset and lease liability for leases with a term of 12 months or less. Our current operating leases are for facilities. Our leases may contain renewal options; however, we do not recognize right-of-use assets or lease liabilities for renewal periods unless it is determined that we are reasonably certain of renewing the lease at inception or when a triggering event occurs. Some of our lease agreements may contain rent escalation clauses, rent holidays, capital improvement funding, or other lease concessions.

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

We recognize our minimum rental expense on a straight-line basis based on the fixed components of a lease arrangement. Payments are set on a pre-determined schedule within each lease agreement. We amortize this expense over the term of the lease beginning with the date of the standard adoption for current leases and beginning with the date of initial possession, which is the date we enter the leased space and begin to make improvements in the preparation for its intended use, for future leases. Variable lease components represent amounts that are not fixed in nature and are not tied to an index or rate and are recognized as incurred. Variable lease components consist primarily of the Company's proportionate share of common area maintenance, utilities, taxes and insurance and are presented as operating expenses in the Company's statements of operations in the same line item as expense arising from fixed lease payments.

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

The components of lease expense for the nine months ended September 30, 2020 were as follows:

Operating lease expense:		
Operating lease cost – fixed	$	173,556
Variable lease cost		101,725
Total operating lease cost	$	275,281

Other information related to leases as of September 30, 2020 was as follows:

Operating lease liability – current	$	237,048
Operating lease liability – long-term	$	636,622
Operating cash outflows from operating leases	$	166,918
Weighted-average remaining lease term of operating leases		5.01 years
Weighted-average discount rate of operating leases		8.5%

Future annual minimum operating lease payments as of September 30, 2020 were as follows:

2020 (excluding the nine months ended September 30, 2020)	$	56,917
2021		242,299
2022		195,176
2023		193,169
2024 and thereafter		384,119
Total minimum lease payments		1,071,680
Less imputed interest		(198,010)
Total	$	873,670

Rental expenses charged to operations for the three months ended September 30, 2020 and 2019 were $86,329 and $87,633, respectively. Rental expenses charged to operations for the nine months ended September 30, 2020 and 2019 were $275,281 and $268,465, respectively.

Litigation

The Company is subject to legal proceedings and claims which arise in the ordinary course of its business. Although occasional adverse decisions or settlements may occur, other than the Sipco Lawsuit discussed below, 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.

Sipco, LLC v Telkonet, Inc.

On June 30, 2020, Sipco, LLC ("Sipco") filed a lawsuit against the Company in the United States District Court for the Eastern District of Wisconsin (Case No. 20-CV-00981) (the "Sipco Lawsuit") alleging infringement on multiple essential wireless mesh ("EWM") patents held by the Sipco. The EWM patent portfolio covers technologies used in multi-hop wireless networks utilizing wireless protocols such as, but not limited to, Zigbee. The portfolio also covers applications including, but not limited to, home and building automation and industrial controls. The complaint contends the Company sold and is continuing to sell various automated networked products designed to manage energy, lighting and temperature and those products employ wireless mesh network communication utilizing Zigbee enabled technology. The complaint alleges patent infringement and seeks damages, costs, expenses, pre-judgment and post-judgment interest and post-judgment royalties. The complaint also alleges that the infringement was willful and that this is an "exceptional case" and requests treble damages and attorneys' fees.

In an effort to avoid the expense of costly litigation, the Company and Sipco are engaging in discussions regarding a potential settlement of the Sipco Lawsuit. Based on these discussions, the Company determined the likelihood of a settlement to be probable, and as a result, as of September 30, 2020, the Company recorded, as its best estimate, a current liability of $100,000 included in Accrued liabilities and a non-current liability of $500,000 included in Accrued royalties – long-term of the Condensed Consolidated Balance Sheet for settlement-related costs. The corresponding expense is recorded in the Selling, general and administrative line of the Condensed Consolidated Statements of Operations. The payment of such estimated settlement-related royalty fees is expected to have a material and adverse impact on the Company's results of operations and liquidity. There is, however, no assurance that the Sipco Lawsuit will be settled, and if settled, the amount of any costs.

Sales Tax

Unless provided with a resale or tax exemption certificate, the Company assesses and collects sales tax on sales transactions and records the amount as a liability. It is recognized as a liability until remitted to the applicable state. Total revenues do not include sales tax as the Company is considered a pass through conduit for collecting and remitting sales taxes.

The following table sets forth the change in the sales tax accrual as of September 30, 2020 and December 31, 2019:

	September 30, 2020	December 31, 2019
Balance, beginning of year	$ 26,957	$ 43,400
Sales tax collected	67,413	167,233
Provisions (reversals)	24,353	(10,664)
Payments	(101,215)	(173,012)
Balance, end of period	$ 17,508	$ 26,957

NOTE J – BUSINESS CONCENTRATION

For the nine months ended September 30, 2020, two customers represented approximately 33% of total net revenues. For the nine months ended September 30, 2019, three customers represented approximately 44% of total net revenues.

As of September 30, 2020, two customers accounted for approximately 55% of the Company's net accounts receivable. As of December 31, 2019, two customers represented 36% of the Company's net accounts receivable.

Purchases from one supplier approximated $1,973,000, or 90%, of total purchases for the nine months ended September 30, 2020 and approximately $2,522,000, or 84%, of total purchases for the nine months ended September 30, 2019. The amount due to this supplier, net of deposits paid, was approximately $716,000 and $579,000 as of September 30, 2020 and December 31, 2019, respectively.

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 nine months ended September 30, 2020, 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, 2019, filed with the US. Securities and Exchange Commission (the "SEC") on March 30, 2020.

Business

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

The Company's direct sales effort targets the hospitality, education, commercial, utility and government/military markets. The Company is focusing its sales efforts in areas with available public funding and incentives, such as rebate programs offered by utilities for efficiency upgrades. Through the Company's proprietary platform, technology and partnerships with energy efficiency providers, the Company's management intends to position the Company as a leading provider of energy management solutions.

Forward-Looking Statements

In accordance with the Private Securities Litigation Reform Act of 1995, the Company can obtain a "safe-harbor" for forward-looking statements by identifying those statements and by accompanying those statements with cautionary statements which identify factors that could cause actual results to differ materially from those in the forward-looking statements. Accordingly, the following "Management's Discussion and Analysis of Financial Condition and Results of Operations" may contain certain forward-looking statements regarding strategic growth initiatives, growth opportunities and management's expectations regarding orders and financial results for the remainder of 2020 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 as described in the Company's filings with the SEC, including the current reports on Form 8-K, which factors are incorporated herein by reference. The Company expressly disclaims a duty to provide updates to forward-looking statements, whether as a result of new information, future events or other occurrences.

Critical Accounting Policies and Estimates and New Accounting Pronouncements

Please refer to the Company's Form 10-K filed March 30, 2020 for critical accounting policies and estimates. For information regarding recent accounting pronouncements and their effect on the Company, see "New Accounting Pronouncements" in Note B of the Notes to Unaudited Condensed Consolidated Financial Statements contained herein.

Revenues

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

	Three Months Ended					
	September 30, 2020		September 30, 2019		Variance	
Product	$ 2,050,170	92%	$ 1,995,788	91%	$ 54,382	3%
Recurring	189,801	8%	202,855	9%	(13,054)	(6%)
Total	$ 2,239,971	100%	$ 2,198,643	100%	$ 41,328	2%

	Nine Months Ended								
	September 30, 2020			September 30, 2019			Variance		
Product	$	4,762,802	89%	$	7,963,349	93%	$	(3,200,547)	(40%)
Recurring		562,274	11%		568,531	7%		(6,257)	(1%)
Total	$	5,325,076	100%	$	8,531,880	100%	$	(3,206,804)	(38%)

Product Revenue

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

For the three and nine months ended September 30, 2020, product revenues increased by 3% or $0.05 million and decreased 40% or $3.20 million, respectively, when compared to the prior year. Product revenues derived from value added resellers and distribution partners were $1.69 million and $3.61 million, respectively, for the three and nine months ended September 30, 2020, an increase of 1% and a decrease of 43% compared to the prior year period.

Beginning in the third quarter of 2019, the Company began implementing portfolio pricing increases, which under normal circumstances would be expected to positively impact product revenue, but given the COVID-19 pandemic, the impact of these price increases has been offset by reduced demand for our products at this time.

For the three months ended September 30, 2020, hospitality revenues increased $0.13 million to $1.89 million, government revenues increased $0.08 million to $0.10 million, education revenues decreased $0.09 million to $0.06 million and MDU revenues decreased $0.06 million to $0.00 million compared to the prior year period. For the three months ended September 30, 2020, international revenues increased $0.38 million to $0.47 million when compared to the prior year period. The increase in international revenues was primarily driven by one customer. Two customers accounted for approximately 67% of total product revenues for the three months ended September 30, 2020.

For the nine months ended September 30, 2020, all major industry sectors decreased when compared to the prior year period. Hospitality revenues decreased $1.71 million to $4.07 million, government revenues decreased $0.77 million to $0.17 million, education revenues decreased $0.48 million to $0.38 million and MDU revenues decreased $0.24 million to $0.13 million. For the nine months ended September 30, 2020, international revenues decreased $0.36 million to $0.62 million when compared to the prior year period. The decrease in international revenues was primarily driven by non-repeatable revenues from three customers in 2019 and limited international revenues in 2020.

Backlogs were approximately $2.7 million and $3.6 million at September 30, 2020 and 2019, respectively.

Recurring Revenue

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

For the three and nine months ended September 30, 2020, recurring revenue decreased by 6% and 1%, respectively, when compared to the prior year period. Variances are related to changes in unit sales of call center support services.

Cost of Sales

The table below outlines product versus recurring cost of sales, along with respective amounts of those costs as a percentage of revenue for the comparable periods:

	Three Months Ended					
	September 30, 2020		September 30, 2019		Variance	
Product	$ 1,131,205	55%	$ 1,259,151	63%	$ (127,946)	(10%)
Recurring	16,468	9%	74,437	37%	(57,969)	(78%)
Total	$ 1,147,673	51%	$ 1,333,588	61%	$ (185,915)	(14%)

	Nine Months Ended					
	September 30, 2020		September 30, 2019		Variance	
Product	$ 2,933,679	62%	$ 5,026,815	63%	$ (2,093,136)	(42%)
Recurring	65,037	13%	237,551	42%	(172,514)	(73%)
Total	$ 2,998,716	56%	$ 5,264,366	62%	$ (2,265,650)	(43%)

Costs of Product Sales

Costs of product revenue include equipment and installation labor related to EcoSmart technology. For the three and nine months ended September 30, 2020, product costs decreased by 10% and 42%, respectively, compared to the prior year period based upon lower revenues.

For the three month comparison, the variance was primarily attributable to decreases in material costs of $0.10 million, use of installation subcontractors of $0.09 million and salary expense of $0.03 million, partially offset by an increase in the inventory reserve of $0.11 million. Material costs as a percentage of product revenues was 39%, unchanged compared to the prior year period.

For the nine month comparison, the variance was primarily attributable to decreases in material costs of $1.3 million, logistical expenses of $0.24 million, inclusive of import tariffs, the use of installation subcontractors of $0.37 million and salary expense of $0.07 million. Material costs as a percentage of product revenues was 40%, a decrease of 2%, compared to the prior year period.

Costs of Recurring Revenue

Recurring costs are comprised primarily of call center support labor. For the three and nine months ended September 30, 2020, recurring costs decreased by 78% and 73%, respectively, when compared to the prior year period. The variance was primarily due to decreases in call center staffing as the Company migrated to a combination of internal and external solutions.

Gross Profit

The table below outlines product versus recurring gross profit, along with respective actual gross profit percentages for the comparable periods:

	Three Months Ended								
	September 30, 2020			September 30, 2019			Variance		
Product	$	918,965	45%	$	736,637	37%	$	182,328	25%
Recurring		173,333	91%		128,418	63%		44,915	35%
Total	$	1,092,298	49%	$	865,055	39%	$	227,243	26%

	Nine Months Ended								
	September 30, 2020			September 30, 2019			Variance		
Product	$	1,829,124	38%	$	2,936,534	37%	$	(1,107,410)	(38%)
Recurring		497,236	88%		330,980	58%		166,256	50%
Total	$	2,326,360	44%	$	3,267,514	38%	$	(941,154)	(29%)

Gross Profit on Product Revenue

Gross profit on product revenue for the three and nine months ended September 30, 2020 increased 25% and decreased 38%, respectively, when compared to the prior year period.

For the three months ended September 30, 2020, the actual gross profit percentage increased 8% to 45%. The increase was primarily attributable to an increase in revenues of $0.05 million combined with decreases in material costs of $0.10 million, use of installation subcontractors of $0.09 million and salary expense of $0.03 million, partially offset by an increase in the inventory reserve of $0.11 million. Tariffs imposed on Chinese imports resulted in an adverse impact of approximately 8% on the actual gross profit percentage for the three months ended September 30, 2020, compared to approximately 7% for the prior year period.

For the nine months ended September 30, 2020, the actual gross profit percentage increased 1% to 38%. Despite the increase in gross profit percentage, there was a decrease in gross profit compared to prior year period, primarily attributable to a decline in revenues of $3.20 million partially offset by decreases in material costs of $1.3 million, logistical expenses of $0.24 million, inclusive of import tariffs, the use of installation subcontractors of $0.37 million and salary expense of $0.07 million. Tariffs imposed on Chinese imports resulted in an adverse impact of approximately 7% on the actual gross profit percentage for the nine months ended September 30, 2020, which is consistent with the prior year period.

Gross Profit on Recurring Revenue

Gross profit on recurring revenue for the three and nine months ended September 30, 2020 increased 35% and 50%, respectively, when compared to the prior year period. The increase was primarily due to decreases in call center staffing as the Company migrated to a combination of internal and external solutions decreased call center staffing.

Operating Expenses

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

	Three Months Ended September 30,			
	2020	2019	Variance	
Total	$ 1,764,661	$ 1,602,549	$ 162,112	10%

	Nine Months Ended September 30,			
	2020	2019	Variance	
Total	$ 4,582,621	$ 5,348,587	$ (765,966)	(14%)

The Company's operating expenses are comprised of research and development, selling, general and administrative expenses and depreciation and amortization expense. During the three and nine months ended September 30, 2020, operating expenses increased by 10% and decreased by 14%, respectively, when compared to the prior year period as outlined below.

Research and Development

	Three Months Ended September 30,			
	2020	2019	Variance	
Total	$ 231,088	$ 448,690	$ (217,602)	(49%)

	Nine Months Ended September 30,			
	2020	2019	Variance	
Total	$ 892,179	$ 1,360,986	$ (468,807)	(34%)

Research and development costs are related to both present and future product development and integration and are expensed in the period incurred. During the three and nine months ended September 30, 2020, research and development costs decreased 49% and 34%, respectively, when compared to the prior year period. For the three month comparison, the variance is primarily attributable to decreases in expenses incurred with third-party consultants of $0.11 million, certification expenses of $0.05 million and salary expense of $0.05 million. The decrease in salary expense is primarily attributable to furloughs and/or pay reductions implemented at the beginning of the third quarter in response to the impact of COVID-19.

For the nine month comparison, the variance is primarily attributable to decreases in expenses incurred with third-party consultants of $0.34 million, certification expenses of $0.04 million and salary expense of $0.08 million.

Selling, General and Administrative Expenses

	Three Months Ended September 30,			
	2020	2019	Variance	
Total	$ 1,518,915	$ 1,137,084	$ 381,831	34%

	Nine Months Ended September 30,			
	2020	2019	Variance	
Total	$ 3, 646,246	$ 3,936,851	$ (290,605)	(7%)

During the three and nine months ended September 30, 2020, selling, general and administrative expenses increased by 34% and decreased by 7%, respectively, compared to the prior year period.

For the three month comparison, the variance is primarily attributable to a $0.60 million expense related to the Sipco Lawsuit and a $0.07 million increase in legal fees, partially offset by decreases in the 401k employer match of $0.03 million, salary expense of $0.17 million, marketing and advertising expense of $0.06 million and sales commissions of $0.04 million. As discussed in the "Litigation" section in Note I – Commitments and Contingencies in the Notes to the Condensed Consolidated Financial Statements under Item 1 of Part I of this Form 10-Q, based on settlement discussions between the Company and Sipco, the Company determined the likelihood of a settlement of the Sipco Lawsuit to be probable. As a result, as of September 30, 2020, the Company recorded, as its best estimate, a current liability of $100,000 included in Accrued liabilities and a non-current liability of $500,000 included in Accrued royalties – long-term of the Condensed Consolidated Balance Sheet for settlement-related costs, with the corresponding expense recorded in selling, general and administrative expenses. There is, however, no assurance that the Sipco Lawsuit will be settled, and if settled, the amount of any costs. The decrease in salary expense is primarily attributable to furloughs and/or pay reductions implemented at the beginning of the third quarter in response to the impact of COVID-19. At the end of the third quarter, management determined it was necessary to discontinue the furloughs and pay reductions in order to retain necessary personnel for the Company's ongoing operations as of September 30, 2020.

For the nine month comparison, the variance is primarily attributable to decreases in trade shows of $0.20 million, audit fees of $0.07 million, marketing and advertising expenses of $0.10 million, salary and recruitment of $0.40 million and sales commissions of $0.14 million, partially offset by the $0.60 million expense related to the Sipco Lawsuit discussed above and an $0.08 million increase in temporary staffing.

Non-GAAP Financial Measures

Management believes that certain non-GAAP financial measures may be useful to investors in certain instances to provide additional meaningful comparisons between current results and results in prior operating periods. Adjusted earnings before interest, taxes, depreciation, amortization and stock-based compensation ("Adjusted EBITDA") is a metric used by management and frequently used by the financial community. Adjusted EBITDA provides insight into an organization's operating trends and facilitates comparisons between peer companies, since interest, taxes, depreciation, amortization and stock-based compensation can differ greatly between organizations as a result of differing capital structures and tax strategies. Adjusted EBITDA is one of the measures used for determining our debt covenant compliance. Adjusted EBITDA excludes certain items that are unusual in nature or not comparable from period to period. While management believes that non-GAAP measurements are useful supplemental information, such adjusted results are not intended to replace our GAAP financial results. Adjusted EBITDA is not, and should not be considered, an alternative to net income (loss), operating income (loss), or any other measure for determining operating performance or liquidity, as determined under accounting principles generally accepted in the United States (GAAP). In assessing the overall health of its business for the three and nine months ended September 30, 2020 and 2019, the Company excluded items in the following general categories described below:

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

RECONCILIATION OF NET LOSS TO ADJUSTED EBITDA (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
Net loss	$ (676,755)	$ (753,869)	(2,279,353)	$ (2,118,048)
Gain on sale of fixed assets	–	(150)	–	(150)
Interest expense, net	4,392	16,525	19,976	37,125
Income tax provision	–	–	3,116	–
Depreciation and amortization	14,658	16,775	44,196	50,750
EBITDA	(657,705)	(720,719)	(2,212,065)	(2,030,323)
Adjustments:				
Stock-based compensation	1,815	1,815	5,446	5,446
Adjusted EBITDA	$ (655,890)	$ (718,904)	(2,206,619)	$ (2,024,877)

Liquidity and Capital Resources

For the nine-month period ended September 30, 2020, the Company reported a net loss of $2,279,353 and had cash used in operating activities of $795,754 and ended the period with an accumulated deficit of $127,384,892 and total current assets in excess of current liabilities of $2,455,069. At September 30, 2020, the Company had $2,858,879 of cash and approximately $963,000 of availability on its Credit Facility. The Credit Facility is a $2,000,000 line of credit, which is subject to a borrowing base calculation based on the Company's eligible accounts receivable and eligible inventory each multiplied by an applicable advance rate, with an overall limitation tied to the Company's eligible accounts receivable as well as financial covenants including a requirement to maintain a minimum unrestricted cash balance of $2,000,000. As of September 30, 2020, we had a total borrowing base of approximately $1,078,000, an outstanding balance of $65,317, and a cash management services reserve of $50,000, resulting in the approximate availability of $963,000 on the Credit Facility.

Since inception through September 30, 2020, we have incurred cumulative losses of $127,384,892 and have never generated enough cash through operations to support our business. For the nine-month period ended September 30, 2020, we had a cash flow deficit from operations of $795,754. The Company has made significant investments in the engineering, development and marketing of an intelligent automation platform, including but not limited to, hardware and software enhancements, support services and applications. The funding for these development efforts has contributed to, and continues to contribute to, the ongoing operating losses and use of cash. Operating losses have been financed by debt and equity transactions, Credit Facility capacity, the sale of a wholly-owned subsidiary, and the management of working capital levels. The report from our previous independent registered public accounting firm on our consolidated financial statements for the year ended December 31, 2019 stated there is substantial doubt about our ability to continue as a going concern. The Company's ability to continue as a going concern is dependent upon generating profitable operations in the future and obtaining the necessary financing to meet its obligations and repay its liabilities arising from normal business operations when they come due.

The Company's operations and financial results have also been impacted by the COVID-19 pandemic. Both the health and economic aspects of the COVID-19 pandemic are highly fluid and the future course of each is uncertain. We cannot predict whether the outbreak of COVID-19 will be effectively contained on a sustained basis. Depending on the length and severity of the COVID-19 pandemic, the demand for our products, our customers' ability to meet payment obligations to the Company, our supply chain and production capabilities, and our workforces' ability to deliver our products and services could be impacted. Management is actively monitoring the impact of the global situation on the Company's financial condition, liquidity, operations, suppliers, industry, and workforce. While we expect this disruption to continue to have a material adverse impact on our results of operations, financial condition cash flows, and liquidity, the Company is unable to reasonably determine the full extent of the impact at this time.

The Company's sales and gross profits have decreased significantly resulting from a contraction in commercial demand for our products, a lower revenue conversion rate in our existing pipeline and significant one-off transactions from customers in 2019 that have not been, and are not expected to be, repeated in 2020. Due to travel restrictions, social distancing and shelter at home edicts, the hospitality industry, our largest market that generally accounts for a majority of our revenue, has suffered as much as any. According to data from STR and Tourism Economics, full recovery in U.S. hotel demand and room revenue remains unlikely until 2023 and 2024, respectively. [3] For the remainder of 2020, Ernst & Young estimates that international travel is likely to contract anywhere between 58% to 78% for the year.[4]

In addition, the Company currently in discussions related to the settlement of patent infringement lawsuit (the Sipco Lawsuit). See the "Litigation" section in Note I – Commitments and Contingencies in the Notes to the Condensed Consolidated Financial Statements under Item 1 of Part I of this Form 10-Q for a discussion of the Sipco Lawsuit. Based on these discussions, the Company determined the likelihood of a settlement to be probable, and as a result, as of September 30, 2020, the Company recorded, as its best estimate, a current liability of $100,000 included in Accrued liabilities and a non-current liability of $500,000 included in Accrued royalties – long-term of the Condensed Consolidated Balance Sheet for settlement-related costs. The corresponding expense is recorded in the Selling, general and administrative line of the Condensed Consolidated Statements of Operations. The payment of such estimated settlement-related royalty fees is expected to have a material and adverse impact on the Company's results of operations and liquidity. There is, however, no assurance that the Sipco Lawsuit will be settled, and if settled, the amount of any costs.

The Company has taken, and is continuing to take, a number of actions to preserve cash. These actions include suspending the use of engineering consultants and cancelling all non-essential travel and the Company's attendance at tradeshows (implemented prior to applicable government stay-at-home orders being put in place). In early April of 2020, management made the decision to furlough certain employees, instituted pay cuts for certain other employees and suspended the Company's 401(k) match through the end of 2020. With the receipt of the PPP Loan (discussed below), the Company was able to bring back the furloughed employees, restore payroll to prior levels and delay suspension of the 401(k) match. However, the pandemic continued to impact the Company's operations and financial results, and consequently, in late June of 2020 management once again made the decision to furlough certain employees, instituted pay cuts for certain other employees and suspended the Company's 401(k) match through the end of 2020. The furloughs and pay cuts continued through September 2020, at which time management determined it was necessary to discontinue the furloughs and pay cuts in order to retain necessary personnel for the Company's ongoing operations.

The more recent actions described above are in addition to the cost elimination and liquidity management actions that the Company began implementing in the second half of 2019, including reviewing opportunities to decrease spend with third party consultants and providers, strategically reviewing whether or not to fill employee positions in the event of vacancies, and implementing sales campaigns to sell slow-moving inventory and reduce existing inventory volumes. There is no guarantee, however, that these actions, nor any other actions identified, will yield profitable operations in the foreseeable future.

In addition to the actions noted above, on April 21, 2020, the Company entered into an unsecured promissory note, dated April 17, 2020 ("the PPP Loan"), with Heritage Bank of Commerce, a California state chartered bank ("Heritage Bank") for a $913,063 loan under the Paycheck Protection Program ("PPP"). See Note G – Debt for a summary of the terms of the PPP Loan, including eligibility for forgiveness.

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[3] Fox, Jena Tesse. "Hotel Data Conference: Sluggish recovery for U.S. hotels."*Hotel Management* September 2020: 10.

[4] Fox, Jena Tesse. "WTTC, EY take in-depth look at the path to tourism recovery."*Hotel Management* August 2020: 9.

The Company also has a $2 million revolving credit facility with Heritage Bank (the "Credit Facility"), which is secured by all of the Company's assets. The Company is currently in compliance with the financial covenants in the loan agreement for the Credit Facility. However, based on the Company's current level of operations and forecasted cash flow analysis for the twelve-month period subsequent to the date of this filing, without further cost cutting measures, working capital management, and/or enhanced revenues, the Company believes it is reasonably likely that it will breach the covenant to maintain a minimum unrestricted cash balance of $2 million at some time during 2021. Violation of any covenant under the Credit Facility provides Heritage Bank with the option to accelerate repayment of amounts borrowed, terminate its commitment to extend further credit, and foreclose on the Company's assets. A default under the Credit Facility would also result in a cross-default under the Company's PPP Loan with Heritage Bank, in which case Heritage Bank could require immediate repayment of all amounts due under the PPP Loan. As of September 30, 2020, the outstanding balance on the Credit Facility was $65,317 and the PPP Loan had a balance of $913,063.

The Company plans to discuss the possibility of a waiver or a change to the financial covenant with Heritage Bank in the near term. Any covenant waiver or amendment could lead to increased costs, increased interest rates, additional restrictive covenants, and other lender protections. There is no assurance, however, that the Company will be able to obtain a covenant waiver or amendment, in which case Heritage Bank could immediately declare all amounts due under both the Credit Facility and the PPP Loan, terminate the Credit Facility, and foreclose on the Company's assets. Currently, the Company has sufficient cash balances to pay the amounts due under the Credit Facility and the PPP Loan, and the Company plans to submit an application for forgiveness of the PPP Loan. However, depending on the timing of a default and the Company's ongoing use of cash reserves and the Credit Facility to finance its near-term working capital needs, there is no assurance that at the time of a default that the Company would have sufficient cash balances to pay the amounts due at such time. There is also no assurance that the Company will obtain forgiveness of the PPP Loan in whole or in part. The Company may also seek additional financing from alternative sources, but there is no assurance that such financing will be available at commercially reasonable terms, if at all.

The Company currently expects to draw on its cash reserves and utilize the Credit Facility to finance its near-term working capital needs. It expects to continue to incur operating losses and negative operating cash flows for at least one year beyond the date of these financial statements. The Credit Facility provides the Company with needed liquidity to assist in meeting its obligations. However, as discussed above, without further cost cutting measures, working capital management, and/or enhanced revenues, the Company believes it is reasonably likely that it will breach a financial covenant under the Credit Facility at some time during 2021, in which case, without a waiver or amendment, the Credit Facility could be terminated, and without additional financing, the Company may be unable to meet its obligations or fund its operations within the next twelve months. The Company's Board also continues to consider strategic alternatives to maximize shareholder value, including but not limited to, a sale of the Company, an investment in the Company, a merger or other business combination, a sale of all or substantially all assets or a strategic joint venture. However, these actions are not solely within the control of the Company.

If cash resources become insufficient to meet the Company's ongoing obligations, the Company may be required to scale back or discontinue portions of its operations or discontinue operations entirely, pursue a sale of the Company or its assets at a price that may result in a significant or complete loss on investment for its shareholders, file for bankruptcy or seek other protection from creditors, or liquidate all its assets. In addition, if the Company defaults under the Credit Facility and is unable to pay the outstanding balance, Heritage Bank could foreclose on the Company's assets. The Company's shareholders may lose some or all of their investment as a result of any of these outcomes. Accordingly, and in light of the Company's historic losses, there is substantial doubt about the Company's ability to continue as a going concern.

Working Capital

Working capital (current assets in excess of current liabilities) decreased by $1,732,380 during the nine months ended September 30, 2020 from $4,187,449 at December 31, 2019 to $2,455,069 at September 30, 2020. The reduction in working capital was primarily due to the PPP Loan and a decrease in accounts receivable resulting primarily from a decline in revenues.

Revolving Credit Facility

On September 30, 2014, the Company entered into a loan and security agreement (the "Heritage Bank Loan Agreement"), with Heritage Bank of Commerce, a California state chartered bank ("Heritage Bank"), governing a revolving credit facility in a principal amount not to exceed $2,000,000 (the "Credit Facility"). Availability of borrowings under the Credit Facility is subject to a borrowing base calculation based on the Company's eligible accounts receivable and eligible inventory each multiplied by an applicable advance rate, with an overall limitation tied to the Company's eligible accounts receivable. The Credit Facility is secured by all of the Company's assets. The Heritage Bank Loan Agreement is available for working capital and other general business purposes.

The outstanding principal balance of the Credit Facility bears interest at the Prime Rate plus 3.00%, which was 6.25% at September 30, 2020 and 7.75% December 31, 2019. On October 9, 2014, as part of the Heritage Bank Loan Agreement, Heritage Bank was granted a warrant to purchase 250,000 shares of Telkonet common stock. The warrant has an exercise price of $0.20 and expires October 9, 2021. On November 6, 2019, the eleventh amendment to the Credit Facility was executed to extend the maturity date of the Credit Facility to September 30, 2021, unless earlier accelerated under the terms of the Heritage Bank Loan Agreement, and eliminate the maximum EBITDA loss covenant. The eleventh amendment was effective as of September 30, 2019.

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

The outstanding balance on the Credit Facility was $65,317 and $624,347 at September 30, 2020 and December 31, 2019, respectively, and the remaining available borrowing capacity was approximately $963,000 and $424,000, respectively. As of September 30, 2020, the Company was in compliance with all financial covenants.

See the "Liquidity and Capital Resources" section above for a discussion of a potential default under the Credit Facility.

Paycheck Protection Program

On April 21, 2020, the Company entered into an unsecured promissory note, dated as of April 17, 2020 ("the PPP Loan"), with Heritage Bank under the PPP administered by the United States SBA and authorized by the Keeping American Workers Employed and Paid Act, which is part of the CARES Act, enacted on March 27, 2020. The principal amount of the PPP Loan is $913,063, bears interest of 1.0% per annum and was disbursed on April 21, 2020.

The PPP Loan has a maturity date of April 21, 2022. No payments of principal or interest are required during the first six months, but interest accrues during this period. The PPP Flexibility Act (discussed below) extended the six-month loan payment deferral period. After the deferral period, monthly payments of principal and interest are required and continue until maturity with respect to any portion of the PPP Loan not forgiven, as discussed below. The PPP Loan may be prepaid, in full or in part, at any time prior to maturity with no prepayment penalties. The note contains events of default and other provisions customary for a loan of this type.

Under the terms of the PPP, the Company can apply for, and be granted, forgiveness for all or a portion of the PPP Loan. Such forgiveness will be determined, subject to limitations and ongoing rulemaking by the SBA, based on the use of loan proceeds for eligible purposes, including payroll costs, mortgage interest, rent, utility costs and the maintenance of employee and compensation levels. Prior to the enactment of the PPP Flexibility Act, at least 75% of such forgiven amounts must be used for eligible payroll costs. The amount of loan forgiveness will be reduced if the Company terminates employees or reduces salaries during the eight-week period following the date the proceeds are disbursed, and if it is not eligible to claim any of the safe harbors or exemptions.

On June 5, 2020, the PPP Flexibility Act of 2020 was signed into law. It amended the CARES Act and eased rules on how and when recipients can use loans and still be eligible for forgiveness. The PPP Flexibility Act changed many aspects of the PPP, including: (1) extending the covered period for loan forgiveness purposes from eight weeks to the earlier of 24 weeks from the loan origination date or December 31, 2020; (2) lowering the amount required to be spent on payroll costs from 75% to 60% of the loan principal; (3) extending the loan maturity period from two years to five years for PPP loans made on or after June 5, 2020; and (4) revising the loan payment deferral period until the date when the amount of loan forgiveness is determined and remitted to the lender. For PPP recipients who do not apply for forgiveness, the loan payment deferral period expires ten months after the applicable forgiveness period ends. No assurance is provided that the Company will obtain forgiveness of the PPP Loan in whole or in part.

The outstanding balance was $913,063 at September 30, 2020.

See the “Liquidity and Capital Resources” section above for a discussion of a potential default under the PPP Loan.

Cash Flow Analysis

Cash used in operations was $795,754 and $1,977,408, during the nine months ended September 30, 2020 and 2019, respectively. As of September 30, 2020, our primary capital needs included costs incurred to increase energy management sales, inventory procurement and managing current liabilities. The working capital changes during the nine months ended September 30, 2020 were primarily a result of a $701,000 decrease in net accounts receivable, a $275,000 increase in other accrued expenses, a $142,000 decrease in contract assets, partially offset by a $95,000 increase in net inventory, a $71,000 decrease in accounts payable, and a $56,000 decrease in contract liabilities. The working capital changes during the nine months ended September 30, 2019 were primarily related to an approximate $999,000 increase in net accounts receivable, $112,000 decrease in contract liabilities, $109,000 increase in contract assets, partially offset by a $597,000 increase in accounts payable, a $423,000 decrease in net inventory, and a $204,000 decrease in prepaid expenses. Accounts receivable balances fluctuate based on the negotiated billing terms with customers and collections. We purchase inventory based on forecasts and orders, and when those forecasts and orders change, the amount of inventory may also fluctuate. Accounts payable balances fluctuate with changes in inventory levels, volume of inventory purchases, and negotiated supplier and vendor terms.

There was no cash used in investing activities during the nine months ended September 30, 2020. Cash used in investing activities was $5,318 to purchase computer equipment during the nine months ended September 30, 2019.

Cash provided by financing activities was $354,033 during the nine months ended September 30, 2020 and $787,949 during the nine months ended September 30, 2019. Proceeds from the PPP loan were $913,063, proceeds borrowed from the line of credit were $5,425,000 and cash used for payments on the line of credit were $5,984,030 during the nine months ended September 30, 2020. Proceeds borrowed from the line of credit were $9,079,000 and cash used for payments on the line of credit were $8,291,051 during the nine months ended September 30, 2019.

See the discussion above in the “Liquidity and Capital Resources” section for a discussion of our liquidity

Off-Balance Sheet Arrangements

The Company has no material off-balance sheet arrangements.

Acquisition or Disposition of Property and Equipment

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

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that material information required to be disclosed in our periodic reports filed under the Securities Exchange Act of 1934, as amended (the "Exchange Act") is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms and to ensure that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer as appropriate, to allow timely decisions regarding required disclosure. The Company's Chief Executive Officer and Chief Financial Officer each evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act) as of September 30, 2020. Based on these evaluations, the Chief Executive Officer and the Chief Financial Officer concluded that our disclosure controls and procedures required by paragraph (b) of Rule 13a-15 and 15d-15 were not effective as of September 30, 2020 as a result of the material weaknesses discussed below.

Management's Report on Internal Control over Financial Reporting

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

With the participation of our Chief Executive Officer, our management conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2019 based on the framework in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on our evaluation and the material weaknesses described below, management concluded that the Company did not maintain effective internal control over financial reporting as of December 31, 2019 based on the COSO framework criteria.

As previously disclosed in Item 9A of our Annual Report on Form 10-K for the year ended December 31, 2019, our management did not properly design or maintain effective controls over the control environment and monitoring components of COSO. We did not have a sufficient complement of accounting and financial personnel with an appropriate level of knowledge to address technical accounting and financial reporting matters in accordance with generally accepted accounting principles and the Company's overall financial reporting requirements. We also lack sufficient information technology resources to address our IT general control environment requirements. The failures within the control environment and monitoring components contributed to the following control activity level material weaknesses:

- Revenues – We did not properly design or maintain effective controls over the recording of revenue recognition for contracts whose performance obligations are fulfilled over time.

- Financial Statement Close and Reporting – We did not properly design or maintain effective controls over the period end financial close and reporting process. Specifically, we lacked control over the review of account reconciliations, journal entries, identification of related party transactions, and reporting of our financial results and disclosures.

- Information Technology – We did not properly design or maintain effective controls to prevent unauthorized access to certain systems, programs and data, and provide for periodic review and monitoring of access and changes in programs, including review of security logs and analysis of segregation of duties conflicts.

- Segregation of Duties – We did not maintain adequate segregation of duties within the Company’s business processes, financial applications, and IT systems. Specifically, we did not have appropriate controls in place to adequately assess the segregation of job responsibilities and system user access for initiating, authorizing, and recording transactions.

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

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

In light of these material weaknesses, we performed additional analyses and procedures in order to conclude that our consolidated financial statements as of and for the years ended December 31, 2019 and 2018 included in the Annual Report on Form 10-K and as of September 30, 2020 and 2019 included in this Form 10-Q were fairly stated in accordance with U.S. GAAP. Notwithstanding the identified material weaknesses, our management has concluded that the audited financial statements included in the Annual Report on Form 10K for the year ended December 31, 2019 and the unaudited condensed consolidated financial statements included in this quarterly filing fairly represent, in all material respects, our financial position, results of operations, cash flows, and changes in stockholders’ equity as of and for the periods presented in accordance with U.S. GAAP.

Under applicable Securities Law, the Company is not required to obtain an attestation report from the Company's independent registered public accounting firm regarding internal control over financial reporting, and accordingly, such an attestation has not been obtained or included in the Annual Report on Form 10-K for the year ended December 31, 2019.

Attestation Report of the Registered Public Accounting Firm

Not applicable.

Changes in Internal Controls

Other than the material weaknesses discussed above, during the quarter ended September 30, 2020, there have been no changes in our internal control over financial reporting that have materially affected or are reasonably likely to materially affect our internal controls over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

See Note I – Commitments and Contingencies in the Notes to the Condensed Consolidated Financial Statements under Item 1 of Part I of this Form 10-Q for a discussion of the Sipco Lawsuit.

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, other than the Sipco Lawsuit, the Company believes that the final disposition of such matters should not have a material adverse effect on its financial position, results of operations or liquidity.

Item 1A. Risk Factors.

Reference is made to Part I Item 1A – "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2019. Except as set forth below, there have been no material changes to the risk factors contained in our Annual Report on Form 10-K for the year ended December 31, 2019.

Risks Relating to Our Financial Results and Need for Financing

We expect to continue to incur operating losses and have negative operating cash flows for the foreseeable future and we may not be able to access sources of liquidity necessary to continue our operations, and as a result, there is substantial doubt about our ability to continue as a going concern and our shareholders may lose some or all of their investment.

Since inception through September 30, 2020, we have incurred cumulative losses of $127,384,892 and have never generated enough funds through operations to support our business. For the nine-month period ended September 30, 2020, we had a cash flow deficit from operations of $795,754. Further, without further cost cutting measures, working capital management, and/or enhanced revenues, the Company believes it is reasonably likely that it will breach a financial covenant under its Credit Facility at some time during 2021. See the "Going Concern and Management's Plan" section in Note A – Basis of Presentation and Significant Accounting Policies in the Notes to the Condensed Consolidated Financial Statements under Item 1 of Part I of this Form 10-Q for a discussion of a potential default under the Credit Facility and the PPP Loan.

The Company's ability to continue as a going concern is dependent upon generating profitable operations in the future and obtaining the necessary financing to meet its obligations and repay its liabilities arising from normal business operations when they come due. There can be no assurance that the Company will be able to obtain a covenant waiver or amendment, in which case the lender, Heritage Bank, could immediately declare all amounts due under both the Company's Credit Facility and PPP Loan, terminate the Credit Facility, and foreclose on the Company's assets. The Company may also seek additional financing from alternative sources, but there is no assurance that such financing will be available at commercially reasonable terms, if at all.

If cash resources become insufficient to meet the Company's ongoing obligations, the Company may be required to scale back or discontinue portions of its operations or discontinue operations entirely, pursue a sale of the Company or its assets at a price that may result in a significant or complete loss on investment for its shareholders, file for bankruptcy or seek other protection from creditors, or liquidate all its assets. In addition, if the Company defaults under the Credit Facility and is unable to pay the outstanding balance, Heritage Bank could foreclose on the Company's assets. The Company's shareholders may lose some or all of their investment as a result of any of these outcomes. Accordingly, and in light of the Company's historic losses, there is substantial doubt about the Company's ability to continue as a going concern.

The Company's potential inability to comply with covenants under the Credit Facility could trigger prepayment obligations or other penalties and the Company may not be able to secure additional financing from alternative sources.

The Company is currently in compliance with the financial covenants in the loan agreement for the Credit Facility, which is secured by all of the Company's assets. However, based on the Company's current level of operations and forecasted cash flow analysis for the twelve-month period subsequent to the date of this filing, without further cost cutting measures, working capital management, and/or enhanced revenues, the Company believes it is reasonably likely that it will breach the covenant to maintain a minimum unrestricted cash balance of $2 million at some time during 2021. There can be no assurance the Company will be able to obtain a covenant waiver or amendment, in which case Heritage Bank could accelerate repayment of amounts borrowed, terminate its commitment to extend further credit, and foreclose on the Company's assets. A default under the Credit Facility would also result in a cross-default under the Company's PPP Loan with Heritage Bank, in which case Heritage Bank could require immediate repayment of all amounts due under the PPP Loan. As of September 30, 2020, the outstanding balance on the Credit Facility was $65,317 and the PPP Loan had a balance of $913,063. There can be no assurance that the Company will be able to secure financing to refinance these borrowings at commercially reasonable terms, if at all.

If cash resources become insufficient to meet the Company's ongoing obligations, the Company may be required to scale back or discontinue portions of its operations or discontinue operations entirely, pursue a sale of the Company or its assets at a price that may result in a significant or complete loss on investment for its shareholders, file for bankruptcy or seek other protection from creditors, or liquidate all its assets. In addition, if the Company defaults under the Credit Facility and is unable to pay the outstanding balance, Heritage Bank could foreclose on the Company's assets.

Risks Related to Our Business

The Company's operations, financial results, and liquidity have been materially and adversely impacted by the COVID-19 pandemic.

The Company's sales and gross profits have decreased significantly resulting from a contraction in commercial demand for our products, a lower revenue conversion rate in our existing pipeline and significant one-off transactions from customers in 2019 that have not been, and are not expected to be, repeated in 2020. Due to travel restrictions, social distancing and shelter at home edicts, the hospitality industry, our largest market that generally accounts for a majority of our revenue, has suffered as much as any. According to data from STR and Tourism Economics, full recovery in U.S. hotel demand and room revenue remains unlikely until 2023 and 2024, respectively.[5] For the remainder of 2020, Ernst & Young estimates that international travel is likely to contract anywhere between 58 to 78% for the year.[6]

Further, both the health and economic aspects of the COVID-19 pandemic are highly fluid and the future course of each is uncertain. We cannot predict whether the outbreak of COVID-19 will be effectively contained on a sustained basis. Depending on the length and severity of the COVID-19 pandemic, the demand for our products, our customers' ability to meet payment obligations to the Company, our supply chain and production capabilities, and our workforces' ability to deliver our products and services could be impacted. Management is actively monitoring the impact of the global situation on its financial condition, liquidity, operations, suppliers, industry, and workforce. While we expect this disruption to continue to have a material adverse impact on our results of operations, financial condition and cash flows, the Company is unable to reasonably determine the full extent of the impact at this time.

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[5] Fox, Jena Tesse. "Hotel Data Conference: Sluggish recovery for U.S. hotels."*Hotel Management* September 2020: 10.

[6] Fox, Jena Tesse. "WTTC, EY take in-depth look at the path to tourism recovery."*Hotel Management* August 2020: 9.

The Company is involved in ongoing patent litigation and recorded an accrued liability of $600,000 during the three months ended September 30, 2020; actual expenses may exceed this amount.

As discussed in the "Litigation" section in Note I – Commitments and Contingencies in the Notes to the Condensed Consolidated Financial Statements under Item 1 of Part I of this Form 10-Q, on June 30, 2020, Sipco filed a lawsuit alleging infringement on multiple essential wireless mesh patents held by it. In an effort to avoid the expense of costly litigation, the Company and Sipco are engaging in discussions regarding a potential settlement of the Sipco Lawsuit. Based on these discussions, the Company determined the likelihood of a settlement to be probable, and as a result, as of September 30, 2020, the Company recorded, as its best estimate, a current liability of $100,000 included in Accrued liabilities and a non-current liability of $500,000 included in Accrued royalties – long-term of the Condensed Consolidated Balance Sheet for settlement-related costs. The corresponding expense is recorded in the Selling, general and administrative line of the Condensed Consolidated Statements of Operations. The payment of such estimated settlement-related royalty fees is expected to have a material and adverse impact on the Company's results of operations and liquidity. There is, however, no assurance that the Sipco Lawsuit will be settled, and if settled, the amount of any costs.

Item 6. Exhibits.

Exhibit Number	Description Of Document
31.1	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Jason L. Tienor
31.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Richard E. Mushrush
32.1	Certification of Jason L. Tienor pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Richard E. Mushrush pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Schema Document
101.CAL	XBRL Calculation Linkbase Document
101.DEF	XBRL Definition Linkbase Document
101.LAB	XBRL Label Linkbase Document
101.PRE	XBRL Presentation Linkbase Document

SIGNATURES

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

Telkonet, Inc.
Registrant

Date: November 16, 2020	By:	/s/ Jason L. Tienor Jason L. Tienor Chief Executive Officer (principal executive officer)
Date: November 16, 2020	By:	/s/ Richard E. Mushrush Richard E. Mushrush Chief Financial Officer (principal financial officer)

EXHIBIT 31.1

CERTIFICATION

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

I, Jason L. Tienor, certify that:

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

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

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

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

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

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

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

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

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

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

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

Date: November 16, 2020

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

EXHIBIT 31.2

CERTIFICATION

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

I, Richard E. Mushrush certify that:

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

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

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

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

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

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

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

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

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

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

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

Date: November 16, 2020

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, 2020 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 16, 2020

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, 2020 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 16, 2020