TELKONET INC
Form 10-Q
May 14, 2009

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

FORM 10-Q

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

OR

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

For the transition period from __________ to __________.

For the period ended March 31, 2009

Commission file number 001-31972

TELKONET, INC.

(Exact name of Issuer as specified in its charter)

Utah	87-0627421
(State of Incorporation)	(IRS Employer Identification No.)

20374 Seneca Meadows Parkway, Germantown, MD 20876
(Address of Principal Executive Offices)

(240) 912-1800
Issuer's Telephone Number

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 x No o

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

Indicate by check mark whether the registrant is a large accelerated filer, and accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act, (check one).

Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer x

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

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 95,783,771 shares of Common Stock ($.001 par value) as of May 14, 2009.

TELKONET, INC.
FORM 10-Q for the Quarter Ended March 31, 2009

Index

	Page
PART I. FINANCIAL INFORMATION	2
Item 1. Financial Statements (Unaudited)	2
Condensed Consolidated Balance Sheets: March 31, 2009 and December 31, 2008	2
Condensed Consolidated Statements of Operations and Comprehensive Loss: Three Months Ended March 31, 2009 and 2008	3
Condensed Consolidated Statement of Equity January 1, 2009 through March 31, 2009	4
Condensed Consolidated Statements of Cash Flows: Three Months Ended March 31, 2009 and 2008	5
Notes to Unaudited Condensed Consolidated Financial Statements: March 31, 2009	7
Item 2. Management's Discussion and Analysis	23
Item 3. Quantitative and Qualitative Disclosures About Market Risk.	33
Item 4. Controls and Procedures	33
PART II. OTHER INFORMATION	33
Item 1. Legal Proceedings	33
Item 1A. Risk Factors	34
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	34
Item 3. Defaults Upon Senior Securities	34
Item 4. Submission of Matters to a Vote of Security Holders	34
Item 5. Other Information	34
Item 6. Exhibits	35

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

TELKONET, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

ASSETS	(Unaudited) March 31, 2009	December 31, 2008
Current assets:		
Cash and cash equivalents	$ 198,767	$ 281,989
Accounts receivable, net	840,253	1,024,909
Inventories	1,772,801	1,733,940
Other current assets	357,461	404,928
Total current assets	3,169,282	3,445,766
Property and equipment, net	3,510,509	3,744,525
Other assets:		
Marketable securities	367,653	397,403
Deferred financing costs, net	399,999	432,136
Goodwill and other intangible assets, net	18,123,007	18,322,303
Other long term assets	166,210	166,210
Total other assets	19,056,869	19,318,052
Total Assets	$ 25,736,660	$ 26,508,343
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$ 10,464,930	$ 10,328,255
Line of credit	774,005	574,005
Capital lease payable – current	191,092	204,416
Related party advances	284,692	285,784
Convertible debentures of subsidiary – current	7,010,503	7,010,503
Other current liabilities	564,462	456,694
Total current liabilities	19,289,684	18,859,657
Long-term liabilities:		
Convertible debentures, net of debt discounts of $735,463 and $825,585, respectively	1,093,074	1,311,065
Derivative liability	2,395,348	2,573,126
Deferred lease liability and other	50,791	50,791
Total long-term liabilities	3,539,213	3,934,982
Commitments and contingencies		
Equity		

Preferred stock, par value $.001 per share; 15,000,000 shares authorized; none issued and outstanding at March 31, 2009 and December 31, 2008	-	-
Common stock, par value $.001 per share; 130,000,000 shares authorized; 93,058,566 and 87,525,495 shares issued and outstanding at March 31, 2009 and December 31, 2008, respectively	93,059	87,526
Additional paid-in-capital	118,785,727	118,197,450
Accumulated deficit	(115,909,018)	(114,801,318)
Accumulated comprehensive loss	-	(32,750)
Total stockholders' equity	2,969,768	3,450,908
Non-controlling interest	(62,005)	262,795
Total equity	2,907,763	3,713,703
Total Liabilities and Equity	$ 25,736,660	$ 26,508,343

See accompanying notes to the unaudited condensed consolidated financial statements

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

	Three Months Ended March 31,	
Revenues, net:	2009	2008
Product	$ 2,078,978	$ 3,374,826
Recurring	1,854,942	1,584,195
Total Revenue	3,933,920	4,959,021
Cost of Sales:		
Product	1,161,393	2,551,939
Recurring	1,063,472	1,290,264
Total Cost of Sales	2,224,865	3,842,203
Gross Profit	1,709,055	1,116,818
Operating Expenses:		
Research and Development	275,962	665,122
Selling, General and Administrative	2,175,483	3,585,510
Stock Based Compensation	93,810	303,698
Stock Based Compensation of Subsidiary	99,847	133,301
Depreciation and Amortization	232,512	256,284
Total Operating Expenses	2,877,614	4,943,915
Loss from Operations	(1,168,559)	(3,827,097)
Other Income (Expenses):		
Financing Expense, net	(608,121)	(2,074,322)
Gain on Derivative Liability	263,701	-
(Loss) on Sale of Investments	(29,371)	-
Other Income	-	270,950
Total Other Income (Expenses)	(373,791)	(1,803,372)
Loss Before Provision for Income Taxes	(1,542,350)	(5,630,469)
Provision for Income Tax	-	-
Net loss	(1,542,350)	(5,630,469)
Loss attributable to the noncontrolling interest	434,648	509,438
Net loss attributable to common shareholders	$ (1,107,702)	$ (5,121,031)
Loss per share attributable to common shareholders (basic and assuming dilution)	$ (0.01)	$ (0.07)
Weighted average common shares outstanding	90,325,734	71,848,016
Comprehensive Loss:		
Net loss attributable to common shareholders	$ (1,107,702)	$ (5,121,031)

Unrealized gain (loss) on investment	32,750	(538,967)
Comprehensive loss attributable to common shareholders	$ (1,074,952)	$ (5,659,998)

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENT OF EQUITY (UNAUDITED)
FOR THE PERIOD FROM JANUARY 1, 2009 THROUGH MARCH 31, 2009

	Preferred Shares	Preferred Stock Amount	Common Shares	Common Stock Amount	Additional Paid in Capital	Accumulated Deficit	Comprehensive Income (Loss)	Noncontrolling Interest	Total
Balance at January 1, 2009			87,525,495	$ 87,526	$ 118,197,450	$ (114,801,318)	$ (32,750)	$ 262,795	$ 3,713,703
Shares issued in exchange for services rendered at approximately $0.12 per share	-	-	83,333	83	9,917	-	-	-	10,000
Shares issued in exchange for convertible debentures	-	-	5,449,738	5,450	494,550	-	-	-	500,000
Stock-based compensation expense related to employee stock options	-	-	-	-	83,810	-	-	99,847	183,657
Unrealized Gain on available for sale securities	-	-	-	-	-	-	32,750	-	32,750
Sale of investment to noncontrolling interest	-	-	-	-	-	-	-	10,000	10,000
Net Loss	-	-	-	-	-	(1,107,702)	-	(434,648)	(1,542,350)
Balance at March 31, 2009	-	-	93,058,566	$ 93,059	$ 118,785,727	$ (115,909,018)	$ -	$ (62,005)	$ 2,907,763

See accompanying notes to the unaudited condensed consolidated financial statements

4

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

	For the Three Months Ended March 31, 2009	2008
Increase (Decrease) In Cash and Equivalents		
Cash Flows from Operating Activities:		
Net loss attributable to common shareholders	$ (1,107,702)	$ (5,121,031)
Adjustments to reconcile net loss from operations to cash used in operating activities:		
Loss allocable to noncontrolling interest	(434,648)	(509,438)
Registration rights liquidated damages of subsidiary (financing expense)	-	(500,000)
Amortization of debt discounts and financing costs	233,182	771,913
Loss on sale of investment	29,371	-
(Gain) on derivative liability	(263,701)	-
Stock based compensation	193,657	545,906
Fair value of issuance of warrants and re-pricing (financing expense)	-	1,736,279
Depreciation and Amortization	417,178	475,613
Increase / decrease in:		
Accounts receivable, trade and other	193,442	1,328,434
Inventories	(47,647)	18,380
Prepaid expenses and deposits	(14,612)	(99,217)
Deferred revenue	(29,884)	(14,999)
Other Assets	171,193	(21,909)
Accounts payable, accrued expenses, net	383,696	575,408
Net Cash Used In Operating Activities	(276,475)	(814,661)
Cash Flows From Investing Activities:		
Purchase of cable and related equipment	(3,000)	(440,353)
Purchase of property and equipment	(1,300)	(9,001)
Proceeds from sale of investment	33,129	-
Net Cash Provided By (Used In) Investing Activities	28,829	(449,354)
Cash Flows From Financing Activities:		
Proceeds from sale of common stock, net of costs and fees	-	1,500,000
Proceeds from issuance of note payable to officer	-	200,000
Proceeds from line of credit	200,000	-
Financing fees for factoring agreement	(25,000)	(102,359)
Repayment of notes payable	-	(1,500,000)
Repayment of capital lease and other	(10,576)	(4,804)
Net Cash Provided By Financing Activities	164,424	92,837
Net (Decrease) In Cash and Equivalents	(83,222)	(1,171,178)
Cash and cash equivalents at the beginning of the period	281,989	1,629,583
Cash and cash equivalents at the end of the period	$ 198,767	$ 458,405

See accompanying notes to the unaudited condensed consolidated financial statements

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

	For the Three Months Ended March 31, 2009	2008
Supplemental Disclosures of Cash Flow Information:		
Cash transactions:		
Cash paid during the period for financing expenses	$ 108,204	$ 103,520
Income taxes paid	-	-
Non-cash transactions:		
Stock based compensation to employees and consultants in exchange for services	$ 193,657	$ 545,906
Value of warrant repricing and additional warrants issued	-	1,736,279
Registration rights liquidated damages	-	(500,000)
Gain (Loss) on derivative liability	263,701	-
Equipment purchased under capital lease obligations	-	226,185
Amortization of debt discount on convertible debentures	176,045	686,968

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2009
(UNAUDITED)

NOTE A-SUMMARY OF ACCOUNTING POLICIES

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

Business and Basis of Presentation

Telkonet, Inc., formed in 1999 and incorporated under the laws of the state of Utah, has evolved into a Clean Technology company that develops and manufactures proprietary energy efficiency and SmartGrid networking technology. Prior to January 1, 2007, the Company was primarily engaged in the business of developing, producing and marketing proprietary equipment enabling the transmission of voice and data communications over electric utility lines.

In January 2006, following the acquisition of Microwave Satellite Technologies, Inc. (MST), the Company began offering complete sales, installation, and service of VSAT and business television networks, and became a full-service national Internet Service Provider (ISP). The MST solution offers a complete "Quad-play" solution to subscribers of HDTV, VoIP telephony, NuVision broadband internet access and wireless fidelity ("Wi-Fi") access, to commercial multi-dwelling units and hotels.

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

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

In May 2007, Microwave Acquisition Corp., a newly formed, wholly-owned subsidiary of MSTI Holdings Inc. (formerly Fitness Xpress-Software Inc.) merged with MST. As a result of the merger, the Company's common stock in MST was exchanged for shares of common stock of MSTI Holdings Inc. Immediately following the merger, MSTI Holdings Inc. completed a private placement of its common stock for aggregate gross proceeds of $3,078,716 and sold senior convertible debentures in the aggregate principal amount of $6,050,000 (plus an 8% original issue discount added to such principal amount). As a result of these transactions, the Company's 90% interest in MST became a 63% interest in MSTI Holdings Inc. In February 2009, the Company completed the sale of 2,800,000 shares of MSTI Holdings, Inc. common stock, reducing its ownership in MSTI Holdings, Inc. to 49%.

In July 2007, MST, the wholly-owned subsidiary of the Company's subsidiary MSTI Holdings Inc., acquired substantially all of the assets of Newport Telecommunications Co., a New Jersey general partnership. Pursuant to the terms of the acquisition, the total consideration paid was $2,550,000, consisting of unregistered shares of the Company's common stock, equal to $1,530,000, and (ii) $1,020,000 in cash.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Telkonet Communications, Inc. and EthoStream, LLC and 49%-owned subsidiary MSTI Holdings Inc. (reported as the Company's MST Segment). Significant intercompany transactions have been eliminated in consolidation.

Going Concern

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern. However, the Company has reported a net loss available to common shareholders of $1,107,702 for the three months ended March 31, 2009, accumulated deficit of $115,909,918 and a working capital deficit of $16,120,402 as of March 31, 2009.

The Company believes that anticipated revenues from operations will be insufficient to satisfy its ongoing capital requirements for at least the next 12 months. If the Company's financial resources from operations are insufficient, the Company will require additional financing in order to execute its operating plan and continue as a going concern. The Company cannot predict whether this additional financing will be in the form of equity or debt, or be in another form. The Company may not be able to obtain the necessary additional capital on a timely basis, on acceptable terms, or at all. In any of these events, the Company may be unable to implement its current plans for expansion, repay its debt obligations as they become due, or respond to competitive pressures, any of which circumstances would have a material adverse effect on its business, prospects, financial condition and results of operations.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2009
(UNAUDITED)

Management intends to raise capital through asset-based financing and/or the sale of its stock in private placements. Management believes that with this financing, the Company will be able to generate additional revenues that will allow the Company to continue as a going concern. There can be no assurance that the Company will be successful in obtaining additional funding.

Goodwill and Other Intangibles

Goodwill represents the excess of the cost of businesses acquired over fair value or net identifiable assets at the date of acquisition. Goodwill is subject to a periodic impairment assessment by applying a fair value test based upon a two-step method. The first step of the process compares the fair value of the reporting unit with the carrying value of the reporting unit, including any goodwill. The Company utilizes a discounted cash flow valuation methodology to determine the fair value of the reporting unit. If the fair value of the reporting unit exceeds the carrying amount of the reporting unit, goodwill is deemed not to be impaired in which case the second step in the process is unnecessary. If the carrying amount exceeds fair value, the Company performs the second step to measure the amount of impairment loss. Any impairment loss is measured by comparing the implied fair value of goodwill, calculated per SFAS No. 142, with the carrying amount of goodwill at the reporting unit, with the excess of the carrying amount over the fair value recognized as an impairment loss.

Fair Value of Financial Instruments

In January 2008, the Company adopted the provisions of SFAS No. 157, “Fair Value Measurements”, (“FAS 157”) which defines fair value for accounting purposes, establishes a framework for measuring fair value and expands disclosure requirements regarding fair value measurements. The Company’s adoption of FAS 157 did not have a material impact on its consolidated financial statements. Fair value is defined as an exit price, which is the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date. The degree of judgment utilized in measuring the fair value of assets and liabilities generally correlates to the level of pricing observability. Financial assets and liabilities with readily available, actively quoted prices or for which fair value can be measured from actively quoted prices in active markets generally have more pricing observability and require less judgment in measuring fair value. Conversely, financial assets and liabilities that are rarely traded or not quoted have less price observability and are generally measured at fair value using valuation models that require more judgment. These valuation techniques involve some level of management estimation and judgment, the degree of which is dependent on the price transparency of the asset, liability or market and the nature of the asset or liability. The Company has categorized its financial assets and liabilities measured at fair value into a three-level hierarchy in accordance with FAS 157.

Investments

Telkonet maintained investments in two publicly-traded companies for the three months ended March 31, 2009. The Company has classified these securities as available for sale. Such securities are carried at fair market value. Unrealized gains and losses on these securities, if any, are reported as accumulated other comprehensive income (loss), which is a separate component of stockholders’ equity. Unrealized gains on the sale of one investment resulted in a gain of $32,750 recorded for the three months ended March 31, 2009 and unrealized losses of $538,967 were recorded for the three months ended March 31, 2008. Realized gains and losses and declines in value judged to be other than temporary on securities available for sale, if any, are included in operations. Realized losses of $29,371

were recorded for the sale of the Company's investment in Multiband during the three months ended March 31, 2009. There were no realized gains or losses for the three months ended March 31, 2008.

Use of Estimates

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

Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with Staff Accounting Bulletin No. 104, Revenue Recognition ("SAB104"), which includes the provisions of Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements ("SAB101"). SAB 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the selling prices of the products delivered and the collectibility of those amounts. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. The Company defers any revenue for which the product has not been delivered or is subject to refund until such time that the Company and the customer jointly determine that the product has been delivered or no refund will be required. SAB 104 incorporates Emerging Issues Task Force 00-21 ("EITF 00-21"), Multiple-Deliverable Revenue Arrangements. EITF 00-21 addresses accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2009
(UNAUDITED)

For equipment under lease, revenue is recognized over the lease term for operating lease and rental contracts. All of the Company’s leases are accounted for as operating leases. At the inception of the lease, no lease revenue is recognized and the leased equipment and installation costs are capitalized and appear on the balance sheet as “Equipment Under Operating Leases.” The capitalized cost of this equipment is depreciated from two to three years, on a straight-line basis down to the Company’s original estimate of the projected value of the equipment at the end of the scheduled lease term. Monthly lease payments are recognized as rental income.

MST accounts for the revenue, costs and expense related to residential cable services as the related services are performed in accordance with SFAS No. 51, Financial Reporting by Cable Television Companies. Installation revenue for residential cable services is recognized to the extent of direct selling costs incurred. Direct selling costs have exceeded installation revenue in all reported periods. Generally, credit risk is managed by disconnecting services to customers who are delinquent.

Revenue from sales-type leases for EthoStream products is recognized at the time of lessee acceptance, which follows installation. The Company recognizes revenue from sales-type leases at the net present value of future lease payments. Revenue from operating leases is recognized ratably over the lease period

Reclassifications

Certain reclassifications have been made in prior year's financial statements to conform to classifications used in the current year.

Noncontrolling Interest

As a result of adopting Statement of Financial Accounting Standards (“SFAS”) No. 160,Noncontrolling Interests in Consolidated Statements, an amendment of ARB No. 51 , on January 1, 2009, we present non-controlling interests (previously shown as minority interest) as a component of equity on our Consolidated Balance Sheets and Consolidated Statement of Equity (Deficit). The adoption of SFAS 160 did not have any other material impact on our financial position, results of operations or cash flow.

New Accounting Pronouncements

FSP FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly, provides guidelines for making fair value measurements more consistent with the principles presented in FASB Statement No. 157 (“SFAS 157”), Fair Value Measurements. FSP FAS 157-4 reaffirms what SFAS 157 states is the objective of fair value measurement, to reflect how much an asset would be sold for in an orderly transaction at the date of the financial statements under current market conditions. Specifically, it reaffirms the need to use judgment to ascertain if a formerly active market has become inactive and in determining fair values when markets have become inactive. The Company does not expect this pronouncement to have a material impact on its results of operations, financial position, or cash flows.

FSP FAS 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments, enhances consistency in financial reporting by increasing the frequency of fair value disclosures. This relates to fair value disclosures for any financial instruments that are not currently reflected on the consolidated balance sheet at fair value. FSP FAS 107-1 and APB 28-1 now require that fair value disclosures be made on a quarterly basis, providing qualitative and

quantitative information about fair value estimates for all those financial instruments not measured on the balance sheet at fair value. The Company does not expect this pronouncement to have a material impact on its results of operations, financial position, or cash flows.

FSP FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments, provides additional guidance designed to create greater clarity and consistency in accounting for and presenting impairment losses on securities. This FSP is intended to bring greater consistency to the timing of impairment recognition and to provide greater clarity to investors about the credit and noncredit components of impaired debt securities that are not expected to be sold. This FSP also requires increased and timelier disclosures sought by investors regarding expected cash flows, credit losses, and an aging of securities with unrealized losses. The Company does not expect this pronouncement to have a material impact on its results of operations, financial position, or cash flows.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2009
(UNAUDITED)

NOTE B- INTANGIBLE ASSETS AND GOODWILL

Total identifiable intangible assets acquired and their carrying values at December 31, 2008 are:

	Gross Carrying Amount	Accumulated Amortization	Net	Residual Value	Weighted Average Amortization Period (Years)
Amortized Identifiable Intangible Assets:					
Subscriber lists – MSTI	$ 4,444,114	$ (1,259,281)	$ 3,184,833	$ -	8.0
Subscriber lists - EthoStream	2,900,000	(432,985)	2,467,015	-	12.0
Total Amortized Identifiable Intangible Assets	7,344,114	(1,692,266)	5,651,848	-	9.6
Goodwill - MSTI	2,377,768	(2,377,768)	-		
Goodwill - EthoStream	8,796,439	(2,000,000)	6,796,439	-	
Goodwill - SSI	5,874,016	-	5,874,016	-	
Total	$ 24,392,337	$ (6,070,034)	$ 18,322,303	$ -	

Total identifiable intangible assets acquired and their carrying values at March 31, 2009 are:

	Gross Carrying Amount	Accumulated Amortization	Net	Residual Value	Weighted Average Amortization Period (Years)
Amortized Identifiable Intangible Assets:					
Subscriber lists – MSTI	$ 4,444,114	$ (1,398,159)	$ 3,045,955	$ -	8.0
Subscriber lists - EthoStream	2,900,000	(493,403)	2,406,597	-	12.0
Total Amortized Identifiable Intangible Assets	7,344,114	(1,891,562)	5,452,552	-	9.6
Goodwill - MSTI	2,377,768	(2,377,768)	-		
Goodwill - EthoStream	8,796,439	(2,000,000)	6,796,439	-	
Goodwill - SSI	5,874,016	-	5,874,016	-	
Total	$ 24,392,337	$ (6,269,330)	$ 18,123,007	$ -	

Total amortization expense charged to operations for the three months ended March 31, 2009 and 2008 was $199,296 and 199,295, respectively.

NOTE C – ACCOUNTS RECEIVABLE

Components of accounts receivable as of March 31, 2009 and December 31, 2008 are as follows:

March 31, 2009

				December 31, 2008
Accounts receivable (factored)	$	1,312,747	$	1,961,535
Advances from factor		(688,379)		(1,075,879)
Due from factor		624,368		885,656
Accounts receivable (non-factored)		402,285		325,653
Allowance for doubtful accounts		(186,400)		(186,400)
Total	$	840,253	$	1,024,909

In February 2008, the Company entered into a factoring agreement to sell, without recourse, certain receivables to an unrelated third party financial institution in an effort to accelerate cash flow. Under the terms of the factoring agreement the maximum amount of outstanding receivables at any one time is $2.5 million. Proceeds on the transfer reflect the face value of the account less a discount. The discount is recorded as interest expense in the Consolidated Statement of Operations in the period of the sale. Net funds received reduced accounts receivable outstanding while increasing cash. Fees paid pursuant to this arrangement are included in “Financing expense” in the Consolidated Statement of Operations and amounted to $50,356 for the three months ended March 31, 2009. The amounts borrowed are collateralized by the outstanding accounts receivable, and are reflected as a reduction to accounts receivable in the accompanying consolidated balance sheets.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2009
(UNAUDITED)

NOTE D - INVENTORIES

Components of inventories as of March 31, 2009 and December 31, 2008 are as follows:

	March 31, 2009	December 31, 2008
Raw Materials	$ 765,606	$ 843,978
Finished Goods	1,207,195	1,089,962
Reserve for Obsolescence	(200,000)	(200,000)
Total	$ 1,772,801	$ 1,733,940

NOTE E - PROPERTY AND EQUIPMENT

The Company's property and equipment at March 31, 2009 and December 31, 2008 consists of the following:

	March 31, 2009	December 31, 2008
Cable equipment and installations of subsidiary	$ 4,882,799	$ 4,879,799
Telecommunications and related equipment	117,637	117,493
Development Test Equipment	153,486	153,487
Computer Software	160,894	160,894
Leasehold Improvements	490,811	512,947
Office Equipment	377,851	382,851
Office Fixtures and Furniture	383,361	383,361
Total	6,566,839	6,590,831
Accumulated Depreciation	(3,056,330)	(2,846,306)
	$ 3,510,509	$ 3,744,525

Depreciation expense included as a charge to income was $33,216 and $56,989 for the three months ended March 31, 2009 and 2008, respectively.

NOTE F – MARKETABLE SECURITIES

Multiband Corporation

In connection with a payment of $75,000 of accounts receivable, the company received 30,000 shares of common stock of Multiband Corporation, a Minnesota-based communication services provider to multiple dwelling units. The Company classifies this security as available for sale, and is carried at fair market value. The Company sold its remaining investment in Multiband and recorded a loss of $29,371 during the three months ended March 31, 2009.

NOTE G – LINE OF CREDIT

In September 2008, the Company entered into a two-year line of credit facility with a third party financial institution. The line of credit has an aggregate principal amount of $1,000,000 and is secured by the Company's

inventory. The outstanding principal balance bears interest at the greater of (i) the Wall Street Journal Prime Rate plus nine (9%) percent per annum, adjusted on the date of any change in such prime or base rate, or (ii) Sixteen percent (16%). Interest, computed on a 365/360 simple interest basis, and fees on the credit facility are payable monthly in arrears on the last day of each month and continuing on the last day of each month until the maturity date. The Company may prepay amounts outstanding under the credit facility in whole or in part at any time. In the event of such prepayment, the lender will be entitled to receive a prepayment fee of four percent (4.0%) of the highest aggregate loan commitment amount if prepayment occurs before the end of the first year and three percent (3.0%) if prepayment occurs thereafter. The outstanding borrowing under the agreement at March 31, 2009 was $774,005. The Company has incurred interest expense of $33,156 related to the line of credit for the three months ended March 31, 2009. The Prime Rate was 3.25% at March 31, 2009.

On May 12, 2009, the Company received a notice of waiver of the “minimum cash flow to debt service ratio” and the “tangible net worth” requirements under the line of credit facility, as such terms are defined in items D(10)a and D(10)b, respectively, of the line of credit agreement. The waiver is in effect as of March 31, 2009 and continues for the 90 day period thereafter.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2009
(UNAUDITED)

NOTE H - SENIOR CONVERTIBLE DEBENTURES

Senior Convertible Debenture

A summary of convertible debentures payable at March 31, 2009 and December 31, 2008 is as follows:

	March 31, 2009	December 31, 2008
Senior Convertible Debentures, accrue interest at 13% per annum and mature on May 29, 2011	$ 1,828,537	$ 2,136,650
Debt Discount - beneficial conversion feature, net of accumulated amortization of $407,249 and $295,508 at March 31, 2009 and December 31, 2008, respectively.	(399,640)	(425,458)
Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of $342,217 and $277,913 at March 31, 2009 and December 31, 2008, respectively.	(335,823)	(400,127)
Total	$ 1,093,074	$ 1,311,065
Less: current portion	-	-
	$ 1,093,074	$ 1,311,065

As of March 31, 2009, the Company has $1,828,537 outstanding in convertible debentures. During the three months ended March 31, 2009, $500,000 of convertible debentures was converted into 5,449,738 shares of common stock.

The Company amortized the beneficial conversion feature and the value of the attached warrants, and recorded non-cash interest expense in the amount of $111,741 and $64,304, respectively, for the three months ended March 31, 2009.

On February 20, 2009, the Company and YA Global entered into an Agreement of Clarification pursuant to which the parties agreed that interest accrued as of December 31, 2008, in the amount of $191,887 shall be added to the principal amount outstanding under the Debentures and that each Debenture be amended to reflect the applicable increase in principal amount. In connection with this increase in the principal value of the debenture, the Company has recognized an additional $85,923 of debt discount attributed to the beneficial conversion feature of the debenture for the period ended March 31, 2009.

On March 31, 2009, the Company received a notice of waiver from YA Global Investments, L.P. pursuant to which it agreed that, to the extent MSTI is in default under the MSTI Debentures, such default shall not constitute an Event of Default as defined in Section 2(a)(iii) of the May 30, 2008 Debentures the Company issued to YA Global. The waiver is in effect as of December 31, 2008 through June 1, 2009.

At March 31, 2009, the Senior Convertible Debenture had an estimated fair value of $1.1 million.

Senior Convertible Debentures - MST

A summary of convertible promissory notes payable at March 31, 2009 and December 31, 2008 is as follows:

		March 31, 2009		December 31, 2008
Senior Convertible Debentures, accrue interest at 8% per annum commencing on the first anniversary of the original issue date of the debentures, payable quarterly in cash or common stock, at MSTI Holdings Inc.'s option, and mature on April 30, 2010	$	6,657,872	$	6,657,872
Senior Convertible Debentures, accrue interest at 8% per annum commencing on the first anniversary of the original issue date of the debentures, payable quarterly in cash or common stock, at MSTI Holdings Inc.'s option, and mature on December 15, 2008		352,631		352,631
Original Issue Discount - net of accumulated amortization of $550,503 and $550,503 at March 31, 2009 and December 31, 2008, respectively.		-		-
Debt Discount - beneficial conversion feature, net of accumulated amortization of $1,591,697 and $1,591,697 at March 31, 2009 and December 31, 2008, respectively.		-		-
Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of $2,124,569 and $2,124,569 at March 31, 2009 and December 31, 2008, respectively.		-		-
Total	$	7,010,503	$	7,010,503
Less: current portion		(7,010,503)		(7,010,503)
	$	-	$	-

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2009
(UNAUDITED)

The Company amortized the original issue discount, the beneficial conversion feature and the value of the attached warrants, and recorded non-cash interest expense in the amount of $131,588, $299,622, and $255,763, respectively, for the three months ended March 31, 2008.

Triggering Events that Accelerate or Increase a Direct Financial Obligation

As previously described, MSTI entered into an October 16, 2008 letter agreement with the Senior Lenders pursuant to which each of the Senior Lenders agreed to purchase from MSTI, and MSTI agreed to sell to such Senior lenders, additional Debentures in the aggregate principal amount of $352,631 (the "Additional Debentures"). Unless certain conditions were satisfied the Additional Debentures were to mature on December 15, 2008. Upon satisfaction of such conditions, the Maturity Date of the Additional Debentures would be automatically extended to April 30, 2010. As a result of MSTI's failure to satisfy the conditions for extension of the Maturity Date, the Additional Debentures matured on December 15, 2008.

As a result of MSTI's failure to timely pay its current obligations due to the Senior Lenders under the Additional Debentures in the amount of $352,631, certain events of default have occurred and are continuing beyond any applicable cure or grace period with respect to all of MSTI's secured obligations due to the Senior Lenders and subordinate lenders. The total amount due is $9,448,506 ($7,010,503 in debenture principal, $2,103,151 in default penalty and $334,852 in accrued interest). MSTI did not make such payments, and, accordingly, the Senior Lenders may take all steps they deem necessary to protect the Senior Lenders' interests, including the enforcement and exercise of any and all of its rights, remedies, liens and security interests available to them.

The MSTI Debentures are senior indebtedness and the holders of the MSTI Debentures have a security interest in all of MSTI Holdings, Inc.'s assets. As a consequence of MSTI's default, the Senior Lenders have the right to pursue any of the remedies set forth in the security agreements.

As a result of MSTI's default and ongoing losses, MSTI's Board and management has determined that it is advisable and in the best interests of the Company and its stockholders, in cooperation with the Senior Lenders to explore various options to satisfy its obligations, including but not limited to, the sale or spin-off of all or substantially all of the assets of Microwave Satellite Technologies, Inc., a wholly owned subsidiary of MSTI which process is currently ongoing.

At March 31, 2009, the carrying amounts of the Senior Convertible Debenture of MST approximate fair value because the entire note had been classified to current maturity.

Aggregate maturities of long-term debt as of March 31, 2009 are as follows:

For the twelve months ended December 31,	Amount
2009	$ 7,010,503
2010	-
2011	1,828,537
	$ 8,839,040

NOTE I - CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock, with a par value of $.001 per share. As of March 31, 2009 and December 31, 2008, the Company has no preferred stock issued and outstanding. The Company has authorized 130,000,000 shares of common stock, with a par value of $.001 per share. As of March 31, 2009 and December 31, 2008, the Company has 93,058,566 and 87,525,495, respectively, of shares of common stock issued and outstanding.

During the three months ended March 31, 2009, the Company issued 83,333 shares of common stock to consultants for services performed and services accrued in fiscal 2008. These shares were valued at $10,000, which approximated the fair value of the shares when they were issued.

During the three months ended March 31, 2009, the Company issued 5,449,738 shares of common stock at approximately $0.09 per share to its senior convertible debenture holders in exchange for $500,000 of debentures.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2009
(UNAUDITED)

NOTE J - STOCK OPTIONS AND WARRANTS

Employee Stock Options

The following table summarizes the changes in options outstanding and the related prices for the shares of the Company's common stock issued to employees of the Company under a non-qualified employee stock option plan.

	Options Outstanding				Options Exercisable	
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)		Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 1.00 - $1.99	4,558,429	4.39	$	1.02	4,227,929	$ 1.01
$ 2.00 - $2.99	1,232,500	5.63	$	2.48	1,179,500	$ 2.48
$ 3.00 - $3.99	966,000	6.31	$	3.27	832,750	$ 3.31
$ 4.00 - $4.99	90,500	6.31	$	4.32	72,000	$ 4.32
$ 5.00 - $5.99	124,000	6.08	$	5.22	102,000	$ 5.23
	6,971,429	4.93	$	1.71	6,414,179	$ 1.68

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

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2008	8,105,429	$ 1.98
Granted	185,000	1.00
Exercised	-	-
Cancelled or expired	(1,296,500)	2.71
Outstanding at December 31, 2008	6,993,929	$ 1.82
Granted	320,000	1.00
Exercised	-	-
Cancelled or expired	(342,500)	2.71
Outstanding at March 31, 2009	6,971,429	$ 1.71

The weighted-average fair value of stock options granted to employees during the three months ended March 31, 2009 and 2008 and the weighted-average significant assumptions used to determine those fair values, using a Black-Scholes option pricing model are as follows:

	March 31, 2009	March 31, 2008
Significant assumptions (weighted-average):		
Risk-free interest rate at grant date	3.5%	3.0%
Expected stock price volatility	81%	74%
Expected dividend payout	-	-
Expected option life (in years)	5.0	5.0
Fair value per share of options granted	$ 0.30	$ 0.62

The expected life of awards granted represents the period of time that they are expected to be outstanding. We determine the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules, exercise patterns and pre-vesting and post-vesting forfeitures. We estimate the volatility of our common stock based on the calculated historical volatility of our own common stock using the trailing 24 months of share price data prior to the date of the award. We base the risk-free interest rate used in the Black-Scholes-Merton option valuation model on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term equal to the expected life of the award. We have not paid any cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero in the Black-Scholes-Merton option valuation model. We use historical data to estimate pre-vesting option forfeitures and record share-based compensation for those awards that are expected to vest. In accordance with SFAS No. 123R, we adjust share-based compensation for changes to the estimate of expected equity award forfeitures based on actual forfeiture experience.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2009
(UNAUDITED)

There were no options exercised during the period ended March 31, 2009 or March 31, 2008.

The total fair value of shares vested during the period ended March 31, 2009 and 2008 was $83,810 and $222,198, respectively.

Total stock-based compensation expense recognized in the consolidated statement of earnings for the period ended March 31, 2009 and 2008 was $193,657 and $355,499, respectively, net of tax effect. Additionally, the aggregate intrinsic value of options outstanding and unvested as of March 31, 2009 is $0.

Non-Employee Stock Options

The following table summarizes the changes in options outstanding and the related prices for the shares of the Company's common stock issued to the Company consultants. These options were granted in lieu of cash compensation for services performed.

Options Outstanding				Options Exercisable	
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 1.00	1,815,937	3.09	$ 1.00	1,815,937	$ 1.00

Transactions involving options issued to non-employees are summarized as follows:

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2008	1,815,937	$ 1.00
Granted	-	-
Exercised	-	-
Canceled or expired	-	-
Outstanding at December 31, 2008	1,815,937	$ 1.00
Granted	-	-
Exercised	-	-
Canceled or expired	-	-
Outstanding at March 31, 2009	1,815,937	$ 1.00

There were no non-employee stock options vested during the three months ended March 31, 2009 and 2008, respectively.

Warrants

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

		Warrants Outstanding				Warrants Exercisable		
Exercise Prices		Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighed Average Exercise Price		Number Exercisable	Weighted Average Exercise Price	
$	0.58	856,739	3.08	$	0.58	856,739	$	0.58
$	0.60	800,000	4.35	$	0.60	800,000	$	0.60
$	0.61	2,500,000	4.41	$	0.61	2,500,000	$	0.61
$	2.59	862,452	2.62	$	2.59	862,452	$	2.59
$	3.98	3,078,864	3.56	$	3.98	3,078,864	$	3.98
$	4.17	359,712	2.79	$	4.17	359,712	$	4.17
		8,457,767	3.46	$	2.19	8,457,767	$	2.19

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2009
(UNAUDITED)

Transactions involving warrants are summarized as follows:

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2008	7,673,627	$ 4.15
Issued	4,164,140	1.31
Exercised	(3,380,000)	0.70*
Canceled or expired	-	-
Outstanding at December 31, 2008	8,457,767	$ 2.19
Issued	-	-
Exercised	-	-
Canceled or expired	-	-
Outstanding at March 31, 2009	8,457,767	$ 2.19

*The warrants were issued to Enable Capital and originally priced at $4.17 per share. In February 2008, these warrants were re-priced to $0.6978258 per share and the holders exercised the warrants on a cashless basis and received 1,000,000 shares

The Company did not issue any warrants during the period ended March 31, 2009. The Company granted 383,782 warrants to Convertible Senior Notes holders during the period ended March 31, 2008. The Company did not issue any compensatory warrants during the period ended March 31, 2009 and 2008.

The purchase price of the warrants issued to Convertible Senior Note holders was adjusted from $4.70 to $4.39 per share and approximately 79,000 additional warrants were issued during the period ended March 31, 2008 in accordance with the anti-dilution protection provision of the Convertible Senior Notes Payable Agreement (“the Agreement”) dated October 27, 2005, upon the occurrence of certain events as defined in the Agreement.

In February 2008, the Company amended certain stock purchase warrants held by private placement investors to reduce the exercise price under such warrants from $4.17 per share to $0.6978258 per share. The warrants entitled the holders to purchase an aggregate of up to 3,380,000 shares of Telkonet’s common stock. Subsequently, these private placement investors exercised all of their warrants on a cashless basis using the five day volume average weighted price (VWAP) as of January 31, 2008 of $.99 resulting in the issuance of 1,000,000 shares of Company common stock. The Company has accounted for the amended warrants issued, valued at $1,224,236, as other expense using the Black-Scholes pricing model and the following assumptions: contractual term of 5 years, an average risk-free interest rate of 3.5% a dividend yield of 0% and volatility of 70%. In addition, during the period ended March 31, 2008, the Company recorded non-cash expenses of $574,426 for issuing additional warrants and the re-pricing of outstanding warrants in accordance with the anti-dilution provision of the warrant agreements.

NOTE K - COMMITMENTS AND CONTINGENCIES

Employment and Consulting Agreements

On August 1, 2007, the Company entered into an agreement with Barry Honig, President of GRQ Consultants, Inc. (“GRQ”). Telkonet has agreed to pay Mr. Honig 50,000 shares of common stock per month for six (6) months, to

provide the Company with transaction advisory services. As of December 31, 2007, GRQ held a Senior Promissory Note issued by Telkonet on July 24, 2007, in the principal amount of $1,500,000 (Note J). On February 8, 2008, this note was repaid in full including $49,750 in accrued but unpaid interest from the issuance date through the date of repayment.

Litigation

The Company is subject to legal proceedings and claims which arise in the ordinary course of its business. Although occasional adverse decisions or settlements may occur, the Company believes that the final disposition of such matters should not have a material adverse effect on its financial position, results of operations or liquidity.

Senior Convertible Noteholder Claim

The August 14, 2006 Settlement Agreement with the Senior Convertible Debenture Noteholders provided that the number of shares issued to the Noteholders shall be adjusted based upon the arithmetic average of the weighted average price of the Company's common stock on the American Stock Exchange for the twenty trading days immediately following the settlement date. The Company has concluded that, based upon the weighted average of the Company's common stock between August 16, 2006 and September 13, 2006, the Company is entitled to a refund from the two Noteholders. One of the Noteholders has informed the Company that it does not believe such a refund is required. As a result, the Company has declined to deliver to the Noteholders certain stock purchase warrants issued to them pursuant to the Settlement Agreement pending resolution of this disagreement. The Noteholder has alleged that the Company has failed to satisfy its obligations under the Settlement Agreement by failing to deliver the warrants. In addition, the Noteholder maintains that the Company has breached certain provisions of the Registration Rights Agreement and, as a result of such breach, such Noteholder claims that it is entitled to receive liquidated damages from the Company. In the Company's opinion, the ultimate disposition of these matters will not have a material adverse effect on the Company's results of operations or financial position.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2009
(UNAUDITED)

Purchase Price Contingency

In conjunction with the acquisition of MST on January 31, 2006, the purchase price contingency shares are price protected for the benefit of the former owner of MST. In the event the Company's common stock price is below $4.50 per share upon the achievement of thirty three hundred (3,300) subscribers a pro rata adjustment in the number of shares will be required to support the aggregate consideration of $5.4 million. The price protection provision provides a cash benefit to the former owner of MST if the as-defined market price of the Company's common stock is less than $4.50 per share at the time of issuance from the escrow on or before January 31, 2009. The issuance of additional shares or distribution of other consideration upon resolution of the contingency based on the Company's common stock prices will not affect the cost of the acquisition. When the contingency is resolved or settled, and additional consideration is distributable, the Company will record the current fair value of the additional consideration and the amount previously recorded for the common stock issued will be simultaneously reduced to the lower current value of the Company's common stock. In addition, the Company agreed to fully fund the MST three year business plan, established on January 31, 2006, to satisfy the benchmarks established to achieve 3,300 subscribers. In the event, for any reason, the Company materially fails to satisfy its obligations under the acquisition agreement, then the former owners of MST shall be entitled to the release of any and all consideration held in reserve. In May 2008, the Company executed an agreement for a minimum commitment of $2.3 million to fund MST's business plan in accordance with Section 11.1 of the Purchase Agreement between Telkonet and Frank T. Matarazzo. In addition, the adjustment date for the achievement of MST's 3,300 subscribers has been extended an additional six months from January 31, 2009 to July 31, 2009. Additionally, in April 2008 the Company issued from escrow 200,000 shares of the purchase price contingency and advanced 400,000 shares in June 2008 in exchange for Mr. Matarazzo's agreement to a debt covenant restricting the use of proceeds in the Company's debenture financing with YA Global Investments LP.

Senior Convertible Debentures

On February 11, 2008, purchasers of MSTI Holdings, Inc. Debentures executed a letter agreement with MSTI Holdings, Inc. providing that, among other things, in the event Frank Matarazzo ceases being Chief Executive Officer of MSTI Holdings, Inc., MSTI Holdings, Inc. will be in default under the Debentures.

NOTE L- BUSINESS CONCENTRATION

Revenue from one (1) major customer approximated $563,758 or 14% of total revenues for the three months ended March 31, 2009. Revenue from two (2) major customers approximated $1,949,384 or 39% of total revenues for the three months ended March 31, 2008. Total accounts receivable of $158,676, or 9% of total accounts receivable, were due from these customers as of March 31, 2009. Total accounts receivable of $158,353, or 13% of total accounts receivable, was due from these customers as of March 31, 2008.

Purchases from two (2) major suppliers approximated $795,686, or 66% of purchases, and $1,038,652, or 55% of purchases, for the three months ended March 31, 2009 and 2008, respectively. Total accounts payable of approximately $278,787, or 5% of total accounts payable, was due to this supplier as of March 31, 2009, and $1,084,000, or 21% of total accounts payable, was due to this supplier as of March 31, 2008.

NOTE M- FAIR VALUE MEASUREMENTS

The financial assets of the Company measured at fair value on a recurring basis are cash equivalents, and long-term marketable securities. The Company's cash equivalents and long term marketable securities are generally classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The Company's long-term investments are classified within Level 3 of the fair value hierarchy because they are valued using unobservable inputs, due to the fact that observable inputs are not available, or situations in which there is little, if any, market activity for the asset or liability at the measurement date. The Company's derivative liabilities are classified within Level 2 of the fair value hierarchy because they are valued using inputs which are not actively observable, either directly or indirectly.

- Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2009
(UNAUDITED)

- Level 2: Quoted prices in markets that are not active, or inputs which are observable, either directly or indirectly, for substantially the full term of the asset or liability; or

- Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and are unobservable.

The following table sets forth the Company's short- and long-term investments as of March 31, 2009 which are measured at fair value on a recurring basis by level within the fair value hierarchy. As required by SFAS No. 157, these are classified based on the lowest level of input that is significant to the fair value measurement, (in thousands):

(in thousands)	Level 1	Level 2	Level 3	Assets at fair value
Cash and cash equivalents	$ 199	$ -	$ -	$ 199
Marketable securities	368	-	-	368
Long-term investments	-	-	63	63
Derivative liabilities	-	2,395	-	2,395
Long-term debt	-	-	$ 1,093	1,093
Total	$ 567	$ 2,395	$ 1,156	$ 4,118

NOTE N- BUSINESS SEGMENTS AND GEOGRAPHIC INFORMATION

The Company's reportable operating segments are strategic businesses differentiated by the nature of their products, activities and customers and are described as follows:

Telkonet is a "clean technology" company that develops and manufactures proprietary energy efficiency and smart grid networking technology. Through the Company's wholly owned subsidiary, EthoStream, LLC, the Company also operates one of the largest hospitality high-speed internet access (HSIA) networks in the United States.

Microwave Satellite Technologies (MST), offers complete sales, installation, and service of VSAT and business television networks, and became a full-service national Internet Service Provider (ISP). The MST solution offers a complete "Quad-play" solution to subscribers of HDTV, VoIP telephony, NuVision Broadband Internet access and wireless fidelity ("Wi-Fi") access, to commercial multi-dwelling units and hotels.

The measurement of losses and assets of the reportable segments is based on the same accounting principles applied in the consolidated financial statements.

Financial data relating to reportable operating segments is as follows:

	March 31, 2009		December 31, 2008	
	TKO	MST	TKO	MST
Current assets, excluding intercompany	$ 2,630,648	$ 538,634	$ 2,915,859	$ 529,907
Property and equipment, net	355,330	3,155,179	274,403	3,470,122

Other assets	15,943,511	3,113,358	16,065,815	3,252,237
Due from MST (intercompany)	2,478,414	-	2,181,793	-
Total assets	$ 21,407,903	$ 6,807,171	$ 21,437,870	$ 7,252,266
Current liabilities, excluding intercompany	5,552,967	13,776,031	5,371,645	13,488,012
Long term liabilities	3,537,550	-	3,934,982	-
Due to TKO (intercompany)	-	2,478,414	-	2,181,793
Total liabilities	$ 9,090,517	$ 16,254,445	$ 9,306,627	$ 15,669,805
Capital expenditures	$ 1,300	$ 3,000	$ 9,000	$ 1,133,629

18

TELKONET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2009
(UNAUDITED)

	Three Months Ended March 31, 2009		March 31, 2008	
	TKO	MST	TKO	MST
Revenues	$ 2,897,952	$ 1,035,968	$ 4,037,566	$ 921,455
Gross profit (loss)	1,515,479	193,576	1,143,405	(26,587)
Research and development	275,962	-	665,122	-
Selling, general and administrative	1,629,792	555,691	2,525,443	1,060,067
Depreciation and amortization	86,834	145,678	107,577	148,707
Stock based compensation	83,810	99,847	303,698	133,301
Total operating expenses	2,076,398	801,216	3,601,840	1,342,075
Loss from operations	(560,919)	(607,640)	(2,458,435)	(1,368,662)
Other income (expenses)	(34,486)	(339,305)	(1,819,471)	(8,197)
Loss before noncontrolling interest and provision for income taxes	$ (595,405)	$ (946,945)	$ (4,277,906)	$ (1,376,859)

NOTE O - SUBSEQUENT EVENTS

NYSE AMEX Notice of a Listing Deficiency

The Company has been informally notified by NYSE AMEX (the “Exchange”) that it intends to cite the company for a financial impairment based on a review of the Company's latest Annual Report on Form 10-K. The Company expects to receive formal notice, after which it will be required to submit a plan of remediation (the "Plan") by a date certain advising the Exchange of any action it has taken, or will take, that would bring the Company into compliance with the Exchange's continued listing standards. Upon receipt of the Plan, the Exchange will evaluate it and determine whether the Company has made a reasonable demonstration of an ability to regain compliance with the Exchange's continued listing standards. If the Plan is accepted, the Company may be able to continue its listing during the Plan period, during which time it will be subject to periodic reviews to determine whether it is making progress consistent with the Plan.

Lawsuit filed by the Company’s former CEO

The Company has been served with a summons and complaint by Ronald Pickett, the Company’s former CEO, in a lawsuit brought against the Company in the Circuit Court for Montgomery County, Maryland. The complaint alleges that the Company failed to make certain agreed upon severance payments to Mr. Pickett and failed to reimburse Mr. Pickett for his cellular phone bills and high speed internet access during the severance period. The complaint further alleges that the Company failed to pay certain travel expenses from Air Wilmington of approximately $40,000.00 that the Company had previously agreed to pay on Mr. Pickett’s behalf. Mr. Pickett is seeking a judgment for $294,000 plus interest, costs and attorneys fees. Additionally, Mr. Pickett makes a claim for treble damages under the Maryland Wage Payment and Collection Act. The Company intends to vigorously defend against this claim.

Senior Convertible Debenture

Subsequent to the period ended March 31, 2009, the Company has issued 2,725,205 shares of its common stock for the repayment of $222,514 of the principal value of the outstanding convertible debentures issued to YA Global Investments LP.

Loss of Control - MSTI

As previously reported, on February 26, 2009, the Company executed and completed a Stock Purchase Agreement with William Davis pursuant to which the Company sold, and Mr. Davis purchased, 2,800,000 shares of MSTI Holdings, Inc. (“MSTI”) common stock (the “MSTI Shares”) beneficially owned by the Company for an aggregate purchase price of $10,000. In connection with the sale of the MSTI Shares to Mr. Davis, the Company entered into a Partial Release of Lien with YA Global Investments, L.P. (“YA Global”), pursuant to which, in consideration of YA Global’s agreement to release its lien and security interest on the MSTI Shares, the Company paid a commitment fee to YA Global comprised of 157,000 shares of MSTI common stock. As a result of the transactions described above, the Company now beneficially owns 15,543,000 shares of MSTI common stock, which represents 49% of the issued and outstanding shares of MSTI common stock.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
MARCH 31, 2009
(UNAUDITED)

The Company has historically consolidated its investment in MSTI as a consolidated majority-owned subsidiary. On April 22, 2009, Warren V. Musser and Thomas C. Lynch submitted their resignations as directors of MSTI. As a result of these resignations and the decrease in beneficial ownership resulting from the transactions described above, the Company is no longer required to consolidate MSTI as a majority- owned subsidiary and the Company's investment in MSTI will now be accounted for under the cost method.

The following unaudited pro forma condensed financial statements are based on the historical financial statements of Telkonet, Inc. ("Telkonet") and MSTI Holdings, Inc. ("MSTI") after giving effect to the assumptions and adjustments which management made based on available information and in their opinion, fairly present the unaudited pro forma condensed financial statements. The pro forma balance sheet was prepared as if the transaction occurred on March 31, 2009 and the statements of operations were prepared as if the loss of control event, using the cost method of accounting, had occurred on the first day of the period presented.

The pro forma data is for informational purposes only and may not necessarily reflect future results of operations or financial position or what the results of operations or financial position would have been had the loss of control event occurred on the first day of the period presented. The unaudited pro forma condensed financial statements should be read in conjunction with the historical financial statements, including the notes thereto, of Telkonet included in this Form 10-Q.

TELKONET, INC.
UNAUDITED PRO FORMA CONDENSED COMBINED BALANCE SHEET
AS OF MARCH 31, 2009

	Historical			Pro Forma		
	Telkonet	MSTI Holdings, Inc.	Combined Total	Adjustments		Telkonet
ASSETS						
Current Assets:						
Cash and cash equivalents	$ 97,336	$ 101,431	$ 198,767	$ (101,431)	(1)	$ 97,336
Accounts Receivable, net	561,560	278,693	840,253	(278,693)	(1)	561,560
Inventory	1,772,801	-				