TELKONET INC
Form 10-Q
August 16, 2010

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

For the quarterly period ended June 30, 2010

OR

o 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 Issuer as specified in its charter)

Utah (State or Other Jurisdiction of Incorporation or Organization)	87-0627421 (I.R.S. Employer Identification No.)
10200 Innovation Drive, Suite 300, Milwaukee, WI (Address of Principal Executive Offices)	53226 (Zip Code)

(414) 223-0473
(Registrant’s Telephone Number, Including Area Code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one):

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 100,089,493 shares of Common Stock ($.001 par value) as of August 16, 2010.

TELKONET, INC.
FORM 10-Q for the Quarter Ended June 30, 2010

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements (Unaudited)

TELKONET, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS

	(Unaudited) June 30, 2010	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 102,437	$ 503,870
Accounts receivable, net	914,594	251,684
Inventories	687,532	906,583
Other current assets	434,649	246,936
Total current assets	2,139,212	1,909,073
Property and equipment, net	116,396	254,499
Other assets:		
Deferred financing costs, net	135,092	227,767
Goodwill and other intangible assets, net	13,774,952	13,895,792
Other assets	8,000	8,000
Total other assets	13,918,044	14,131,559
Total Assets	$ 16,173,652	$ 16,295,131
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Accounts payable	$ 3,510,282	$ 2,866,120
Accrued liabilities and expenses	2,342,575	2,271,838
Line of credit	98,583	387,000
Note payable – current	23,649	-
Note payable – related party	50,000	
Convertible debentures, net of debt discounts of $296,115	1,309,908	-
Derivative liability - current	812,442	-
Other current liabilities	145,805	169,606
Total current liabilities	8,293,244	5,694,564
Long-term liabilities:		
Convertible debentures, net of debt discounts of $457,560	-	1,148,463
Derivative liability – long term	372,064	1,881,299
Note payable – long term	276,351	300,000
Other long term liabilities	49,142	50,791
Total long-term liabilities	697,557	3,380,553
Commitments and contingencies		
	811,303	732,843

Redeemable preferred stock, Series A; par value $.001 per share; 215 shares authorized, issued and outstanding at June 30, 2010 and December 31, 2009, net (Face value $1,075,000)		
Stockholders' Equity		
Preferred stock, undesignated, par value $.001 per share; 14,999,785 shares authorized; none issued and outstanding at June 30, 2010 and December 31, 2009	-	-
Common stock, par value $.001 per share; 155,000,000 shares authorized; 96,967,129 and 96,563,771 shares issued and outstanding at June 30, 2010 and December 31, 2009, respectively	96,967	96,564
Additional paid-in-capital	120,204,363	120,132,088
Accumulated deficit	(113,929,782)	(113,741,481)
Total stockholders' equity	6,371,548	6,487,171
Total Liabilities and Stockholders' Equity	$ 16,173,652	$ 16,295,131

See accompanying notes to the unaudited condensed consolidated financial statements

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

	For The Three Months Ended June 30, 2010	For The Three Months Ended June 30, 2009	For The Six Months Ended June 30, 2010	For The Six Months Ended June 30, 2009
Revenues, net:				
Product	$ 1,970,286	$ 2,098,640	$ 3,536,737	$ 4,017,067
Recurring	1,213,115	1,011,729	2,230,704	1,991,254
Total Revenue	3,183,401	3,110,369	5,767,441	6,008,321
Cost of Sales:				
Product	1,012,124	1,032,183	1,911,907	2,108,822
Recurring	326,062	303,513	631,907	609,347
Total Cost of Sales	1,338,186	1,335,696	2,543,814	2,718,169
Gross Profit	1,845,215	1,774,673	3,223,627	3,290,152
Operating Expenses:				
Research and Development	264,049	222,316	529,900	498,278
Selling, General and Administrative	1,304,845	1,821,186	2,995,584	3,534,788
Depreciation and Amortization	77,790	93,683	158,200	180,517
Total Operating Expense	1,646,684	2,137,185	3,683,684	4,213,583
Income (Loss) from Operations	198,531	(362,512)	(460,057)	(923,431)
Other Income (Expenses):				
Financing Expense, net	(155,547)	(212,720)	(324,293)	(481,536)
Gain on Derivative Liability	541,326	1,175,573	696,793	1,439,274
(Loss) on Sale of Investment	-	-	-	(29,371)
(Loss) on Disposal of Fixed Asset	(100,744)	-	(100,744)	-
Total Other Income	285,035	962,853	271,756	928,367
Income (Loss) Before Provision for Income Taxes	483,566	600,341	(188,301)	4,936
Provision for Income Taxes	-	-	-	-
Income (Loss) from Continuing Operations	$ 483,566	$ 600,341	$ (188,301)	$ 4,936
Discontinued Operations				
(Loss) from Discontinued Operations	-	(123,438)	-	(635,735)
Gain on Deconsolidation	-	6,932,586	-	6,932,586
Net income (loss) attributable to common shareholders before accretion of preferred dividends and discount	$ 483,566	$ 7,409,489	$ (188,301)	$ 6,301,787
Accretion of preferred dividends and discount	(39,347)	-	(78,460)	-
	$ 444,219	$ 7,409,489	$ (266,761)	$ 6,301,787

Net income (loss) attributable to common shareholders								
Net income (loss) per share:								
Income (loss) per share from continuing operations - basic	$	0.00	$	0.01	$	(0.00)	$	0.00
Income (loss) per share from continuing operations - diluted	$	0.00	$	0.01	$	(0.00)	$	0.00
Income (loss) per share from discontinued operations – basic	$	-	$	0.07	$	-	$	0.07
Income (loss) per share from discontinued operations – diluted	$	-	$	0.07	$	-	$	0.07
Net income (loss) per share – basic	$	0.00	$	0.08	$	(0.00)	$	0.07
Net income (loss) per share - diluted	$	0.00	$	0.08	$	(0.00)	$	0.07
Weighted Average Common Shares Outstanding - basic		96,916,357		94,765,021		96,714,804		92,550,245
Weighted Average Common Shares Outstanding - diluted		97,140,595		97,832,501		96,714,804		92,617,724
Comprehensive Income (Loss):								
Net Income (Loss)	$	483,566	$	7,409,489	$	(188,301)	$	6,301,787
Unrecognized Gain (Loss) on Investment		-		-		-		32,750
Comprehensive Income (Loss)	$	483,566	$	7,409,489	$	(188,301)	$	6,334,537

See accompanying notes to the unaudited condensed consolidated financial statements

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TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)
FOR THE PERIOD FROM JANUARY 1, 2010 THROUGH JUNE 30, 2010

	Preferred Shares	Preferred Stock Amount	Common Shares	Common Stock Amount	Additional Paid in Capital	Accumulated Deficit	Total
Balance at January 1, 2010	0	0	96,563,771	$ 96,564	$ 120,132,088	$ (113,741,481)	$ 6,487,171
Shares issued to pay off accounts payable at approximately $0.12 per share	-	-	403,358	403	62,554	-	62,957
Stock-based compensation expense related to employee stock options	-	-	-	-	88,181	-	88,181
Accretion of preferred stock discount	-	-	-	-	(35,802)	-	(35,802)
Accretion of preferred stock dividend	-	-	-	-	(42,658)	-	(42,658)
Net Loss	-	-	-	-	-	(188,301)	(188,301)
Balance at June 30, 2010	-	-	96,967,129	$ 96,967	$ 120,204,363	$ (113,929,782)	$ 6,371,548

See accompanying notes to the unaudited condensed consolidated financial statements

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

	For the Six Months Ended June 30, 2010	2009
Increase (Decrease) In Cash and Equivalents		
Cash Flows from Operating Activities:		
Net income (loss) attributable to common shareholders before accretion of preferred dividends and discounts	$ (188,301)	$ 6,301,787
Net (income) from discontinued operations	-	(6,296,851)
Net income (loss) from continuing operations	(188,301)	4,936
Adjustments to reconcile net income (loss) from operations to cash (used in) operating activities:		
Amortization of debt discounts and financing costs	254,120	409,006
Loss on sale of investment	-	29,371
(Gain) on derivative liability	(696,793)	(1,439,274)
Loss on disposal of fixed assets	100,744	-
Stock based compensation	88,181	177,620
Fair value of issuance of warrants and re-pricing (financing expense)	-	2,510
Depreciation and amortization	158,200	180,517
Increase / decrease in:		
Accounts receivable, trade and other	(730,572)	671,371
Inventories	219,051	359,447
Prepaid expenses and deposits	(187,713)	63,975
Deferred revenue	-	(61,095)
Other Assets	42,212	82,840
Accounts payable, accrued expenses, net	827,855	(369,354)
Cash provided by (used in) continuing operations	(113,016)	111,870
Cash used in discontinued operations	-	(287,997)
Net Cash Used In Operating Activities	(113,016)	(176,127)
Cash Flows From Investing Activities:		
Advances to unconsolidated subsidiary	-	(305,539)
Purchase of property and equipment	-	(2,675)
Proceeds from sale of investment	-	33,129
Cash used in continuing operations	-	(275,085)
Cash used in discontinued operations	-	(5,979)
Net Cash Used In Investing Activities	-	(281,064)
Cash Flows From Financing Activities:		
Proceeds (repayment) from line of credit	(288,417)	140,015
Financing fees	-	(25,000)
Proceeds from the exercise of warrants	-	4,595
Repayment of capital lease and other	-	(4,714)
Cash provided by continuing operations	(288,417)	114,896
Cash provided by discontinued operations	-	293,976

Net Cash Provided By (Used In) Financing Activities	(288,417)	408,872
Net (Decrease) In Cash and cash equivalents	(401,433)	(48,319)
Cash and cash equivalents at the beginning of the period	503,870	168,492
Cash and cash equivalents at the end of the period	$ 102,437	$ 120,173

See accompanying notes to the unaudited condensed consolidated financial statements

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

	For the Six Months Ended June 30, 2010		For the Six Months Ended June 30, 2009	
Supplemental Disclosures of Cash Flow Information:				
Cash transactions:				
Cash paid during the period for financing expenses	$	301,351	$	114,739
Income taxes paid	$	-	$	-
Non-cash transactions:				
Common stock issuance to pay off accounts payable	$	62,957	$	-
Accretion of discount on redeemable preferred stock	$	35,802	$	-
Accretion of dividend on redeemable preferred stock	$	42,658	$	-

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2010
(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.

General

The accompanying unaudited condensed consolidated financial statements of Telkonet Inc. (the “Company”), have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information 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. Accordingly, the results from operations for the three and six month periods ended June 30, 2010, are not necessarily indicative of the results that may be expected for the year ending December 31, 2010. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated December 31, 2009 financial statements and footnotes thereto included in the Company's Form 10-K filed with the SEC.

The consolidated financial statements as of December 31, 2009 have been derived from the audited consolidated financial statements at that date but do not include all disclosures required by the accounting principles generally accepted in the United States of America.

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, manufactures and sells 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 a building’s internal electrical wiring.

In January 2006, following the acquisition of Microwave Satellite Technologies (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). In 2009, the Company completed the deconsolidation of MST by reducing its ownership percentage and board membership. Financial statements and accompanying notes included in this report include disclosure of the results of operations for MST, for all periods presented, as discontinued operations.

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 enabled Telkonet to provide installation and support for PLC products and third party applications to customers across North America.

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

Investments in entities over which the Company has significant influence, typically those entities that are 20 to 50 percent owned by the Company, are accounted for using the equity method of accounting, whereby the investment is carried at cost of acquisition, plus the Company’s equity in undistributed earnings or losses since acquisition.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2010
(UNAUDITED)

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 from continuing operations of $(188,301) for the period ended June 30, 2010, accumulated deficit of $(113,929,782) and total current liabilities in excess of current assets of $(6,154,032) as of June 30, 2010.

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.

Management intends to raise capital through asset-based financing and/or 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.

Fair Value of Financial Instruments

In January 2008, we adopted the provisions under FASB for Fair Value Measurements, which define fair value for accounting purposes, establishes a framework for measuring fair value and expands disclosure requirements regarding fair value measurements. Our adoption of these provisions did not have a material impact on our 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. We have categorized our financial assets and liabilities that are recurring, at fair value into a three-level hierarchy in accordance with these provisions.

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. We utilize 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, we perform the second step to measure the amount of impairment loss. Any impairment loss is measured by comparing the implied fair value of goodwill 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.

Long-Lived Assets

We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable in accordance with ASC 360-10 (formerly Statement of Financial Accounting Standards No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets). Recoverability is measured by comparison of the carrying amount to the future net cash flows which the assets are expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the projected discounted future cash flows arising from the asset using a discount rate determined by management to be commensurate with the risk inherent to our current business model.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2010
(UNAUDITED)

Investments

Telkonet maintained investments in two publicly-traded companies during the six months ended June 30, 2009. The Company 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. Sale of one investment resulted in a gain of $32,750 recorded for the period ended June 30, 2009. 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 recognized for the six months ended June 30, 2009, of which, the loss was recorded in February 2009 for the sale of the Company's remaining investment in Multiband.

Net Income (Loss) per Common Share

The Company computes earnings per share under Accounting Standards Codification subtopic 260-10, Earnings Per Share ("ASC 260-10"). Basic net income (loss) per common share is computed by dividing net loss by the weighted average number of shares of common stock. Diluted earnings per share is computed using the weighted average number of common and common stock equivalent shares outstanding during the period. Dilutive common stock equivalents consist of shares issuable upon conversion of convertible notes and the exercise of the Company's stock options and warrants.

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, we recognize revenue in accordance with FASB's Accounting Standards Codification, or ASC, 605-10, and ASC Topic 13 guidelines that require that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectability is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the selling prices of the products delivered and the collectability of those amounts. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. We defer any revenue for which the product has not been delivered or is subject to refund until such time that we and the customer jointly determine that the product has been delivered or no refund will be required. The guidelines also address the accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

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.

Stock Based Compensation

We account for our stock based awards in accordance with Accounting Standards Codification subtopic 718-10, Compensation ("ASC 718-10"), which requires a fair value measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors, including employee stock options and restricted stock awards. We estimate the fair value of stock options granted using the Black-Scholes valuation model. This model requires us to make estimates and assumptions including, among other things, estimates regarding the length of time an employee will retain vested stock options before exercising them, the estimated volatility of our 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 our consolidated statements of operations.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2010
(UNAUDITED)

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. For 2010 and prior years, expected stock price volatility is based on the historical volatility of the Company’s stock for the related vesting periods.

Stock-based compensation expense in connection with options granted to employees for the six months ended June 30, 2010 and 2009 was $88,181 and $167,620, respectively.

Reclassifications

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

NOTE B – NEW ACCOUNTING PRONOUNCEMENTS

In February 2010, the FASB Accounting Standards Update 2010-10 (ASU 2010-10), “Consolidation (Topic 810): Amendments for Certain Investment Funds.” The amendments in this Update are effective as of the beginning of a reporting entity’s first annual period that begins after November 15, 2009 and for interim periods within that first reporting period. Early application is not permitted. The adoption of provisions of ASU 2010-10 does not have a material effect on the Company’s financial position, results of operations or cash flows.

ASU No. 2010-11 was issued in March 2010, and clarifies that the transfer of credit risk that is only in the form of subordination of one financial instrument to another is an embedded derivative feature that should not be subject to potential bifurcation and separate accounting. This ASU will be effective for the first fiscal quarter beginning after June 15, 2010, with early adoption permitted. The Company does not expect the provisions of ASU 2010-11 to have a material effect on the financial position, results of operations or cash flows of the Company.

In April 2010, the FASB issued Accounting Standard Update No. 2010-12. “Income Taxes” (Topic 740). In April 2010, the FASB (Financial Accounting Standards Board) issued Accounting Standards Update 2010-12 (ASU 2010-12), Income Taxes (Topic 740): Accounting for Certain Tax Effects of the 2010 Health Care Reform Acts. After consultation with the FASB, the SEC stated that it “would not object to a registrant incorporating the effects of the Health Care and Education Reconciliation Act of 2010 when accounting for the Patient Protection and Affordable Care Act”. The Company does not expect the provisions of ASU 2010-12 to have a material effect on the financial position, results of operations or cash flows of the Company.

ASU No. 2010-13 was issued in April 2010, and will clarify the classification of an employee share based payment award with an exercise price denominated in the currency of a market in which the underlying security trades. This ASU will be effective for the first fiscal quarter beginning after December 15, 2010, with early adoption permitted. The Company does not expect the provisions of ASU 2010-13 to have a material effect on the financial position, results of operations or cash flows of the Company.

In April 2010, the FASB (Financial Accounting Standards Board) issued Accounting Standards Update 2010-17 (ASU 2010-17), Revenue Recognition-Milestone Method (Topic 605): Milestone Method of Revenue Recognition. The amendments in this Update are effective on a prospective basis for milestones achieved in fiscal years, and interim periods within those years, beginning on or after June 15, 2010. Early adoption is permitted. If a vendor elects early adoption and the period of adoption is not the beginning of the entity's fiscal year, the entity should apply the amendments retrospectively from the beginning of the year of adoption. The Company does not expect the provisions of ASU 2010-17 to have a material effect on the financial position, results of operations or cash flows of the Company.

In April 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2010-18 "Receivables (Topic 310) – Effect of a Loan Modification When the Loan is Part of a Pool that is Accounted for as a Single Asset – a consensus of the FASB Emerging Issues Task Force." ASU 2010-18 provides guidance on account for acquired loans that have evidence of credit deterioration upon acquisition. It allows acquired assets with common risk characteristics to be accounted for in the aggregate as a pool. ASU 2010-18 is effective for modifications of loans accounted for within pools under Subtopic 310-30 in the first interim or annual reporting period ending on or after July 15, 2010. The Company does not expect ASU 2010-18 to have an impact on its financial condition, results of operations, or disclosures.

In May 2010, the FASB (Financial Accounting Standards Board) issued Accounting Standards Update 2010-19 (ASU 2010-19), Foreign Currency (Topic 830): Foreign Currency Issues: Multiple Foreign Currency Exchange Rates. The amendments in this Update are effective as of the announcement date of March 18, 2010. The Company does not expect the provisions of ASU 2010-19 to have a material effect on the financial position, results of operations or cash flows of the Company.

There were various other updates recently issued, most of which represented technical corrections to the accounting literature or application to specific industries and are not expected to a have a material impact on the Company's consolidated financial position, results of operations or cash flows.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2010
(UNAUDITED)

NOTE C - INTANGIBLE ASSETS AND GOODWILL

Total identifiable intangible assets acquired and their carrying values at June 30, 2010 are:

	Gross Carrying Amount	Accumulated Amortization/ Impairment	Net	Residual Value	Weighted Average Amortization Period (Years)
Amortized Identifiable Intangible Assets:					
Subscriber lists - EthoStream	$ 2,900,000	$ (795,503)	$ 2,104,497	$ -	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(795,503)	2,104,497	-	12.0
Goodwill - EthoStream	8,796,439	(3,000,000)	5,796,439	-	
Goodwill - SSI	5,874,016	-	5,874,016	-	
Total	$ 17,570,455	$ (3,795,503)	$ 13,774,952	$ -	

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

	Gross Carrying Amount	Accumulated Amortization/ Impairment	Net	Residual Value	Weighted Average Amortization Period (Years)
Intangible Assets and Goodwill:					
Amortized Identifiable Intangible Assets:					
Subscriber lists - EthoStream	$ 2,900,000	$ (674,663)	$ 2,225,337	$ -	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(674,663)	2,225,337	-	12.0
Goodwill - EthoStream	8,796,439	(3,000,000)	5,796,439	-	
Goodwill - SSI	5,874,016	-	5,874,016	-	
Total	$ 17,570,455	$ (3,674,663)	$ 13,895,792	$ -	

Total amortization expense charged to operations for the three and six months ended June 30, 2010 and 2009 was $60,420 and $120,840, and $60,417 and $120,833, respectively.

Estimated amortization expense as of June 30, 2010 is as follows:

Remainder of 2010	$ 120,816
2011	241,667

2012	241,667
2013	241,667
2014 and after	1,258,680
Total	$ 2,104,497

The Company does not amortize goodwill. The Company recorded goodwill in the amount of $14,670,455 as a result of the acquisitions of EthoStream and SSI during the year ended December 31, 2007. The Company evaluates goodwill for impairment based on the fair value of the operating business units to which this goodwill relates at least once a year. The Company generally determines the fair value of a reporting unit using a combination of the income approach, which is based on the present value of estimated future cash flows, and the market approach, which compares the business unit's multiples to its competitors. At December 31, 2009 and 2008, the Company has determined that a portion of the value of EthoStream's goodwill has been impaired based upon management's assessment of operating results and forecasted discounted cash flow and has written off a total of $3,000,000 of its value.

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NOTE D – ACCOUNTS RECEIVABLE

Components of accounts receivable as of June 30, 2010 and December 31, 2009 are as follows:

	June 30, 2010	December 31, 2009
Accounts receivable (factored)	$ 914,300	$ 736,781
Advances from factor	(368,677)	(462,957)
Due from factor	545,623	273,824
Accounts receivable (non-factored)	543,971	152,860
Allowance for doubtful accounts	(175,000)	(175,000)
Total	$ 914,594	$ 251,684

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 amounted to $123,787 and $105,189 for the period ended June 30, 2010 and 2009, respectively. 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.

NOTE E – 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 six months ended June 30, 2009.

NOTE F – 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 June 30, 2010 and December 31, 2009 was $98,583 and $387,000, respectively. The Company has incurred interest expense of $41,898 and $78,069 related to the line of credit for the six months ended June 30, 2010 and 2009, respectively. The Prime Rate was 3.25% at June 30, 2010.

On August 13, 2010, 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 June 30, 2010 and continues for the 90 day period thereafter. The outstanding principal balance is subject to additional interest of three (3%) percent per annum until such debt covenant requirements are met.

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NOTE G – LONG TERM DEBT

Senior Convertible Debenture

A summary of convertible debentures payable at June 30, 2010 and December 31, 2009 is as follows:

	June 30, 2010	December 31, 2009
Senior Convertible Debentures, accrue interest at 13% per annum and mature on May 29, 2011	$ 1,606,023	$ 1,606,023
Debt Discount - beneficial conversion feature, net of accumulated amortization of $645,931 and $558,256 at June 30, 2010 and December 31, 2009, respectively.	(160,958)	(248,633)
Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of $542,883 and $469,113 at June 30, 2010 and December 31, 2009, respectively.	(135,157)	(208,927)
Total	$ 1,309,908	$ 1,148,463
Less: current portion	1,309,908	-
	$ -	$ 1,148,463

As of June 30, 2010 and December 31, 2009, the Company has $1,606,023 outstanding in convertible debentures. During the year ended December 31, 2009, $722,514 of convertible debentures was converted into 8,174,943 shares of common stock.

Business Loan

On September 11, 2009, the Company entered into a Loan Agreement in the aggregate principal amount of $300,000 with the Wisconsin Department of Commerce (the “Department”). The outstanding principal balance bears interest at the annual rate of two (2.00) percent. Payment of interest and principal is to be made in the following manner: (a) payment of any and all interest that accrues from the date of disbursement commences on January 1, 2010 and continues on the first day of each consecutive month thereafter through and including December 31, 2010; (b) commencing on January 1, 2011 and continuing on the first day of each consecutive month thereafter through and including November 1, 2016, the Company shall pay equal monthly installments of $4,426 each; followed by a final installment on December 1, 2016 which shall include all remaining principal, accrued interest and other amounts owed by the Company to the Department under the Loan Agreement. The Company may prepay amounts outstanding under the credit facility in whole or in part at any time without penalty. The credit facility is secured by the Company’s assets and the proceeds from this loan were used for the working capital requirements of the Company. The outstanding borrowing under the agreement at June 30, 2010 and December 31, 2009 was $300,000.

Aggregate maturities of long-term debt as of June 30, 2010 are as follows:

For the twelve months ended June 30,	Amount
2010	$ -

2011		1,653,529
2012		48,465
2013		49,443
2014 and thereafter		154,586
	$	1,906,023
Less: Current portion		(1,629,672)
Total Long term portion	$	276,351

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NOTE H – REDEEMABLE PREFERRED STOCK

The Company has designated 215 shares of preferred stock as Series A Preferred Stock ("Series A"). Each share of Series A shall be convertible, at the option of the holder thereof, at any time, into shares of our Common Stock at an initial conversion price of $0.363 per share, subject to adjustments for anti-dilution provisions. In the event of a change of control (as defined in the purchase agreement with respect to the Series A), or at the holder's option, on November 19, 2014 and for a period of 180 days thereafter, provided that at least fifty percent (50%) of the shares of Series A issued on the Series A Original Issue Date remain outstanding as of November 19, 2014, and the holders of at least a majority of the then outstanding shares of Series A provide written notice requesting redemption of all shares of Series A, we are required to redeem the Series A for the purchase price plus any accrued but unpaid dividends. The Series A accrues dividends at an annual rate of 8% of the original purchase price, and shall be payable only when, as, and if declared by our Board of Directors.

On November 16, 2009, the Company sold 215 shares of Series A with attached warrants to purchase an aggregate of 1,628,800 shares of the Company's common stock at $0.33 per share. The Series A shares were sold at a price per share of $5,000 and each Series A share is convertible into approximately 13,774 shares of common stock at a conversion price of $0.363 per share. The Company received $1,075,000 from the sale of the Series A shares. Since the Series A may ultimately be redeemable at the option of the holder, the carrying value of the preferred stock, net of discount and accumulated dividends, has been classified as temporary equity on the balance sheet at June 30, 2010 and December 31, 2009.

In accordance with ASC 470 Topic "Debt", a portion of the proceeds were allocated to the warrants based on their relative fair value, which totaled $287,106 using the Black Scholes option pricing model. Further, the Company attributed a beneficial conversion feature of $70,922 to the Series A preferred shares based upon the difference between the effective conversion price of those shares and the closing price of the Company's common stock on the date of issuance. The assumptions used in the Black-Scholes model are as follows: (1) dividend yield of 0%; (2) expected volatility of 123%, (3) weighted average risk-free interest rate of 2.2%, (4) expected life of 5 years, and (5) estimated fair value of Telkonet common stock of $0.24 per share. The expected term of the warrants represents the estimated period of time until exercise and is based on historical experience of similar awards and giving consideration to the contractual terms. The amounts attributable to the warrants and beneficial conversion feature, aggregating $358,028, have been recorded as a discount and deducted from the face value of the preferred stock. Since the preferred stock is classified as temporary equity, the discount will be amortized over the period from issuance to November 19, 2014 (the initial redemption date) as a charge to additional paid-in capital (since there is a deficit in retained earnings).

The charge to additional paid in capital for amortization of discount and costs for the period ended June 30, 2010 was $35,802. There was no amortization of discounts for Series A preferred stock for the period ended June 30, 2009.

For the three months ended June 30, 2010 we have accrued dividends in the amount of $21,446 and cumulative accrued dividends of $42,658. The accrued dividends have been charged to additional paid-in capital (since there is a deficit in retained earnings) and the net unpaid accrued dividends been added to the carrying value of the preferred stock. There were no accrued dividends for Series A preferred stock for the period ended June 30, 2009.

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 June 30, 2010 and December 31, 2009 the Company has 215 shares of preferred stock issued and outstanding, designated Series A preferred stock. The Company has authorized 155,000,000 shares of common stock, with a par value of $.001 per share. As of June 30, 2010 and December 31, 2009, the Company has 96,967,129 and 96,563,771, respectively, shares of common stock issued and outstanding.

During the six months ended June 30, 2010, the Company issued 403,358 shares of common stock to consultants for services performed and services accrued in fiscal 2009. These shares were valued at $62,957, which approximated the fair value of the shares when they were issued.

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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	4,417,133	3.18	$ 1.02	4,293,550	$ 1.01
$ 2.00 - $2.99	997,500	4.73	$ 2.52	971,000	$ 2.51
$ 3.00 - $3.99	536,250	5.33	$ 3.23	452,500	$ 3.26
$ 4.00 - $4.99	70,000	5.08	$ 4.33	68,500	$ 4.33
$ 5.00 - $5.99	100,000	4.82	$ 5.17	97,000	$ 5.16
	6,120,883	3.67	$ 1.56	5,882,550	$ 1.54

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

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2009	6,993,929	$ 1.82
Granted	320,000	1.00
Exercised	-	-
Cancelled or expired	(1,193,046)	2.91
Outstanding at December 31, 2009	6,120,883	$ 1.56
Granted	-	-
Exercised	-	-
Cancelled or expired	-	-
Outstanding at June 30, 20010	6,120,883	$ 1.56

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

		June 30, 2009
Significant assumptions (weighted-average):		
Risk-free interest rate at grant date		3.5%
Expected stock price volatility		81%
Expected dividend payout		-
Expected option life (in years)		5.0
Expected forfeiture rate		12%
Fair value per share of options granted	$	0.30

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 ASC 718-10, we adjust share-based compensation for changes to the estimate of expected equity award forfeitures based on actual forfeiture experience.

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There were no options exercised during the period ended June 30, 2010 or 2009.

Total stock-based compensation expense in connection with options granted to employees recognized in the unaudited condensed consolidated statement of earnings for the three and six months ended June 30, 2010 and 2009 was $41,401 and $88,181, and $83,810 and $167,620, respectively. Additionally, the aggregate intrinsic value of options outstanding and unvested as of June 30, 2010 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	675,000	1.18	$ 1.00	675,000	$ 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, 2009	1,815,937	$ 1.00
Granted	-	-
Exercised	-	-
Canceled or expired	(1,075,937)	-
Outstanding at December 31, 2009	740,000	$ 1.00
Granted	-	-
Exercised	-	-
Canceled or expired	(65,000)	-
Outstanding at June 30, 2010	675,000	$ 1.00

There were no non-employee stock options vested during the period ended June 30, 2010 and 2009.

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
$ 0.33	6,326,751	3.77	$ 0.33	6,326,751	$ 0.33
$ 0.60	800,000	2.85	$ 0.60	800,000	$ 0.60
$ 1.00	500,000	1.50	$ 1.00	500,000	$ 1.00
$ 2.59	862,452	2.06	$ 2.59	862,452	$ 2.59
$ 3.82	3,310,026	1.12	$ 3.82	3,310,026	$ 3.82
$ 4.17	359,712	1.51	$ 4.17	359,712	$ 4.17
	12,158,941	2.76	$ 1.60	12,158,941	$ 1.60

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Transactions involving warrants are summarized as follows:

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2009	8,457,767	$ 2.19
Issued	4,481,174	0.58
Exercised	(780,000)	0.58
Canceled or expired	-	-
Outstanding at December 31, 2009	12,158,941	$ 1.60
Issued	-	-
Exercised	-	-
Canceled or expired	-	-
Outstanding at June 30, 2010	12,158,941	$ 1.60

The Company did not issue any warrants during the periods ended June 30, 2010 and 2009.

NOTE K – RELATED PARTIES

In connection with the Series A Preferred Stock private placement transaction, on November 16, 2009, the Company entered into an Executive Officer Reimbursement Agreement with each of (i) Jason L. Tienor, the Company's President and Chief Executive Officer, (ii) Richard J. Leimbach, the Company's Chief Financial Officer, and (iii) Jeffrey J. Sobieski, the Company's Chief Operating Officer (collectively, the "Executive Officers"), pursuant to which the Executive Officers agreed to convert a portion of outstanding indebtedness of the Company owed to such Executive Officers into Series A shares and Warrants pursuant to the Securities Purchase Agreement. Mr. Tienor converted $20,000 of outstanding indebtedness into 4 Series A shares and Warrants to purchase 30,304 shares of Common Stock. Mr. Leimbach converted $10,000 of outstanding indebtedness into 2 Series A shares and Warrants to purchase 15,152 shares of Common Stock. Mr. Sobieski converted $20,000 of outstanding indebtedness into 4 Series A shares and Warrants to purchase 30,304 shares of Common Stock.

Anthony Paoni, Chairman of the Company's Board of Directors, participated in the private placement of Series A Preferred Stock, purchasing five shares of Series A convertible redeemable preferred stock (convertible into 68,870 shares of common stock) and warrants to purchase 37,880 shares of common stock, for an aggregate purchase price of $25,000.

From time to time the Company may receive advances from certain of its officers to meet short term working capital needs. These advances may not have formal repayment terms or arrangements. As of June 30, 2010, the Company owed deferred salary payments to certain executive officers in the amount of $40,738 to Jason L. Tienor, President and Chief Executive Officer, $56,327 to Richard J. Leimbach, Chief Financial Officer, and $43,720 to Jeffrey J. Sobieski, Chief Operating Officer.

On April 1, 2010, Jason Tienor, President and Chief Executive Officer, and on April 6, 2010 Jeff Sobieski, Chief Operating Officer, each advanced $25,000 to the Company to fund the payment of certain trade payables pursuant to which, on May 13, 2010, the Company issued to each of Messrs. Tienor and Sobieski a promissory note in the amount of $25,000 bearing interest at a variable rate equal to the prime rate. The notes are due and payable on the earlier to occur of (i) demand and (ii) termination pursuant to paragraph 6 (a), (b), (c) or (d) of such executive’s employment agreement.

For information regarding Related Party activities subsequent to June 30, 2010 by the Company, see “Subsequent Events” in Note P of the Notes to Unaudited Condensed Consolidated Financial Statements contained herein.

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NOTE L - COMMITMENTS AND CONTINGENCIES

Office Leases Obligations

The Company presently leases approximately 12,000 square feet of office space in Milwaukee, WI for its corporate headquarters. The Milwaukee lease expires in February 2019.

The Company presently leases 16,416 square feet of commercial office space in Germantown, Maryland. The lease commitments expire in December 2015.

Commitments for minimum rentals under non cancelable leases at June 30, 2010 are as follows:

2010	$	237,093
2011		477,024
2012		482,264
2013		487,552
2014 and thereafter		1,835,968
Total	$	3,519,901

Rental expenses charged to operations for the three and six months ended June 30, 2010 and 2009 are $325,116 and $230,982, respectively.

On May 3, 2010, the Company vacated the 11,626 square feet of space under sublease from Tellabs Operations, Inc. that formerly housed our corporate offices. The sublease is due to expire on November 29, 2010. Our landlord has filed a claim for unpaid rent and was granted a judgment in March 2010. Pursuant to that judgment, we received a notice of eviction from our landlord for the unpaid rent. We sought to extend the date for eviction but were unable to negotiate a payment plan acceptable to the landlord and voluntarily vacated the space. The Company has accrued lease costs of $37,976 at June 30, 2010 and the remaining rent due on the lease amounts to $95,408. This same 11,626 square foot space is under lease to us pursuant to a lease agreement with Seneca Meadows Corporate Center III Limited Partnership ("Seneca") for the period November 30, 2010 through December 15, 2015 to run concurrently with a lease with Seneca for a separate but adjacent 4,790 square foot facility expiring on December 31, 2015. We are currently actively pursuing an acceptable financial settlement and/or a sublease for all or a portion of this office space.

Employment and Consulting Agreements

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

The Company has consulting agreements with outside contractors to provide marketing and financial advisory services. The Agreements are generally for a term of 12 months from inception and renewable automatically from year to year unless either the Company or Consultant terminates such engagement by written notice.

The Company entered into an exclusive financial advisor and consulting agreement in January 2007. The agreement provides a minimum consideration fee, not less than $250,000, in the event of an equity or financing transaction where the advisor is engaged. The agreement may be terminated with sixty days notification by either party.

Jason Tienor, President and Chief Executive Officer, is employed pursuant to an employment agreement dated May 13, 2010. Mr. Tienor's employment agreement is for a term expiring on March 15, 2011, is renewable at the agreement of the parties and provides for a base salary of $200,000 per year.

Jeff Sobieski, Chief Operating Officer, is employed pursuant to an employment agreement, dated May 13, 2010. Mr. Sobieski's employment agreement is for a term expiring on March 15, 2011, is renewable at the agreement of the parties and provides for a base salary of $190,000 per year.

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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.

Ronald Pickett v. Telkonet, Inc.

As of June 30, 2010, we were a defendant in the matter captioned Ronald Pickett v. Telkonet, Inc., in the Circuit Court for Montgomery County, Maryland. The Plaintiff alleged that the Company failed to pay severance compensation in the amount of $238,000 as well as certain benefits and claimed an additional amount of $63,000 in unpaid business and travel expenses. The plaintiff sought an award of treble damages on the severance claim alleging that the claimed benefits constitute “wages” under the Maryland Wage Payment and Collection Act; though as an alternative to the breach of contract claim the plaintiff plead the equitable claim of promissory estoppel/detrimental reliance. The court granted our motion for summary judgment on the breach of contract and treble damages claim. The Company conceded the expenses issue and the only issue left before the court was the promissory estoppel/detrimental reliance claim. On July 14, 2010, the court, after hearing testimony on the matter, issued a verdict in favor of the plaintiff in the amount of $259,456 (including prejudgment interest and gave the Company forty five (45) days from the entry of the judgment to satisfy the judgment after which the plaintiff may commence enforcement proceedings. The Company has thirty (30) days following the entry of judgment within which to take an appeal. The Company is currently considering its options and has accrued the amount of the judgement as of June 30, 2010.

Tellabs, Inc. v. Telkonet, Inc.

Our landlord has filed a claim for unpaid rent in a case styled Tellabs, Inc. v. Telkonet, Inc. in the Circuit Court for Montgomery County, State of Maryland. Tellabs was granted a judgment in March 2010 in the amount of $64,966. Pursuant to that judgment, we received a notice of eviction from our landlord for the unpaid rent. We sought to extend the date for eviction but were unable to negotiate a payment plan acceptable to the landlord and voluntarily vacated the space on May 3, 2010. Our landlord has filed an additional claim for unpaid rent and other expenses alleged to be due in a case styled Tellabs, Inc. v. Telkonet, Inc. in the Circuit Court for Montgomery County, State of Maryland.

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

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

On August 1, 2008, we timely filed an answer to the complaint denying the allegations. On February 27, 2009, the United States Patent Office ("USPTO") granted a reexamination request with respect to the patent the defendants allegedly infringe upon. Based upon four highly relevant and material prior art references that had not been considered by the USPTO in its initial examination, it found a “substantial new question of patentability” affecting all claims of the patent allegedly infringed upon. There is a possibility that the claims of the patent will be cancelled or narrowed during the reexamination which may result in the narrowing or elimination of some and possibly all of the issues in the pending litigation. The case is currently in discovery. A mandatory mediation will likely be held in September, 2010.

Defendant Ramada Worldwide, Inc. provided us with notice of the suit and demanded that we defend and indemnify it pursuant to a vendor direct supplier agreement between EthoStream and WWC Supplier Services, Inc., a Ramada affiliate (wherein we agreed to indemnify, defend and hold Ramada harmless from and against claims of infringement). After a review of that agreement, it was determined that EthoStream owes the duty to defend and indemnify and it has assumed Ramada's defense. An answer on Ramada's behalf was filed in U.S. District Court, for the Eastern District of Texas, Marshall Division on September 19, 2008. The matter is currently pending in that court.

Irrevocable Letter of Credit

In connection with certain work contracted to us, in April 2010 we entered into a letter agreement with an unrelated third party pursuant to which, in consideration of our agreement to pay such party the sum of $15,000 following the acceptance of the contracted for work, such party agreed to furnish to us an irrevocable letter of credit in an amount equal to $150,000, showing the contracting party as the beneficiary thereof. We entered into a Subcontractor Agreement pursuant to which we subcontracted the installation portion of the project to an unrelated third party. In consideration of our agreement to pay our subcontractor the additional sum of $15,000, our subcontractor agreed to furnish to us an irrevocable letter of credit in an amount equal to $150,000, showing the contracting party as the beneficiary thereof.

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NOTE M – BUSINESS CONCENTRATION

Revenue from one (1) major customer approximated $658,109 or 11% of total revenues for the period ended June 30, 2010. Revenue from one (1) major customer approximated $785,649 or 13% of total revenues for the period ended June 30, 2009. Total accounts receivable of $0, or 0% of total accounts receivable, were due from this customer as of June 30, 2010. Total accounts receivable of $532,190 or 29% of total accounts receivable, was due from this customer as of June 30, 2009.

Purchases from two (2) major suppliers approximated $1,028,314, or 33% of purchases, and one (1) major supplier approximated $698,482, or 62% of purchases, for the six months ended June 30, 2010 and 2009, respectively. Total accounts payable of approximately $543,572, or 15% of total accounts payable, was due to this supplier as of June 30, 2010, and $92,507, or 3% of total accounts payable, was due to this supplier as of June 30, 2009.

NOTE N- 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 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 and convertible debentures are classified within Level 3 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;

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 June 30, 2010 which are measured at fair value on a recurring basis by level within the fair value hierarchy. 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	Total
Long-term investments	-	-	8	8
Total	$ -	$ -	$ 8	$ 8
Derivative liabilities	-	-	1,184	1,184
Convertible debenture	-	-	1,310	1,310
Total	$ -	$ -	$ 2,494	$ 2,494

The table below sets forth a summary of changes in the fair value of the Company's Level 3 financial liabilities (convertible notes and derivative liability) for the six months ended June 30, 2010.

		2010
Balance at beginning of year	$	3,029,762
Amortization of debt discount		161,445
Change in fair value of derivative liability		(696,793)
Balance at end of period	$	2,494,414

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TELKONET, INC.
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NOTE O – DISCONTINUED OPERATIONS

On April 22, 2009, the Company completed the deconsolidation of MST by reducing its ownership percentage and board membership. The deconsolidation of MST has been accounted for as discontinued operations and accordingly, the assets and liabilities have been segregated in the accompanying consolidated balance sheet and reclassified as discontinued operations. The operating results relating to MST have been reclassified from continuing operations and reported as discontinued operations in the accompanying consolidated statements of operations.

On April 22, 2009, Warren V. Musser and Thomas C. Lynch, members of the Company's Board of Directors, submitted their resignations as directors of MSTI. As a result of these resignations, and the decrease in beneficial ownership resulting from the transaction 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.

On June 26, 2009, MSTI entered into an Agreement and Consent to Acceptance of Collateral ("Agreement") with its senior secured lenders, Alpha Capital Anstalt, Gemini Master Fund, Ltd., Whalehaven Capital Fund Limited and Brio Capital L.P. ("Secured Lenders"). The Secured Lenders were the senior secured creditors of MSTI with regard to obligations in the total principal amount of $1,893,295 (together, the "Secured Lender Obligations").

Under the Agreement: (a) MSTI (i) agreed and consented to the transfer to MST Acquisition Group LLC (the "Designee"), for the benefit of the Secured Lenders, of all of the assets of MSTI (the "Pledged Collateral") in full satisfaction of the Secured Lender Obligations, and (ii) waived and released (x) all right, title and interest it has or might have in or to the Pledged Collateral, including any right to redemption, and (y) any claim for a surplus; and (b) the Secured Lenders agreed to accept the Pledged Collateral in full satisfaction of the Secured Lender Obligations and waived and released MSTI from any further obligations with respect to the Secured Lender Obligations.

Net income (loss) from discontinued operations on the consolidated statement of operations for the year ended December 31, 2009 includes the gain on deconsolidation of $6,932,586, offset by MSTI's net losses of $(635,735) for the period January 1, 2009 through April 30, 2009, the date of deconsolidation. The market value of the MSTI common shares owned by the Company as of December 31, 2009 was deemed permanently impaired by management and as a result the Company has fully written off its investment in MSTI and has not included any value for MSTI in the balance sheet as of December 31, 2009.

The following table summarizes net income from discontinued operations for the period ended June 30, 2009.

	For The Three Months Ended June 30, 2009	For The Six Months Ended June 30, 2009
Loss from operations	$(123,438)	$(635,735)
Elimination of liabilities, net of assets	7,000,185	7,000,185

Other expenses	(67,599)	(67,599)
Income from discontinued operations	6,809,148	6,296,851

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NOTE P – SUBSEQUENT EVENTS

As of June 30, 2010, we were a defendant in the matter captioned Ronald Pickett v. Telkonet, Inc., in the Circuit Court for Montgomery County, Maryland. The Plaintiff alleged that the Company failed to pay severance compensation in the amount of $238,000 as well as certain benefits and claimed an additional amount of $63,000 in unpaid business and travel expenses. The plaintiff sought an award of treble damages on the severance claim alleging that the claimed benefits constitute “wages” under the Maryland Wage Payment and Collection Act; though as an alternative to the breach of contract claim the plaintiff plead the equitable claim of promissory estoppel/detrimental reliance. The court granted our motion for summary judgment on the breach of contract and treble damages claim. The Company conceded the expenses issue and the only issue left before the court was the promissory estoppel/detrimental reliance claim. On July 14, 2010, the court, after hearing testimony on the matter, issued a verdict in favor of the plaintiff in the amount of $259,456.00 (including prejudgment interest and gave the Company forty five (45) days from the entry of the judgment to satisfy the judgment after which the plaintiff may commence enforcement proceedings. The Company has thirty (30) days following the entry of judgment within which to take an appeal. The Company is currently considering its options and has accrued the amount of the judgment as of June 30, 2010.

On August 4, 2010, the Company entered into a Securities Purchase Agreement in connection with a private placement of 267 shares of the Company’s Series B Convertible Redeemable Preferred Stock, par value $0.001 per share, and warrants to purchase an aggregate of 5,134,626 shares of the Company’s common stock, par value $0.001 per share. The Company completed the transaction on August 6, 2010 and received gross proceeds of $1,335,000 from the sale of the Series B shares. The Series B shares were sold at a price per share of $5,000 and the Warrants have an exercise price of $0.13, which is equal to the closing bid price of a share of common stock on August 4, 2010. The Company intends to use the net proceeds from the sale of the Series B shares and the Warrants for sales and marketing, inventory and general working capital needs and may use the proceeds in the short term to repay certain outstanding indebtedness, satisfy judgments against the Company and to pay expenses of the offering as well as other general corporate capital purposes.

On August 4, 2010 the Company entered into a Board of Director Reimbursement Agreement with each of (i) Warren V. Musser, (ii) Thomas C. Lynch, (iii) Seth Blumenfeld, (iv) Thomas M. Hall and (v) Anthony J. Paoni pursuant to which each agreed to convert outstanding indebtedness of the Company owed to such individual for service as a member of the board of directors into shares of Common Stock of the Company at a conversion price equal to $0.36 per share. Mr. Musser converted $286,000 of outstanding indebtedness into 794,444 shares of Common Stock. Mr. Hall converted $147,000 of outstanding indebtedness into 408,333 shares of Common Stock. Mr. Lynch converted $180,000 of outstanding indebtedness into 500,000 shares of Common Stock. Mr. Blumenfeld converted $164,000 of outstanding indebtedness into 455,556 shares of Common Stock. Mr. Paoni converted $174,000 of outstanding indebtedness into 483,333 shares of Common Stock.

As previously announced by the Company in a Current Report on Form 8-K filed December 28, 2009, Richard J. Leimbach , the Company’s Chief Financial Officer, will be leaving the Company to pursue other opportunities. In connection with Mr. Leimbach’s resignation from his position as Chief Financial Officer, the Company and Mr. Leimbach entered into a Transition Agreement and Release on August 4, 2010, which provides that, among other things, Mr. Leimbach provided his services to the Company as an employee until June 30, 2010 and that the period July 1 through August 6, 2010 is a transition period during which Mr. Leimbach assisted the Company with the transition of his duties. Following August 6 and for the ensuing two month period, Mr. Leimbach will be paid a severance benefit and a health care reimbursement should he elect COBRA coverage. Mr. Leimbach will also receive an award of 333,333 shares of the Company's Common Stock.

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

The following discussion and analysis of the Company's financial condition and results of operations should be read in conjunction with the accompanying financial statements and related notes thereto for the quarter ended June 30, 2010 and 2009, 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, 2009 filed on March 31, 2010.

Business

Telkonet, Inc. was formed in 1999 and is incorporated under the laws of the state of Utah. We develop, manufacture and sell proprietary energy efficiency and smart grid networking technology products and platforms that have helped position us as a leading clean technology provider.

We began as a developer of powerline communications, or PLC, technology. Our proprietary, patented PLC products utilize a building's internal electrical wiring to form a data communications network, turning power outlets into data ports while leaving the electrical functionality unaffected. In 2003, we launched our PlugPlusInternet suite of products, designed to maximize the use of the existing electrical wiring in commercial buildings, such as hotels, schools, multi-dwelling units, government and military buildings and office buildings. Our PlugPlusInternet products provided high-speed Internet access throughout a building, utilizing the electrical wiring already in place, converting virtually every electrical outlet into a high-speed data network. The PlugPlusInternet product suite was comprised of the PlugPlus Gateway, the PlugPlus Coupler and the PlugPlus Modem, which together built an Internet delivery system throughout an entire building. We received our first order for our PlugPlusInternet products in October 2003.

In March 2007, we completed two strategic acquisitions. On March 15, 2007, we completed the acquisition of EthoStream, LLC, or EthoStream, a leading high-speed wireless Internet access, or HSIA, solutions and technology provider targeting the hospitality industry with a customer base then consisting of approximately 1,800 hotel and timeshare properties representing in excess of 180,000 guest rooms. We acquired 100% of the outstanding membership units of EthoStream for a purchase price of $11,756,097, which was comprised of $2.0 million in cash and 3,459,609 shares of our common stock. The entire stock portion of the purchase price was deposited into escrow upon closing to satisfy certain potential indemnification obligations of the sellers under the purchase agreement. The shares held in escrow are distributable over the three years following the closing. As of June 30, 2010, all shares are distributed to investors.

Our EthoStream Hospitality Network is now one of the largest hospitality HSIA service providers in the United States, with a customer base of approximately 2,350 properties representing over 205,000 hotel rooms. This network has created a ready opportunity for us to market our energy efficiency solutions. It also provides a marketing opportunity for our more traditional HSIA offerings, including the Telkonet iWire System. The iWire System offers a fast and cost effective way to deliver commercial high-speed broadband access using a building's existing electrical infrastructure to convert virtually every electrical outlet into a high-speed data port without the installation of additional wiring or major disruption of business activity. The EthoStream Hospitality Network represents a significant portion of our hospitality growth and market share. The EthoStream Hospitality Network is backed by a 24/7 U.S.-based in-house support center that uses integrated, web-based centralized management tools enabling proactive customer support.

While we continue to grow the EthoStream Hospitality Network, through our March 9, 2007 acquisition of Smart Systems International, or SSI, a leading manufacturer of in-room energy management systems for the hospitality industry with over 60,000 product installs as of the acquisition date, and the continued development of our PLC products, we have evolved into a "clean technology" company that develops, manufactures and sells proprietary energy efficiency and smart grid networking technology. We acquired substantially all of the assets of SSI for cash and shares of our common stock having an aggregate value of $6,875,000. The purchase price was comprised of $875,000 in cash and 2,227,273 shares of our common stock. Of the stock issued in the transaction, 1,090,909 shares were held in an escrow account for a period of one year following the closing from which certain potential indemnification obligations under the purchase agreement could be satisfied. The aggregate number of shares held in escrow was subject to adjustment upward or downward depending upon the trading price of our common stock during the one year period following the closing date. On March 12, 2008, we released these shares from escrow, and on June 12, 2008 we issued an additional 1,882,225 shares pursuant to the adjustment provisions of the SSI asset purchase agreement.

Our Telkonet SmartEnergy, or TSE, and Networked Telkonet SmartEnergy, or NTSE, energy efficiency products incorporate our patented Recovery Time™ technology, allowing for the continuous monitoring of climate conditions to automatically adjust a room's temperature accounting for the presence or absence of an occupant. Our SmartEnergy products save energy while at the same time ensuring occupant comfort. This technology is particularly attractive to our customers in the hospitality area, as well as the education, healthcare and government/military markets, who are continually seeking ways to reduce costs without impacting building occupant comfort. By reducing energy usage automatically when a space is unoccupied, our customers are able to realize a significant cost savings without diminishing occupant comfort. The hospitality, education, healthcare and government/military markets represent a significant audience for the occupancy-based energy management controls offered by the SmartEnergy platform and provide a large footprint for utility-based consumption management. This platform may also be integrated with property management systems, automation systems and load shedding initiatives to increase the savings recognized. Working directly with management companies and utilities allows us to offer enhanced opportunities to our customers for savings and control. Our energy management systems are dynamically lowering HVAC costs in over 180,000 rooms and are an integral part of the numerous state and federal energy efficiency and rebate programs.

Our smart grid networking technology, including the Telkonet iWire System and the 200 Mbps Telkonet Series 5 PLC products, use PLC technology to quickly, economically and non-disruptively transform a site's existing internal electrical infrastructure into an internet protocol, or IP, network backbone. Our PLC systems offer the hard-wired security and reliability of a CAT-5 cabled network, but without the cost, physical disturbance and business disruption of wiring CAT-5 or the security issues inherent to wireless systems.

The development of an industrial PLC product for use within the utility space has introduced a competitive alternative to traditional local area network, or LAN, solutions. By capitalizing on the shortcomings of previously available offerings, we have gained traction and opened a new market opportunity. Our Series 5 SmartGrid networking technology provides a compelling solution for power substation automation, power generation, renewable facilities, manufacturing, and research environments by providing a rapidly-deployed, low cost alternative to structured cable, wireless and fiber. Operating at 200 Mbps, our PLC platform offers a secure new competitive alternative in grid communications, enabling LAN infrastructure for power substation command and control, monitoring and grid management, transforming a traditional power management system into a "smart grid" that delivers electricity in a manner that can save energy, reduce cost and increase reliability. By leveraging the existing electrical wiring within a facility to transport data, our PLC solutions enable facilities to deploy sensing and control systems to locations without the need for new network wiring, and without the security risks associated with wireless systems.

We employ direct and indirect sales channels in all areas of our business. With a growing value-added reseller network, we continue to broaden our reach throughout the industry. Utilizing key integrators and strategic OEM partners, we have been able to recognize significant success in each of our targeted markets. With an increasing share of our business originating outside of the hospitality industry, we have proven the versatility of our technology and the savings that can be derived through the use of our products.

Discontinued Operations

On January 31, 2006, we acquired a 90% interest in Microwave Satellite Technologies, Inc. from Frank Matarazzo, its sole stockholder, in exchange for $1.8 million in cash and 1.6 million unregistered shares of our common stock, for an aggregate purchase price of $9,000,000. The cash portion of the purchase price was paid in two installments, $900,000 at closing and $900,000 in February 2007. The stock portion is payable from shares held in escrow, 400,000 shares of which were paid at closing and the remaining 1,200,000 reserve shares, which shall be issued based on the achievement of 3,300 video and data subscribers over a three year period from the closing (later extended to July 2009 pursuant to a May 2008 agreement between the parties). The escrow agreement terminated on July 31, 2009. As of August 14, 2009, we had issued 800,000 of the reserve shares.

On April 22, 2009, we completed the deconsolidation of our subsidiary, MSTI Holdings, Inc., or MSTI. To effect the deconsolidation of MSTI, we were required to reduce our ownership percentage and board membership in MSTI. On February 26, 2009, we executed a Stock Purchase Agreement pursuant to which we sold 2.8 million shares of MSTI common stock and as a result of this transaction, we reduced our beneficial ownership in MSTI from 58% to 49% of the issued and outstanding shares of MSTI common stock. On April 22, 2009, Warren V. Musser and Thomas C. Lynch, members of our Board of Directors, submitted their resignations as directors of MSTI. Because of these resignations we no longer control a majority of MSTI’s board of directors. As a result of the deconsolidation, the financial statements and accompanying footnotes included in this prospectus include disclosures of the results of operations of MSTI, for all periods presented, as discontinued operations.

Forward Looking Statements

This report may contain “forward-looking statements,” which represent the Company’s expectations or beliefs, including, but not limited to, statements concerning industry performance and the Company’s results, operations, performance, financial condition, plans, growth and strategies, which include, without limitation, statements preceded or followed by or that include the words “may,” “will,” “expect,” “anticipate,” “intend,” “could,” “estimate,” or “continue” or the negativ variations thereof or comparable terminology. Any statements contained in this report or the information incorporated by reference that are not statements of historical fact may be deemed to be forward-looking statements within the meaning of Section 27(A) of the Securities Act of 1933 and Section 21(F) of the Securities Exchange Act of 1934. For such statements, the Company claims the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. These statements by their nature involve substantial risks and uncertainties, some of which are beyond the Company’s control, and actual results may differ materially depending on a variety of important factors, including those risk factors discussed under “Trends, Risks and Uncertainties”, many of which are also beyond the Company’s control. You should not place undue reliance on these forward-looking statements, which speak only as of the date of this report. The Company does not undertake any obligation to update or release any revisions to these forward-looking statements to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events, except to the extent such updates and/or revisions are required by applicable law.

Critical Accounting Policies and Estimates

Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with FASB’s Accounting Standards Codification (“ASC”) 605-10, and ASC Topic 13 guidelines that require that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) 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. The guidelines also address the accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

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.

Fair Value of Financial Instruments

In January 2008, the Company adopted the provisions under FASB for Fair Value Measurements, which define 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 these provisions 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 these provisions.

New Accounting Pronouncements

For information regarding recent accounting pronouncements and their effect on the Company, see “New Accounting Pronouncements” in Note B of the Notes to Unaudited Condensed Consolidated Financial Statements contained herein.

Revenues

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

	Three Months Ended								
		June 30, 2010			June 30, 2009			Variance	
Product	$	1,970,286	62%	$	2,098,640	67%	$	(128,354)	-6%
Recurring		1,213,115	38%		1,011,729	33%		201,386	20%
Total	$	3,183,401	100%	$	3,110,369	100%	$	73,032	2%

	Six Months Ended								
		June 30, 2010			June 30, 2009			Variance	
Product	$	3,536,737	61%	$	4,017,067	67%	$	(480,330)	-12%
Recurring		2,230,704	39%		1,991,254	33%		239,450	12%
Total	$	5,767,441	100%	$	6,008,321	100%	$	(240,880)	-4%

Product revenue

Product revenue principally arises from the sale and installation of SmartGrid and broadband networking equipment, including SmartEnergy technology, Telkonet Series 5 and Telkonet iWire products. We market and sell to the hospitality, education, healthcare and government/military markets. The Telkonet Series 5 and the Telkonet iWire products consist of the Telkonet Gateways, Telkonet Extenders, the patented Telkonet Coupler, and Telkonet iBridges. The SmartEnergy product suite consists of thermostats, sensors, controllers, wireless networking products and a control platform.

For the three and six months ended June 30, 2010, product revenue decreased by 6% and 12%, respectively, when compared to the prior year periods. Product revenue in 2009 includes approximately $2.7 million attributed to the sale and installation of energy management products, and approximately $0.6 million for the sale and installation of HSIA products, and approximately $0.3 million attributable to the Telkonet Series 5 products. The decrease in product sales compared to the prior year period is attributed to the economic downturn, however, the current quarter product revenue sales reflects positive anticipated trends in comparison to the second half of the prior year. We expect to see sales growth in 2010 from the addition and/or renewal of incentive based programs for energy efficiency, government stimulus funding through the American Reinvestment and Recovery Act of 2009, and energy savings initiatives in the commercial market.

Recurring Revenue

Recurring revenue includes approximately 2,350 hotels in our broadband network portfolio. We currently support over 205,000 HSIA rooms, with over 2.5 million monthly users. For the three and six months ended June 30, 2010, recurring revenue increased by 20% and 12%, respectively, when compared to the prior year period. The increase of recurring revenue was primarily attributed to new HSIA customers and increase in service charges.

Cost of Sales

	Three Months Ended		
	June 30, 2010	June 30, 2009	Variance

Product	$	1,012,124	51%	$	1,032,183	49%	$	(20,059)	-2%
Recurring		326,062	27%		303,513	30%		22,549	7%
Total	$	1,338,186	42%	$	1,335,696	43%	$	2,490	0%

	Six Months Ended								
	June 30, 2010			June 30, 2009			Variance		
Product	$	1,911,907	54%	$	2,108,822	52%	$	(196,915)	-9%
Recurring		631,907	28%		609,347	31%		22,560	4%
Total	$	2,543,814	44%	$	2,718,169	45%	$	(174,355)	-6%

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Product Costs

Product costs include equipment and installation labor related to the sale of Telkonet SmartEnergy™ products, Telkonet Series 5™ products and the Telkonet iWire System™. For the three and six months ended June 30, 2010, product costs decreased by 2% and 9% when compared to the prior year periods, primarily in connection with the decreased sales in current year. However, product costs for the three and six months ended June 30, 2009 increased as a percentage of revenue from 49% to 51%, and 52% to 54%, when compared to the prior year periods, which is due to more utilization of subcontractors and increase in part purchases in relevant to increase in sales.

Recurring Costs

For the three and six months ended June 30, 2010, recurring costs increased by 7% and 4% when compared to the prior year, primarily due to the increase in efficiency in providing support services to our EthoStream Hospitality Network customers. As we continued to add new HSIA customers to our portfolio, we may need to hire additional support center staff which may affect our recurring product costs and margins.

Gross Profit

	Three Months Ended								
	June 30, 2010			June 30, 2009			Variance		
Product	$	958,162	49%	$	1,066,457	51%	$	(108,295)	-10%
Recurring		887,053	73%		708,216	70%		178,837	25%
Total	$	1,845,215	58%	$	1,774,673	57%	$	70,542	4%

	Six Months Ended								
	June 30, 2010			June 30, 2009			Variance		
Product	$	1,624,830	46%	$	1,908,245	48%	$	(283,415)	-15%
Recurring		1,598,797	72%		1,381,907	69%		216,890	16%
Total	$	3,223,627	56%	$	3,290,152	55%	$	(66,525)	-2%

Product Gross Profit

The gross profit on product revenue for the three and six months ended June 30, 2010 decreased by 10% and 15%, respectively, compared to the prior year period as a result of decreased product sales and installations on energy management and HSIA sales.

Recurring Gross Profit

Our gross profit associated with recurring revenue increased by 25% and 16% for the three and six months ended June 30, 2010. The increase was a combination of additional recurring revenue and maintaining our support labor costs.

Operating Expenses

	Three Months Ended			
	June 30, 2010	June 30, 2009	Variance	
Total	$ 1,646,684	$ 2,137,185	$ (490,501)	-23%

	Six Months Ended			
	June 30, 2010	June 30, 2009	Variance	
Total	$ 3,683,684	$ 4,213,583	$ (529,899)	-13%

During the three and six months ended June 30, 2010, operating expenses decreased by 23% and 13%, respectively, when compared to the prior year periods. This decrease is primarily related to the overall reduction in operating expenses started in 2008 continually through 2010 in connection with the corporate restructuring, and the reduction of research and development and overhead staffing at the corporate headquarters office. We do not anticipate any significant changes to operating expenses for the remainder of 2010.

Research and Development

	Three Months Ended			
	June 30, 2010	June 30, 2009	Variance	
Total	$ 264,049	$ 222,316	$ 41,733	19%

	Six Months Ended			
	June 30, 2010	June 30, 2009	Variance	
Total	$ 529,900	$ 498,278	$ 31,622	6%

Our research and development costs related to both present and future products are expensed in the period incurred. Current research and development costs are associated with the continued development of Telkonet Series 5 products and next generation TSE and NTSE products. The Company anticipates modest growth of research and development costs in 2010.

Selling, General and Administrative Expenses

	Three Months Ended			
	June 30, 2010	June 30, 2009	Variance	
Total	$ 1,304,845	$ 1,821,186	$ (516,341)	-28%

	Six Months Ended			
	June 30, 2010	June 30, 2009	Variance	
Total	$ 2,995,584	$ 3,534,788	$ (539,204)	-15%

During the three and six months ended June 30, 2010, selling, general and administrative expenses decreased over the comparable prior year periods by approximately 28% and 15%, respectively. This decrease when compared to the prior year three month and six month ended is primarily the result of the efficiencies in the organization resulting in reduced salary and related costs by approximately $116,000 and $310,000, respectively, as well as other significant reduction in administrative costs approximately $482,000 and $316,000, respectively, stock expenses approximately $42,000 and $79,000, travel costs approximately $6,000 and $66,000, offset by increase in legal fees approximately $367,000 and $415,000, respectively. We do not expect to significantly increase in legal fees and our selling, general and administrative expenses in the remaining of 2010, except as necessary to meet future growth opportunities.

Discontinued Operations

We had net income from discontinued operations of $6,296,851, or $0.07 per share, for the six months ended June 30, 2009. Net income from discontinued operations for the six months ended June 30, 2009 includes the gain on deconsolidation of $6,932,586, offset by MSTI's net loss of $635,735 for the six months ended June 30, 2009.

Liquidity and Capital Resources

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

Working Capital

Our working capital decreased by $2,368,541 during the six months ended June 30, 2010 from a working capital deficit (current liabilities in excess of current assets) of $3,785,491 at December 31, 2009 to a working capital deficit of $6,154,032 at June 30, 2010, excluding working capital attributed to discontinued operations. The working capital deficit includes convertible debentures of $1,606,023, excluding $296,110 in debt discounts, due to YA Global in May 2011 and non-cash derivative liability of $812,442. The decrease in working capital for the six months ended June 30, 2010 is due to a combination of reasons, of which the significant factors include:

- Cash had a net decrease from working capital by $401,433 for the six months ended June 30, 2010. The most significant uses and proceeds of cash were:
  - Approximately $113,016 of cash consumed in continuing operating activities;
  - A repayment of $288,417 on our line of credit to fund inventory pruchases

Of the total current assets of $2,139,212 as of June 30, 2010, cash represented $102,437. Of the total current assets of $1,909,073 as of December 31, 2009, cash represented $503,870.

Business Loan

On September 11, 2009, we entered into a Loan Agreement to borrow an aggregate principal amount of $300,000 from the Wisconsin Department of Commerce, or the Department. The outstanding principal balance on the loan bears interest at the annual rate of two percent (2.0%). Payment of interest and principal is to be made in the following manner: (a) payment of any and all interest that accrues from the date of disbursement commences on January 1, 2010 and continues on the first day of each consecutive month thereafter through and including December 31, 2010; (b) commencing on January 1, 2011 and continuing on the first day of each consecutive month thereafter through and including November 1, 2016, we are obligated to pay equal monthly installments of $4,426 each; followed by a final installment on December 1, 2016 which will include all remaining principal, accrued interest and other amounts owed by us to the Department under the Loan Agreement. We may prepay amounts outstanding under the loan in whole or in part at any time without penalty. The loan is secured by our assets and the proceeds from this loan will be used for our working capital requirements. The current and long-term outstanding borrowing under the agreement at June 30, 2010 was $23,649 and $276,351, respectively.

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 June 30, 2010 was $98,583. The Company has incurred interest expense of $18,481 and $41,898 related to the line of credit for the three and six months ended June 30, 2010, respectively. The Prime Rate was 3.25% at June 30, 2010. The Company is currently making weekly installments of approximately $9,000 to the principal balance of the line of credit to effectuate a zero balance in September 2011. No renewal of the agreement is anticipated upon expiration.

On August 13, 2010, 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 June 30, 2010 and continues for the 90 day period thereafter. The outstanding principal balance is subject to additional interest of three (3%) percent per annum until such debt covenant requirements are met.

Convertible Debenture

On May 30, 2008, the Company entered into a Securities Purchase Agreement with YA Global Investments, L.P. (the "Buyer") pursuant to which the Company agreed to issue and sell to the Buyer up to $3,500,000 of secured convertible debentures (the "Debentures") and warrants to purchase (the "Warrants") up to 2,500,000 shares of the Company's Common Stock, par value $0.001 per share (the "Common Stock"). The sale of the Debentures and Warrants was effectuated in three separate closings, the first of which occurred on May 30, 2008, and the remainder of which occurred in July 2008. At the May 30, 2008 closing, the Company sold Debentures having an aggregate principal value of $1,500,000 and Warrants to purchase 2,100,000 shares of Common Stock. In July 2008, the Company sold the remaining Debentures having an aggregate principal value of $2,000,000 and Warrants to purchase 400,000 shares of Common Stock.

The Debentures accrue interest at a rate of 13% per annum and mature on May 29, 2011. The Debentures may be redeemed at any time, in whole or in part, by the Company upon payment by the Company of a redemption premium equal to 15% of the principal amount of Debentures being redeemed, provided that an Equity Conditions Failure (as defined in the Debentures) is not occurring at the time of such redemption. The Buyer may also convert all or a portion of the Debentures at any time at a price equal to the lesser of (i) $0.58, or (ii) ninety percent (90%) of the lowest volume weighted average price of the Company's Common Stock during the ten (10) trading days immediately preceding the conversion date. The Warrants expire five years from the date of issuance and entitle the Buyers to purchase shares of the Company's Common Stock at a price per share of $0.61.

In November 2009, the Company issued warrants to YA Global Investments LP pursuant to anti-dilution provisions in their existing warrant agreements that were triggered by the completion of the Series A preferred stock private placement. These warrants entitled the holders to purchase up to 2,121,212 shares of our common stock at a price per share of $0.33.

On May 12, 2009, YA Global met the Exchange Cap for the conversion of its debentures, and thus could not receive additional shares of our common stock upon the conversion of its debentures or exercise of its warrants. In the Agreement of Clarification, we agreed to seek shareholder approval to remove the Exchange Cap at our 2009 annual meeting of shareholders, which was held on May 28, 2009. On May 28, 2009, our shareholders voted against the proposal to remove the Exchange Cap, which would have allowed YA Global to potentially acquire in excess of 19.99% of the outstanding shares of our common stock.

On February 20, 2009, the Company and Buyer 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.

Proceeds from the issuance of common stock

During the six months ended June 30, 2010, the Company did not receive any proceeds from the issuance of its common stock.

Cashflow analysis

Cash used in continuing operations was $113,016 and $176,127 during the period ending June 30, 2010 and 2009, respectively. During the period ended June 30, 2010, our primary capital needs were for operating expenses, including funds to support our business strategy, which primarily includes working capital necessary to fund inventory purchases, and reducing our trade payables.

We utilized cash for investing activities from continuing operations of $0 and $281,064 during the periods ended June 30, 2010, and 2009, respectively. In 2009, these activities involved intercompany loans to MSTI of approximately $305,539, which was partially offset by the sale of our remaining investment in Multiband for proceeds of $33,129.

Cash used in financing activities was $288,417 during the period ending June 30, 2010, compared to cash provided from financing activities from continuing operations $114,896 during the period ending June 30, 2009. The company made repayments on our working capital line of credit used for inventory purchases of $288,417 in 2010.

We have reduced cash required for operations by reducing operating costs and reducing staff levels. In addition, we are working to manage our current liabilities while we continue to make changes in operations to improve our cash flow and liquidity position.

Our registered independent certified public accountants have stated in their report dated March 31, 2010 that we have incurred operating losses in the past years, and that we are dependent upon management’s ability to develop profitable operations and/or obtain necessary funding from outside sources, including by the sale of our securities, or obtaining loans from financial institutions, where possible. These factors, among others, may raise substantial doubt about our ability to continue as a going concern. This may also affect our ability to obtain financing in the future.

Management expects that global economic conditions will continue to present a challenging operating environment through 2010. To the extent permitted by working capital resources, management intends to continue making targeted investments in strategic operating and growth initiatives. Working capital management will continue to be a high priority for 2010.

While we have been able to manage our working capital needs with the current credit facilities, additional financing is required in order to meet our current and projected cash flow requirements from operations. We cannot predict whether this new financing will be in the form of equity or debt. We may not be able to obtain the necessary additional capital on a timely basis, on acceptable terms, or at all. Additional investments are being sought, but we cannot guarantee that we will be able to obtain such investments. Financing transactions may include the issuance of equity or debt securities, obtaining credit facilities, or other financing mechanisms. However, the trading price of our common stock and the downturn in the U.S. stock and debt markets could make it more difficult to obtain financing through the issuance of equity or debt securities. Even if we are able to raise the funds required, it is possible that we could incur unexpected costs and expenses, fail to collect significant amounts owed to us, or experience unexpected cash requirements that would force us to seek alternative financing. Further, if we issue additional equity or debt securities, stockholders may experience additional dilution or the new equity securities may have rights, preferences or privileges senior to those of existing holders of our common stock. If additional financing is not available or is not available on acceptable terms, we will have to curtail our operations.

Inflation

We do not believe that inflation has had a material effect on our business, financial condition or results of operations. If our costs were to become subject to significant inflationary pressures, we may not be able to fully offset such higher costs through price increases. Our inability or failure to do so could adversely affect our business, financial condition and results of operations.

Off-Balance sheet Arrangements

We do not maintain off-balance sheet arrangements nor do we participate in any non-exchange traded contracts requiring fair value accounting treatment.

Acquisition or Disposition of Property and Equipment

During the six months ended June 30, 2010, there were no expenditures on fixed assets and costs of equipment under operating leases. The Company does not anticipate the sale or purchase of any significant property, plant or equipment during the next twelve months, other than computer equipment and peripherals to be used in the Company's day-to-day operations.

We presently lease two commercial office spaces in Germantown, Maryland totaling, in the aggregate, 16,400 square feet. One space consists of 11,626 square feet under sublease from Tellabs Operations, Inc. ("Tellabs") expiring on November 29, 2010.. As described in the section "Legal Proceedings" in Part II, Item 1 hereof, Tellabs has filed a claim for unpaid rent in a case styled Tellabs, Inc. v. Telkonet, Inc. in the Circuit Court for Montgomery County, State of Maryland. Tellabs was granted a judgment in March 2010 in the amount of $64,966. Pursuant to that judgment, we received a notice of eviction from our landlord for the unpaid rent. We sought to extend the date for eviction but were unable to negotiate a payment plan acceptable to the landlord and voluntarily vacated the space on May 3, 2010.

This same 11,626 square foot space is under lease to us from November 30, 2010 through December 15, 2015 to run concurrently with the lease for a separate 4,790 square foot facility expiring on December 31, 2015. We are currently actively pursuing an acceptable financial settlement and/or a sublease for all or a portion of this office space.

In the first quarter of 2010, we began the transfer of inventory and certain property in conjunction with the relocation of our corporate headquarters. We anticipate the sale or disposal of certain furniture, fixtures and computer equipment during 2010.

Number of Employees

As of August 16, 2010, the Company had 88 full time employees.

Disclosure of Contractual Obligations

We currently have outstanding purchase orders with the contract manufacturer for our Smart Energy products totaling approximately $696,000, of which approximately $260,000 represents amounts owed for future shipments of Smart Energy products which we will need to fulfill existing purchase orders with our customers. We are currently negotiating with the manufacturer and our lenders to ensure the timely payment of these purchases to prevent any delays in the delivery of these products to our customers which could negatively impact our results of operations and financial condition.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Short Term Investments

Our excess cash is held in money market accounts in a bank and brokerage firms both of which are nationally ranked top tier firms with an average return of approximately 400 basis points. Due to the conservative nature of our investment portfolio, an increase or decrease of 100 basis points in interest rates would not have a material effect on our results of operations or the fair value of our portfolio.

Investments in Privately Held Companies

We have invested in a privately held company, which is in the startup or development stage. This investment is inherently risky because the market for the products of this company is developing and may never materialize. As a result, we could lose our entire initial investment in this company. In addition, we could also be required to hold our investment indefinitely, since there is presently no public market in the securities of this company and none is expected to develop. This investment is carried at cost, which as of August 16, 2010 was $8,000 and recorded in other assets in the Consolidated Balance Sheet.

Item 4. Controls and Procedures.

As of June 30, 2010, the Company performed an evaluation, under the supervision and with the participation of management, including the Chief Executive Officer and Chief Financial Officer (Principal Accounting Officer), of the effectiveness of the design and operation of its disclosure controls and procedures as defined in Rules 13a - 15(e) or 15d - 15(e) promulgated under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Based on that evaluation and due to the lack of segregation of duties and failure to implement accounting controls of acquired businesses, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures were ineffective as of the end of the period covered by this report. During the six months ended June 30, 2010, there was no change in the Company's internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

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

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

On August 1, 2008, we timely filed an answer to the complaint denying the allegations. On February 27, 2009, the United States Patent Office ("USPTO") granted a reexamination request. Based upon four highly relevant and material prior art references that had not been considered by the USPTO in its initial examination, it found a "substantial new question of patentability" affecting all claims of the patent allegedly infringed upon. There is a possibility that the claims of the patent will be cancelled or narrowed during the reexamination which may result in the narrowing or elimination of some and possibly all of the issues in the pending litigation. The case is currently in discovery. A mandatory mediation will likely be held in July, 2010.

Defendant Ramada Worldwide, Inc. provided us with notice of the suit and demanded that we defend and indemnify it pursuant to a vendor direct supplier agreement between EthoStream and WWC Supplier Services, Inc., a Ramada affiliate (wherein we agreed to indemnify, defend and hold Ramada harmless from and against claims of infringement). After a review of that agreement, it was determined that EthoStream owes the duty to defend and indemnify and it has assumed Ramada's defense. An answer on Ramada's behalf was filed in U.S. District Court, for the Eastern District of Texas, Marshall Division on September 19, 2008. The matter is currently pending in that court.

Ronald Pickett v. Telkonet, Inc.

As of June 30, 2010, we were a defendant in the matter captioned Ronald Pickett v. Telkonet, Inc., in the Circuit Court for Montgomery County, Maryland. The Plaintiff alleged that the Company failed to pay severance compensation in the amount of $238,000 as well as certain benefits and claimed an additional amount of $63,000 in unpaid business and travel expenses. The plaintiff sought an award of treble damages on the severance claim alleging that the claimed benefits constitute "wages" under the Maryland Wage Payment and Collection Act; though as an alternative to the breach of contract claim the plaintiff plead the equitable claim of promissory estoppel/detrimental reliance. The court granted our motion for summary judgment on the breach of contract and treble damages claim. The Company conceded the expenses issue and the only issue left before the court was the promissory estoppel/detrimental reliance claim. On July 14, 2010, the court, after hearing testimony on the matter, issued a verdict in favor of the plaintiff in the amount of $259,456 (including prejudgment interest and gave the Company forty five (45) days from the entry of the judgment to satisfy the judgment after which the plaintiff may commence enforcement proceedings. The Company has thirty (30) days following the entry of judgment within which to take an appeal. The Company is currently considering its options and has accrued the amount of the judgment as of June 30, 2010.

Tellabs, Inc. v. Telkonet, Inc.

Our landlord has filed a claim for unpaid rent in a case styled Tellabs, Inc. v. Telkonet, Inc. in the Circuit Court for Montgomery County, State of Maryland. Tellabs was granted a judgment in March 2010 in the amount of $64,966.

Pursuant to that judgment, we received a notice of eviction from our landlord for the unpaid rent. We sought to extend the date for eviction but were unable to negotiate a payment plan acceptable to the landlord and voluntarily vacated the space on May 3, 2010.

Item 1A. Risk Factors.

The Company's results of operations, financial condition and cash flows can be adversely affected by various risks. These risks include, but are not limited to, the principal factors listed below and the other matters set forth in this quarterly report on Form 10-Q. You should carefully consider all of these risks.

The Company has a history of operating losses and an accumulated deficit and expects to continue to incur losses for the foreseeable future.

Since inception through June 30, 2010, the Company has incurred cumulative losses of $(113,929,782) and has never generated enough funds through operations to support its business. Additional capital may be required in order to provide working capital requirements for the next twelve months.

A significant portion of our total assets consists of goodwill, which is subject to a periodic impairment analysis and a significant impairment determination in any future period could have an adverse effect on our results of operations even without a significant loss of revenue or increase in cash expenses attributable to such period.

We have goodwill totaling approximately $11.7 million at June 30, 2010 resulting from recent and past acquisitions. We evaluate this goodwill for impairment based on the fair value of the operating business units to which this goodwill relates at least once a year. This estimated fair value could change if we are unable to achieve operating results at the levels that have been forecasted, the market valuation of those business units decreases based on transactions involving similar companies, or there is a permanent, negative change in the market demand for the services offered by the business units. These changes could result in an impairment of the existing goodwill balance that could require a material non-cash charge to our results of operations.

Our independent auditors have expressed substantial doubt about our ability to continue as a going concern, which may hinder our ability to obtain future financing.

In their report dated March 31, 2010, our independent auditors stated that our financial statements for the year ended December 31, 2009 were prepared assuming that we would continue as a going concern, and that they have substantial doubt about our ability to continue as a going concern. Our auditors' doubts are based on our net losses and deficits in cash flows from operations. We continue to experience net operating losses. Our ability to continue as a going concern is subject to our ability to generate a profit and/or obtain necessary funding from outside sources, including by the sale of our securities, or obtaining loans from financial institutions, where possible. Our continued net operating losses and our auditors' doubts increase the difficulty of our meeting such goals. If we are not successful in raising sufficient additional capital, we may not be able to continue as a going concern and our stockholders may lose their entire investment.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Submission of Matters to a Vote of Security Holders.

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

Exhibit Number	Description Of Document
2.1	MST Stock Purchase Agreement and Amendment (incorporated by reference to our 8-K filed on February 2, 2006)
2.2	Asset Purchase Agreement by and between Telkonet, Inc. and Smart Systems International, dated as of February 23, 2007 (incorporated by reference to our Form 8-K filed on March 2, 2007)
2.3	Unit Purchase Agreement by and among Telkonet, Inc., EthoStream, LLC and the members of EthoStream, LLC dated as of March 15, 2007 (incorporated by reference to our Form 8-K filed on March 16, 2007)
3.1	Articles of Incorporation of the Registrant (incorporated by reference to our Form 8-K (No. 000-27305), filed on August 30, 2000 and our Form S-8 (No. 333-47986), filed on October 16, 2000)
3.2	Amendment to Articles of Incorporation (incorporated by reference to our Form 10-Q (No. 001-31972), filed August 11, 2008)
3.3	Amendment to Articles of Incorporation (incorporated by reference to our Form 10-Q (No. 001-31972), filed August 14, 2009)
3.4	Amendment to Articles of Incorporation (incorporated by reference to our Form 8-K (No. 001-31972), filed November 18, 2009)
3.5	Bylaws of the Registrant (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
4.1	Form of Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K (No. 001-31972) filed on May 12, 2008)
4.2	Form of Convertible Debenture (incorporated by reference to our Form 8-K (No. 001-31972) filed on June 5, 2008)
4.3	Form of Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K (No. 001-31972) filed on June 5, 2008)
4.4	Promissory Note in Favor of Thermo Credit, LLC (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 10, 2008)
4.5	Promissory Note in Favor of the Wisconsin Department of Commerce (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 17, 2009)
10.1	Amended and Restated Telkonet, Inc. Incentive Stock Option Plan (incorporated by reference to our Registration Statement on Form S-8 (No. 333-412), filed on April 17, 2002)
10.2	Amended and Restated Stock Option Plan (incorporated by reference to our Registration Statement on Form S-8 (No. 333-161909), filed on September 14, 2009)
10.3	Employment Agreement by and between Telkonet, Inc. and Jason Tienor, dated as of May 13, 2010 (incorporated by reference to our Form 8-K (No. 001-31972), filed May 13, 2010)
10.4	Employment Agreement by and between Telkonet, Inc. and Jeff Sobieski, dated as of May 13, 2010 (incorporated by reference to our Form 8-K (No. 001-31972), filed May 13, 2010)
10.5	Securities Purchase Agreement, dated May 30, 2008, by and between Telkonet, Inc. and YA Global Investments LP (incorporated by reference to our Current Report on Form 8-K filed on June 5, 2008)

10.6	Registration Rights Agreement, dated May 30, 2008, by and between Telkonet, Inc. and YA Global Investments LP (incorporated by reference to our Current Report on Form 8-K filed on June 5, 2008)
10.7	Security Agreement, dated May 30, 2008, by and between Telkonet, Inc. and YA Global Investments LP (incorporated by reference to our Current Report on Form 8-K filed on June 5, 2008)
10.8	Commercial Business Loan Agreement, dated September 9, 2008, by and between Telkonet, Inc. and Thermo Credit, LLC (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 10, 2008)
10.9	Loan Agreement, dated September 11, 2009, by and between Telkonet, Inc. and the Wisconsin Department of Commerce (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 17, 2009)
10.10	General Business Security Agreement, dated September 11, 2009, by and between Telkonet, Inc. and the Wisconsin Department of Commerce (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 17, 2009)
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 Jeffery Sobieski
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 Jeffery Sobieski pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

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

	Telkonet, Inc. Registrant	
Date: August 16, 2010	By:	/s/ Jason L. Tienor Jason L. Tienor Chief Executive Officer