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TELKONET INC  
Form 10QSB  
August 20, 2002

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

FORM 10QSB  
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the period ended June 30, 2002

Commission file number 333-47986

TELKONET, INC.  
(Name of Small Business Issuer in Its Charter)

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

902 A Commerce Road Annapolis, Maryland 21401  
(Address of Principal Executive Offices)

(410) 897-5900  
Issuer's Telephone Number

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 16,596,181 shares of Common Stock (\$.001 par value) as of August 15, 2002.

Transitional small business disclosure format: Yes  No   
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TELKONET, INC.

Quarterly Report on Form 10-QSB for the  
Quarterly Period Ending June 30, 2002

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Item 1. Financial Statements (Unaudited)

TELKONET, INC.  
(A DEVELOPMENT STAGE COMPANY)  
CONDENSED CONSOLIDATED BALANCE SHEETS

#### ASSETS

|   | June 30,<br>2002   | December 31,<br>2001 |
|---|--------------------|----------------------|
|   | -----<br>Unaudited | -----                |
| CURRENT ASSETS:   |                    |                      |
| Cash and equivalents  | \$ 142,001         | \$ 21,885            |
| Prepaid and deposit   | 4,625              | 4,625                |
|   | -----              | -----                |
| Total current assets  | 146,626            | 26,510               |
| PROPERTY AND EQUIPMENT:   |                    |                      |
| Furniture, equipment, and leasehold improvements, at cost   | 74,449             | 54,950               |
| Less: Accumulated depreciation  | 37,052             | 28,108               |
|   | -----              | -----                |
|   | 37,397             | 26,842               |
| OTHER ASSETS  |                    |                      |
| Financing costs, less amortization costs of \$471,542 and<br>\$415,742 at June 30, 2002 and December 31, 2001 | 628,525            | 684,325              |

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|   |             |             |
|---|-------------|-------------|
|   | -----       | -----       |
|   | \$ 812,548  | \$ 737,677  |
|   | =====       | =====       |
| LIABILITIES AND DEFICIENCY IN STOCKHOLDERS' EQUITY  |             |             |
| CURRENT LIABILITIES:  |             |             |
| Accounts payable and accrued liabilities  | \$ 314,585  | \$ 116,741  |
| Notes payable   | 566,500     | 400,000     |
| Due to shareholders   | 7,500       | 7,500       |
|   | -----       | -----       |
| Total current liabilities   | 888,585     | 524,241     |
| Convertible debentures  | 1,655,407   | 940,000     |
| COMMITMENTS AND CONTINGENCIES   | --          | --          |
| DEFICIENCY IN STOCKHOLDER'S EQUITY  |             |             |
| Common stock, par value \$.001 per share; 100,000,000 shares authorized; 15,271,711 issued at June 30, 2002 and 2,115,371 issued at December 31, 2001 |             |             |
|   | 15,272      | 22,115      |
| Common stock subscription   | (1,000,000) | --          |
| Additional paid-in-capital  | 3,466,421   | 2,221,154   |
| Deficiency accumulated during development stage   | (4,213,137) | (2,969,833) |
|   | -----       | -----       |
| Deficiency in stockholder's equity  | (1,731,444) | (726,564)   |
|   | -----       | -----       |
|   | \$ 812,548  | \$ 737,677  |
|   | =====       | =====       |

See accompanying notes to the unaudited condensed consolidated financial information

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TELKONET, INC.  
(A DEVELOPMENT STAGE COMPANY)  
CONDENSED CONSOLIDATED STATEMENTS OF LOSSES  
(UNAUDITED)

|                                     | Three Months ended June 30,<br>2002 | 2001       | Six Months ended J<br>2002 | ----- |
|-------------------------------------|-------------------------------------|------------|----------------------------|-------|
|                                     | -----                               | -----      | -----                      | ----- |
| Costs and Expenses:                 |                                     |            |                            |       |
| Research & Development              | \$ 30,760                           | \$ 109,024 | \$ 151,431                 | \$    |
| Selling, General and Administrative | 625,380                             | 230,365    | 1,009,913                  |       |
| Depreciation and Amortization       | 32,372                              | 7,882      | 64,744                     |       |
|                                     | -----                               | -----      | -----                      | ----- |
| Total Operating Expense             | 688,512                             | 347,271    | 1,226,088                  |       |
| Loss from Operations                | (688,512)                           | (347,271)  | (1,226,088)                |       |

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|  |              |              |                |       |
|--|--------------|--------------|----------------|-------|
| Interest Income (Expense)                              | (4,171)      | (10,426)     | (17,216)       |       |
| Provision for Income Tax                               | --           | --           | --             |       |
|  | -----        | -----        | -----          | ----- |
|  | (4,171)      | (10,426)     | (17,216)       |       |
| Net income   | \$ (692,683) | \$ (357,697) | \$ (1,243,304) | \$    |
|  | =====        | =====        | =====          | ===== |
| Loss per common share (basic and<br>assuming dilution) | \$ (0.05)    | \$ (0.02)    | \$ (0.07)      | \$    |
|  | =====        | =====        | =====          | ===== |
| Weighted average common shares outstanding             | 14,154,678   | 21,859,149   | 17,244,540     | 21    |

See accompanying notes to the unaudited condensed consolidated financial informat

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TELKONET, INC.  
(A DEVELOPMENT STAGE COMPANY)  
CONSOLIDATED STATEMENT OF DEFICIENCY IN STOCKHOLDERS' EQUITY  
FOR THE PERIOD NOVEMBER 3, 1999 (DATE OF INCEPTION) TO JUNE 30, 2002

|  | Common Shares | Stock Amount |
|--|---------------|--------------|
|  | -----         | -----        |
| Net Loss   | \$ --         | \$ --        |
|  | -----         | -----        |
| Balance at December 31, 1999   | --            | --           |
| Shares issued to founders January 2000, in exchange for<br>services and costs valued at \$ 0.60 per share                    | 19,300        | 193          |
| Shares issued in June 2000, for cash in connection with<br>private placement at \$375 per share, net of costs                | 1,735         | 17           |
| Shares issued in July 2000, for warrants exercised at a price<br>of \$375 per share  | 190           | --           |
| Shares issued in August 2000, in connection with the merger of<br>Comstock Coal and Telkonet Communications, Inc             | 21,775,335    | 21,775       |
| August 2000, retirement of Telkonet Communications, Inc shares   | (21,225)      | (210)        |
| Shares issued in October 2000, in exchange for warrants<br>exercised at a price of \$1 per share                             | 29,145        | 29           |
| Shares issued in October 2000, in exchange for warrants<br>exercised at a price of \$ 0.40 per share                         | 10,891        | 11           |
| Net loss   | --            | --           |
|  | -----         | -----        |
| Balance at December 31, 2000   | 21,815,371    | 21,815       |
|  | =====         | =====        |
| Shares issued in June 2001, for cash in connection with a<br>private placement, shares issued at \$.50 a share, net of costs | 260,000       | 260          |
| 1,839,378 warrants issued in June 2001, valued at \$0.13 per<br>warrant, in exchange for services                            | --            | --           |
| 72,668 stock options issued in June 2001, valued at \$ 0.09 per<br>stock option, in exchange for services                    | --            | --           |

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|   |              |             |
|---|--------------|-------------|
| 245,287 warrants issued in July 2001, valued at \$0.08 per warrant, in exchange for services                                | --           | --          |
| 36,917 stock options issued in July 2001, valued at \$ 0.08 per warrant, in exchange for services                           | --           | --          |
| Shares issued in August 2001, for cash in connection with a private placement, shares issued at \$.50 a share, net of costs | 40,000       | 40          |
| 241,000 warrants issued in August 2001, valued at \$ 0.39 per warrant in exchange for financing costs                       | --           | --          |
| 114,000 warrants issued in August 2001, valued at \$ 0.43 per warrant, in exchange for interest                             | --           | --          |
| 150,000 warrants issued in August 2001, valued at \$ 0.16 per warrant, in exchange for services                             | --           | --          |
| 36,917 stock options issued in August 2001, valued at \$ 0.06 per stock option, in exchange for services                    | --           | --          |
| 818,000 warrants issued in September 2001, valued at \$ 0.14 per warrant, in exchange for financing costs                   | --           | --          |
|   |              |             |
|   |              | Deficit     |
|   |              | Accumulated |
|   |              | During      |
|   | Common Stock | Development |
|   | Subscription | Stage       |
|   | -----        | -----       |
| Net Loss  | \$ --        | \$ (33,973) |
|   | -----        | -----       |
| Balance at December 31, 1999  | --           | (33,973)    |
| Shares issued to founders January 2000, in exchange for services and costs valued at \$ 0.60 per share                      | --           | --          |
| Shares issued in June 2000, for cash in connection with private placement at \$375 per share, net of costs                  | --           | --          |
| Shares issued in July 2000, for warrants exercised at a price of \$375 per share  | --           | --          |
| Shares issued in August 2000, in connection with the merger of Comstock Coal and Telkonet Communications, Inc               | --           | --          |
| August 2000, retirement of Telkonet Communications, Inc shares  | --           | --          |
| Shares issued in October 2000, in exchange for warrants exercised at a price of \$1 per share                               | --           | --          |
| Shares issued in October 2000, in exchange for warrants exercised at a price of \$ 0.40 per share                           | --           | --          |
| Net loss  | --           | (929,720)   |
|   | -----        | -----       |
| Balance at December 31, 2000  | --           | (963,693)   |
|   | =====        | =====       |
| Shares issued in June 2001, for cash in connection with a private placement, shares issued at \$.50 a share, net of costs   | --           | --          |
| 1,839,378 warrants issued in June 2001, valued at \$0.13 per warrant, in exchange for services                              | --           | --          |
| 72,668 stock options issued in June 2001, valued at \$ 0.09 per stock option, in exchange for services                      | --           | --          |
| 245,287 warrants issued in July 2001, valued at \$0.08 per warrant, in exchange for services                                | --           | --          |
| 36,917 stock options issued in July 2001, valued at \$ 0.08 per warrant, in exchange for services                           | --           | --          |
| Shares issued in August 2001, for cash in connection with a private placement, shares issued at \$.50 a share, net of costs | --           | --          |
| 241,000 warrants issued in August 2001, valued at \$ 0.39 per warrant in exchange for financing costs                       | --           | --          |
| 114,000 warrants issued in August 2001, valued at \$ 0.43 per warrant, in exchange for interest                             | --           | --          |
| 150,000 warrants issued in August 2001, valued at \$ 0.16 per   | --           | --          |

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|   |    |    |
|---|----|----|
| warrant, in exchange for services   | -- | -- |
| 36,917 stock options issued in August 2001, valued at \$ 0.06 per stock option, in exchange for services  | -- | -- |
| 818,000 warrants issued in September 2001, valued at \$ 0.14 per warrant, in exchange for financing costs | -- | -- |

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TELKONET, INC.  
(A DEVELOPMENT STAGE COMPANY)  
CONSOLIDATED STATEMENT OF DEFICIENCY IN STOCKHOLDERS' EQUITY  
FOR THE PERIOD NOVEMBER 3, 1999 (DATE OF INCEPTION) TO JUNE 30, 2002  
(CONTINUED)

|  | Common Shares | Stock Amount |
|--|---------------|--------------|
|  | -----         | -----        |
| 1,636,000 warrants issued in September 2001, valued at \$ 0.40 per warrant, in exchange for interest         | --            | --           |
| 25,000 warrants issued in September 2001, valued at \$0.30 per warrant in exchange for services              | --            | --           |
| 60,000 warrants issued in October 2001, valued at \$ 0.16 per warrant, in exchange for financing costs       | --            | --           |
| 120,000 warrants issued in October 2001, valued at \$ 0.44 per warrant, in exchange for interest             | --            | --           |
| 95,000 warrants issued in October 2001, valued at \$ 0.21 per warrant, in exchange for services              | --            | --           |
| 5,000 warrants issued in November 2001, valued at \$ 0.16 per warrant, in exchange for financing costs       | --            | --           |
| 10,000 warrants issued in November 2001, valued at \$ 0.44 per warrant, in exchange for interest             | --            | --           |
| 25,000 warrants issued in November 2001, valued at \$ 0.33 per warrant, in exchange for services             | --            | --           |
| 25,000 warrants issued in December 2001, valued at \$ 0.30 per warrant, in exchange for services             | --            | --           |
| Net loss   | --            | --           |
|  | -----         | -----        |
| Balance at December 31, 2001   | 22,115,371    | 22,115       |
|  | =====         | =====        |
| Shares issued in February 2002, in exchange for convertible debentures at \$ .50 per share                   | 43,586        | 44           |
| Shares issued in March 2002, to a founder in exchange for shares canceled (Note B)                           | 5,250,000     | 5,250        |
| Shares canceled in March 2002 due to capital restructure (Note B)  | (13,480,961)  | (13,481)     |
| Shares issued in June 2002, for warrants exercised at \$1.00 per share for services rendered                 | 47,906        | 48           |
| Shares issued in June 2002, for warrants exercised at \$.40 per share for services rendered                  | 26,443        | 26           |
| Shares issued in June 2002 to founders, for options exercised at \$1.00 per share (Note B and C)             | 1,000,000     | 1,000        |
| Shares issued in June 2002, for warrants exercised at \$1.0025 per share, for services rendered              | 80,039        | 80           |
| Shares issued in June 2002, for warrants exercised at \$ .402, in connection with original private placement | 189,327       | 189          |
| Common stock subscription (Note C)   | --            | --           |
| Net Loss   | --            | --           |
|  | -----         | -----        |
| Balance at June 30, 2002   | 15,271,711    | \$ 15,272    |

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|  | Common Stock<br>Subscription | Deficit<br>Accumulated<br>During<br>Development<br>Stage |
|--|------------------------------|--|
|  | -----                        | -----  |
| 1,636,000 warrants issued in September 2001, valued at \$ 0.40 per warrant, in exchange for interest         | --                           | --   |
| 25,000 warrants issued in September 2001, valued at \$0.30 per warrant in exchange for services              | --                           | --   |
| 60,000 warrants issued in October 2001, valued at \$ 0.16 per warrant, in exchange for financing costs       | --                           | --   |
| 120,000 warrants issued in October 2001, valued at \$ 0.44 per warrant, in exchange for interest             | --                           | --   |
| 95,000 warrants issued in October 2001, valued at \$ 0.21 per warrant, in exchange for services              | --                           | --   |
| 5,000 warrants issued in November 2001, valued at \$ 0.16 per warrant, in exchange for financing costs       | --                           | --   |
| 10,000 warrants issued in November 2001, valued at \$ 0.44 per warrant, in exchange for interest             | --                           | --   |
| 25,000 warrants issued in November 2001, valued at \$ 0.33 per warrant, in exchange for services             | --                           | --   |
| 25,000 warrants issued in December 2001, valued at \$ 0.30 per warrant, in exchange for services             | --                           | --   |
| Net loss   | --                           | (2,006,140)  |
|  | -----                        | -----  |
| Balance at December 31, 2001   | --                           | (2,969,833)  |
|  | =====                        | =====  |
| Shares issued in February 2002, in exchange for convertible debentures at \$ .50 per share                   | --                           | --   |
| Shares issued in March 2002, to a founder in exchange for shares canceled (Note B)                           | --                           | --   |
| Shares canceled in March 2002 due to capital restructure (Note B)  | --                           | --   |
| Shares issued in June 2002, for warrants exercised at \$1.00 per share for services rendered                 | --                           | --   |
| Shares issued in June 2002, for warrants exercised at \$.40 per share for services rendered                  | --                           | --   |
| Shares issued in June 2002 to founders, for options exercised at \$1.00 per share (Note B and C)             | --                           | --   |
| Shares issued in June 2002, for warrants exercised at \$1.0025 per share, for services rendered              | --                           | --   |
| Shares issued in June 2002, for warrants exercised at \$ .402, in connection with original private placement | --                           | --   |
| Common stock subscription (Note C)   | (1,000,000)                  | --   |
| Net Loss   | --                           | (1,243,304)  |
|  | -----                        | -----  |
| Balance at June 30, 2002   | \$ (1,000,000)               | \$ (4,213,137)   |
|  | =====                        | =====  |

See accompanying notes to the unaudited condensed consolidated financial informat

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## CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

|   | Six Months Ended June 30, |                  | For the p<br>from Nov<br>3, 1999<br>of incep<br>through<br>30, 20 |
|---|---------------------------|------------------|---|
|   | 2002                      | 2001             |   |
| INCREASE (DECREASE) IN CASH AND EQUIVALENTS   |                           |                  |   |
| CASH FLOWS FROM OPERATING ACTIVITIES:   |                           |                  |   |
| Net loss from development stage operations  | \$ (1,243,304)            | \$ (609,742)     | \$ (4,213,  |
| Adjustments to reconcile net loss from development stage operations to cash used for operating activities |                           |                  |   |
| Warrants issued in exchange for financing and interest  | --                        | --               | 378,  |
| Warrants issued in exchange for services  | --                        | --               | 333,  |
| Common stock issued in exchange for services rendered   | 138,722                   | --               | 150,  |
| Depreciation and amortization   | 64,744                    | 15,727           | 130,  |
| Increase (decrease) in:   |                           |                  |   |
| Deposits  | --                        | --               | (4,   |
| Accounts payable and accrued expenses, net  | 197,844                   | 73,693           | 314,  |
| <b>NET CASH USED IN OPERATING ACTIVITIES</b>  | <b>(841,994)</b>          | <b>(520,322)</b> | <b>(2,911,</b>  |
| CASH FLOWS USED IN INVESTING ACTIVITIES:  |                           |                  |   |
| Capital expenditures, net of disposals  | (19,499)                  | (4,629)          | (74,  |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>  | <b>(19,499)</b>           | <b>(4,629)</b>   | <b>(74,</b>   |
| CASH FLOWS FROM FINANCING ACTIVITIES:   |                           |                  |   |
| Proceeds from sale of common stock, net of costs  | 99,702                    | 130,000          | 898,  |
| Proceeds from (repayments of) stockholder advances  | --                        | (2,500)          | 7,  |
| Proceeds from issuance of convertible debentures  | 715,407                   | --               | 1,655,  |
| Proceeds from loans   | 166,500                   | 400,000          | 566,  |
| <b>NET CASH PROVIDED (USED) IN FINANCING ACTIVITIES</b>   | <b>981,609</b>            | <b>527,500</b>   | <b>3,127,</b>   |
| <b>NET (DECREASE) INCREASE IN CASH AND EQUIVALENTS</b>  | <b>120,116</b>            | <b>2,549</b>     | <b>142,</b>   |
| Cash and cash equivalents at the beginning of the period  | 21,885                    | 10,450           |   |
| Cash and cash equivalents at the end of the period  | \$ 142,001                | \$ 12,999        | \$ 142,   |
| Supplemental Disclosures of Cash Flow Information   |                           |                  |   |
| Cash paid during the period for interest  | \$ 17,216                 | \$ --            | \$ 24,  |
| Income taxes paid   | --                        | --               |   |
| Issuance of warrants for financing and interest   | --                        | --               | 1,278,  |
| Issuance of warrants and options for services   | --                        | --               | 333,  |
| Common stock issued for services  | 138,722                   | --               | 150,  |
| Acquisition:  |                           |                  |   |
| Assets Acquired   | --                        | --               |   |
| Accumulated Deficit   | --                        | --               | 2,  |
| Liabilities Assumed   | --                        | --               | (2,   |
|   | \$ --                     | \$ --            | \$  |



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See accompanying notes to the unaudited condensed consolidated financial information

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TELKONET, INC.  
(A DEVELOPMENT STAGE COMPANY)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION  
JUNE 30, 2002  
(UNAUDITED)

NOTE A - SUMMARY OF ACCOUNTING POLICIES  
-----

General  
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The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions to Form 10-QSB, and therefore, do not include all the information necessary for a fair presentation of financial position, results of operations and cash flows in conformity with generally accepted accounting principles.

In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. The results from developmental stage operations for the six-month period ended June 30, 2002 are not necessarily indicative of the results that may be expected for the year ended December 31, 2002. The unaudited consolidated financial statements should be read in conjunction with the consolidated December 31, 2001 financial statements and footnotes thereto included in the Company's SEC Form 10-KSB dated February 14, 2002.

Basis of Presentation  
-----

Telkonet Communications, Inc., a wholly-owned subsidiary of Telkonet, Inc., formerly Comstock Coal Company, Inc., was formed on November 3, 1999 under the laws of the state of Utah. Telkonet Communications, Inc. is a development stage enterprise, as defined by Statement of Financial Accounting Standards No. 7 ("SFAS No. 7") and is seeking to develop, produce and market proprietary equipment enabling the transmission of voice and data over electric utility lines. From its inception through the date of these financial statements the Telkonet Communications, Inc. has recognized no revenues and has incurred significant operating expenses. The consolidated financial statements include the accounts of the Company, and its wholly owned subsidiary, Telkonet Communications, Inc. Significant inter-company transactions have been eliminated in consolidation.

Reclassification  
-----

Certain reclassifications have been made to conform to prior periods' data to the current presentation. These reclassifications had no effect on reported losses.

NOTE B - CAPITAL RESTRUCTURE

In January 2002, the Company re-organized its capital structure, whereby the Company agreed to purchase 8,936,244 shares of the Company's common stock held by the Founders and cancel certain vested options held by the Founders to purchase the Company's common stock, in exchange for the issuance of newly

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issued options to purchase 3,500,000 of the Company's common stock. The new stock options expire in January 2012, and have an exercise price of \$1.00 per share.

| FOUNDERS     | PRIOR<br>SHARES | RETURNED<br>SHARES | ADJUSTED<br>SHARES | RETURNED<br>OPTIONS | VESTED<br>OPTIONS |
|--------------|-----------------|--------------------|--------------------|---------------------|-------------------|
| Dave Grimes  | 4,971,918       | 3,721,918          | 1,250,000          | 160,000             | 1,000,000         |
| Peter Larson | 1,455,285       | 705,285            | 750,000            | 200,000             | 1,000,000         |
| Don Erat     | 2,861,348       | 2,361,348          | 500,000            | -                   | 500,000           |
| Steve Sadle  | 5,647,695       | 2,147,695          | 3,500,000          | 200,000             | 1,000,000         |
|              | -----           | -----              | -----              | -----               | -----             |
|              | 14,936,246      | 8,936,246          | 5,500,000          | 560,000             | 3,500,000         |

In connection with this transaction, the Company cancelled 13,480,961 shares of previously issued common stock.

### NOTE C - COMMON STOCK SUBSCRIPTION

In connection with the stock options described in Note B, 1,000,000 shares of common stock were issued to two of the Company's Founders in June 2002. The Company also entered into four promissory notes with the Founders to ensure payments for issued stock, each notes with principle amounts of \$250,000. The

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notes are due one year from date of issuance with all notes being due no later than June 30, 2003. Interest will begin to accrue at June 30, 2003 on any unpaid balances at an interest rate of 6%.

### Item 2. Management's Plan of Operation

The following discussion should be read in conjunction with the Company's Consolidated Financial Statements and Notes thereto, included elsewhere within this Report.

#### Description of the Company

-----

Telkonet is a high technology systems application developer with a primary focus on high speed Internet distribution over the electrical power lines for the commercial and the multi-dwelling residential markets. Telkonet believes that through extensive research and development, it has refined a business model that will provide marketable Internet services across a wide spectrum of commercial and business end users.

Telkonet has designed and constructed its third generation of power line communication products to provide high speed Internet access to office buildings, hotels, schools, shopping malls, commercial buildings, and multi-dwelling units. These products provide connectivity over the existing electrical wiring and do not require the addition of costly wiring, or major disruption to business activity.

In many situations the Telkonet system can be implemented more quickly and less expensively than adding dedicated wiring or installing wireless systems.

Telkonet believes that utilizing the power line to deliver Internet and telephone connectivity for the commercial and the multi-dwelling residential

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markets creates a significant and definitive niche market opportunity for Telkonet. Telkonet's solutions overcome many of the difficulties associated with power-line communications that historically have prevented the achievement of high data transmission rates.

Telkonet is now at a point in its business development cycle at which the system requirements and hardware have been developed, and the Company is ready to bring to market its suite of PlugFast products for high-speed Internet access.

As Internet access becomes a more critical tool, the demand for higher access speeds has triggered the growth of broadband solutions, and as these roll out, the desire for access to these emerging broadband networks provides opportunities for Telkonet. The built-in dial-up modems that have become a part of most new PCs are not suitable for higher speed connections. Hardwired network connections with high construction costs and disruption of the workplace, or complex wireless networks which have coverage and security issues are the only solutions available today.

The Telkonet PlugFast family of Internet access products provides a viable and cost effective alternative to the challenges of hard-wired and wireless local area networks (LANs). This solution set is comprised of two products, the PLUGFAST GATEWAY and the PLUGFAST TERMINAL.

The Telkonet PlugFast Gateway and Terminal are aimed at multi-user applications such as residential apartment complexes, hotels and motels, and a variety of small and medium sized businesses. High-speed Internet connections are becoming widely available and providers are anxious to sell these connections to their new and existing customers. Several companies now specialize in providing T1 access and most telephone companies now offer DSL products. Providers are also offering connectivity through Microwave networks, 2-way Satellite, Fiber and Cable connections. However, these products share in the same problem: getting the access to where the customers want it.

The Telkonet solution interfaces to the backbone of the Internet by taking the signal from any of these broadband sources and, through the Telkonet PlugFast Gateway, distributing access to the Internet to the ultimate user over the existing electrical wiring in the building. With the Telkonet PlugFast Gateway in place, access is provided by simply plugging the user's Telkonet PlugFast Terminal into the nearest standard electrical outlet. Any existing electrical outlet in the structure can provide immediate access to the Internet via a Telkonet PlugFast Terminal. Moving the location of a PC, server, or printer is accomplished by simply moving the PlugFast Terminal to another electrical outlet. No additional wiring is required and changes can be made quickly and easily.

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The Telkonet PlugFast Gateway provides the connection to the incoming broadband signal (DSL, TL, Satellite, Cable Modem) and the Telkonet PlugFast Terminal connects to a user device. Many PCs, each equipped with one Telkonet PlugFast Terminal, can communicate amongst themselves and can share a single broadband resource via the Telkonet PlugFast Gateway.

Telkonet has applied for patents that cover its unique technology, and intends to utilize recently announced advancements in transmission speeds to build next generation devices for field tests and marketing demonstrations.

Telkonet will continue to identify, design and develop enhancements to its core technologies that will provide additional functionality, diversification of application and desirability for current and future users.

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### Forward Looking Statements

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CERTAIN STATEMENTS INCLUDED HEREIN OR INCORPORATED BY REFERENCE CONSTITUTE "FORWARD-LOOKING STATEMENTS" WITHIN THE MEANING OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995 (THE "REFORM ACT"). TELKONET DESIRES TO TAKE ADVANTAGE OF CERTAIN "SAFE HARBOR" PROVISIONS OF THE REFORM ACT AND IS INCLUDING THIS SPECIAL NOTE TO ENABLE THE COMPANY TO DO SO. FORWARD-LOOKING STATEMENTS INCLUDED OR INCORPORATED BY REFERENCE IN THIS PART INVOLVE KNOWN AND UNKNOWN RISKS, UNCERTAINTIES AND OTHER FACTORS WHICH COULD CAUSE THE COMPANY'S ACTUAL RESULTS, PERFORMANCE (FINANCIAL OR OPERATING) OR ACHIEVEMENTS TO DIFFER MATERIALLY FROM THE FUTURE RESULTS, PERFORMANCE (FINANCIAL OR OPERATING) OR ACHIEVEMENTS EXPRESSED OR IMPLIED BY SUCH FORWARD LOOKING STATEMENTS.

### Management's Discussion and Analysis of Financial Condition and Results of

#### Operations

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Telkonet is still a development stage company and is yet to earn revenues from operations. Telkonet may experience fluctuations in operating results in future periods due to a variety of factors including, but not limited to, market acceptance of the Internet and power line communication technologies as a medium for customers to purchase the Telkonet's products, Telkonet's ability to acquire and deliver high quality products at a price lower than currently available to consumers, Telkonet's ability to obtain additional financing in a timely manner and on terms favorable to the Telkonet, Telkonet's ability to successfully attract customers at a steady rate and maintain customer satisfaction, Telkonet promotions, branding and sales programs, the amount and timing of operating costs and capital expenditures relating to the expansion of the Telkonet's business, operations and infrastructure and the implementation of marketing programs, key agreements and strategic alliances, the number of products offered by the Telkonet, the number of returns experienced by the Telkonet, and general economic conditions specific to the Internet, power-line communications, and the communications industry.

#### Revenues

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Telkonet generated no revenues from operations from its inception. Telkonet believes it will begin earning revenues from operations within the next twelve months as it transitions from a development stage company to that of an active growth and acquisition stage company.

#### Costs and expenses

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>From its inception on November 3, 1999 through June 30, 2002, Telkonet has not generated any revenues. Telkonet has incurred operating expenses of \$3,764,099 during this period. These expenses were associated principally with compensation to employees, product development costs and professional services. During the second quarter of 2002, Telkonet transitioned it's focus on bringing their initial offering of powerline communication products to the commercial and residential market, expenses increased by 98% over the second quarter of 2001 due to an increase in manpower expense from the further expansion of the core technical team, initial production costs for the PlugFast powerline products, and the ramp-up and increase in sales and marketing activities.

### Liquidity and Capital Resources

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To date the Company has generated no sales revenues, has incurred expenses, and has sustained losses. As a result of the Telkonet's operating losses from its inception through June 30, 2002, Telkonet generated a cash flow deficit of \$2,911,209 from operating activities. The Company's current liabilities exceeded its current assets by \$741,959 as of June 30, 2002. For the period from inception through June 30, 2002, the Company has accumulated losses of \$4,213,137. Consequently, its operations are subject to all risks inherent in the establishment of a new business enterprise.

While Telkonet has raised capital to meet its working capital and financing needs in the past, additional financing is required in order to meet the Telkonet's current and projected cash flow deficits from operations and development. Telkonet is seeking financing in the form of equity investment in order to provide the necessary working capital. Telkonet currently has no commitments for financing. There are no assurances Telkonet will be successful in raising the funds required.

The Company's independent certified public accountants have stated in their report included in the Company's December 31, 2001 Form 10-KSB, that the Company has incurred operating losses in the last two years, and that the Company is dependent upon management's ability to develop profitable operations. These factors among others may raise substantial doubt about the Company's ability to continue as a going concern.

### Product Research and Development

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Company-sponsored research and development costs related to both present and future products are expended in the period incurred. Total expenditures on research and product development for the second quarter of 2002 were \$30,760 compared to \$109,024 for the second quarter of 2001.

### Acquisition or Disposition of Plant and Equipment

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Telkonet does not anticipate the sale of any significant property, plant or equipment during the next twelve months. Telkonet does not anticipate the acquisition of any significant property, plant or equipment during the next 12 months, other than computer equipment and peripherals used in the Telkonet's day-to-day operations.

### Number of Employees

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During the period ended June 30, 2002, the Company had 12 employees. In order for the Company to attract and retain quality personnel, the Company anticipates it will continue to offer competitive salaries to current and future employees. As the Company continues to expand, the Company will incur additional costs for personnel. This projected increase in personnel is dependent upon the Company generating revenues and obtaining sources of financing. There are no assurances the Company will be successful in raising the funds required or generating revenues sufficient to fund the projected increase in the number of employees.

### Trends, Risks and Uncertainties

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Telkonet has sought to identify what it believes to be the most significant risks to its business, but cannot predict whether or to what extent any of such risks may be realized nor can there be any assurances that Telkonet has identified all possible risks that might arise. Investors should carefully

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consider all of such risk factors before making an investment decision with respect to the Company's stock. Telkonet's prospects must be evaluated with a view to the risks encountered by a company in an early stage of development, particularly in light of the uncertainties relating to the new and evolving power line modulation and transmission technologies. Telkonet will be incurring costs to develop, introduce and enhance its products, to establish marketing relationships, to acquire and develop products that will compliment each other and to build an administrative organization. To the extent that such expenses are not subsequently followed by commensurate revenues, Telkonet's business, results of operations and financial condition will be materially adversely affected. There can be no assurance that Telkonet will be able to generate sufficient revenues from the sale of their first product and other product candidates. Telkonet expects negative cash flow from operations to continue for the next 6 months as it continues to develop and market its business. Telkonet will be required to sell additional equity or debt securities. The sale of additional equity or convertible debt securities will result in additional dilution to Telkonet's stockholders.

### Potential fluctuations in quarterly operating results

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Telkonet's quarterly operating results may fluctuate significantly in the future as a result of a variety of factors, most of which are outside Telkonet's control, including: the level of use of the Internet; the demand for high-tech

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goods; trends in broadband service provisioning, the amount and timing of capital expenditures and other costs relating to the expansion of the Telkonet's operations; price competition or pricing changes in the industry; technical difficulties; general economic conditions, and economic conditions specific to the Internet and communications industry.

### Limited public market, possible volatility of share price

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Telkonet's common stock is currently quoted on the NASD OTC Bulletin Board under the ticker symbol TLKO.OB. As of June 30, 2002, there were approximately 15,271,711 shares of common stock outstanding. There can be no assurance that a trading market will be sustained in the future. Factors such as, but not limited to, technological innovations, new products, acquisitions or strategic alliances entered into by Telkonet or its competitors, failure to meet securities analysts' expectations, government regulatory action, patent or proprietary rights developments, and market conditions for technology stocks in general could have a material effect on the volatility of the Telkonet's stock price.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

None

### Item 2 - Changes in Securities and Use of Proceeds

(a) None

(b) None

(c) In June, 2002 the Company issued 138,722 shares of its restricted common stock in exchange for previously issued warrants with exercise prices ranging from \$.40 to \$1.0025 per share to outside consultants in exchange

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for legal and consulting services. These issuances were considered exempt by reason of Section 4(2) of the Securities Act of 1933.

In June 2002, the Company issued 189,327 shares of its restricted common stock in exchange for previously issued warrants with an exercise price \$.402 per share to accredited investors in exchange for \$77,907. These issuances were considered exempt by reason of Section 4(2) of the Securities Act of 1933.

In June 2002, the Company issued an aggregate of 1,000,000 shares of registered common stock in exchange for previously issued options with an exercise price of \$1.00 per share to two Company officers in exchange for a \$1,000,000 note receivable. The options were issued pursuant to an employee stock option plan filed on SEC Form S-8 on April 17, 2002.

### 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 and Reports on Form 8-K

#### (a) Exhibits

| No.  | Description  |
|------|--|
| ---  | -----  |
| 99.1 | Certification of J. Gregory Fowler Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith). |
| 99.2 | Certification of Stephen Sadle Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).     |

#### (b) Reports on Form 8-K filed during the three months ended June 30, 2002.

None

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## 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

August 19, 2002  
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Date

By: /s/ J. Gregory Fowler  
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J. Gregory Fowler

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President and Chief Executive Officer

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