

Edgar Filing: TELKONET INC - Form 10QSB

TELKONET INC
Form 10QSB
August 13, 2003

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, 2003

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: 23,793,264 shares of Common Stock (\$.001 par value) as of August 12, 2003.

Transitional small business disclosure format: Yes No

TELKONET, INC.

Quarterly Report on Form 10-QSB for the
Quarterly Period Ending June 30, 2003

Table of Contents

PART I. FINANCIAL INFORMATION

Edgar Filing: TELKONET INC - Form 10QSB

Item 1. Financial Statements (Unaudited)

Condensed Consolidated Balance Sheets:
June 30, 2003 and December 31, 2002

Condensed Consolidated Statements of Losses:
Three Months Ended June 30, 2003 and 2002
Six Months Ended June 30, 2003 and 2002
November 3, 1999 (Date of Inception) through June 30, 2003

Consolidated Statement of Deficiency in Stockholders' Equity
November 3, 1999 (Date of Inception) through June 30, 2003

Condensed Consolidated Statements of Cash Flows:
Six Months Ended June 30, 2003 and 2002
November 3, 1999 (Date of Inception) through June 30, 2003

Notes to Unaudited Condensed Consolidated Financial Information:
June 30, 2003

Item 2. Management's Plan of Operation

Item 3. Controls and Procedures

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Item 2. Changes in Securities

Item 3. Defaults Upon Senior Securities

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

Item 5. Other Information

Item 6. Exhibits and Reports on Form 8-K

2

Item 1. Financial Statements (Unaudited)

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

	(Unaudited) June 30, 2003	(Audited) December 31, 2002
	-----	-----
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 4,580,779	\$ 18,820,000
Inventory, net	449,487	39,790
Other receivable	--	1,550

Edgar Filing: TELKONET INC - Form 10QSB

Prepaid expenses and deposits	75,785	4,62
	-----	-----
Total current assets	5,106,051	64,79
PROPERTY AND EQUIPMENT:		
Furniture and equipment, at cost	161,462	73,21
Less: accumulated depreciation	54,628	35,25
	-----	-----
	106,833	37,96
OTHER ASSETS		
Financing costs, less accumulated amortization of \$164,449 and \$101,692 at June 30, 2003 and December 31, 2002, respectively	217,060	192,60
	\$ 5,429,945	\$ 295,35
	=====	=====
LIABILITIES AND DEFICIENCY IN STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable and accrued liabilities	\$ 981,038	\$ 518,86
Notes payable and capital leases	309,291	310,00
Due to shareholders	7,500	130,33
	-----	-----
Total current liabilities	1,297,829	959,19
Convertible debentures, net of discounts - including related parties (Note B)	1,453,720	862,68
Senior notes payable (Note C)	5,000,000	-
COMMITMENTS AND CONTINGENCIES		
	--	-
DEFICIENCY IN STOCKHOLDERS' EQUITY		
Preferred stock, par value \$.001 per share; 15,000,000 shares authorized; none issued at June 30, 2003 and December 31, 2002 (Note E)	--	-
Common stock, par value \$.001 per share; 100,000,000 shares authorized; 15,977,795 and 15,721,131 shares issued and outstanding at June 30, 2003 and December 31, 2002, respectively (Note E)	15,978	15,72
Additional paid-in-capital	7,580,809	4,916,43
Accumulated deficit during development stage	(9,918,391)	(6,458,67
	-----	-----
Deficiency in stockholders' equity	(2,321,604)	(1,526,52
	-----	-----
	\$ 5,429,945	\$ 295,35
	-----	-----

See accompanying footnotes to the unaudited condensed consolidated financial information

Edgar Filing: TELKONET INC - Form 10QSB

	For The Three Months Ended June 30,		For The Six Months June 30,	
	2003	2002 (As Restated - Note F)	2003	2002
Costs and Expenses:				
Research and Development	\$ 282,821	\$ 331,704	\$ 597,550	\$ 600,000
Selling, General and Administrative	1,173,675	236,321	1,693,797	1,693,797
Non-Employee Stock Options (Note D)	67,884	113,115	286,904	286,904
Depreciation and Amortization	48,589	21,743	82,133	82,133
Total Operating Expense	1,572,969	702,883	2,660,384	2,660,384
Loss from Operations	(1,572,969)	(702,883)	(2,660,384)	(2,660,384)
Other Income (Expense)	--	--	--	--
Interest Income (Expense)	(446,003)	(126,148)	(799,332)	(799,332)
Provision for Income Tax	--	--	--	--
Net Loss	\$ (2,018,972)	\$ (829,031)	\$ (3,459,715)	\$ (3,459,715)
Loss per common share (basic and assuming dilution)	\$ (0.13)	\$ (0.06)	\$ (0.22)	\$ (0.22)
Weighted average common shares outstanding	15,827,613	14,154,678	15,774,666	15,774,666

See accompanying footnotes to the unaudited condensed consolidated financial

4

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
CONDENSED CONSOLIDATED STATEMENT OF DEFICIENCY IN STOCKHOLDERS' EQUITY
FOR THE PERIOD NOVEMBER 3, 1999 (DATE OF INCEPTION) TO JUNE 30, 2000

	Pref- erred Shares	Pref- erred Stock Amount	Common Shares	Common Stock Amount	Additional Paid in Capital	Retained Earnings
Net Loss	--	--	--	--	--	--

Edgar Filing: TELKONET INC - Form 10QSB

BALANCE AT DECEMBER 31, 1999	--	--	--	--	--
Shares issued to founders January 2000, in exchange for services and costs valued at \$ 0.60 per share	--	--	19,300	193	11,387
Shares issued in June 2000, for cash in connection with private placement at \$375 per share, net of costs	--	--	1,735	17	644,219
Shares issued in July 2000, for warrants exercised at a price of \$375 per share	--	--	190	--	71,250
Shares issued in August 2000, in connection with the merger of 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 exercised at a price of \$1 per share	--	--	29,145	29	29,115
Shares issued in October 2000, in exchange for warrants exercised at a price of \$ 0.40 per share	--	--	10,891	11	4,345
Net loss	--	--	--	--	--
BALANCE AT DECEMBER 31, 2000	--	\$ --	21,815,371	\$ 21,815	\$ 760,316
	=====	=====	=====	=====	=====

See accompanying footnotes to the unaudited condensed consolidated financial statements.

5

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
CONDENSED CONSOLIDATED STATEMENT OF DEFICIENCY IN STOCKHOLDERS' EQUITY
FOR THE PERIOD NOVEMBER 3, 1999 (DATE OF INCEPTION) TO JUNE 30, 2001

	Pref- ferred Shares	Pref- ferred Stock Amount	Common Shares	Common Stock Amount	Additional Paid in Capital	Other Equity
	-----	-----	-----	-----	-----	-----
Balance Forward	--	\$ --	21,815,371	\$21,815	\$ 760,316	\$ --
Shares issued in June 2001, for cash in connection with a private placement, shares issued at \$.50 a share, net of costs	--	--	260,000	260	129,740	--
1,839,378 warrants issued in						

Edgar Filing: TELKONET INC - Form 10QSB

June 2001, valued at \$0.13 per warrant, in exchange for services	--	--	--	--	237,035
72,668 stock options issued in June 2001, valued at \$ 0.09 per stock option, in exchange for services	--	--	--	--	6,375
245,287 warrants issued in July 2001, valued at \$0.08 per warrant, in exchange for services	--	--	--	--	18,568
36,917 stock options issued in July 2001, valued at \$ 0.08 per warrant, in exchange for services	--	--	--	--	2,795
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	19,960
241,000 warrants issued in August 2001, valued at \$ 0.39 per warrant in exchange for financing costs	--	--	--	--	85,818
150,000 warrants issued in August 2001, valued at \$ 0.16 per warrant, in exchange for services	--	--	--	--	23,340
36,917 stock options issued in August 2001, valued at \$0.06 per stock option, in exchange for services	--	--	--	--	2,422
25,000 warrants issued in September 2001, valued at \$0.30 per warrant in exchange for services	--	--	--	--	7,380
95,000 warrants issued in October 2001, valued at \$0.21 per warrant, in exchange for services	--	--	--	--	19,558
25,000 warrants issued in November 2001, valued at \$0.33 per warrant, in exchange for services	--	--	--	--	8,218
25,000 warrants issued in December 2001, valued at \$0.30 per warrant, in exchange for services	--	--	--	--	7,380
Beneficial conversion feature of convertible debentures (Note B)	--	--	--	--	837,874
Value of warrants attached to convertible debentures (Note B)	--	--	--	--	77,254
Net loss	--	--	--	--	--
BALANCE AT DECEMBER 31, 2001 (AS RESTATED- NOTE D)	--	\$ --	22,115,371	\$22,115	\$2,244,033

See accompanying footnotes to the unaudited condensed consolidated financial statements.

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

	Pref- erred Shares	Pref- erred Stock Amount	Common Shares	Common Stock Amount	Additional Paid in Capital	Common Stock Subsc ription
	-----	-----	-----	-----	-----	-----
Balance Forward	--	\$ --	22,115,371	\$ 22,115	\$ 2,244,033	\$
Shares issued in February 2002, in exchange for convertible debentures interest, at \$.50 per share	--	--	43,586	44	21,749	
Shares issued in March 2002, to a founder in exchange for shares canceled	--	--	5,250,000	5,250	(5,250)	
Shares canceled in March 2002 in connection with capital restructure	--	--	(13,480,961)	(13,481)	13,481	
Shares issued in June 2002, for warrants exercised at \$1.00 per share for services rendered	--	--	47,906	48	47,857	
Shares issued in June 2002, for warrants exercised at \$.40 per share for services rendered	--	--	26,443	26	10,551	
Shares issued in June 2002 to founders, for options exercised at \$1.00 per share	--	--	1,000,000	1,000	999,000	
Shares issued in June 2002, for warrants exercised at \$1.0025 per share, for services rendered	--	--	80,039	80	80,158	
Shares issued in June 2002, for warrants exercised at \$.41, in connection with original private placement	--	--	189,327	189	77,720	
Shares issued in July 2002, for warrants exercised at \$.40, in connection with original private placement	--	--	41,970	42	16,830	
Shares issued in July 2002 to founders, for options exercised at \$1.00 per share	--	--	1,000,000	1,000	999,000	
Shares issued in August 2002, for warrants exercised at \$.43, in connection with original private placement	--	--	542,500	543	232,459	
Shares issued in August 2002, for warrants exercised at \$.40, in connection with original private placement	--	--	193,302	193	77,127	
Shares issued in October 2002, for warrants exercised at \$.40,						

Edgar Filing: TELKONET INC - Form 10QSB

in connection with original private placement	--	--	77,048	77	30,896	
Shares issued in October 2002, for warrants exercised at \$0.50 per share in connection with original private placement	--	--	400,000	400	199,600	
Common stock subscription	--	--	--	--	--	(1,805)
Return of founders shares in connection with stock subscription	--	--	(1,805,400)	(1,805)	(1,803,595)	1,805
Stock based compensation for the issuance of stock options to consultants in exchange for services	--	--	--	--	452,459	
Stock based compensation for the issuance of warrants to consultants in exchange for services	--	--	--	--	170,330	
Stock based compensation for the issuance of warrants to consultants in exchange for financing costs	--	--	--	--	86,474	
Beneficial conversion feature of convertible debentures (Note B)	--	--	--	--	840,877	
Value of warrants attached to convertible debentures (Note B)	--	--	--	--	124,677	
Net Loss	--	--	--	--	--	
BALANCE AT DECEMBER 31, 2002	--	\$ --	15,721,131	\$ 15,721	\$ 4,916,433	\$

See accompanying footnotes to the unaudited condensed consolidated financial statements.

7

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
CONDENSED CONSOLIDATED STATEMENT OF DEFICIENCY IN STOCKHOLDERS' EQUITY
FOR THE PERIOD NOVEMBER 3, 1999 (DATE OF INCEPTION) TO JUNE 30, 2003

	Pref- erred Shares	Pref- erred Stock Amount	Common Shares	Common Stock Amount	Additional Paid in Capital	Common Stock Subsc ription
	-----	-----	-----	-----	-----	-----
BALANCE FORWARD	--	\$ --	15,721,131	\$15,721	\$4,916,433	
Shares issued in April 2003 in exchange for convertible debentures at \$.50 per share (Note E)	--	--	40,000	40	19,960	
Shares issued in April 2003 in exchange for services @ \$1.54 per share (Note E)	--	--	49,998	50	76,695	
Shares issued in June 2003 for employee options exercised						

Edgar Filing: TELKONET INC - Form 10QSB

at \$1.00 per share (Note E)	--	--	83,333	83	83,250	
Shares issued in June 2003 for non-employee options exercised at \$1.00 per share (Note E)	--	--	83,333	83	83,250	
Stock based compensation for the issuance of stock options to consultants in exchange for services (Note D)	--	--	--	--	286,904	
Stock based compensation for the issuance of warrants in exchange for financing costs (Note D)	--	--	--	--	87,217	
Beneficial conversion feature of convertible debentures (Note B)	--	--	--	--	1,761,675	
Value of warrants attached to convertible debentures (Note B)	--	--	--	--	265,425	
Net Loss	--	--	--	--	--	
	-----	-----	-----	-----	-----	-----
BALANCE AT JUNE 30, 2003	--	\$ --	15,977,795	\$15,978	\$7,580,809	\$
	=====	=====	=====	=====	=====	=====

See accompanying footnotes to the unaudited condensed consolidated financial

8

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

	Six Months Ended June 30,	
	-----	-----
	2003	2002 (As Restated - Note F)
	-----	-----
INCREASE (DECREASE) IN CASH AND EQUIVALENTS CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss from development stage operations	\$(3,459,715)	\$(1,475,134)
Adjustments to reconcile net loss from development stage operations to cash used for operating activities		
Amortization of debt discount - beneficial conversion feature of convertible debentures	538,425	183,926
Amortization of debt discount - value of warrants		

Edgar Filing: TELKONET INC - Form 10QSB

attached to convertible debentures	72,614	16,452
Stock options and warrants issued in exchange for services rendered	286,904	--
Common stock issued in exchange for services rendered	76,745	138,722
Common stock issued in exchange for conversion of interest	--	21,793
Impairment of property and equipment	--	--
Depreciation and amortization of financing costs	82,133	71,196
Increase (decrease) in:		
Other receivable	1,550	--
Inventory	(409,696)	--
Prepaid expenses and deposits	(71,160)	--
Accounts payable and accrued expenses, net	462,173	201,051
	-----	-----
NET CASH USED IN OPERATING ACTIVITIES	(2,420,027)	(841,994)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures, net of disposals	(28,957)	(19,499)
	-----	-----
NET CASH USED IN INVESTING ACTIVITIES	(28,957)	(19,499)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from sale of common stock, net of costs	--	99,702
Proceeds from (repayments of) stockholder advances	(122,830)	--
Proceeds from issuance of convertible debentures, net of costs	2,027,100	715,407
Proceeds from issuance of senior notes, net of costs	5,000,000	--
Proceeds from exercise of stock options	166,666	--
Repayments of loans	(60,000)	166,500
Proceeds from loans	--	--
	-----	-----
NET CASH PROVIDED BY FINANCING ACTIVITIES	7,010,935	981,609
NET (DECREASE) INCREASE IN CASH AND EQUIVALENTS	4,561,952	120,116
Cash and cash equivalents at the beginning of the period	18,827	21,885
	-----	-----
Cash and cash equivalents at the end of the period	\$ 4,580,779	\$ 142,001
	-----	-----

See accompanying footnotes to the unaudited condensed consolidated financial information

Edgar Filing: TELKONET INC - Form 10QSB

(UNAUDITED)

	Six Months Ended June	
	2003	2002 Restated - Not
	-----	-----
Supplemental Disclosures of Cash Flow Information		
Cash paid during the period for interest	\$ 10,423	\$ 1
Income taxes paid	--	
Non-cash transactions:	--	
Issuance of stock options and warrants in exchange for services rendered	286,904	
Issuance of stock warrants in exchange for financing costs	87,217	
Common stock issued for services rendered	76,745	13
Common stock issued in exchange for interest	--	2
Common stock issued in exchange for conversion of convertible debenture	20,000	
Notes payable issued in connection with capital lease	59,291	
Beneficial conversion feature on convertible debentures	1,761,675	69
Value of warrants attached to convertible debentures	265,425	5
Acquisition:		
Assets Acquired	--	
Accumulated Deficit	--	
Liabilities Assumed	--	
	-----	-----
	\$ --	\$
	-----	-----

See accompanying footnotes to the unaudited condensed consolidated financial i

10

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
JUNE 30, 2003
(UNAUDITED)

NOTE A - SUMMARY OF ACCOUNTING POLICIES

General

The accompanying unaudited condensed consolidated financial statements 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-QSB. 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 six-month period ended June 30,

Edgar Filing: TELKONET INC - Form 10QSB

2003, are not necessarily indicative of the results that may be expected for the year ended December 31, 2003. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated December 31, 2002 financial statements and footnotes thereto included in the Company's SEC Form 10-KSB.

Basis of Presentation

Telkonet, Inc. (the "Company"), formerly Comstock Coal Company, Inc., was formed on November 3, 1999 under the laws of the state of Utah. The Company is a development stage enterprise, as defined by Statement of Financial Accounting Standards No. 7 ("SFAS 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 Company 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 intercompany 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.

Concentrations of Credit Risk

Financial instruments and related items, which potentially subject the Company to concentrations of credit risk, consist primarily of cash, cash equivalents. The Company places its cash and temporary cash investments with credit quality institutions. At times, such investments may be in excess of the FDIC insurance limit.

Stock Based Compensation

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure-an amendment of SFAS 123." This statement amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25 and related interpretations. Accordingly, compensation expense for stock options is measured as the excess, if any, of the fair market value of the Company's stock at the date of the grant over the exercise price of the related option. The Company has adopted the annual disclosure provisions of SFAS No. 148 in its financial reports for the year ended December 31, 2002 and for the quarter ended June 30, 2003.

Edgar Filing: TELKONET INC - Form 10QSB

(A DEVELOPMENT STAGE COMPANY)
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
 JUNE 30, 2003
 (UNAUDITED)

NOTE A - SUMMARY OF ACCOUNTING POLICIES

Stock Based Compensation (Continued)

Had compensation costs for the Company's stock options been determined based on the fair value at the grant dates for the awards, the Company's net loss and losses per share would have been as follows (transactions involving stock options issued to employees and Black-Scholes model assumptions are presented in Note D):

	For the three months ended June 30,		For th
	2003 ----	2002 ----	2003 ----
Net loss - as reported	\$ (2,018,972)	\$ (829,031)	\$ (3,459,
Add: Total stock based employee compensation expense as reported under intrinsic value method (APB. No. 25)	--	--	
Deduct: Total stock based employee compensation expense as reported under fair value based method (SFAS No. 123)	(1,129,199)	(52,708)	(1,291,
	\$ (3,148,171)	\$ (881,739)	\$ (4,750,
Net loss - Pro Forma	\$ (3,148,171)	\$ (881,739)	\$ (4,750,
Net loss attributable to common stockholders - Pro forma	\$ (3,148,171)	\$ (881,739)	\$ (4,750,
Basic (and assuming dilution) loss per share - as reported	\$ (0.13)	\$ (0.06)	\$ (0
Basic (and assuming dilution) loss per share - Pro forma	\$ (0.20)	\$ (0.06)	\$ (0

New Accounting Pronouncements

In April 2003, the FASB issued Statement of Financial Accounting Standards (SFAS) No. 149, AMENDMENT OF STATEMENT 133 ON DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES. SFAS 149 amends SFAS No. 133 to provide clarification on the financial accounting and reporting of derivative instruments and hedging activities and requires that contracts with similar characteristics be accounted for on a comparable basis. The provisions of SFAS 149 are effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. The adoption of SFAS 149 will not have a material impact on the Company's results of operations or financial position.

In May 2003, the FASB issued SFAS No. 150, ACCOUNTING FOR CERTAIN FINANCIAL INSTRUMENTS WITH CHARACTERISTICS OF BOTH LIABILITIES AND EQUITY. SFAS 150 establishes standards on the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. The provisions of SFAS 150 are effective for financial instruments entered into or modified after May 31, 2003 and to all other instruments that exist as of the beginning of the first interim financial reporting period beginning after June 15, 2003. The adoption of SFAS 150 will not have a material impact on the Company's

Edgar Filing: TELKONET INC - Form 10QSB

results of operations or financial position.

12

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
JUNE 30, 2003
(UNAUDITED)

NOTE B - CONVERTIBLE PROMISSORY NOTES PAYABLE

A summary of convertible promissory notes payable at June 30, 2003 and December 31, 2002 is as follows:

	June 30, 2003 -----	December 31, 2002 -----
Convertible notes payable ("Debenture-1"), in quarterly installments of interest only at 8% per annum, unsecured and due three years from the date of the note with the latest maturity May 2005; Noteholder has the option to convert unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of \$.50 per share six months after issuance.	\$ 1,669,100	\$ 1,689,100
Debt Discount - beneficial conversion feature, net of accumulated amortization of \$787,014 and \$531,858 at June 30, 2003 and December 31, 2002, respectively	(743,878)	(999,030)
Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of \$69,428 and \$47,216 at June 30, 2003 and December 31, 2002, respectively	(63,908)	(86,120)
	----- 861,314	----- 603,940
Convertible notes payable ("Series B Debenture"), in quarterly installments of interest only at 8% per annum, unsecured and due three years from the date of the note with the latest maturity February 2006; Noteholder has the option to convert unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of \$.55 per share six months after issuance.	2,500,000	472,900
Debt Discount - beneficial conversion feature, net of accumulated amortization of \$284,833 and \$1,564 at June 30, 2003 and December 31, 2002, respectively	(1,624,702)	(146,290)
Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of \$51,128 and \$726 at June 30, 2003 and December 31, 2002, respectively	(282,892)	(67,860)
	----- 592,406	----- 258,730

Edgar Filing: TELKONET INC - Form 10QSB

Total	----- \$ 1,453,720 -----	----- \$ 862,68 -----
Less: current portion	----- - -----	----- ----- -----
	\$ 1,453,720 -----	\$ 862,68 -----

13

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
JUNE 30, 2003
(UNAUDITED)

NOTE B - CONVERTIBLE PROMISSORY NOTES PAYABLE (CONTINUED)

Convertible Debentures

During the year ended December 31, 2001, the Company issued convertible promissory notes (the "Debenture-1") to Company officers, shareholders, and sophisticated investors in exchange for \$940,000, exclusive of placement costs and fees. The Debenture-1 accrues interest at 8% per annum and is payable and due three years from the date of the note with the latest maturity date of November 2004. Noteholder has the option to convert any unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of \$.50 per share six months after issuance. In accordance with EMERGING ISSUES TASK FORCE ISSUE 98-5, ACCOUNTING FOR CONVERTIBLE SECURITIES WITH A BENEFICIAL CONVERSION FEATURES OR CONTINGENTLY ADJUSTABLE CONVERSION RATIOS ("EITF 98-5"), the Company recognized an imbedded beneficial conversion feature present in the Debenture-1 note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid in capital. The Company recognized and measured an aggregate of \$837,874 of the proceeds, which is equal to the intrinsic value of the imbedded beneficial conversion feature, to additional paid in capital and a discount against the Debenture-1. The debt discount attributed to the beneficial conversion feature is amortized over the Debenture-1's maturity period (three years) as interest expense.

In connection with the placement of the Debenture-1 notes, the Company issued non-detachable warrants granting the holders the right to acquire 940,000 shares of the Company's common stock at \$1.00 per share. In accordance with EMERGING ISSUES TASK FORCE ISSUE 00-27, APPLICATION OF ISSUE NO. 98-5 TO CERTAIN CONVERTIBLE INSTRUMENTS ("EITF - 0027"), the Company recognized the value attributable to the warrants in the amount of \$77,254 to additional paid in capital and a discount against the Debenture-1. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 1.25%, a dividend yield of 0%, and volatility of 26%. The debt discount attributed to the value of the warrants issued is amortized over the Debenture-1's maturity period (three years) as interest expense.

During the year ended December 31, 2002, the Company issued convertible promissory notes (the "Debenture-1") to Company officers, shareholders, and sophisticated investors in exchange for \$749,100, exclusive of placement costs and fees. The Debenture-1 accrues interest at 8% per annum and is payable and due three years from the date of the note with the latest maturity date of May 2005. Noteholders have the option to convert any unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of \$.50

Edgar Filing: TELKONET INC - Form 10QSB

per share six months after issuance.

In accordance with EMERGING ISSUES TASK FORCE ISSUE 98-5, ACCOUNTING FOR CONVERTIBLE SECURITIES WITH A BENEFICIAL CONVERSION FEATURES OR CONTINGENTLY ADJUSTABLE CONVERSION RATIOS ("EITF 98-5"), the Company recognized an imbedded beneficial conversion feature present in the Debenture-1 note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid in capital. The Company recognized and measured an aggregate of \$693,018 of the proceeds, which is equal to the intrinsic value of the imbedded beneficial conversion feature, to additional paid in capital and a discount against the Debenture-1. The debt discount attributed to the beneficial conversion feature is amortized over the Debenture-1's maturity period (three years) as interest expense.

In connection with the placement of the Debenture-1 notes in 2002, the Company issued non-detachable warrants granting the holders the right to acquire 749,100 shares of the Company's common stock at \$1.00 per share. In accordance with EMERGING ISSUES TASK FORCE ISSUE 00-27, APPLICATION OF ISSUE NO. 98-5 TO CERTAIN CONVERTIBLE INSTRUMENTS ("EITF -0027"), the Company recognized the value attributable to the warrants in the amount of \$56,082 to additional paid in capital and a discount against the Debenture-1. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 1.67%, a dividend yield of 0%, and volatility of 26%. The debt discount attributed to the value of the warrants issued is amortized over the Debenture-1's maturity period (three years) as interest expense.

14

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
JUNE 30, 2003
(UNAUDITED)

NOTE B - CONVERTIBLE PROMISSORY NOTES PAYABLE (CONTINUED)

Series B Debentures

In October and December 2002, the Company issued convertible promissory notes (the "Series B Debenture") to Company officers, shareholders, and sophisticated investors in exchange for \$472,900, exclusive of placement costs and fees. The Series B Debenture accrues interest at 8% per annum and is payable and due three years from the date of the note with the latest maturity date of December 2005. Noteholders have the option to convert any unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of \$.55 per share six months after issuance.

In accordance with EMERGING ISSUES TASK FORCE ISSUE 98-5, ACCOUNTING FOR CONVERTIBLE SECURITIES WITH A BENEFICIAL CONVERSION FEATURES OR CONTINGENTLY ADJUSTABLE CONVERSION RATIOS ("EITF 98-5"), the Company recognized an imbedded beneficial conversion feature present in the Series B Debenture note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid in capital. The Company recognized and measured an aggregate of \$147,859 of the proceeds, which is equal to the intrinsic value of the imbedded beneficial conversion feature, to additional paid in capital and a discount against the Series B Debenture. The debt discount attributed to the beneficial conversion feature is amortized over the Series B Debenture's maturity period (three years) as interest expense.

In connection with the placement of the Series B Debenture notes in 2002, the

Edgar Filing: TELKONET INC - Form 10QSB

Company issued non-detachable warrants granting the holders the right to acquire 472,900 shares of the Company's common stock at \$1.00 per share. In accordance with EMERGING ISSUES TASK FORCE ISSUE 00-27, APPLICATION OF ISSUE NO. 98-5 TO CERTAIN CONVERTIBLE INSTRUMENTS ("EITF -0027"), the Company recognized the value attributable to the warrants in the amount of \$68,595 to additional paid in capital and a discount against the Series B Debenture. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 1.67%, a dividend yield of 0%, and volatility of 26%. The debt discount attributed to the value of the warrants issued is amortized over the Series B Debenture's maturity period (three years) as interest expense.

In January and February 2003, the Company issued convertible promissory notes (the "Series B Debenture") to Company officers, shareholders, and sophisticated investors in exchange for \$2,027,100, exclusive of placement costs and fees. The Series B Debenture accrues interest at 8% per annum and is payable and due three years from the date of the note with the latest maturity date of February 2006. Noteholders have the option to convert any unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of \$.55 per share six months after issuance.

In accordance with EMERGING ISSUES TASK FORCE ISSUE 98-5, ACCOUNTING FOR CONVERTIBLE SECURITIES WITH A BENEFICIAL CONVERSION FEATURES OR CONTINGENTLY ADJUSTABLE CONVERSION RATIOS ("EITF 98-5"), the Company recognized an imbedded beneficial conversion feature present in the Series B Debenture note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid in capital. The Company recognized and measured an aggregate of \$1,761,675 of the proceeds, which is equal to the intrinsic value of the imbedded beneficial conversion feature, to additional paid in capital and a discount against the Series B Debenture. The debt discount attributed to the beneficial conversion feature is amortized over the Series B Debenture's maturity period (three years) as interest expense.

In connection with the placement of the Series B Debenture notes in January and February 2003, the Company issued non-detachable warrants granting the holders the right to acquire 2,027,100 shares of the Company's common stock at \$1.00 per share. In accordance with EMERGING ISSUES TASK FORCE ISSUE 00-27, APPLICATION OF ISSUE NO. 98-5 TO CERTAIN CONVERTIBLE INSTRUMENTS ("EITF -0027"), the Company recognized the value attributable to the warrants in the amount of \$265,425 to additional paid in capital and a discount against the Series B Debenture. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 1.25%, a dividend yield of 0%, and volatility of 26%. The debt discount attributed to the value of the warrants issued is amortized over the Series B Debenture's maturity period (three years) as interest expense.

The Company amortized the Debenture 1 and the Series B Debenture debt discount attributed to the beneficial conversion feature and the value of the attached warrants and recorded non-cash interest expense of \$611,039 and \$200,377 for the six month ended June 30, 2003 and 2002, respectively.

15

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
JUNE 30, 2003
(UNAUDITED)

NOTE C - SENIOR NOTES PAYABLE

Edgar Filing: TELKONET INC - Form 10QSB

In April, May and June 2003, the Company issued Senior Note to Company officers, shareholders, and sophisticated investors in exchange for \$5,000,000, exclusive of placement costs and fees. The Senior Note is in units of \$100,000, in quarterly installments of interest at 8% per annum and is due three years from the date of the note with the latest maturity date of June 2006. Attached to each unit of the Senior Note are 125,000 warrants to purchase the common stock of the Company. The warrants have a three-year contractual life and are exercisable immediately after the issuance of the note at exercise price of \$1.00 per share. The Senior Notes are secured by a first lien priority security interest in all intellectual property assets of the Company. The Company plans to use the proceeds from Senior Note for expansion of sales, marketing and strategic partnership programs, build of required infrastructure and as working capital.

NOTE D - 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.

Exercise Prices	Options Outstanding ----- Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Options Ex ----- Number Exercisable
\$1.00	6,775,000	9.19	\$1.00	1,769,935
\$1.51	200,000	9.75	\$1.51	16,667
\$2.35	465,000	9.75	\$2.35	38,751
\$3.43	25,000	9.75	\$3.43	2,083
	----- 7,465,000 -----	----- 9.27 -----	----- \$1.11 -----	----- 1,827,436 -----

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

	Number of Shares -----	Weigh Pric -----
Outstanding at January 1, 2001	840,000	
Granted	215,000	\$
Exercised	-	
Canceled or expired	-	
	-----	-----
Outstanding at December 31, 2001	1,055,000	
	-----	-----
Granted	2,835,000	
Exercised	(1,000,000)	
Canceled or expired	(1,440,000)	
	-----	-----
Outstanding at December 31, 2002	1,450,000	\$

Edgar Filing: TELKONET INC - Form 10QSB

Granted	6,098,333
Exercised	(83,333)
Canceled or expired	-
Outstanding at June 30, 2003	7,465,000

16

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
JUNE 30, 2003
(UNAUDITED)

NOTE D - STOCK OPTIONS AND WARRANTS (CONTINUED)

Employee Stock Options (Continued)

The weighted-average fair value of stock options granted to employees during the period ended June 30, 2003 and 2002 and the weighted-average significant assumptions used to determine those fair values, using a Black-Scholes option pricing model are as follows:

	2003	2002
	----	----
Significant assumptions (weighted-average):		
Risk-free interest rate at grant date	1.25%	1.67%
Expected stock price volatility	26%	26%
Expected dividend payout	-	-
Expected option life-years (a)	10	10

(a) The expected option life is based on contractual expiration dates.

If the Company recognized compensation cost for the non-qualified employee stock option plan in accordance with SFAS No. 123, the Company's pro forma net loss and net loss per share would have been \$(4,750,849) and \$(0.30) for the period ended June 30, 2003 and \$(1,580,550) and \$(0.09) for the period ended June 30, 2002, respectively.

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.

Exercise Prices	Options Outstanding			Options Exercisable
	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	
-----	-----	-----	-----	-----

Edgar Filing: TELKONET INC - Form 10QSB

\$ 1.00 2,871,667 9.18 \$ 1.00 1,598,750

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

	Number of Shares	Wei Pri
	-----	-----
Outstanding at January 1, 2001	246,502	\$
Granted	-	
Exercised	-	
Canceled or expired	-	
	-----	-----
Outstanding at December 31, 2001	246,502	
Granted	2,455,000	
Exercised	(1,146,502)	
Canceled or expired	-	
	-----	-----
Outstanding at December 31, 2002	1,555,000	\$
Granted	1,400,000	
Exercised	(83,333)	
Canceled or expired	-	
	-----	-----
Outstanding at June 30, 2003	2,871,667	\$
	-----	-----

17

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
JUNE 30, 2003
(UNAUDITED)

NOTE D - STOCK OPTIONS AND WARRANTS (CONTINUED)

Non-Employee Stock Options (Continued)

The estimated value of the options granted to consultants during the period ended June 30, 2003 was determined using the Black-Scholes option pricing model and the following assumptions: contractual term of 10 years, a risk free interest rate of 1.25%, a dividend yield of 0% and volatility of 26%. The amount of the expense charged to operations in connection with granting the options was \$286,904 and \$226,230 during the period June 30, 2003 and 2002, respectively.

Warrants

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

Edgar Filing: TELKONET INC - Form 10QSB

Exercise Prices	Warrants Outstanding			Weighed Average Exercise Price	Warrants Exercisable
	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average		
\$.50	815,000	8.00	\$.50	815,000	
\$.53	354,460	3.00	\$.53	354,460	
\$.66	229,700	3.00	\$.66	229,700	
\$ 1.00	10,639,100	3.00	\$ 1.00	10,639,100	
\$ 2.54	50,000	3.00	\$ 2.54	50,000	
\$ 2.97	35,000	3.00	\$ 2.97	35,000	
	12,123,260	3.34	\$ 0.96	12,123,260	

Transactions involving warrants are summarized as follows:

	Number of Shares	Weighted Average Price
Outstanding at January 1, 2001	1,210,572	\$
Granted	3,528,665	
Exercised	-	
Canceled or expired	(1,210,572)	
Outstanding at December 31, 2001	3,528,665	\$
Granted	1,667,460	
Exercised	(1,650,675)	
Canceled or expired	(13,990)	
Outstanding at December 31, 2002	3,531,460	\$
Granted	8,591,800	
Exercised	-	
Canceled or expired	-	
Outstanding at June 30, 2003	12,123,260	\$

The estimated value of the compensatory warrants granted to non-employees in exchange for services and financing expenses during the period ended June 30, 2003 was determined using the Black-Scholes pricing model and the following assumptions: contractual term of 3 to 8 years, a risk free interest rate of 1.25%, a dividend yield of 0% and volatility of 26%. The amount of the expense charged to operations for compensatory warrants granted in exchange for financing expenses was \$0 and \$85,620 during the period ended June 30, 2003 and 2002, respectively. The Company also capitalized financing costs of \$87,732 and \$39,346 for compensatory warrants granted in connection with placement of convertible debentures for the period ended June 30, 2003 and 2002, respectively. The financing cost was amortized over the life (three years) of the convertible debenture.

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
JUNE 30, 2003
(UNAUDITED)

NOTE E - 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, 2003 and December 31, 2002, the Company has no preferred stock issued and outstanding. The company has authorized 100,000,000 shares of common stock, with a par value of \$.001 per share. As of June 30, 2003 and December 31, 2002, the Company has 15,977,795 and 15,721,131 shares of common stock issued and outstanding, respectively.

In April 2003, the Company issued 40,000 shares of common stock at \$0.50 per share to one of its Debenture-1 noteholder in exchange for \$20,000 of conversion of debts.

In April 2003, the Company issued 49,998 shares of common stock at approximately \$1.54 per share to consultants for in exchange for services rendered, which approximated the fair value of the shares issued during the period the services were completed and rendered. Compensation costs of \$76,745 were charged to income during the period ended June 30, 2003.

In June 2003, the Company issued 83,333 shares of common stock to an employee in exchange for exercised employee stock options at \$1.00 per share, totaling \$83,333. Additionally, the Company issued 83,333 shares of common stock to a consultant in exchange for exercised non-employee stock options at \$1.00 per share, totaling \$83,333.

Share amounts presented in the consolidated balance sheets and consolidated statements of stockholders' equity reflect the actual share amounts outstanding for each period presented.

NOTE F - RESTATEMENT OF FINANCIAL STATEMENTS

The Company has restated its financial statements for the year ended December 31, 2001 and for the period ended June 30, 2002 to correct the following errors in the financial statements previously filed:

- o For the year ended December 31, 2001, the Company erroneously recorded the Black-Scholes value of the 940,000 warrants attached to its convertible debentures as an asset (financing cost), and amortized over the maturity period (three year) of the note.
- o For the year ended December 31, 2001, the Company erroneously recorded the beneficial conversion feature of its convertible debentures as an asset (financing cost) and the beneficial conversion feature was erroneously amortized over six-months (from the issuance of the note to the earliest conversion date).
- o For the year ended December 31, 2001, the Company erroneously recorded impairment of property and equipment as research and development expense.
- o For the period ended June 30, 2002, the Company erroneously did not record and amortize the beneficial conversion feature of its convertible debentures and value of warrants attached

Edgar Filing: TELKONET INC - Form 10QSB

to the convertible debentures.

The net effect of the correction of these errors was to:

- o Decrease the Company's reported net loss for the year ended December 31, 2001 by \$289,645 from \$(2,006,140) to \$(1,716,495). Increase the Company's reported net loss for the period June 30, 2002 by \$231,830 from \$(1,243,304) to \$(1,475,134).
- o Decrease the loss per share for the year ended December 31, 2001 by \$.01 from \$(.09) to \$(.08) per share. Increase the loss per share for the period ended June 30, 2002 by \$.02 from \$(.07) to \$(.09) per share.
- o Decrease the deficiency accumulated during the development stage from November 3, 1999 to June 30, 2002, by \$57,815 from \$(4,213,137) to \$(4,155,322).
- o Decrease other assets (financing costs) as of June 30, 2002, by \$507,728 from \$628,525 to \$120,797.
- o Increase debt discount as of June 30, 2002, by \$1,362,523 from \$0 to \$1,362,523.
- o Increase additional paid in capital as of June 30, 2002, by \$771,979 from \$3,466,421 to \$4,238,400.

19

TELKONET, INC.
 (A DEVELOPMENT STAGE COMPANY)
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
 JUNE 30, 2003
 (UNAUDITED)

NOTE G - SUBSEQUENT EVENTS

Subsequent to the date of the financial statements, the Debenture-1 Noteholders (see Note B) put forth to the Company its demand registration request for the registration of common shares of the Company sufficient to cover the conversion of their debentures and exercise of the attached warrants. Accordingly, the Company notified the Series B Debenture Noteholder (Note B), Senior Noteholders (Note C) and Warrant holders with piggy-back registration rights requesting their election to participate in the registration. The Company anticipates additional cash resources generated as the result of exercise of the warrants however the amount of funding cannot be determined until September 12th, at which time the exercise price is required to be paid to the Company. In August 2003, the Company issued an aggregate of 7,514,541 shares of common stock in connection with the conversion of Debenture-1 of \$1,517,100 and Series B Debentures of \$2,180,000 and the issuance of common stock related accrued interest of \$187,039 and \$85,586, respectively. The proforma balance sheet below represents the effect of the conversion of the debentures as if it had occurred as of June 30, 2003.

SUMMARY PROFORMA BALANCE SHEET

	Unaudited June 30, 2003	Proforma Adjustments Dr. Cr.	Proforma June 30,
ASSETS:			
Cash	4,580,779	3,000,000	7,580
Other current assets	525,272		525
Total current assets	5,106,051	3,000,000	8,106

Edgar Filing: TELKONET INC - Form 10QSB

Other assets	323,893			323,893
Total Assets	5,429,945	3,000,000		8,429,945
LIABILITIES & SHAREHOLDER'S EQUITY				
Current liabilities	1,297,829	272,625	-	1,025,204
Convertible debentures - net of discounts	1,453,720	1,453,720		2,907,440
Senior notes	5,000,000			5,000,000
Shareholder's (deficiency) equity	(2,321,604)		4,726,345	2,404,741
Total liabilities & shareholder's equity	5,429,945	1,726,345	4,726,345	8,429,945

NOTES TO PROFORMA BALANCE SHEET:

- (1) Conversion of convertible debentures
- (2) Assumes 30% exercise warrants.
- (3) Stock Issuance for debenture interest

20

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 buildings, hotels, multi-dwelling residential units, government and schools. 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. These products provide connectivity over the existing electrical wiring does not require the addition of costly wiring, or major disruption to business activity. In many situations the Telkonet solution 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 high-speed Internet and telephone connectivity to these markets creates a significant and definitive niche market opportunity for the Company. Telkonet's solutions overcome many of the difficulties associated with powerline communications that historically have prevented the achievement of high data transmission rates.

Telkonet has completed its development cycle of its commercial grade high-speed Internet access product solution, manufactured product and has commenced marketing its suite of PlugPlus 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

Edgar Filing: TELKONET INC - Form 10QSB

complex wireless networks which have coverage and security issues are the only solutions available today.

The Telkonet PlugPlus 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 three products, the PLUGPLUS GATEWAY, PLUGPLUS COUPLER and the PLUGPLUS MODEM.

The Telkonet PlugPlus Solution is aimed at multi-user applications such as hotels/motels, residential apartment complexes, government, schools and a variety of small and medium sized businesses. High-speed Internet connections are becoming widely available and providers are focused on meeting the demands of new and existing customers needs for high-speed Internet access. 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 PlugPlus Gateway, distributing access to the Internet to the ultimate user over the existing electrical wiring in the building. With the Telkonet PlugPlus Gateway in place, access is provided by simply plugging the user's Telkonet PlugPlus Modem into the nearest standard electrical outlet. Any existing electrical outlet in the structure can provide immediate access to the Internet via a Telkonet PlugPlus Modem. Moving the location of a PC, server, or printer is accomplished by simply moving the PlugPlus Modem to another electrical outlet. No additional wiring is required and changes can be made quickly and easily.

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

21

Forward Looking Statements

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

Edgar Filing: TELKONET INC - Form 10QSB

Operations

Telkonet is commencing its transition from a development stage company with its planned PlugPlus product suite launched during the second quarter 2003. 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 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 Telkonet's business, operations and infrastructure and the implementation of marketing programs, key agreements and strategic alliances, the number of products offered by Telkonet, the number of returns experienced by Telkonet, and general economic conditions specific to the Internet, power-line communications, and the communications industry.

Revenues

To date, Telkonet has not generated any revenues as it was in the development stage. Telkonet believes it will begin earning revenues from operations within the next three to six months with the acceleration of its sales and marketing efforts.

Costs and expenses

From its inception on November 3, 1999 through June 30, 2003, Telkonet has incurred operating expenses of \$8,340,971. These expenses were associated principally with compensation to employees, product development costs, professional services and costs associated with non-employee stock options.

Overall expenses increased for the three and six months ended June 30 2003 over the comparable period in 2002 by \$870,086 or 124% and \$ \$1,402,843 or 112% respectively. These increases are principally due to an increase in payroll and related costs for development, sales and marketing and administrative functions, and external costs associated with product development, pre-production costs for the PlugPlus powerline products, ramp-up of sales and marketing activities and costs associated with non-employee stock options issued in connection with services rendered.

Liquidity and Capital Resources

To date Telkonet has not generated revenues to offset any development and organizational expenses. As a result of Telkonet's operating losses from its inception through June 30, 2003, Telkonet generated a cash flow deficit of \$6,520,252 from operating activities. Telkonet's current assets exceeded its current liabilities by \$3,808,222 as of June 30, 2003. For the period from inception through June 30, 2003, Telkonet has accumulated losses of \$9,918,391. 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 to date, additional financing may be required in order to meet Telkonet's current and projected cash flow deficits from operations and development during the next twelve months. Management believes it has sufficient capital resources

Edgar Filing: TELKONET INC - Form 10QSB

to meet projected cash flow deficits through the next twelve months. However, if thereafter, we are not successful in generating sufficient liquidity from operations or in raising sufficient capital resources on terms acceptable to us, this could have a material adverse effect on our business, results of operations, liquidity and financial condition.

22

During the second quarter, Telkonet completed its \$5,000,000, 8.0% senior note offering, the proceeds of which were used to provide the necessary working capital. These notes provide for interest payable quarterly and include non-detachable warrants to purchase 125,000 shares of our common stock for each \$100,000 units sold. The warrants are exercisable for three years from issuance at an exercise price of \$1.00 per share.

After June 30, 2003, the Series A Debenture noteholders demanded registration of shares of common stock sufficient to cover the conversion of their debentures and exercise of the attached warrants. Accordingly, Telkonet notified the Series B Debenture Noteholder, Senior Noteholders and Warrant holders with piggy-back registration rights of the right to participate in the registration. Telkonet anticipates that additional cash resources will be generated as the result of exercise of the warrants. However, the amount of such funding cannot be determined until September 12, 2003, at which time the exercise price for the warrants is required to be paid to Telkonet.

Telkonet's independent certified public accountants have stated in their report included in Telkonet's December 31, 2002 Form 10-KSB, that Telkonet has incurred operating losses in the last two years, and that Telkonet is dependent upon management's ability to develop profitable operations. These factors, among others, may raise substantial doubt about Telkonet's ability to continue as a going concern.

Product Research and Development

Company-sponsored research and development costs related to both present and future products are expended in the period incurred. Total expenses for the three and six months ended June 30, 2003 decreased over the comparable period in 2002 by \$48,882 or 15.0% and \$4,773 or 1.0% respectively. During the second quarter of 2002, non-recurring costs of approximately \$49,000 related to the purchase of prototype units, PCB board testing and UL and FCC testing were incurred.

Selling, General and Administrative

Selling, general and administrative expenses increased for the three and six months ended June 30, 2003 over the comparable period in 2002 by \$937,354 or 397% and \$1,335,966 or 373.0%, respectively. These increases were related to one-time costs associated with the Senior Note and Series B Debenture fund raising including commissions, public relations and employee separation costs.

Acquisition or Disposition of Plant and Equipment

During the period ended June 30, 2003, Telkonet renewed certain operating equipment leases and added a \$1.00 buy-out option at the end of the new 18 month lease term. Accordingly, the leases and the related debt obligations for approximately \$52,000 were capitalized. 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

Edgar Filing: TELKONET INC - Form 10QSB

or equipment during the next twelve months, other than leasehold improvements, computer equipment and peripherals used in Telkonet's day-to-day operations.

Number of Employees

During the period ended June 30, 2003, Telkonet had 17 employees. In order for Telkonet to attract and retain quality personnel, Telkonet anticipates it will continue to offer competitive salaries to current and future employees. As Telkonet continues to expand, Telkonet will incur additional costs for personnel. This projected increase in personnel is dependent upon Telkonet generating revenues and obtaining sources of financing. There are no assurances Telkonet 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

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 consider all such risk factors before making an investment in Telkonet's common 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 its first product and other product candidates. Telkonet expects negative cash flow from operations to continue for the next six 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.

23

Potential fluctuations in quarterly operating results

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 goods; trends in broadband service provisioning, the amount and timing of capital expenditures and other costs relating to the expansion of 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

Telkonet's common stock is currently quoted on the NASD OTC Bulletin Board under the ticker symbol "TLKO." As of June 30, 2003, there were approximately 15,977,795 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

Edgar Filing: TELKONET INC - Form 10QSB

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 Telkonet's stock price.

Item 3. Controls and Procedures.

As of the end of the period covered by this Report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-14 under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, the Chief Executive and Chief Financial Officer concluded that our disclosure controls and procedures are effective in timely alerting them to material information required to be included in our periodic filings with the U.S. Securities and Exchange Commission. There were no significant changes in our internal controls or in other factors that could significantly affect these internal controls subsequent to the date of our most recent evaluation.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

In March 2003, Jenson Services, Inc. and James P. Doolin filed an action against Telkonet in the Third Judicial District Court in and for Salt Lake County, State of Utah. The action sets forth various counts all based on allegations that Telkonet, through its agents, promised to undertake a registration of Telkonet common stock and thereby allow the plaintiffs to exercise piggy-back registration rights under a registration rights agreement. The action seeks damages from Telkonet in unspecified amounts. Telkonet believes that the claims of the plaintiffs are without merit, that it has meritorious defenses to such claims, and Telkonet intends to defend itself against the plaintiffs' claims in their entirety.

Item 2 - Changes in 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

24

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

No.	Description
---	-----
31.1	Certification of Ronald W. Pickett Pursuant to Section 302 of the

Edgar Filing: TELKONET INC - Form 10QSB

- 31.2 Sarbanes-Oxley Act of 2002.
Certification of E. Barry Smith
Pursuant to Section 302 of the
Sarbanes-Oxley Act of 2002.
- 32.1 Certification of Ronald W. Pickett
Pursuant to Section 906 of the
Sarbanes-Oxley Act of 2002.
- 32.2 Certification of E. Barry Smith
Pursuant to Section 906 of the
Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K filed during the three months ended June 30, 2003.

On May 21, 2003, Telkonet filed a Current Report on Form 8- K dated May 21, 2003, reporting under Item 5, disclosing an update letter to shareholders announcing the status of product and market development.

On June 26, 2003, Telkonet filed a Current Report on Form 8- K dated June 26, 2003, reporting under Item 5, disclosing an update letter to shareholders announcing the completion of Senior Note offering.

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 13, 2003

By: /s/ Ronald W. Pickett

Ronald W. Pickett
President