

Edgar Filing: TELKONET INC - Form 10QSB

TELKONET INC  
Form 10QSB  
November 14, 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 September 30, 2003

Commission file number 000-27305

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: 30,235,189 shares of Common Stock (\$.001 par value) as of November 12, 2003.

Transitional small business disclosure format: Yes  No

TELKONET, INC.

QUARTERLY REPORT ON FORM 10-QSB FOR THE  
QUARTERLY PERIOD ENDING SEPTEMBER 30, 2003

Table of Contents

	Page
	----
PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements (Unaudited)	
Condensed Consolidated Balance Sheets: September 30, 2003 and December 31, 2002	4
Condensed Consolidated Statements of Losses:	

## Edgar Filing: TELKONET INC - Form 10QSB

Three Months Ended September 30, 2003 and 2002 Nine Months Ended September 30, 2003 and 2002 November 3, 1999 (Date of Inception) through September 30, 2003	5
Consolidated Statement of Stockholders' Equity (Deficiency) November 3, 1999 (Date of Inception) through September 30, 2003	6 - 9
Condensed Consolidated Statements of Cash Flows: Nine Months Ended September 30, 2003 and 2002 November 3, 1999 (Date of Inception) through September 30, 2003	10 - 11
Notes to Unaudited Condensed Consolidated Financial Information: September 30, 2003	12 - 22
Item 2. Management's Discussion and Analysis	23 - 26
Item 3. Controls and Procedures	26
PART II. OTHER INFORMATION	26
Item 1. Legal Proceedings	26
Item 2. Changes in Securities	27
Item 3. Defaults Upon Senior Securities	27
Item 4. Submission of Matters to a Vote of Security Holders	27
Item 5. Other Information	27
Item 6. Exhibits and Reports on Form 8-K	27

3

Item 1. Financial Statements (Unaudited)

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

	(Unaudited) September 30, 2003	(Audited) December 31, 2003
	-----	-----
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 6,807,358	\$ 18,000,000
Accounts Receivable	3,847	1,000,000
Other receivable	--	1,000,000
Inventory, net	606,294	39,000,000
Prepaid expenses and deposits	54,746	4,000,000
	-----	-----
Total current assets	7,472,245	64,000,000

Edgar Filing: TELKONET INC - Form 10QSB

PROPERTY AND EQUIPMENT:

Furniture and equipment, at cost	172,526	73,
Less: accumulated depreciation	63,016	35,
	-----	-----
	109,510	37,

OTHER ASSETS

Financing costs, less accumulated amortization of \$10,743 and \$101,692 at September 30, 2003 and December 31, 2002, respectively (Note B)	20,343	192,
	-----	-----
	\$ 7,602,098	\$ 295,
	=====	=====

LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIENCY)

CURRENT LIABILITIES:

Accounts payable and accrued liabilities	\$ 630,301	\$ 518,
Notes payable	--	310,
Capital leases	33,569	
Due to shareholders	7,500	130,
	-----	-----
Total current liabilities	671,370	959,

Convertible debentures, net of discounts - including related parties (Note B)	123,362	862,
Senior notes payable (Note C)	2,989,000	

COMMITMENTS AND CONTINGENCIES

--

STOCKHOLDERS' EQUITY (DEFICIENCY)

Preferred stock, par value \$.001 per share; 15,000,000 shares authorized; none issued at September 30, 2003 and December 31, 2002 (Note E)	--	
Common stock, par value \$.001 per share; 100,000,000 shares authorized; 30,275,189 and 15,721,131 shares issued and outstanding at September 30, 2003 and December 31, 2002, respectively (Note E)	30,275	15,
Additional paid-in-capital	15,696,536	4,916,
Accumulated deficit during development stage	(11,908,445)	(6,458,
	-----	-----
Stockholders' equity (Deficiency)	3,818,366	(1,526,
	-----	-----
	\$ 7,602,098	\$ 295,
	=====	=====

See accompanying footnotes to the unaudited condensed consolidated financial information

Edgar Filing: TELKONET INC - Form 10QSB

	For The Three Months Ended September 30,		For The Nine Mo September
	2003	2002 (As Restated - Note F)	2003
	----	-----	----
Net Revenues	\$ 13,848	\$ --	\$ 13,848
Cost of Sales	4,216	--	4,216
	-----	-----	-----
Gross Profit	9,632	--	9,632
Costs and Expenses:			
Research and Development	367,374	340,888	964,924
Selling, General and Administrative	1,030,794	311,222	2,724,591
Non-Employee Stock Options (Note D)	188,988	--	475,892
Depreciation and Amortization	18,704	21,930	100,838
	-----	-----	-----
Total Operating Expense	1,605,860	674,040	4,266,245
Loss from Operations	(1,596,228)	(674,040)	(4,256,613)
Other Income (Expense)	--	996	--
Interest Income (Expense)	(393,825)	(231,568)	(1,193,156)
Provision for Income Tax	--	--	--
	-----	-----	-----
	(393,825)	(230,572)	(1,193,156)
Net Loss	\$ (1,990,053)	\$ (904,612)	\$ (5,449,769)
	=====	=====	=====
Loss per common share (basic and assuming dilution)	\$ (0.09)	\$ (0.05)	\$ (0.31)
	=====	=====	=====
Weighted average common shares outstanding	20,962,065	16,692,841	17,521,860

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 SEPTEMBER 30, 2003  
(UNAUDITED)

Edgar Filing: TELKONET INC - Form 10QSB

	Preferred Shares	Preferred Stock Amount	Common Shares	Common Stock Amount	Additio Paid i Capita
Net Loss	--	--	--	--	
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	11,3
Shares issued in June 2000, for cash in connection with private placement at \$375 per share, net of costs	--	--	1,735	17	644,2
Shares issued in July 2000, for warrants exercised at a price of \$375 per share	--	--	190	--	71,2
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	29,1
Shares issued in October 2000, in exchange for warrants exercised at a price of \$ 0.40 per share	--	--	10,891	11	4,3
Net loss	--	--	--	--	
BALANCE AT DECEMBER 31, 2000	--	\$ --	21,815,371	\$ 21,815	\$ 760,3

See accompanying footnotes to the unaudited condensed consolidated financial statements.

6

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

	Preferred Shares	Preferred Stock Amount	Common Shares	Common Stock Amount	Additional Paid in Capital	Su
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 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	

Edgar Filing: TELKONET INC - Form 10QSB

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 F)	-	\$ --	22,115,371	\$ 22,115	\$ 2,244,033
=====					

See accompanying footnotes to the unaudited condensed consolidated finan

7

TELKONET, INC.  
(A DEVELOPMENT STAGE COMPANY)  
CONDENSED CONSOLIDATED STATEMENT OF (DEFICIENCY IN) STOCKHOLDERS' EQ  
FOR THE PERIOD NOVEMBER 3, 1999 (DATE OF INCEPTION) TO SEPTEMBER 30, 20

	Preferred Shares	Preferred Stock Amount	Common Shares	Common Stock Amount	Additional Paid in Capital	Comm Sto Subscr
BALANCE FORWARD	-	\$ --	22,115,371	\$ 22,115	\$ 2,244,033	\$
Shares issued in February 2002, in						

Edgar Filing: TELKONET INC - Form 10QSB

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, 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	-	--	--	--	--	(1,803,595)
Return of founders shares in connection with stock subscription	-	--	(1,805,400)	(1,805)	(1,803,595)	1,803,595
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						

Edgar Filing: TELKONET INC - Form 10QSB

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.

8

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

	Preferred Shares	Preferred Stock Amount	Common Shares	Common Stock Amount	Additional Paid in Capital	Co Sub
BALANCE FORWARD			15,721,131	\$15,721	\$ 4,916,433	
Shares issued in April 2003 in exchange for convertible debentures at \$.50 per share	--	--	40,000	40	19,960	
Shares issued in April 2003 in exchange for services at \$1.54 per share	--	--	49,998	50	76,695	
Shares issued in June 2003 for employee options exercised at \$1.00 per share (Note D)	--	--	83,333	83	83,250	
Shares issued in June 2003 for non-employee options exercised at \$1.00 per share (Note D)	--	--	83,333	83	83,250	
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	
Shares issued in July 2003 for warrants exercised at \$.66 per share, for services rendered	--	--	114,799	115	(115)	
Shares issued in July 2003 for warrants exercised at \$.53 per share, for services rendered	--	--	64,052	64	(64)	
Shares issued in July 2003 for 220,000 warrants (attached to convertible debentures) exercised at \$1.00 per share	--	--	143,648	144	(144)	
Shares issued in August 2003 in exchange for convertible debentures (Note B)	--	--	7,157,836	7,158	3,769,942	
Shares issued in August 2003 in exchange for accrued interest on convertible debentures (Note B)	--	--	511,143	511	272,114	



Edgar Filing: TELKONET INC - Form 10QSB

Shares issued in August 2003 for non-employee options exercised at \$1.00 per share	--	--	83,333	83	83,250
Shares purchased in August 2003 for cash at \$2.00 per share, net of costs	--	--	333	--	666
Shares issued in September 2003 for warrants exercised at \$1.00	--	--	3,597,250	3,597	3,593,653
Shares issued in September 2003 for warrants exercised at \$.50	--	--	500,000	500	249,500
Shares issued in September 2003 for warrants exercised at \$1.00, in exchange for Senior Notes (Note C)	--	--	2,011,000	2,011	2,008,989
Shares issued in September 2003 in exchange for services at approximately \$2.50 per share	--	--	114,000	114	285,148
Stock based compensation for the issuance of stock options to consultants in exchange for services (Note D)	--	--	--	--	475,892
Stock based compensation for the issuance of warrants to consultants in exchange for services (Note D)	--	--	--	--	6,750
Write-off of beneficial conversion feature in connection with conversion of Debenture-1 and Series B debentures (Note B)	--	--	--	--	(2,046,479)
Write-off of value of warrants attached to convertible debentures in connection with conversion of Debenture-1 and Series B debentures (Note B)	--	--	--	--	(296,470)
Net Loss	--	--	--	--	--
	-----	-----	-----	-----	-----
BALANCE AT SEPTEMBER 30, 2003	--	\$ --	30,275,189	\$30,275	\$ 15,696,536
	=====	=====	=====	=====	=====

See accompanying footnotes to the unaudited condensed consolidated financial statements.

9

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

	Nine Months Ended Septe	2002 (As R
	2003	- Note
	----	-----
INCREASE (DECREASE) IN CASH AND EQUIVALENTS		
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss from development stage operations	\$ (5,449,769)	\$ (2,

## Edgar Filing: TELKONET INC - Form 10QSB

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	629,455	
Amortization of debt discount - value of warrants attached to convertible debentures	85,377	
Stock options and warrants issued in exchange for services rendered (Note D)	482,642	
Common stock issued in exchange for services rendered (Note E)	362,006	
Common stock issued in exchange for conversion of interest (Note B)	272,625	
Impairment of property and equipment	--	
Write-off of financing costs in connection with conversion of convertible debentures (Note B)	186,400	
Depreciation and amortization	100,838	
(Increase) decrease in:		
Accounts receivable	(2,297)	
Inventory	(566,504)	
Prepaid expenses and deposits	(50,120)	
Accounts payable and accrued expenses, net	111,435	
	-----	-----
NET CASH USED IN OPERATING ACTIVITIES	(3,837,912)	(1,)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures, net of disposals	(65,742)	
	-----	-----
NET CASH USED IN INVESTING ACTIVITIES	(65,742)	
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from sale of common stock, net of costs (Note E)	666	
Proceeds from (repayments of) stockholder advances	(122,830)	
Proceeds from issuance of convertible debentures, net of costs (Note B)	2,027,100	
Proceeds from issuance of senior notes, net of costs (Note C)	5,000,000	
Proceeds from exercise of warrants (Note E)	3,847,250	
Proceeds from exercise of stock options and warrants	249,999	
Proceeds from (repayments of) loans	(310,000)	
	-----	-----
NET CASH PROVIDED BY FINANCING ACTIVITIES	10,692,185	1,
NET (DECREASE) INCREASE IN CASH AND EQUIVALENTS	6,788,531	
Cash and cash equivalents at the beginning of the period	18,827	
	-----	-----
Cash and cash equivalents at the end of the period	\$ 6,807,358	\$
	-----	-----

See accompanying footnotes to the unaudited condensed consolidated financial statements.

Edgar Filing: TELKONET INC - Form 10QSB

	Nine Months Ended September 30	
	2003	2002 (As Restated - Note F)
	----	-----
Supplemental Disclosures of Cash Flow Information		
Cash paid during the period for interest	\$ 33,105	\$ 25,011
Income taxes paid	--	--
Non-cash transactions:	--	--
Issuance of stock options and warrants in exchange for services rendered	482,642	--
Issuance of stock warrants in exchange for financing costs	87,217	--
Common stock issued for services rendered	362,006	138,720
Common stock issued in exchange for interest	272,625	21,793
Common stock issued in exchange for conversion of convertible debenture	3,797,100	--
Common stock issued in exchange for Senior Note	2,011,000	--
Notes payable issued in connection with capital lease, net of repayments	33,569	--
Beneficial conversion feature on convertible debentures	1,761,675	693,018
Value of warrants attached to convertible debentures	265,425	56,082
Acquisition:		
Assets Acquired	--	--
Accumulated Deficit	--	--
Liabilities Assumed	--	--
	-----	-----
	\$ --	\$ --
	-----	-----

See accompanying footnotes to the unaudited condensed consolidated financial statements.

11

TELKONET, INC.  
(A DEVELOPMENT STAGE COMPANY)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION  
SEPTEMBER 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 nine-month period ended September 30, 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 for the year ended December 31, 2002.

## Edgar Filing: TELKONET INC - Form 10QSB

### 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 minimal 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 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 and 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 subsequent periods.

12

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

NOTE A - SUMMARY OF ACCOUNTING POLICIES

## Edgar Filing: TELKONET INC - Form 10QSB

### 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 September 30,		
	2003	2002	2001
Net loss - as reported	\$ (1,990,053)	\$ (904,612)	\$ (5,400,000)
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)	(1,053,747)	(52,708)	(2,300,000)
Net loss - Pro Forma	\$ (3,043,800)	\$ (957,320)	\$ (7,700,000)
Net loss attributable to common stockholders - Pro forma	\$ (3,043,800)	\$ (957,320)	\$ (7,700,000)
Basic (and assuming dilution) loss per share - as reported	\$ (0.09)	\$ (0.05)	\$ (0.15)
Basic (and assuming dilution) loss per share - Pro forma	\$ (0.15)	\$ (0.06)	\$ (0.15)

### 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 results of operations or financial position.

# Edgar Filing: TELKONET INC - Form 10QSB

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

NOTE B - CONVERTIBLE PROMISSORY NOTES PAYABLE

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

	September 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	\$ 72,000	\$ 1,689,100
Debt Discount - beneficial conversion feature, net of accumulated amortization of \$35,972 and \$531,858 at September 30, 2003 and December 31, 2002, respectively	(30,157)	(999,034)
Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of \$3,132 and \$47,216 at September 30, 2003 and December 31, 2002, respectively	(2,589)	(86,120)
	39,254	603,946
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	320,000	472,900
Debt Discount - beneficial conversion feature, net of accumulated amortization of \$55,058 and \$1,564 at September 30, 2003 and December 31, 2002, respectively	(200,914)	(146,295)
Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of \$9,631 and \$726 at September 30, 2003 and December 31, 2002, respectively	(34,978)	(67,869)
	84,108	258,736
Total	\$ 123,362	\$ 862,682
Less: current portion	--	--
	\$ 123,362	\$ 862,682

Edgar Filing: TELKONET INC - Form 10QSB

TELKONET, INC.  
(A DEVELOPMENT STAGE COMPANY)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION  
SEPTEMBER 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 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 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

## Edgar Filing: TELKONET INC - Form 10QSB

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.

15

TELKONET, INC.  
(A DEVELOPMENT STAGE COMPANY)  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION  
SEPTEMBER 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 Debentures") to Company officers, shareholders, and sophisticated investors in exchange for \$472,900, exclusive of placement costs and fees. The Series B Debentures accrue interest at 8% per annum and are 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 Debentures. The debt discount attributed to the beneficial conversion feature is amortized over the Series B Debentures maturity period (three years) as interest expense.

In connection with the placement of the Series B Debentures in 2002, the 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 Debentures. 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



## Edgar Filing: TELKONET INC - Form 10QSB

discount attributed to the value of the warrants issued is amortized over the Series B Debentures maturity period (three years) as interest expense.

In January and February 2003, the Company issued convertible Series B Debentures to Company officers, shareholders, and sophisticated investors in exchange for \$2,027,100, exclusive of placement costs and fees. The Series B Debentures accrue interest at 8% per annum and are 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 Debentures. The debt discount attributed to the beneficial conversion feature is amortized over the Series B Debentures 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 Debentures. 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 Debentures maturity period (three years) as interest expense.

16

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

NOTE B - CONVERTIBLE PROMISSORY NOTES PAYABLE (CONTINUED)

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 \$714,832 and \$339,061 for the nine months ended September 30, 2003 and 2002, respectively.

During the quarter ended September 30, 2003, the Debenture-1 noteholders demanded registration of that number 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 noteholders, Senior noteholders (Note C) and warrant holders with piggy-back registration rights of their right to participate in the registration. During the quarter ended September 30, 2003, the Company issued an aggregate of 7,157,836 shares of common stock in connection with the conversion of \$1,597,100 aggregate principal

Edgar Filing: TELKONET INC - Form 10QSB

amount of the Debenture-1 and \$2,180,000 aggregate principal amount of the Series B Debentures. The Company also issued an aggregate of 511,143 shares of common stock in exchange for accrued interest of \$187,039 and \$85,586 for Debenture 1 and Series B Debentures respectively.

In connection with the conversion of Debenture-1 and Series B Debentures, the Company wrote off the un-amortized debt discount attributed to the beneficial conversion feature and the value of the attached warrants in the amount of \$2,046,479 and \$296,470, respectively. Un-amortized financing cost of \$186,400 in connection with issuance of Debenture-1 and Series B Debenture was charged to operation during the quarter ended September 30, 2003.

NOTE C - SENIOR NOTES PAYABLE

In April, May and June 2003, the Company issued Senior Notes to Company officers, shareholders, and sophisticated investors in exchange for \$5,000,000, exclusive of placement costs and fees. The Senior Notes are denominated in units of \$100,000, accrue interest at 8% per annum and are due three years from the date of issuance with the latest maturity date of June 2006. Attached to each Senior Note are warrants to purchase 125,000 shares of common stock. The warrants have a three-year contractual life and are exercisable immediately after the issuance of the Senior Note at an exercise price of \$1.00 per share. The Senior Notes are secured by a first priority security interest in all intellectual property assets of the Company. The Company plans to use the proceeds from the Senior Notes for expansion of sales, marketing and strategic partnership programs, building required infrastructure and for working capital. In September 2003, certain Senior noteholders elected to surrender their Senior Note as consideration for the exercise of warrants to purchase shares of common stock of the Company. The Company issued an aggregate of 2,011,000 restricted shares of common stock for warrants exercised at \$1.00 per share, in exchange for \$2,011,000 of Senior Notes. The outstanding balance on the Senior Notes as of September 30, 2003 is \$2,989,000.

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			Options Exercisable
	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	
\$1.00	6,775,000	8.09	\$1.00	2,301,185
\$1.51	200,000	9.50	\$1.51	33,334
\$2.35	465,000	9.50	\$2.35	77,501
\$3.43	25,000	9.50	\$3.43	4,166
	-----	----	-----	-----
	7,465,000	9.02	\$1.11	2,416,186
	=====	=====	=====	=====

# Edgar Filing: TELKONET INC - Form 10QSB

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

NOTE D - STOCK OPTIONS AND WARRANTS (CONTINUED)

Employee Stock Options (Continued)

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

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2001	840,000	--
Granted	215,000	\$ 1.00
Exercised	--	--
Canceled or expired	--	--
	-----	-----
Outstanding at December 31, 2001	1,055,000	1.00
Granted	2,835,000	1.00
Exercised	(1,000,000)	1.00
Canceled or expired	(1,440,000)	1.00
	-----	-----
Outstanding at December 31, 2002	1,450,000	\$ 1.00
Granted	6,098,333	1.11
Exercised	(83,333)	1.00
Canceled or expired	--	--
	-----	-----
Outstanding at September 30, 2003	7,465,000	\$ 1.11

The weighted-average fair value of stock options granted to employees during the period ended September 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	1.02%	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 \$(7,794,650) and \$(0.44) for the nine months ended September 30, 2003 and \$(2,537,870) and \$(0.15) for the nine months ended September 30, 2002, respectively.

Non-Employee Stock Options

Edgar Filing: TELKONET INC - Form 10QSB

-----  
 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	
\$ 1.00	2,788,334	8.93	\$ 1.00	1,715,417

18

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

NOTE D - STOCK OPTIONS AND WARRANTS (CONTINUED)

Non-Employee Stock Options (Continued)

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

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2001	246,502	\$ 0.70
Granted	-	-
Exercised	-	-
Canceled or expired	-	-
Outstanding at December 31, 2001	246,502	0.70
Granted	2,455,000	1.00
Exercised	(1,146,502)	0.96
Canceled or expired	-	-
Outstanding at December 31, 2002	1,555,000	\$ 1.00
Granted	1,400,000	1.00
Exercised	(166,666)	1.00
Canceled or expired	-	-
Outstanding at September 30, 2003	2,788,334	\$ 1.00

The estimated value of the options granted to consultants during the period ended September 30, 2003 was determined using the Black-Scholes option pricing

## Edgar Filing: TELKONET INC - Form 10QSB

model and the following assumptions: contractual term of 10 years, a risk free interest rate of 1.02%, a dividend yield of 0% and volatility of 26%. The amount of the expense charged to operations in connection with granting the options was \$475,892 and \$0 during the period ended September 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.

Exercise Prices	Warrants Outstanding Number Outstanding	Warrants Outstanding Weighted Average Remaining Contractual Life (Years)	Weighed Average Exercise Price	Warrants E Number Exercisable
-----	-----	-----	-----	-----
\$ .50	315,000	7.75	\$ .50	315,000
\$ .53	279,080	2.75	\$ .53	279,080
\$ .66	80,000	2.75	\$ .66	80,000
\$ 1.00	6,903,661	2.75	\$ 1.00	6,903,661
\$ 2.54	50,000	2.75	\$ 2.54	8,334
\$ 2.97	35,000	2.75	\$ 2.97	5,834
	-----	----	-----	-----
	7,662,741	3.09	\$ 0.98	7,662,741
	=====	====	=====	=====

19

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

### NOTE D - STOCK OPTIONS AND WARRANTS (CONTINUED)

#### Warrants (Continued)

Transactions involving warrants are summarized as follows:

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2001	1,210,572	\$ 1.00
Granted	3,528,665	0.67
Exercised	--	--
Canceled or expired	(1,210,572)	1.00
	-----	-----
Outstanding at December 31, 2001	3,528,665	\$ 0.67
	-----	-----
Granted	1,667,460	0.87
Exercised	(1,650,675)	0.51

## Edgar Filing: TELKONET INC - Form 10QSB

Canceled or expired	(13,990)	1.00
	-----	-----
Outstanding at December 31, 2002	3,531,460	\$ 0.84
	-----	-----
Granted	8,591,800	1.01
Exercised	(4,460,519)	1.00
Canceled or expired	--	--
	-----	-----
Outstanding at September 30, 2003	7,662,741	\$ 0.98
	=====	=====

The estimated value of the compensatory warrants granted to non-employees in exchange for services and financing expenses during the period ended September 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 1.02%, a dividend yield of 0% and volatility of 26%. The amount of the expense charged to operations for compensatory warrants granted in exchange for services was \$6,750 and \$0 during the period ended September 30, 2003 and 2002, respectively. The Company also capitalized financing costs of \$87,217 and \$0 for compensatory warrants granted in connection with placement of convertible debentures for the period ended September 30, 2003 and 2002, respectively. The financing cost was amortized over the life (three years) of the convertible debenture.

### NOTE E - CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock, par value \$.001 per share. As of September 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, par value \$.001 per share. As of September 30, 2003 and December 31, 2002, the Company had 30,275,189 and 15,721,131 shares of common stock authorized 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 convertible debenture holders in exchange for the forgiveness of \$20,000 of the Debenture-1 principal amount due to the noteholder.

In April 2003, the Company issued 49,998 shares of common stock at approximately \$1.54 per share to consultants 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 operations.

In June 2003, the Company issued 83,333 shares of common stock for an aggregate purchase price of \$83,333 to an employee upon exercise of employee stock options at \$1.00 per share. Additionally, the Company issued 83,333 shares of common stock for an aggregate purchase price of \$83,333 to a consultant upon exercise of non-employee stock options at \$1.00 per share.

20

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

### NOTE E - CAPITAL STOCK (CONTINUED)

In July 2003, the Company issued an aggregate of 178,851 shares of common stock to consultants upon exercise of warrants at \$0.66 and \$0.53 per share.

## Edgar Filing: TELKONET INC - Form 10QSB

Additionally, the Company issued an aggregate of 143,648 shares of common stock to its convertible debenture holders upon exercise of warrants at \$1.00 per share.

In August 2003, the Company issued an aggregate of 7,668,979 shares of common stock to its convertible debenture holders upon conversion of \$3,777,100 of debt and \$272,625 of accrued interest (see Note B). The Company also issued 83,333 shares of common stock to an consultant, for non-employee stock options exercised at \$1.00 per share. Additionally, the Company issued 333 shares of common stock for \$666, net of costs and fees.

In September 2003, the Company issued an aggregate of 3,597,250 and 500,000 shares of common stock upon the exercise of warrants at \$1.00 and \$0.50 per share, respectively. The Company issued an aggregate of 2,011,000 restricted shares of common stock upon the exercise of warrants exercisable at \$1.00 per share, in exchange for \$2,011,000 of Senior Notes (see Note C). The Company also issued an aggregate of 114,000 shares at an average price per share of \$2.50 to consultants for services rendered, which approximated the fair value of the shares issued during the period the services were completed and rendered.

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 September 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 September 30, 2002, the Company erroneously failed to record and amortize the beneficial conversion feature of its convertible debentures and value of warrants attached 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 September 30, 2002 by \$335,303 from \$(2,044,443) to \$(2,379,746).
- 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 September 30, 2002 by \$.02 from \$(.12) to \$(.14) per share.
- o Increase the deficiency accumulated during the development stage from November 3, 1999 to September 30, 2002, by \$45,659

## Edgar Filing: TELKONET INC - Form 10QSB

- o from \$(5,014,276) to \$(5,059,935).
- o Decrease other assets (financing costs) as of September 30, 2002, by \$497,288 from \$600,625 to \$103,337.
- o Increase debt discount as of September 30, 2002, by \$1,223,838 from \$0 to \$1,223,838.
- o Increase additional paid in capital as of September 30, 2002, by \$771,977 from \$4,791,838 to \$5,563,815.

21

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

NOTE G - SUBSEQUENT EVENTS

Subsequent to the date of the financial statements, a Director/Shareholder, and an Officer/Director/Shareholder exercised warrants of 315,000 and 11,667 at an exercise price of \$.50 and \$1.00, respectively. Additionally, stock options were exercised by a non-employee and employee for 20,833 and 10,000 respectively, at an exercise price of \$1.00. The proforma balance sheet below represents the effect of the exercise of warrants and options as if it had occurred as of September 30, 2003.

SUMMARY PROFORMA BALANCE SHEET

(\$000's)	Unaudited 9/30/03	Proforma Dr.	Adjustments Cr.	Pr 9
<b>ASSETS:</b>				
Cash	\$6,807,358	\$ 200,000	--	\$7
Other current assets	664,887	--	--	
<b>Total current assets</b>	<b>7,472,245</b>	<b>200,000</b>	<b>--</b>	<b>7</b>
Other assets	129,853	--	--	
<b>Total Assets</b>	<b>7,602,098</b>	<b>\$ 200,000</b>	<b>--</b>	<b>\$7</b>
<b>LIABILITIES &amp; SHAREHOLDER'S EQUITY</b>				
Current liabilities	\$ 671,369	--	--	\$
Convertible debentures - net of discounts	123,362	--	--	
Senior notes	2,989,000			2
Shareholder's equity	3,818,367		\$ 200,000	4
<b>Total liabilities &amp; shareholder's equity</b>	<b>\$7,602,098</b>	<b>--</b>	<b>\$ 200,000</b>	<b>\$7</b>

Item 2. Management's Discussion and Analysis

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



## Edgar Filing: TELKONET INC - Form 10QSB

### Description of the Company

-----

Telkonet is a high technology systems application developer that focuses primarily on high-speed Internet distribution over the electrical power lines of commercial buildings, hotels, multi-dwelling residential units, government buildings and schools. Telkonet's 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 solution can be implemented more quickly and less expensively than adding dedicated wiring or installing wireless systems.

Since the Company's formation it has worked on the development of its commercial grade high speed Internet access product solution. The Company has recently 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 complex wireless networks which have coverage and security issues are the only solutions available today.

22

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 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 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 with 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 end 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.

Telkonet has applied for patents that cover the unique technology integrated into the PlugPlus family of products. The Company also continues 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 of the PlugPlus family of products.

## Edgar Filing: TELKONET INC - Form 10QSB

### Forward Looking Statements

-----

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

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

-----

#### Operations

-----

During the period ended September 30, 2003, Telkonet began its transition out of its development stage with the launch of its PlugPlus product suite. 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, 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 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.

23

#### Revenues

-----

To date, Telkonet has not generated any significant revenues as it was emerging from its development stage. Telkonet's management believes the Company will begin earning revenues from operations within the next three to six months as a result of the acceleration of its sales and marketing efforts. During the quarter, the Company doubled its sales and marketing staff with the addition of five industry experienced professionals. Also, with the participation in the hospitality, multi-dwelling and government trade shows, development and

## Edgar Filing: TELKONET INC - Form 10QSB

distribution of marketing collateral and targeted print and electronic advertising, a high level of qualified leads have been generated. Additionally, qualified Value Added Reseller partners have been added to promote our solution to their customer base which will augment our internal sales effort in both the U.S. and Canadian markets.

### Costs and expenses

-----

From its inception on November 3, 1999 through September 30, 2003, Telkonet has incurred operating expenses of \$9,946,831. These expenses were associated principally with compensation to employees, product development costs, professional services, sales and marketing and costs associated with non-employee stock options.

Overall expenses increased for the three and nine months ended September 30 2003 over the comparable period in 2002 by \$931,820 or 138% and \$2,334,665 or 121%, 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 and costs associated with non-employee stock options issued in connection with services rendered.

### Liquidity and Capital Resources

-----

To date, Telkonet has not generated any significant revenues to offset its development and organizational expenses. As a result of Telkonet's operating losses from its inception through September 30, 2003, Telkonet generated a cash flow deficit of \$7,938,137 from operating activities. As of September 30, 2003, Telkonet's current assets exceeded its current liabilities by \$6,800,875. Of the total current assets of \$7,472,245, cash represented \$6,807,358 of this amount as of September 30, 2003. For the period from inception through September 30, 2003, Telkonet has accumulated losses of \$11,908,445. Consequently, its operations are subject to all risks inherent in the establishment of a new business enterprise.

While Telkonet has raised sufficient 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 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.

During the period ended September 30, 2003, the Debenture-1 holders demanded registration of shares of Telkonet common stock sufficient to cover conversion of their debentures and exercise of the attached stock purchase warrants. Following this demand for registration, Telkonet notified the Series B Debenture holders, Senior Noteholders and warrant holders with piggy-back registration rights of their right to participate in the registration. Approximately 11.7 million shares of Telkonet common stock were registered in this registration. The registration statement was declared effective by the SEC on September 24, 2003.

In connection with the registration, certain Debenture-1 holders, Series B Debenture holders and Senior Noteholders exercised their nondetachable stock purchase warrants. Telkonet received approximately \$3.8 million in cash as a result of the exercise of warrants and converted approximately \$6.3 million of debt into equity as a result of the conversion of Debentures-1, Series B

## Edgar Filing: TELKONET INC - Form 10QSB

Debentures and Senior Notes into shares of Telkonet common stock. Moreover, on September 30, 2003, certain Senior Noteholders elected to use their Senior Notes as consideration for the exercise of certain warrants held by them. As a result, approximately \$2.0 million of the Senior Note debt was converted to equity upon exercise of the warrants and issuance of the underlying Telkonet common stock.

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.

24

### 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 nine months ended September 30, 2003 increased over the comparable period in 2002 by \$26,486 or 7.8% and \$21,753 or 2.3%, respectively. The increase in the three and nine month periods was primarily related to a \$20,000 employee relocation expense and an increase of one full-time equivalent headcount.

### Selling, General and Administrative

-----

Selling, general and administrative expenses increased for the three and nine months ended September 30, 2003 over the comparable period in 2002 by \$719,572 or 231% and \$1,829,308 or 204%, respectively. These increases were related to an increase in payroll and associated cost for management, sales and marketing resources, one-time costs associated with the Senior Note and Series B Debenture fundraising, including commissions and public relations and employee separation costs.

### Acquisition or Disposition of Plant and Equipment

-----

During the third quarter ended September 30, 2003, Telkonet purchased \$11,064 of fixed assets consisting primarily of computer equipment. 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 twelve months, other than leasehold improvements, computer equipment and peripherals used in Telkonet's day-to-day operations.

### Number of Employees

-----

As of September 30, 2003, Telkonet had 23 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.

### 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

## Edgar Filing: TELKONET INC - Form 10QSB

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.

### 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.

25

### 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 September 30, 2003, there were approximately 30,275,189 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 Telkonet's stock price.

### Item 3. Controls and Procedures.

As of September 30, 2003, Telkonet performed an evaluation, under the supervision and with the participation of management, including Chief Executive and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures as defined in rules 13a - 15(c) and 15d - 15(c) under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, the Chief Executive and Chief Financial Officer concluded that Telkonet's disclosure controls and procedures are effective in timely alerting them to material information required to be included in Telkonet's periodic filings with the U.S. Securities and Exchange Commission. There were no significant changes in Telkonet's internal controls or in other factors that could significantly affect these internal controls subsequent to the date of the most recent evaluation.

## Edgar Filing: TELKONET INC - Form 10QSB

### 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

On July 3, 2003, Telkonet agreed to issue 5,000 shares of common stock to The Research Works, Inc. as consideration for the preparation of a research report by The Research Works, Inc.

On July 7, 2003, Telkonet agreed to issue 5,000 shares of common stock to Market-Pulse Inc. as consideration for certain public relations services provided by Market Pulse.

On July 21, 2003, Telkonet agreed to issue 17,000 shares of common stock to CEOcast, Inc. as consideration for certain investor relations and consulting services provided by CEOcast, Inc.

On August 26, 2003, Telkonet sold 333 shares of our common stock to H.E. and Paula J. Fowler at a price of \$2.00 per share.

Each of the transactions described in this Item 2 were effected in reliance on the exemption from registration provided by Section 4(2) of the Securities Act of 1933 and/or Rule 506 of Regulation D promulgated thereunder.

On September 23, 2003, the SEC declared effective the Company's registration statement on Form S-1 for the registration of 11,714,503 shares of Telkonet common stock that may be offered and sold from time to time by certain selling stockholders listed in the registration statement. All net proceeds from the sale of Telkonet common stock will go to the selling stockholders selling common stock under the registration statement. The Company will not receive any proceeds from the sale of Telkonet common stock sold by the selling stockholders. The proceeds Telkonet receives from the exercise of warrants, the underlying shares of Telkonet common stock of which are included in the registration statement, will be used to expand sales and marketing efforts, support strategic partnership programs, build required infrastructure and fund working capital requirements.

26

#### Item 3. Defaults Upon Senior Securities

None

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

The Company held its annual meeting of stockholders ( the "Annual Meeting") on September 4, 2003. At the Annual Meeting, the Company's stockholders elected Warren V. Musser, Ronald W. Pickett, A. Hugo DeCesaris, David W. Grimes and Stephen L. Sadle (collectively, the "Nominees") to the Company's Board of

## Edgar Filing: TELKONET INC - Form 10QSB

Directors. The following lists the number of shares of common stock voted for and against each of the Nominees.

Nominee	Votes For	Against
Warren V. Musser	11,148,884	17,817
Ronald W. Pickett	11,149,284	17,417
A. Hugo DeCesaris	11,154,384	12,317
David W. Grimes	11,134,384	32,317
Stephen L. Sadle	11,154,186	12,515

The stockholders also voted at the Annual Meeting to approve stock option grants to certain officers and directors of the Company. 8,873,702 shares of common stock were voted in favor of and 58,712 shares of common stock were voted against the approval of such stock option grants. There were 213,671 abstentions and 2,020,616 broker non-votes with respect to such matter.

The stockholders also ratified at the Annual Meeting the appointment of Russell, Bedford, Stefanou and Mirchandani, LLP as Telkonet's independent public accountants for 2003. 11,113,050 shares of common stock were voted in favor of and 11,869 shares of common stock were voted against the ratification of the independent auditors. There were 41,782 abstentions and no broker non-votes with respect to such matter.

### Item 5. Other Information

None

### 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 Sarbanes-Oxley Act of 2002.
31.2	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 September 30, 2003.

None

### 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.

Edgar Filing: TELKONET INC - Form 10QSB

Telkonet, Inc.  
Registrant

Date: November 13, 2003  
-----

By: /s/ Ronald W. Pickett  
-----

Ronald W. Pickett  
President