

Edgar Filing: TELKONET INC - Form 10KSB

TELKONET INC
Form 10KSB
March 31, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-KSB

Annual Report Pursuant to Section 13 or 15(d) of the
Securities Exchange Act of 1934

For the fiscal year ended December 31, 2002

Commission file number: 0-27305

TELKONET, INC.

(Exact name of small business issuer as specified in its charter)

Utah
(State or other jurisdiction of
incorporation or organization)

87-0627421
(IRS Employee Identification No.)

435 Devon Park Drive Building 500
Wayne, Pennsylvania 19087
(Address of principal executive offices)

(610)- 971-1717
(Issuer's telephone number)

Securities Registered pursuant to section 12(g) of the Act: None

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

Check if disclosure of delinquent filers pursuant to Item 405 of Regulation S-B is not contained in this form, and no disclosure will be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB.

 X

State issuer's revenues for its most recent fiscal year: none

Aggregate market value of the voting stock held by non-affiliates of the registrant as of March 26, 2003: \$6,115,841

Number of outstanding shares of the registrant's par value \$0.001 common stock as of March 26, 2003: 15,721,131

Edgar Filing: TELKONET INC - Form 10KSB

TELKONET, INC.
FORM 10-KSB
INDEX

Part I

Item 1. Business.....

Item 2. Properties.....

Item 3. Legal Proceedings.....

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

Part II

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters.....

Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operation.....

Item 7. Financial Statements and Supplementary Data.....

Item 8. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.....

Part III

Item 9. Directors and Executive Officers of the Registrant.....

Item 10. Executive Compensation.....

Item 11. Security Ownership of Certain Beneficial Owners and Management.....

Item 12. Certain Relationships and Related Transactions.....

Part IV

Item 13. Exhibits, Financial Statement Schedule and Reports on Form 8-K.....

Item 14. Controls and Procedures.....

Signatures

Edgar Filing: TELKONET INC - Form 10KSB

ITEM 1. BUSINESS

When used in this Form 10-KSB, the words "expects," "anticipates," "estimates" and similar expressions are intended to identify forward-looking statements. Such statements are subject to risks and uncertainties, including those set forth below under "Risks and Uncertainties," that could cause actual results to differ materially from those projected. These forward-looking statements speak only as of the date hereof. The Company expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in the Company's expectations with regard thereto or any change in events, conditions or circumstances on which any statement is based. This discussion should be read together with the financial statements and other financial information included in this Form 10-KSB.

GENERAL

Telkonet, Inc. is an innovative creator of Powerline Communications (PLC) solutions for the commercial and industrial markets. Telkonet's PLC solutions utilize their patent-pending technology for the transmission of high-speed data, communications and Internet access over the existing electrical wiring in the buildings. With the Telkonet solution there is no need for costly additional wiring, and there is no disruption to business activity during the installation process. In many situations the Telkonet solution can be implemented more quickly and less expensively than adding dedicated wiring or installing wireless systems offering a viable and cost effective alternative to the challenges of wired and wireless LANs.

Telkonet, Inc. (hereinafter "The Company", "Telkonet" and "TCI"), a development stage company, was incorporated on November 1999 under the laws of the State of Utah. Its Articles of Incorporation provided for authorized capital of One hundred million (100,000,000) shares of Common Stock, par value \$0.001. The Company has authorized 15,000,000 shares of preferred stock, with a par value of \$.001 per share.

In 1999, Telkonet Communications, Inc. was formed to develop applications for the emerging power line carrier technologies. On August 30th, 2000, a Utah Corporation formerly known as Comstock Coal Company, Inc. was merged into Telkonet, Inc., NASDAQ - (OTCBB:"TLKO"), which as of December 31, 2002 has 15,721,131 million shares of common stock outstanding. Telkonet Communications, Inc. is a wholly owned subsidiary of Telkonet, Inc. As of March 26, 2003 there were 15,721,131 outstanding shares as referenced in Item# 12.

There has been no bankruptcy, receiverships, or similar proceedings by or against the Company. There has been no material reclassification, merger, consolidation, or purchase or sale of any significant asset(s).

The Company's principal executive offices are located at: 435 Devon Park Drive, Building 500 Wayne, Pennsylvania 19087

BUSINESS HISTORY

The Company was formed to design and develop high technology applications with a primary focus on high-speed Internet distribution over the existing electrical wiring in buildings. Telkonet believes that utilizing the electrical wiring to deliver Internet and telephony connectivity for the commercial and the multi-dwelling 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-speed data transmission rates. Because the existing electrical wiring is the most ubiquitous wired network in the home, or business, service providers and consumers can now avoid the expense, time and inconvenience of installing new wiring for LAN service. Consumers can achieve reliable, secure communications simply by plugging Telkonet's PlugPlusInternet devices into their existing standard electrical outlets.

In July 2001, the Company announced that it has completed the initial product development phase of their proprietary communications system, which utilizes the existing electrical wiring infrastructure in residential and commercial buildings for Internet connectivity.

In August 2001, the Company announced that successful system tests were recently performed in the Washington D.C. metropolitan area, where Telkonet's PlugPlusInternet connectivity solution was demonstrated in a 28-unit residential apartment building and a 5-story commercial office building. High-speed data connectivity was successfully achieved from the basements to the farthest receptacles on the top floors.

In January 2002, the Company announced that it had shifted its management emphasis from R&D to product sales and marketing in order to move their initial proprietary products into the commercial market. Extensive research and product testing conducted over the previous three years, demonstrated the product's robust capacity and aroused industry demand for the Company's initial proprietary products.

The Board of Directors, Founders and Executive Management reassessed Telkonet's initial capital structure. Agreements were reached on a realignment of the initial Founders' share distribution in order to attract additional management and marketing expertise, and to raise the necessary capital for manufacturing, sales, and marketing. The Founders agreed to surrender 8.9 million shares of their current stock and 560,000 option positions in the capital realignment. This re-allocation of Founders stock and option positions retain the Founders core competence in the Company, provides each with fair and equitable stock positions, an orderly method of liquidity, and reduces the dilution factor for shareholders thus helping to attract perspective management talent and potential investors. The net effect of the recapitalization reduced the number of shares outstanding from approximately 22.1 to 13.9 million shares.

In May 2002 the Company announced that it had successfully concluded an offering of 8%, three year, convertible debentures raising approximately \$1.7 million dollars for working capital purposes. In November 2002, the Company announced the successful installation of its PlugPlusInternet solution at the historic Partridge Inn in Augusta, Georgia. The installation provided high-speed Internet connectivity to guest rooms, meeting rooms and a lobby kiosk.

In July 2002 at the Annual Meeting of Stockholders of Telkonet, Inc. the Company's shareholders ratified the Telkonet Stock Option Plan, which on April 24, 2002, the Board of Directors adopted, subject to stockholder approval. The plan provides for the grant of stock options to employees, officers, consultants, independent contractors and non-employee directors providing services to Telkonet, as determined by the Board of Directors or by a committee of directors designated by the Board of Directors to administer the plan. The plan provides for the issuance of up to 7,000,000 shares of Telkonet common stock, subject to adjustment in the event of stock dividends, recapitalization,

Edgar Filing: TELKONET INC - Form 10KSB

stock splits, reorganizations, mergers, consolidations or other similar changes in the corporate or capital structure of Telkonet. have been reacquired by Telkonet. The types of awards that may be granted under the plan are stock options, restricted stock and stock appreciation rights. Options granted pursuant to the plan will not be transferable without the approval of the Board

4

of Directors, other than by will or by the laws of descent and distribution. During the lifetime of a participant, an award may be exercised only by the participant to whom such award is granted. The full text of the plan is attached as exhibit 10.1.

In December 2002, the Company announced the installation of a product field trial at the Marriott Residence Inn-Landfall in Wilmington, NC. Telkonet implemented a hotel wide PLC system based on the use of its PlugPlusInternet Gateway for providing connectivity to the hotels 90 guest rooms, meeting rooms, common areas and a lobby kiosk.

The Company announced that the Board of Directors unanimously elected Mr. Ronald W. Pickett as Chairman of Board, President and interim CEO. Mr. Pickett had fostered the development of Telkonet since 1999 as the Company's principle investor and stepped forward in December 2002 to take an active leadership role in the Company.

The Company announced that, Company Founders David Grimes and Stephen Sadle retired 1,805,400 shares of the Company's common stock in exchange for the cancellation of a note reducing the total outstanding number of shares of common stock in the Company by approximately 9% from 17,526,531 shares to 15,721,131 shares.

In January 2002, the Company announced that they had satisfactorily complied with Parts 2 and 15 of Title 47 of the Code of Federal Regulations of the Federal Communications Commission ("FCC") to market their Powerline Communications. The rules of the Federal Communications Commission ("FCC") permit the operation of unlicensed digital devices that radiate radio frequency emissions if the manufacturer complies with certain equipment authorization procedures, technical requirements, marketing restrictions and product labeling requirements. An independent, FCC-certified testing lab has verified that Telkonet's gateway PLC device complies with the FCC technical requirements for Class A digital devices. No further testing of this device is required; the device may be manufactured and marketed for commercial use. Additional devices designed by Telkonet for commercial and residential use are subject to the FCC rules for unlicensed digital devices. Unlicensed digital devices for sale to the general public, without restriction, must meet the FCC's technical requirements for Class B devices, and must be verified for compliance by an independent FCC-certified testing lab.

The Company announced that the Board of Directors unanimously elected Warren V. "Pete" Musser as Chairman of Board. Mr. Musser is the Managing Director of The Musser Group and Chairman Emeritus of Safeguard Scientifics, Inc. - (NYSE: SFE).

The Company announced that the Board of Directors unanimously elected Howard Lubert as Chief Executive Officer. Mr. Lubert brings to Telkonet over three decades of diversified expertise, which includes: Technical due diligence and business acceleration services for Safeguard Scientifics in Infrastructure, Internet/e-Business and Telecommunications. Internet, Intranet, Extranet and e-Commerce strategy and implementation expertise as an e. Business service line leader with Deloitte & Touche. PC, Local and Wide Area Networking experience as the founder/president of HEL INC. (Integration, Networking & Connectivity).

Edgar Filing: TELKONET INC - Form 10KSB

General Systems Division of IBM, marketing mid-range computer systems in the manufacturing, distribution, hospitality and not-for-profit vertical markets. Mr. Lubert is a nationally recognized speaker who has lectured on e. Business technologies, Web Content Management and Community Solutions, e. Business integration, The Financial and Human Capital Issues of e. Business.

In February 2003 the Company announced that they had successfully concluded an offering of 8%, three year, convertible debentures raising \$2.5 million dollars for working capital purposes.

5

In March 2003 the Company announced that it had entered into a strategic alliance agreement with Choice Hotels International (NYSE:CHH), one of the largest hotel franchise companies in the world with more than 3,500 hotels, inns, all-suite hotels and resorts open and under development in 46 countries under the Comfort Inn, Comfort Suites, Quality, Clarion, Sleep Inn, Rodeway Inn, EconoLodge and MainStay Suites brand names. The Choice Hotels-Telkonet agreement is an initial two-year contract, wherein Telkonet will become a Choice Endorsed Vendor offering Telkonet's "PlugPlusInternet" high-speed Internet access service to Choice Hotels U.S. franchisees. Telkonet and Choice Hotels will undertake cooperative efforts for the marketing, advertising and promotion of Telkonet's Internet access solution to their franchisees prior to and through the Choice Hotels national convention, May 7-9 in Orlando, Florida. Choice Hotel franchisees that take advantage of Telkonet's "Early Adopter Program" will receive a discount by scheduling prior to or at the national convention.

Telkonet Communications, Inc. is now at a point in the Company's business development cycle where the system requirements and hardware have been developed, customer feedback is highly positive, markets and marketing strategies have been identified and management has put in place a sales and marketing organization to leverage its core strengths for maximum impact. Products for the hospitality market are scheduled for installation in May 2003. The Company has applied for patents that cover its unique technology, and has utilized the recently announced advancements in transmission speeds to build its next generation of products that will be launched into the hospitality market. The Company 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. It is the intent of the Company to protect this Intellectual Property by filing additional Patent applications.

The majority of data network systems in place today are comprised of wired network connections requiring high construction costs and disruption of the workplace, or complex wireless networks, which have coverage and security issues. As the Internet becomes more and more critical to business operations, newly manufactured PC's and laptop computers are configured with high-speed Internet connections and the consumer demand for higher access speeds will fuel the need for more effective broadband solutions.

In many situations the Telkonet PlugPlusInternet family of Internet access products can be implemented more quickly and less expensively than installing dedicated wiring or wireless systems offering a viable and cost effective alternative to the challenges of wired and wireless LANs.

The Telkonet solution consists of two parts-the PlugPlusInternet Gateway and the PlugPlusInternet Modem. The Gateway is a modular, self-contained unit that accepts data from an existing network on one port and distributes it via the second. The most common configuration of the gateway is 10BaseT Ethernet (ETH)

Edgar Filing: TELKONET INC - Form 10KSB

on one side and power line carrier (PLC) on the other. The intelligent backbone of the Gateway is a fast communications processor running a series of proprietary applications under Linux. Other useful configurations of the Gateway are PLC-PLC to bridge data around a physical block to the signal (e.g. from old to new sections of a building that do not share common wiring). Another useful configuration is PLC to wireless access point (WAP) to provide immediate line-of-sight wireless access in a large office. The PLC signal generated by the Gateway can be directly coupled into low voltage wiring via the power cord of the Gateway itself.

In addition, the PLC signal may be routed to a remote injection point via an inexpensive coaxial cable. This allows the Telkonet solution to couple into the medium voltage and multi-phase environments found in commercial buildings. A suite of software applications running on the Gateway can be roughly classified as performing communications functions or system management functions. As an example of the supported management functions, the gateway provides for remote management of the network via a Telnet (command line) interface and remote updating of its own firmware. The gateway is optimized to network with dozens of

6

PlugPlusInternet Modems and provides scalable, robust solution for the commercial market. The PlugPlusInternet Modem is a small, self-contained unit with a standard 110V plug on one side and an Ethernet RJ-45 connector on the other. This intelligent Modem in conjunction with the gateway provides the enhanced communications and management functions required by enterprise customers.

The current generation of the Telkonet PlugPlusInternet system delivers data at speeds in excess of 7 Mega bits per second (Mbps), with burst speeds of 12.6 Mbps. The Telkonet PlugPlusInternet system is installed by connecting the incoming broadband signal (DSL, TL, Satellite, and Cable Modem) into the Gateway and then connecting the Gateway to the buildings electrical panel, which distributes the high-speed Internet signal throughout the entire existing network of electrical wires within the building. The user accesses the high-speed Internet signal by plugging the PlugPlusInternet Modem into any electrical outlet and then plugging their computer Ethernet connection into the Modem. Many PCs, each equipped with one Telkonet PlugPlusInternet Modem, can communicate with one another and can share a single broadband resource via the Telkonet PlugPlusInternet Gateway.

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

BUSINESS DEVELOPMENT

Telkonet's focus is on high-speed Internet distribution over the existing electrical wiring for the commercial, hospitality and multi-dwelling markets. Telkonet has designed and constructed their powerline communication products to

Edgar Filing: TELKONET INC - Form 10KSB

provide high-speed Internet access to office buildings, hotels, schools, shopping malls, commercial buildings, and multi-dwelling units. The Company 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.

The demand for broadband Internet access from the business traveler and multi-dwelling market continues to grow. There are an ever-increasing number of consumers and small businesses with multiple PC's. These factors continue to create a very strong need for residential and in-building networks. According to industry analysts, the market for home and building networks will represent a \$26 Billion market worldwide for the next 4 years.

MARKETING STRATEGY

Management has focused on the commercial sector, initially targeting the hospitality markets with a direct Sales effort (at the regional and national level). The multi-unit dwelling, government, and international markets will follow, accessed through network administrator and systems administrator partners (incorporating the system as a high value added offering to existing customers). These markets have rapidly growing demand for broadband and are now primarily served by wired and wireless technologies, which are costly to install and have significant ongoing costs.

Target markets for Telkonet include office buildings, hotels, schools, shopping malls, commercial buildings, and multi-dwelling units, government facilities, and any other commercial facilities that have a need for Internet access and

7

network connectivity. Telkonet will continue to examine, select and approach entities with existing distribution channels that will be enhanced by the Company's offerings. Several DSL, fiber and satellite access providers have indicated interest in Telkonet's solutions. Our products will allow them to reach whole new classes of users, enhance their product offerings, and ultimately provide a vehicle for incremental revenue.

Additional marketing opportunities exist in Europe, South America, Asia and Pac Rim where the Internet is available. Access to the Internet is restricted in some developing countries by the limitation of the infrastructure of the basic Public Service Telephone Network and the pricing methodology of charging the user for every minute that the user is on line. The Telkonet solution would allow economical access to the Internet by simply bypassing the per-minute charge to the user when implemented in conjunction with a 2-way satellite link, dedicated landline or fixed wireless access.

KEY TELKONET ADVANTAGES:

No special cabling or expensive wiring required for hotels, office buildings or multi-dwelling residential complexes to provide Internet connection. The Telkonet PlugPlusInternet family of commercial products provides excellent connectivity over the existing electrical wiring and does not require the costly installation of additional wiring, or major disruption of business activity. In many situations the PlugPlusInternet system can be implemented quicker and less expensively than adding dedicated wiring or installing a wireless system offering a viable and cost effective alternative to the challenges of wired and wireless LANs.

Edgar Filing: TELKONET INC - Form 10KSB

Competition

Several established networking vendors, including Linksys and Netgear, have planned and/or announced Powerline Communications products that are compliant with the HomePlug Alliance. Both Linksys and Netgear are focused on products for the home and residential marketplace. Telkonet finds potential competitors to actually be complementary in nature and a validation of the viability of the powerline communications market overall. While these companies may choose to move into the commercial market at a future date, at this time they do not represent a direct threat to Telkonet. Telkonet is specifically focused on the needs of the commercial customer where issues like security, support for greater distances, a larger number of users, and enhanced network management preclude the use of a product developed to suit the home market.

Employees

Currently, the Company has 14 full time employees. Additional key staff is planned in the areas of business development, sales and marketing, and engineering.

Government Regulations

The rules of the Federal Communications Commission ("FCC") permit the operation of unlicensed digital devices that radiate radio frequency emissions if the manufacturer complies with certain equipment authorization procedures, technical requirements, marketing restrictions and product labeling requirements. An independent, FCC-certified testing lab has verified that Telkonet's gateway PLC device complies with the FCC technical requirements for Class A digital devices. No further testing of this device is required; the device may be manufactured and marketed for commercial use. Additional devices designed by Telkonet for commercial and residential use are subject to the FCC rules for unlicensed digital devices. Unlicensed digital devices for sale to the general public, without restriction, must meet the FCC's technical requirements for Class B devices, and must be verified for compliance by an independent FCC-certified testing lab.

8

Raw Materials

The Company does not rely on any one or more raw materials or raw material suppliers for the normal course of business. The Company has developed relationships with a cross-section of qualified and quality providers of components and parts necessary for the Company's product line, and uses multiple vendors for certain items dependent on internal purchasing criteria, inclusive of price, delivery schedule and specification evaluation.

Intellectual Property

From the Company's inception, Telkonet has continued to pursue the perfection of its technology and enhance its core technological values. The company believes they have developed certain Intellectual Property and have filed both provisional and standard patent applications with the United States Patent and

Edgar Filing: TELKONET INC - Form 10KSB

Trademark Office. There can be no assurance that any of the Company's current or future patent applications will be granted, or will provide necessary protection for the Company's technology or their product offerings, or be of commercial benefit to the Company, or that these patent applications will not be challenged.

Customers

The Company is neither limited to nor reliant upon a single or narrowly segmented consumer base from which to derive its revenues. As a result of the Company's market research, customers will be developed from within four strategic markets, which includes: hospitality, multi-dwelling, Government, and International markets.

ITEM 2. PROPERTIES

The Company currently leases office space at 902A Commerce Drive, Annapolis, MD 21401, which occupies approximately 3,000 square feet of designated office space, designed to provide short term/temporary accommodation solution to emerging and growing businesses. The facility allows businesses to lease spaces on a short-term or project basis. These office quarters are adequate for the immediate short term. The Company anticipates the need for additional office space in conjunction with the projected personnel requirements in the business plan. The Company's principal executive offices are located at: 435 Devon Park Drive, Building 500 Wayne, Pennsylvania 19087.

- (a) Real Estate- None
- (b) Computer and Office Equipment- \$75,000

ITEM 3. LEGAL PROCEEDINGS

The Company is not a party to any legal proceedings.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

Matters submitted during the fiscal year covered by this report to a vote of security holders of the Company, through the solicitation of proxies consisted of the annual election of Directors and the appointment of independent accountants at the annual shareholders meeting held on Friday July 29, 2002.

9

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

- (a) The Company's Common Shares are currently quoted on NASDAQ -Over The Counter Bulletin Board market under the ticker symbol (OTCBB:"TLKO").
- (b) As of December 31, 2002, the Company had approximately 208 shareholders of record of the common stock.
- (c) No dividends on outstanding common stock have been paid within the last two fiscal years, and interim periods. The Company does not anticipate or intend upon paying dividends for the foreseeable future.

Edgar Filing: TELKONET INC - Form 10KSB

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

The following discussion contains forward-looking statements that are subject to significant risks and uncertainties. There are several important factors that could cause actual results to differ materially from historical results and percentages and results anticipated by the forward-looking statements. The Company has sought to identify 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 assurance that the Company has identified all possible risks that might arise. Investors should carefully consider all of such risks before making an investment decision with respect to the Company's stock. In particular, investors should refer to the section entitled, "Factors that May Affect Future Results and Market Price of Stock".

Plan of Operation

The Company is still in the development stage and is yet to generate revenues from operations. The Company 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 requiring high-speed Internet access utilizing the Company's products, the Company's ability to acquire and deliver high quality products at a price lower than currently available to consumers, the Company's ability to obtain additional financing in a timely manner and on terms favorable to the Company, the Company's ability to successfully attract customers at a steady rate and maintain customer satisfaction, Company promotions, branding and sales programs, the amount and timing of operating costs and capital expenditures relating to the expansion of the Company's business, operations and infrastructure and the implementation of marketing programs, key agreements and strategic alliances, the number of products offered by the Company, the number of returns experienced by the Company, and general economic conditions specific to the Internet, power-line communications, and the communications industry.

Revenues

Telkonet is transitioning from a development stage company to that of an active growth and acquisition stage company. Initial hospitality market revenues are projected to commence in the second quarter 2003 primarily driven by the recent Strategic Alliance Agreement with Choice Hotels International wherein Telkonet became a Choice Endorsed Vendor thereby offering its high-speed Internet access solution to Choices 3,500 U.S. hotel franchisees.

10

Costs and expenses

From its inception on November 3, 1999 through December 31, 2002, the Company has not generated any revenues. The Company has incurred total costs and expenses of \$6,458,676 during this period. These expenses were associated principally with compensation to employees, product development costs, amortization of debt discount costs related to the Company's convertible debentures, and issuance of equity-based compensation to non-employees in exchange for consulting services and financing.

Liquidity and Capital Resources

Edgar Filing: TELKONET INC - Form 10KSB

As of December 31, 2002, the Registrant had a deficiency in working capital of \$894,403. To date the Company has no operating revenues, has incurred expenses, and has sustained losses from operating activities. As a result of the Company's operating losses from its inception through December 31, 2002, the Registrant generated a cash flow deficit of \$4,100,225 from operating activities. Cash flows used in investing activities was \$112,502 during the period November 3, 1999 through December 31, 2002. The Company met its cash requirements during this period through the private placement of \$1,751,224 of the Company's common stock, loan proceeds (net of repayments) of \$440,330 from banks and shareholders, and \$2,040,000 proceeds (net of financing fess) from issuance of convertible debentures.

While the Company has raised capital to meet its working capital and financing needs in the past, additional financing is required in order to meet the Company's current and projected cash flow deficits from operations and development. Such financing may be upon terms that are dilutive or potentially dilutive to our shareholders. The Company is presently seeking financing in the form of debt or equity in order to provide the necessary working capital. The Company currently has no commitments for financing. There are no assurances the Company will be successful in raising the funds required.

By adjusting its operations and development to the level of capitalization, 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 affect on our business, results of operations, liquidity and financial condition.

The independent auditors report on the Company's December 31, 2002 financial statements included in this Form states that the Company's recurring losses raise substantial doubt about the Company'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 expensed in the period incurred. Total expenditures on research and product development for the period November 3, 1999 (date of inception) through December 31, 2002 were \$520,278. We anticipate continuing to incur approximately \$500,000 in research and development expenditures in connection with the development of Telkonet PlugPlusInternet system the Telkonet PlugPlusInternet Gateway and the Telkonet PlugPlusInternet Modem.

These projected expenditures are dependent upon our generating revenues and obtaining sources of financing in excess of our existing capital resources. There is no guarantee that we will be successful in raising the funds required or generating revenues sufficient to fund the projected costs of research and development during the next twelve months.

11

Acquisition or Disposition of Plant and Equipment

We do not anticipate the sale of any significant property, plant or equipment during the next twelve months. The Company does not anticipate the acquisition of any significant property, plant or equipment during the next 12 months, other

Edgar Filing: TELKONET INC - Form 10KSB

than computer equipment and peripherals used in the day-to-day operations. We believe we have sufficient resources available to meet these acquisition needs.

Number of Employees

As of March 26, 2003, the Company had fourteen (14) full time employees. In order for the Company to attract and retain quality personnel, the Company anticipates it will continue to offer competitive salaries to current and future employees. The Company anticipates increasing its employment base to meet the needs outlined in the business plan.

As the Company continues to expand, the Company will incur additional costs for personnel. This projected increase in personnel is dependent upon the Company generating revenues and obtaining sources of financing in excess of our existing capital resources. There are no assurances the Company will be successful in raising the funds required or generating revenues sufficient to fund the projected increase in the number of employees.

Trends, Risks and Uncertainties

The Company 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 the Company has identified all possible risks that might arise. Investors should carefully consider all of such risk factors before making an investment decision with respect to the Company's stock.

Limited Operating History; Anticipated Losses; Uncertainty of Future Results.

Telkonet has only a limited operating history upon which an evaluation of the Company and its prospects can be based. The Company'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 distribution methods with which the Company intends to operate and the acceptance of the Company's business model. The Company will continue to incur costs to develop, introduce and enhance its interactive website, 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, the Company's business, results of operations and financial condition will be materially adversely affected. There can be no assurance that the Company will be able to generate sufficient revenues from the sale of their first product suite, and other product candidates. The Company expects negative cash flow from operations to continue for the next 12 months as it continues to develop and market its business. If cash generated by operations is insufficient to satisfy the Company's liquidity requirements, the Company may be required to sell additional equity or debt securities. The sale of additional equity or convertible debt securities would result in additional dilution to the Company's stockholders.

12

Potential Fluctuations in Quarterly Operating Results

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

Edgar Filing: TELKONET INC - Form 10KSB

high-tech goods; seasonal trends in both Internet use, the amount and timing of capital expenditures and other costs relating to the expansion of the Company's operations; price competition or pricing changes in the industry; technical difficulties or system downtime; general economic conditions, and economic conditions specific to the Internet and Communications Industry. The Company's quarterly results may also be significantly impacted by the impact of the accounting treatment of acquisitions, financing transactions or other matters. Particularly at the Company's early stage of development, such accounting treatment can have a material impact on the results for any quarter. Due to the foregoing factors, among others, it is likely that the Company's operating results will fall below the expectations of the Company or investors in some future quarter.

Limited Public Market, Possible Volatility of Share Price

The Company's Common Stock is currently quoted on the NASDAQ - (OTCBB: "TLKO") As of December 31, 2002, there were 15,721,131 shares of Common Stock outstanding. As of March 26, 2003 there were 15,721,131 outstanding shares as referenced in Item# 12.

Telkonet Communications, Inc. is a wholly owned subsidiary of Telkonet. 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 the Company or its competitors, failure to meet security analysts' expectations, government regulatory action, patent or proprietary rights developments, and market conditions for technology stocks in general could have a material adverse effect on the volatility of the Company's stock price.

New Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141, "Business Combinations" (SFAS No. 141), and Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" (SFAS No. 142). The FASB also issued Statement of Financial Accounting Standards No. 143, "Accounting for Obligations Associated with the Retirement of Long-Lived Assets" (SFAS No. 143), and Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (SFAS No. 144) in August and October 2001, respectively.

SFAS No. 141 requires the purchase method of accounting for business combinations initiated after June 30, 2001 and eliminates the pooling-of-interest method. The adoption of SFAS No. 141 had no material impact on the Company's consolidated financial statements.

Effective January 1, 2002, the Company adopted SFAS No. 142. Under the new rules, the Company will no longer amortize goodwill and other intangible assets with indefinite lives, but such assets will be subject to periodic testing for impairment. On an annual basis, and when there is reason to suspect that their values have been diminished or impaired, these assets must be tested for impairment, and write-downs to be included in results from operations may be necessary. SFAS No. 142 also requires the Company to complete a transitional goodwill impairment test six months from the date of adoption.

Any goodwill impairment loss recognized as a result of the transitional goodwill impairment test will be recorded as a cumulative effect of a change in accounting principle no later than the end of fiscal year 2002. The adoption of SFAS No. 142 had no material impact on the Company's consolidated financial statements.

SFAS No. 143 establishes accounting standards for the recognition and measurement of an asset retirement obligation and its associated asset retirement cost. It also provides accounting guidance for legal obligations associated with the retirement of tangible long-lived assets. SFAS No. 143 is effective in fiscal years beginning after June 15, 2002, with early adoption permitted. The Company expects that the provisions of SFAS No. 143 will not have a material impact on its consolidated results of operations and financial position upon adoption. The Company plans to adopt SFAS No. 143 effective January 1, 2003.

SFAS No. 144 establishes a single accounting model for the impairment or disposal of long-lived assets, including discontinued operations. SFAS No. 144 superseded Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" (SFAS No. 121), and APB Opinion No. 30, "Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions". The Company adopted SFAS No. 144 effective January 1, 2002. The adoption of SFAS No. 144 had no material impact on Company's consolidated financial statements.

In April 2002, the FASB issued Statement No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." This Statement rescinds FASB Statement No. 4, "Reporting Gains and Losses from Extinguishment of Debt", and an amendment of that Statement, FASB Statement No. 64, "Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements" and FASB Statement No. 44, "Accounting for Intangible Assets of Motor Carriers". This Statement amends FASB Statement No. 13, "Accounting for Leases", to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. The Company does not expect the adoption to have a material impact to the Company's financial position or results of operations.

In June 2002, the FASB issued Statement No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." This Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. The Company does not expect the adoption to have a material impact to the Company's financial position or results of operations.

In October 2002, the FASB issued Statement No. 147, "Acquisitions of Certain Financial Institutions—an amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9", which removes acquisitions of financial institutions from the scope of both Statement 72 and Interpretation 9 and requires that those transactions be accounted for in accordance with Statements No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets. In addition, this Statement amends SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, to include in its scope long-term customer-relationship intangible assets of financial institutions such as depositor- and borrower-relationship intangible assets and credit cardholder intangible assets. The requirements relating to acquisitions of financial institutions is effective for acquisitions for which the date of acquisition is on or after October 1,

Edgar Filing: TELKONET INC - Form 10KSB

2002. The provisions related to accounting for the impairment or disposal of certain long-term customer-relationship intangible assets are effective on October 1, 2002. The adoption of this Statement did not have a material impact to the Company's financial position or results of operations as the Company has not engaged in either of these activities.

14

In December 2002, the FASB issued Statement No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure", which amends FASB Statement 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 Statement 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 transition guidance and annual disclosure provisions of Statement 148 are effective for fiscal years ending after December 15, 2002, with earlier application permitted in certain circumstances. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. The adoption of this statement did not have a material impact on the Company's financial position or results of operations as the Company has not elected to change to the fair value based method of accounting for stock-based employee compensation.

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities." Interpretation 46 changes the criteria by which one company includes another entity in its consolidated financial statements. Previously, the criteria were based on control through voting interest. Interpretation 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. A company that consolidates a variable interest entity is called the primary beneficiary of that entity. The consolidation requirements of Interpretation 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established. The Company does not expect the adoption to have a material impact to the Company's financial position or results of operations.

Risk Factors that may affect future results and market price of stock

The business of the Company involves a number of risks and uncertainties that could cause actual results to differ materially from results projected in any forward-looking statement, or statements, made in this report. These risks and uncertainties include, but are not necessarily limited to the risks set forth below. The Company's securities are speculative and investment in the Company's securities involves a high degree of risk and the possibility that the investor will suffer the loss of the entire amount invested.

LIMITED OPERATING HISTORY; ANTICIPATED LOSSES; UNCERTAINTY OF FUTURE RESULTS

The Company was organized in 1999, and has no operating history upon which an evaluation of its business and prospects can be based. The Company's prospects must be evaluated with a view to the risks encountered by a company in an early

Edgar Filing: TELKONET INC - Form 10KSB

stage of development, particularly in light of the uncertainties relating the acceptance of the Company's business model.

The Company will be incurring additional costs to further develop and market its powerline communications solutions, and to build an administrative organization. There can be no assurance that the Company will be profitable on a quarterly or annual basis. In addition, as the Company expands its business network and marketing operations it will likely need to increase its operating expenses, broaden its sales and customer support capabilities, and increase its administrative resources. To the extent that such expenses are not subsequently followed by commensurate revenues, the Company's business, results of operations and financial condition will be materially adversely affected.

15

It is possible that revenues from the Company's operations may not be sufficient to finance its initial operating cost to reach breakeven. If this were to occur, the Company would need to raise or find additional capital. While the Company has raised capital to meet its working capital and financing needs in the past, additional financing is required in order to meet the Company's current and projected cash flow deficits from operations and development. Such financing may be upon terms that are dilutive or potentially dilutive to our shareholders. The Company is presently seeking financing in the form of debt or equity in order to provide the necessary working capital. The Company currently has no commitments for financing. There are no assurances the Company will be successful in raising the funds required. While the Company expects to be able to meet its financial obligations for approximately the next twelve months, there is no assurance that, after such period, the Company will be operating profitably. If they are not, there can be no assurance that any required capital would be obtained on terms favorable to the Company. Failure to obtain adequate additional capital on favorable terms could result in significant delays in the expansion of new services and market share and could even result in the substantial curtailment of existing operations and services to clients, and have a material adverse affect on our business, results of operations, liquidity and financial condition.

UNPREDICTABILITY OF FUTURE REVENUES: POTENTIAL FLUCTUATIONS IN QUARTERLY RESULTS.

As a result of the Company's lack of operating history and the emerging nature of the commercial powerline communications market in which it competes, the Company is unable to accurately forecast its revenues. The Company's current and future expense levels are based largely on its investment/operating plans and estimates of future revenue and are to a large extent based on the Company's own estimates. Sales and operating results generally depend on the volume of, timing of, and ability to obtain customers, orders for services received, and revenues there from generated. These are, by their nature, difficult at best to forecast.

The Company may be unable to adjust spending in a timely manner to compensate for any unexpected revenue shortfall or delay. Accordingly, any significant shortfall or delay in revenue in relation to the Company's planned expenditures would have an immediate adverse affect on the Company's business, financial condition, and results of operations. Further, in response to changes in the competitive environment, the Company may from time to time make certain pricing, service, or marketing decisions that could have a material adverse effect on the Company's business, financial condition, operating results, and cash flows.

DEVELOPING MARKET: ACCEPTANCE OF THE INTERNET AS A MEDIUM FOR COMMERCE JUST NOW

Edgar Filing: TELKONET INC - Form 10KSB

BEING PROVEN.

The Company's long-term viability is substantially dependent upon the continued widespread acceptance and use of the Internet as a medium for business commerce, in terms of the sales of both products and services to businesses and individuals. The use of the Internet as a means of business sales and commerce is has only recently reached a point where many companies are making reasonable profits from their endeavors therein, and there can be no assurance that this trend will continue.

The Internet has experienced, and is expected to continue to experience, significant growth in the number of users and amount of traffic. There can be no assurance that the Internet infrastructure will continue to be able to support the demands placed on it by this continued growth. In addition, delays in the development or adoption of new standards and protocols to handle increased levels of Internet activity or increased governmental regulation could slow or stop the growth of the Internet as a viable medium for business commerce. Moreover, critical issues concerning the commercial use of the Internet (including security, reliability, accessibility and quality of service) remain unresolved and may adversely affect the growth of Internet use or the attractiveness of its use for business commerce.

16

The failure of the necessary infrastructure to further develop in a timely manner, or the failure of the Internet to continue to develop rapidly as a valid medium for business would have a material adverse effect on the Company's business, financial condition, operating results, and cash flows.

UNPROVEN ACCEPTANCE OF THE COMPANY'S SERVICES AND/OR PRODUCTS

The Company is still in its development stage. As a result, it does not know with any certainty whether its services and/or products will be accepted within the business marketplace. If the Company's services and/or products prove to be unsuccessful within the marketplace, or if the Company fails to attain market acceptance, it could materially adversely affect the Company's financial condition, operating results, and cash flows.

DEPENDENCE ON KEY PERSONNEL

The Company's performance and operating results are substantially dependent on the continued service and performance of its officer and directors. The Company intends to hire additional technical, sales, and other personnel as they move forward with their business model. Competition for such personnel is intense, and there can be no assurance that the Company can retain its key technical employees, or that it will be able to attract or retain highly qualified technical and managerial personnel in the future. The loss of the services of any of the Company's key employees or the inability to attract and retain the necessary technical, sales, and other personnel could have a material adverse effect upon the Company's business, financial condition, operating results, and cash flows. The Company does not currently maintain "key man" insurance for any of its key employees.

DEPENDENCE ON THE INTERNET

Online companies have experienced interruptions in their services as a result of outages and other delays occurring due to problems with the Internet network infrastructure, disruptions in Internet access provided by third-party providers or failure of third party providers to handle higher volumes of user traffic. If

Edgar Filing: TELKONET INC - Form 10KSB

Internet usage grows, the Internet infrastructure or third-party service providers may be unable to support the increased demands which may result in a decline of performance, reliability or ability to access the Internet. If outages or delays frequently occur in the future, Internet usage, as well as usage of the Company's Internet Web-sites, could grow more slowly or decline.

COMPETITION

The powerline communications solutions market in which the Company will operate is very competitive. Many competitors have substantially greater, financial, technical, marketing, and distribution resources than the Company.

In all its markets, the Company competes against a large number of companies of varying sizes and resources. There are an increasing number of competitive services and products offered by a growing number of companies. Increased competition in any service or product area may result in a loss of a client, reduction in sales revenue, or additional price competition, any of which could have a material adverse effect on the Company's operating results. In addition, existing competitors may continue to broaden their service and/or product lines and other potential competitors may enter or increase their presence in the powerline communications solutions market, resulting in greater competition for the Company.

Most of the Company's current and potential competitors have substantially longer operating histories, larger customer bases, greater name and service recognition, and significantly greater financial, marketing, and other resources

17

than the Company. In addition, competitors may be acquired by, receive investments from or enter into other commercial relationships with larger, well-established and well-financed companies as the use of the Internet and other online services increases. Many of the Company's competitors may be able to respond more quickly to changes in customer preferences/needs, devote greater resources to marketing and promotional campaigns, adopt more aggressive pricing policies and devote substantially more resources to Internet site and systems development than the Company.

It is possible that new competitors or alliances among competitors may emerge and rapidly acquire market share. Increased competition may result in reduced operating margins and/or loss of market share, either of which could materially adversely affect the Company's business, results of operations and financial condition. There can be no assurance that the Company will be able to compete successfully against current or future competitors or alliances of such competitors, or that competitive pressures faced by the Company will not materially adversely affect its business, financial condition, operating results and cash flows.

INTELLECTUAL PROPERTY RIGHTS

As part of its confidentiality procedures, the Company expects to enter into nondisclosure and confidentiality agreements with its key employees, and any consultants and/or business partners and will limit access to and distribution of its technology, documentation, and other proprietary information.

Despite the Company's efforts to protect any intellectual property rights it may have, unauthorized third parties, including competitors, may from time to time copy or reverse-engineer certain portions of the Company's technology and use such information to create competitive services and/or products.

Edgar Filing: TELKONET INC - Form 10KSB

It is possible that the scope, validity, and/or enforceability of the Company's intellectual property rights could be challenged by other parties, including competitors. The results of such challenges before administrative bodies or courts depend on many factors, which cannot be accurately assessed at this time. Unfavorable decisions by such administrative bodies or courts could have a negative impact on the Company's intellectual property rights. Any such challenges, whether with or without merit, could be time consuming, result in costly litigation and diversion of resources, and cause service or product delays. If such events should occur, the Company's business, operating results and financial condition could be materially adversely affected.

RISKS OF TECHNOLOGY TRENDS AND EVOLVING IINDUSTRY STANDARDS

The Company's success will depend on its ability to develop Information Technology solutions that will meet customers' changing requirements. The powerline communications solutions industry is characterized by rapidly changing technology, evolving industry standards, and changes in customer need and frequent new service and product introductions. The Company's future success will depend, in part, on its ability to effectively use leading edge technologies, to continue to develop its technological expertise, to enhance its current service, to develop new products that meet changing customer preferences and to influence and respond to merging industry standards and other technological changes on a timely and cost-effective basis.

DEPENDENCE OF LICENSED TECHNOLOGY

The Company may rely on certain technology licensed from third parties, and there can be no assurance that these third party technology licenses will be available to the Company on acceptable commercial terms or at all.

18

ITEM 7. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements attached to this Report on Form 10-KSB as pages F-1 to F-30 are incorporated herein by reference.

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None

PART III

ITEM 9. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

(a) Directors and Officers

The following table furnishes the information concerning the Company's directors and officers as of March 26, 2003. The directors of the Company are elected every year and serve until their successors are elected and qualify.

Name	Age	Title	Term
----	---	-----	----
Ronald W. Pickett	55	President & Director	1 year
Howard Lubert	54	CEO	1 year
Robert P. Crabb	55	Secretary	1 year

Edgar Filing: TELKONET INC - Form 10KSB

E. Barry Smith	52	CFO	1 year
Stephen Sadle	56	COO & Director	1 year
James Landry	49	VP Engineering	1 year
Ben Tuorto	47	VP US Sales	1 year
Warren V. Musser	76	Chairman of the Board	1 year
Hugo DeCesaris	43	Director	1 year
David Grimes	63	Director	1 year

The following table sets forth the portion of their time the Officers and Directors devote to the Company:

Name -----	Title -----	Time -----
Ronald W. Pickett	President & Director	100%
Howard Lubert	CEO	100%
Robert P. Crabb	Secretary	100%
E. Barry Smith	CFO	100%
Stephen Sadle	COO & Director	100%
James Landry	VP Engineering	100%
Ben Tuorto	VP US Sales	100%
Warren V. Musser	Chairman of the Board	Director
Hugo DeCesaris	Director	Director
David Grimes	Director	Director

19

The term of office for each director is one (1) year, or until his/her successor is elected at the Company's annual meeting and is qualified. The term of office for each officer of the Company is at the pleasure of the board of directors.

The board of directors does not have a nominating committee. Therefore, the selection of persons or election to the board of directors was neither independently made nor negotiated at arm's length.

- (b) Identification of Certain Significant Employees- The directors and executive officers of the Company handle strategic matters and critical decisions.
- (c) Family Relationships- None
- (d) Business Experience

EXECUTIVE MANAGEMENT TEAM

Telkonet's management team consists of successful individuals with diverse backgrounds in both the public and private sectors encompassing over a century of experience with such well-known public companies and governmental agencies as General Dynamics, Data General, 3Com, US Robotics, Penril Datacomm, CompuCom Systems, Inc, Nortel Networks, Fujitsu, Digital Equipment Corporation, Deloitte and Touche, Textron, Safeguard Scientifics, IBM and NASA. These seasoned professionals possess significant industry and customer knowledge with an extensive network of contacts within the powerline and data networking industry and a proven record of success in start-up ventures that required developing and selling networking solutions into the commercial market.

RONALD W. PICKETT-PRESIDENT & DIRECTOR

Mr. Pickett fostered the development of Telkonet since 1999 as the Company's principle investor and Co-Founder of the Company. He was the Founder, Chairman

Edgar Filing: TELKONET INC - Form 10KSB

of the Board and President of Medical Advisory Systems, Inc., which is now the Digital Angel Corporation- AMEX: "DOC". A graduate of Gordon College, Mr. Pickett has engaged in various entrepreneurial activities for 35 years.

HOWARD LUBERT - CHIEF EXECUTIVE OFFICER

Mr. Lubert brings to Telkonet over three decades of diversified expertise, which includes technical due diligence and business acceleration services for Safeguard Scientifics in Infrastructure, Internet/e-Business and Telecommunications. Internet, Intranet, Extranet and e-Commerce strategy and implementation expertise as an e. Business service line leader with Deloitte and Touche. PC, Local and Wide Area Networking experience as the founder/president of HEL INC. (Integration, Networking & Connectivity), General Systems Division of IBM marketing mid-range computer systems in the manufacturing, distribution, hospitality and not-for-profit vertical markets. Mr. Lubert is a nationally recognized speaker who has lectured on e. Business technologies, Web Content Management and Community Solutions, e. Business integration, The Financial and Human Capital Issues of e. Business

20

E. BARRY SMITH - CHIEF FINANCIAL OFFICER

Mr. Smith is a CPA and senior financial executive with diversified experience in both public and private companies. Mr. Smith's background includes big-four Public accounting experience with the firm of Deloitte & Touche. Senior Financial Partner and over 15 years executive management experience with Safeguard Scientifics, Inc. and their partner companies including: ThinAirApps, Inc.-(Wireless Application Provider-sold to Palm, Inc.), Interactive Marketing Venture -(Database Marketing) and Tangram Enterprise Solutions-(Software/Hardware for PC/LAN Mainframe Connectivity and Enterprise Software Management). Mr. Smith's experience also includes, Vice President of Finance & Administration for US Golf Management- (Public/Private Golf Course & Restaurant Management, Vice President of Finance for International Communications Research-(Market Research & Database Services) and Treasurer for The Chilton Company-(Publishing).

STEPHEN L. SADLE - CHIEF OPERATING OFFICER AND DIRECTOR & CO-FOUNDER

Mr. Sadle was previously employed as Senior Vice President and General Sales Manager of Internos; a provider of Web based vertical extranet applications and has developed operating extranets in the construction and transportation industries. For 15 years prior, Sadle was Vice President of Business Development and Sales for the Driggs Corporation, a major heavy and infrastructure contracting firm interfacing with government and the private sectors. Also, he was president and founder of a successful construction company and was awarded Small Businessman of the Year Award for the Washington Metropolitan Area. Mr. Sadle brings significant management, contracting and entrepreneurial skills to the company.

JAMES F. LANDRY - VICE PRESIDENT OF ENGINEERING

Mr. Landry has over 18 years experience in developing communications hardware for the enterprise/carrier market with 3Com, US Robotics, Penril Datacomm and Data General. While at 3Com/US Robotics, he was singularly responsible for the development of the entire xDSL product line as well as a number of modems and interface cards. At Penril, he served as the product development leader for the Series 1544 multiplexer/channel bank and at Data General he was technical leader of system integration for ISDN WAN. Mr. Landry brings a wealth of practical

Edgar Filing: TELKONET INC - Form 10KSB

design leadership and a solid history of delivering products to the marketplace. He holds four US patents.

ROBERT P. CRABB - SECRETARY

Mr. Crabb has over 35 years of sales, marketing and corporate management experience including 15 years with the Metropolitan Life Insurance Company. His entrepreneurial expertise also includes public company administration, financial consulting and commercial/residential real estate development. Mr. Crabb oversees the Company's public company administration and corporate governance, is a former Director of Telkonet and has been involved with the Company since 1999.

BEN TUORTO - VICE PRESIDENT OF CHANNEL SALES

Mr. Tuorto has over 26 years of industry experience in sales with industry lead networking manufacturers for systems integration, networking, business development and customer service. Mr. Tuorto has developed and implemented numerous successful sales programs and his varied background provides him with a solid understanding of the different channel distribution models that Telkonet will deploy as the company grows. Mr. Tuorto has held strategic sales positions with industry leaders including Nortel Networks, Fujitsu, Digital Equipment

21

Corporation and has participated in several high tech startups. Mr. Tuorto will be responsible for building upon and establishing relationships with business partners and distribution channels, including systems integrators and value added resellers.

JOHN I. VASILJ - VICE PRESIDENT OF US GOVT. & INTERNATIONAL BUSINESS DEVELOPMENT

Mr. Vasilj is a Partner with the Lloyd Group, an international business-consulting firm offering commercial and government client's strategic guidance and support with the growing U.S. state, federal, and military marketplaces. In this role, Mr. Vasilj is responsible for helping clients create and manage business relationships between U.S. and international firms and their respective government and military counterparts. Mr. Vasilj served the Foreign Service of the Republic of Croatia. As a founding member of Croatia's first diplomatic mission to the U.S, expanding bilateral commercial, diplomatic, and political relations. He also served as Chief of Staff and Press Secretary at the Croatian Embassy in Washington, D.C., where he developed and implemented initiatives aimed at supporting the country's international policy objectives relative to the U.S. Administration, Congress, and the armed services. Mr. Vasilj worked closely with the international community to implement policies dedicated to securing peace and prosperity in Croatia. Mr. Vasilj had represented the Government at the local, national and international levels, including a number of U.S. Presidential Trade and Development Missions to Bosnia and Herzegovina and Croatia, the Dayton Peace Accords, and the United Nations General Assembly.

DAVID W. GRIMES, Director is a co-founder of the company. From 1963-1982 Grimes was the Senior Executive with NASA for the Delta Program, heading the \$200 Million per annum program. From 1982-1989 he was Founder and CEO of Transpace Carriers Inc., a venture to commercialize the delta launch vehicle. From 1989-1992 he was the Engineering Division Director at EER Inc., of Seabrook Maryland with responsibility for over 100 engineers and technicians on electrical mechanical and thermal tasks for Goddard Space Flight Center. From 1992-1999, Chief Engineer for Final Analysis, Inc. and led the design and

Edgar Filing: TELKONET INC - Form 10KSB

development of the Low Earth Orbit constellation of 38 satellites for use in global store and forward communications. Grimes is a recognized expert in space and ground communications systems and brings this expertise to bear on the implementation of the hybrid telephony and high speed Internet technology. David Grimes is retired from daily business of the Company; however he maintains an active interest in the Company through a consulting relationship.

ITEM 10. EXECUTIVE COMPENSATION

Section 16(a) of the Securities Exchange Act of 1934, as amended (The "Exchange Act"), requires the Registrant's officers and directors, and persons who own more than 10% of a registered class of the Registrant's equity securities, to file reports of ownership and changes in ownership of equity securities of the Registrant with the Securities and Exchange Commission and NASDAQ. Officers, directors and greater-than 10% shareholders are required by the Securities and Exchange Commission regulation to furnish to Registrant with copies of all Section 16(a) that they file.

Some of the officers and directors of the Company will not devote more than a portion of their time to the affairs of the Company. There will be occasions when the time requirements of the Company's business conflict with the demands of their other business and investment activities. Such conflict may require that the company attempt to employ additional personnel. There is no assurance that the services of such persons will be available or that they can be obtained upon terms favorable to the Company.

(a) Compensation.

22

The following table sets forth all compensation actually paid or accrued by the Company for services rendered to the Company for the years ended December 31, 2000, 2001 and 2002 to the Company's Chief Executive Officer or others who earned a salary greater than \$100,000 annually for any of the periods:

SUMMARY COMPENSATION TABLE OF EXECUTIVES

(a) Name and Principal Position	(b) Year	Annual Compensation		(e) Other Awards	(f) Restr Sto
		(c) Salary (\$)	(d) Bonus Annual Compensation (\$)		
L. Peter Larson	2000	76,747	-	-	1,50
	2001	160,484	-	-	1,50
	2002	4,000	-	-	1,50
David Grimes	2000	60,918	-	-	4,97
	2001	57,041	-	-	4,97
	2002	-	-	-	1,29
Robert Crabb	2000	-	-	-	
	2001	-	-	-	
	2002	8,500	-	-	
Stephen L. Sadle	2000	78,270	-	-	5,72
	2001	160,484	-	-	5,72
	2002	130,000	-	-	3,72
Greg Fowler	2002	114,000	-	-	

Edgar Filing: TELKONET INC - Form 10KSB

Jim Landry	2001	29,000	-	-
	2002	116,000	-	-
Ben Tuorto	2002	49,327	-	-

ITEM 11. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

- a) BENEFICIAL OWNERS OF FIVE PERCENT (5%) OR GREATER, OF THE COMPANY'S COMMON STOCK: No preferred stock is outstanding at the date of this offering. The following sets forth information with respect to ownership by holders of more than five percent (5%) of the Registrant's common stock known by the Registrant based upon 15,721,131 shares outstanding at December 31, 2002.

ALL 5% OWNERS SUPPLEMENTAL BENEFICIAL OWNERSHIP TABLE AS OF DECEMBER 31, 2002

Title of Class	Name and Address of Beneficial Owner	Amount of Beneficial Interest	Percent of Class
Common	David Grimes, Crownsville MD	1,298,000	7.6 %
Common	Stephen Sadle, Crownsville, MD	3,721,600	21.9 %
Common	L. Peter Larson, Annapolis, MD	2,505,285	14.7 %

23

Common	Ron Pickett, Wilmington, NC	2,658,964	15.7 %
Common	Jenson and Associates Salt Lake City, Utah	1,980,000	11.7 %
Common	Hugo DeCesaris Annapolis, MD	1,375,000	8.1 %

ALL 5% OWNERS SUPPLEMENTAL BENEFICIAL OWNERSHIP TABLE AS OF MARCH 26, 2002

Beneficial owners of five percent (5%) or greater, of the Company's common stock: No preferred stock is outstanding at the date of this offering. The following sets forth information with respect to ownership by holders of more than five percent (5%) of the Registrant's common stock known by the Registrant based upon 15,721,131

Title of Class	Name and Address of Beneficial Owner	Amount of Beneficial Interest	Percent of Class
Common	David Grimes, Crownsville MD	2,198,000	9.7 %
Common	Stephen Sadle, Crownsville, MD	4,621,600	20.3 %

Edgar Filing: TELKONET INC - Form 10KSB

Common	L. Peter Larson, Annapolis, MD	2,505,285	11.0 %
	Warren V. Musser	2,000,000	8.8 %
Common	Ron Pickett, Wilmington, NC	2,658,964	11.7 %
Common	Jenson and Associates, Salt Lake City , Utah	1,980,000	8.7 %
Common	Hugo DeCesaris Annapolis, MD	1,375,000	6.0 %

b) The following sets forth information with respect to the Company's common stock beneficially owned by each Officer and Director, and by all Directors and Officers as a group.

OFFICERS AND DIRECTORS SUPPLEMENTAL BENEFICIAL OWNERSHIP TABLE AS OF DECEMBER 31, 2002

Title of Class	Name and Address of Beneficial Owner	Amount of Beneficial Interest	Percent of Class
Common	Ron Pickett, President Wilmington, NC	2,658,964	15.7 %
Common	Howard Lubert, CEO West Chester, PA	0	0
Common	E. Barry Smith, CFO West Chester, PA	0	0
Common	Stephen Sadle, COO Crownsville, MD	3,721,600	21.9 %
Common	Robert Crabb, Secy. Rising Sun, MD	0	0
Common	James Landry, VP Eng. Germantown, MD.	225,000	1.3 %
Common	Ben Tuorto, VP Sales Cary, NC	225,000	1.3 %

24

Common	David Grimes, Director Crownsville, MD	1,298,000	7.6 %
Common	Hugo DeCesaris- Director Annapolis, MD	1,375,000	8.1 %
Common	Warren V. Musser, Chairman Villanova, PA	0	0
All directors and executive officers as a group (6 persons in group)		9,503,564	55.9 %

OFFICERS AND DIRECTORS SUPPLEMENTAL BENEFICIAL OWNERSHIP TABLE AS OF MARCH 26, 2002

Title of Class	Name and Address of Beneficial Owner	Amount of Beneficial Interest	Percent of Class
----------------	--------------------------------------	-------------------------------	------------------

Edgar Filing: TELKONET INC - Form 10KSB

Common	Ron Pickett, President Wilmington, NC	2,658,964	11.7 %
Common	Howard Lubert, CEO West Chester, PA	1,000,000	4.4 %
Common	E. Barry Smith, CFO West Chester, PA	350,000	1.5 %
Common	Stephen Sadle, COO Crownsville, MD	4,621,600	20.3 %
Common	Robert Crabb, Secy. Rising Sun, MD	500,000	2.2 %
Common	James Landry, VP Eng. Germantown, MD.	350,000	1.5 %
Common	Ben Tuorto, VP Sales Cary, NC	225,000	1.0 %
Common	David Grimes, Director Crownsville, MD	2,198,000	9.7 %
Common	Hugo DeCesaris- Director Annapolis, MD	1,375,000	6.0 %
Common	Warren V. Musser, Chairman Villanova, PA	2,000,000	8.8 %
All directors and executive officers as a group (10 persons in group)		15,278,564	63.5 %

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

A company officer has advanced funds to the Company for working capital purposes. No formal repayment terms or arrangements exist. The net amount of advances due the officer at December 31, 2002 was \$4,830.

Significant shareholders of the Company have advanced funds to the Company for working capital purposes. The amount of the advances at December 31, 2002 and 2001 is \$125,500 and \$7,500, respectively. No formal repayment terms or arrangements exist.

For the year ended December 31, 2002 and 2001, the Company entered into several convertible debentures with sophisticated investors in the aggregate principal amount of \$2,162,000, of which \$340,000 was with members of the board directors, officers, and shareholders.

25

PART IV

ITEM 13. EXHIBITS AND REPORTS ON FORM 8-K

(A) Exhibits

The exhibits listed below are required by Item 601 of Regulation S-K. Each management contract or compensatory plan or arrangement required to be filed as an exhibit to this Form 10-K has been identified.

Exhibit Number -----	Description of Document -----
3.1 (a)	Articles of Incorporation of the Registrant

Edgar Filing: TELKONET INC - Form 10KSB

3.2 (a)	By-laws of the Registrant
4.1	Agreement of Convertible Debenture and Warrants
4.2	Agreement of Series B Convertible Debenture and Warrants
10.1	Telkonet, Inc. Stock Option Plan (filed herewith)
10.2	2001 Debenture and Warrant (filed herewith)
10.3	2002 Debenture and Warrant (filed herewith)
23.1	Consent of Independent Accounts (file herewith)
99.1	Certification of Ronald W. Pickett Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).
99.2	Certification of Stephen Sadle Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (filed herewith).

(a) Incorporated by reference herein from Exhibits to the Registrant's Form 8-K dated August 30, 2000

(b) The Company filed the following reports on Form 8-K during the reporting period.

January 16, 2002 - Telkonet Founders Re-align Capital.
December 20, 2002 - Board of Directors elect Mr. Ronald W. Pickett as Chairman of Board, President and interim CEO. J. Gregory Fowler re Telkonet finds potential competitors to actually be complementary in nature and a validation of the viability of the powerline communications market overall. resigned as the President & CEO and from the Board of Directors.

ITEM 14. CONTROLS AND PROCEDURES

The Company has established and maintains disclosure controls and procedures that are designed to ensure that material information required to be disclosed by Telkonet, Inc. in the reports that it files under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

26

Within the 90 days prior to the date of this annual report, under the supervision and with the participation of Telkonet, Inc.'s Chief Executive Officer and Chief Financial Officer, the Company carried out an evaluation of the effectiveness of the design and operation of disclosure controls and procedures. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective as of the date of such evaluation in timely alerting them to material information relating to the Company (including its consolidated subsidiaries) required to be included in Telkonet, Inc.'s periodic SEC filings.

There have been no significant changes to the Company's internal controls or in other factors that could significantly affect internal controls subsequent to the date the Company carried out its evaluation.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its

Edgar Filing: TELKONET INC - Form 10KSB

behalf by the undersigned, thereunto duly authorized.

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.

Date: March 26, 2003

Telkonet, Inc.

/s/ Ronald W. Pickett, President

Ronald W. Pickett, President

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Name -----	Position -----	Date -----
/s/ Warren V. Musser ----- Warren V. Musser	Chairman of the Board	Supplemental Bene Ownership Table March 26, 2003 -----
/s/ Ronald W. Pickett ----- Ronald W. Pickett	President	March 26, 2003
/s/ Stephen Sadle ----- Stephen Sadle	Chief Operating Officer	March 26, 2003
/s/ Hugo DeCesaris ----- Hugo DeCesaris	Director	March 26, 2003
/s/ David Grimes ----- David Grimes	Director	March 26, 2003 Te potential competi complementary in validation of the powerline communi overall.

27

CERTIFICATIONS

I, Ronald W. Pickett, certify that:

1. I have reviewed this quarterly report on Form 10-KSB of Telkonet, Inc.
2. Based on my knowledge, this quarterly report does not contain any untrue

Edgar Filing: TELKONET INC - Form 10KSB

statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;

3. Based on my knowledge, the financial statements and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations, and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14 for the registrant and have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize, and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions, with regard to significant deficiencies and material weaknesses.

28

Date: March 26, 2003

/s/ Ronald W. Pickett

Edgar Filing: TELKONET INC - Form 10KSB

Ronald W. Pickett
President

CERTIFICATIONS

I, Steve Sadle, certify that:

1. I have reviewed this quarterly report on Form 10-KSB of Telkonet, Inc.
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations, and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14 for the registrant and have:
 - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
 - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
 - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize, and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal

Edgar Filing: TELKONET INC - Form 10KSB

controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions, with regard to significant deficiencies and material weaknesses.

Date: March 26, 2003

/s/ Steve Sadle

Steve Sadle
Chief Operating Officer

30

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FINANCIAL STATEMENTS AND SCHEDULES

DECEMBER 31, 2002 AND 2001

FORMING A PART OF ANNUAL REPORT
PURSUANT TO THE SECURITIES EXCHANGE ACT OF 1934

TELKONET, INC.

F-1

TELKONET, INC.

INDEX TO FINANCIAL STATEMENTS

Report of Independent Certified Public Accountants
Consolidated Balance Sheets at December 31, 2002 and 2001
Consolidated Statements of Losses for the Years ended December 31, 2002 and 2001 and for
the Period November 3, 1999 (Date of Inception) Through December 31, 2002
Consolidated Statements of Deficiency in Stockholders' Equity for the Period November 3,
1999 (Date of Inception) Through December 31, 2002
Consolidated Statements of Cash Flows for the Years ended December 31, 2002 and 2001 and
for the Period November 3, 1999 (Date of Inception) through December 31, 2002
Notes to Consolidated Financial Statements

Edgar Filing: TELKONET INC - Form 10KSB

F-2

RUSSELL BEDFORD STEFANOU MIRCHANDANI LLP
CERTIFIED PUBLIC ACCOUNTANTS

REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Directors
Telkonet, Inc.
Annapolis, MD

We have audited the accompanying consolidated balance sheets of Telkonet, Inc. and its wholly-owned subsidiary (the "Company"), a development stage company, as of December 31, 2002 and 2001 and the related consolidated statements of losses, deficiency in stockholders' equity, and cash flows for the years ended December 31, 2002 and 2001 and for the period November 3, 1999 (date of inception) to December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based upon our audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Telkonet, Inc. and its wholly-owned subsidiary as of December 31, 2002 and 2001, and the results of its operations and its cash flows for the two years then ended, and from November 3, 1999 (date of inception), to December 31, 2002, in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As shown in the financial statements, the Company has incurred net losses since its inception. This raises substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to this matter are described in Note K. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

As discussed in Note L, the Company restated its Consolidated Balance Sheet as of December 31, 2001, and the related Statements of Losses, Deficiency in Stockholders' Equity and Cash Flows for the year ended December 31, 2001 and the period November 3, 1999 (date of Inception) to December 31, 2001.

/s/ RUSSELL BEDFORD STEFANOU MIRCHANDANI LLP

Russell Bedford Stefanou Mirchandani LLP
Certified Public Accountants

McLean, Virginia
February 27, 2003

Edgar Filing: TELKONET INC - Form 10KSB

F-3

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2002 AND 2001

	2002	(As Res
	-----	-----
ASSETS		
CURRENT ASSETS:		
Cash and equivalents	\$ 18,827	\$
Inventory, net (Note A)	39,790	
Other receivable	1,550	
Prepaid expenses and deposits	4,625	
Total current assets	----- 64,792	-----
PROPERTY AND EQUIPMENT (Note B):		
Furniture and equipment, at cost	73,215	
Less: accumulated depreciation	35,252	
	----- 37,963	-----
OTHER ASSETS:		
Financing costs, less accumulated amortization of \$76,923 and \$24,769 at December 31, 2002 and 2001, respectively	192,600	
Prepaid expenses and deposits	--	
	----- 192,600	-----
	\$ 295,355	\$
	=====	=====
LIABILITIES AND DEFICIENCY IN STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable and accrued expenses	\$ 518,865	\$
Notes payable (Note D)	310,000	
Due to Shareholders (Note C)	130,330	
Total current liabilities	----- 959,195	-----
Convertible debentures, net of discounts - including related parties (Note E)	862,682	

Edgar Filing: TELKONET INC - Form 10KSB

COMMITMENTS AND CONTINGENCIES (Note I)	--	
DEFICIENCY IN STOCKHOLDERS' EQUITY (Note F)		
Preferred stock, par value \$.001 per share; 15,000,000 shares authorized; none issued and outstanding at December 31, 2002 and 2001	--	
Common stock, par value \$.001 per share; 100,000,000 shares authorized; 15,721,131 and 22,115,371 shares issued and outstanding at December 31, 2002 and 2001, respectively	15,721	
Additional paid-in-capital	4,916,433	
Accumulated deficit during development stage	(6,458,676)	
Deficiency in stockholders' equity	(1,526,522)	
	\$ 295,355	\$
	=====	=====

See accompanying notes to consolidated financial statements

F-4

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

	For the year ended December 31, 2002	2001	For the p Novembe (date of thr Decem 2
	-----	-----	-----
		(As Restated - Note L)	(As Resta
Costs and Expenses:			
Research and Development	\$ 280,450	\$ 120,828	\$
Selling, General and Administrative	2,790,819	1,386,222	4,
Impairment of Property and Equipment (Note B)	--	39,287	
Depreciation and Amortization	84,067	30,797	
Total Operating Expense	3,155,336	1,577,134	5,
Loss from Operations	(3,155,336)	(1,577,134)	(5,
Other Income	3,322	1,257	
Interest Income (Expense)	(626,474)	(140,618)	(

Edgar Filing: TELKONET INC - Form 10KSB

Provision for Income Tax	--	--	--
	-----	-----	-----
	(623,152)	(139,361)	()
Net Loss	\$ (3,778,488)	\$ (1,716,495)	\$ (6,)
	=====	=====	=====
Loss per common share (basic and assuming dilution) (Note J)	\$ (0.22)	\$ (0.08)	\$)
	=====	=====	=====
Weighted average common shares outstanding	17,119,639	21,974,439	16,)

See accompanying notes to consolidated financial statements

F-5

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
CONSOLIDATED STATEMENTS OF DEFICIENCY IN STOCKHOLDERS' EQUITY
FOR THE PERIOD NOVEMBER 3, 1999 (DATE OF INCEPTION) TO DECEMBER 31,

	Preferred Shares	Preferred Stock Amount	Common Shares	Common Stock Amount	Additional Paid in Capital
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	11,387
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					

Edgar Filing: TELKONET INC - Form 10KSB

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 notes to consolidated financial statements

F-6

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
CONSOLIDATED STATEMENTS OF DEFICIENCY IN STOCKHOLDERS' EQUITY
FOR THE PERIOD NOVEMBER 3, 1999 (DATE OF INCEPTION) TO DECEMBER 31,

	Preferred Shares	Preferred Stock Amount	Common Shares	Common Stock Amount	Additional Paid in Capital	Co St Subsc
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	
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	

Edgar Filing: TELKONET INC - Form 10KSB

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 E)	--	--	--	--	837,874	
Value of warrants attached to convertible debentures (Note E)	--	--	--	--	77,254	
Net loss	--	--	--	--	--	
BALANCE AT DECEMBER 31, 2001 (AS RESTATED- NOTE L)	--	\$ --	22,115,371	\$22,115	\$2,244,033	\$

See accompanying notes to consolidated financial statements

F-7

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
CONSOLIDATED STATEMENTS OF DEFICIENCY IN STOCKHOLDERS' EQUITY
FOR THE PERIOD NOVEMBER 3, 1999 (DATE OF INCEPTION) TO DECEMBER 31,

Edgar Filing: TELKONET INC - Form 10KSB

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

Edgar Filing: TELKONET INC - Form 10KSB

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 (Note G)	--	--	--	--	452,459	
Stock based compensation for the issuance of warrants to consultants in exchange for services (Note G)	--	--	--	--	170,330	
Stock based compensation for the issuance of warrants to consultants in exchange for financing costs (Note G)	--	--	--	--	86,474	
Beneficial conversion feature of convertible debentures (Note E)	--	--	--	--	840,877	
Value of warrants attached to convertible debentures (Note E)	--	--	--	--	124,677	
Net Loss	--	--	--	--	--	
BALANCE AT DECEMBER 31, 2002	--	\$ --	15,721,131	\$ 15,721	\$ 4,916,433	\$ 1,803,595

See accompanying notes to consolidated financial statements

F-8

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

For the year Ended December 31

2002	2001
----	----

(As Restated - N

Edgar Filing: TELKONET INC - Form 10KSB

INCREASE (DECREASE) IN CASH AND EQUIVALENTS

CASH FLOWS FROM OPERATING ACTIVITIES:

Net loss from development stage operations	\$(3,778,488)	\$(1,716,4
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 (Note E)	440,646	92,7
Amortization of debt discount - value of warrants attached to convertible debentures (Note E)	39,390	8,5
Stock options and warrants issued in exchange for services (Note G)	622,790	333,0
Common stock issued in exchange for services rendered (Note F)	138,722	
Common stock issued in exchange for debenture interest (Note F)	21,793	
Impairment of property and equipment, net (Note B)	--	39,2
Depreciation and amortization	84,067	30,7
Increase (decrease) in:		
Other receivable	(1,550)	
Inventory	(39,790)	
Deposits	--	
Accounts payable and accrued expenses, net	402,124	(136,8
NET CASH USED IN OPERATING ACTIVITIES	(2,070,296)	(1,348,8
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures, net	(18,265)	(5,2
NET CASH USED IN INVESTING ACTIVITIES	(18,265)	(5,2
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from sale of common stock, net of costs	830,673	150,0
Proceeds from (repayments to) stockholder advances	122,830	(2,5
Proceeds from issuance of convertible debentures, net of costs	1,222,000	818,0
Repayment of loans	(90,000)	
Proceeds from loans	--	400,0
NET CASH PROVIDED BY FINANCING ACTIVITIES	2,085,503	1,365,5
NET (DECREASE) INCREASE IN CASH AND EQUIVALENTS	(3,058)	11,4

Edgar Filing: TELKONET INC - Form 10KSB

Cash and cash equivalents at the beginning of the period	21,885	10,4
	-----	-----
Cash and cash equivalents at the end of the period	\$ 18,827	\$ 21,8
	=====	=====

See accompanying notes to consolidated financial statements

F-9

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

	For the year Ended December 31,	
	2002	2001
	----	----
		(As Restated - Not
Supplemental Disclosures of Cash Flow Information:		
Cash transactions:		
Cash paid during the period for interest	\$ 30,885	\$ 24,965
Income taxes paid	--	--
Non-cash transactions:		
Issuance of warrants and options for services rendered	622,790	333,072
Common stock issued in exchange for services rendered	138,722	--
Common stock issued in exchange for debenture interest	21,793	--
Beneficial conversion feature on convertible debentures	840,877	837,874
Value of warrants attached to convertible debentures	124,677	77,254
Acquisition:		
Assets acquired	--	--
Accumulated deficit	--	--
Liabilities assumed	--	--
	-----	-----
	\$ --	\$ --
	-----	-----

See accompanying notes to consolidated financial statements

F-10

Edgar Filing: TELKONET INC - Form 10KSB

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE A-SUMMARY OF ACCOUNTING POLICIES

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

Business and Basis of Presentation

Telkonet, Inc. (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.

Cash and Cash Equivalents

For purposes of the Statements of Cash Flows, the Company considers all highly liquid debt instruments purchased with a maturity date of three months or less to be cash equivalents.

Property and Equipment

Property and equipment is stated at cost. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets.

Long-Lived Assets

The Company has adopted Statement of Financial Accounting Standards No. 144 (SFAS 144). The Statement requires that long-lived assets and certain identifiable intangibles held and used by the Company be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Events relating to recoverability may include significant unfavorable changes in business conditions, recurring losses, or a forecasted inability to achieve break-even operating results over an extended period. The Company evaluates the recoverability of long-lived assets based upon forecasted undercounted cash flows. Should an impairment in value be indicated, the carrying value of intangible assets will be adjusted, based on estimates of future discounted cash flows resulting from the use and ultimate disposition of the asset. SFAS No. 144 also requires assets to be disposed of be reported at the lower of the carrying amount or the fair value less costs to sell.

Edgar Filing: TELKONET INC - Form 10KSB

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE A-SUMMARY OF ACCOUNTING POLICIES (CONTINUED)

Inventories

Inventories are stated at the lower of cost or market determined by the first-in, first-out (FIFO) method. Inventories consist of Internet applications, routers and related products available for sale to distributors and retailers. Components of inventories as of December 31, 2002 and 2001 are as follows:

	2002	2001
	----	----
Finished Goods	\$ 39,790	\$ -

Income Taxes

The Company has implemented the provisions on Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" (SFAS 109). SFAS 109 requires that income tax accounts be computed using the liability method. Deferred taxes are determined based upon the estimated future tax effects of differences between the financial reporting and tax reporting bases of assets and liabilities given the provisions of currently enacted tax laws.

Net Loss Per Common Share

The Company computes earnings per share under Financial Accounting Standard No. 128, "Earnings Per Share" (SFAS 128). Net loss per common share is computed by dividing net loss by the weighted average number of shares of common stock and dilutive common stock equivalents outstanding during the year. Dilutive common stock equivalents consist of shares issuable upon conversion of convertible preferred shares and the exercise of the Company's stock options and warrants (calculated using the treasury stock method). During 2002 and 2001, common stock equivalents are not considered in the calculation of the weighted average number of common shares outstanding because they would be anti-dilutive, thereby decreasing the net loss per common share.

Use of Estimates

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

Revenue Recognition

The Company follows a policy of recognizing revenues as services are rendered or at the time the product is shipped to or picked up by customers.

Edgar Filing: TELKONET INC - Form 10KSB

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE A-SUMMARY OF ACCOUNTING POLICIES (CONTINUED)

Advertising

The Company follows the policy of charging the costs of advertising to expenses incurred. The Company incurred no advertising costs during the years ended December 31, 2002 and 2001, and for the period from November 3, 1999 (date of inception) to December 31, 2002.

Research and Development

The Company accounts for research and development costs in accordance with the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 2 ("SFAS 2"), "Accounting for Research and Development Costs. Under SFAS 2, all research and development costs must be charged to expense as incurred. Accordingly, internal research and development costs are expensed as incurred. Third-party research and development costs are expensed when the contracted work has been performed or as milestone results have been achieved. Company-sponsored research and development costs related to both present and future products are expensed in the period incurred. Total expenditures on research and product development for 2002, 2001, and the period from November 3, 1999 (date of inception) to December 31, 2002 were \$280,450, \$ 120,828, and \$520,278, respectively.

Liquidity

As shown in the accompanying financial statements, the Company has incurred a net loss of \$6,458,676 from its inception through December 31, 2002. The Company's current liabilities exceeded its current assets by \$894,403 as of December 31, 2002.

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 and related party receivables. 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. The Company periodically reviews its trade receivables in determining its allowance for doubtful accounts. The allowance for doubtful accounts was \$0 at December 31, 2002 and 2001.

Comprehensive Income

Statement of Financial Accounting Standards No. 130 ("SFAS 130"), "Reporting Comprehensive Income," establishes standards for reporting and displaying of comprehensive income, its components and accumulated balances. Comprehensive income is defined to include all changes in equity except those resulting from investments by owners and distributions to owners. Among other disclosures, SFAS

Edgar Filing: TELKONET INC - Form 10KSB

130 requires that all items that are required to be recognized under current accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. The Company does not have any items of comprehensive income in any of the periods presented.

F-13

TELKONET, INC.
 (A DEVELOPMENT STAGE COMPANY)
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 DECEMBER 31, 2002 AND 2001

NOTE A-SUMMARY OF ACCOUNTING POLICIES (CONTINUED)

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 charge 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 will adopt the interim disclosure provisions for its financial reports for the quarter ended March 31, 2003.

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 G):

	2002 -----
Net loss - as reported	\$ (3,778,488)
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)	(210,833)

Net loss - Pro Forma	\$ (3,989,321)
Net loss attributable to common stockholders - Pro forma	\$ (3,989,321)
Basic (and assuming dilution) loss per share - as reported	\$ (0.22)
Basic (and assuming dilution) loss per share - Pro forma	\$ (0.23)

Edgar Filing: TELKONET INC - Form 10KSB

Segment Information

Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information" ("SFAS 131") establishes standards for reporting information regarding operating segments in annual financial statements and requires selected information for those segments to be presented in interim financial reports issued to stockholders. SFAS 131 also establishes standards for related disclosures about products and services and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision maker, or decision-making group, in making decisions how to allocate resources and assess performance. The information disclosed herein materially represents all of the financial information related to the Company's principal operating segment.

F-14

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE A-SUMMARY OF ACCOUNTING POLICIES (CONTINUED)

Reclassifications

Certain reclassifications have been made in prior year's financial statements to conform to classifications used in the current year (see Note L).

New Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 141, "Business Combinations" (SFAS No. 141), and Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets" (SFAS No. 142). The FASB also issued Statement of Financial Accounting Standards No. 143, "Accounting for Obligations Associated with the Retirement of Long-Lived Assets" (SFAS No. 143), and Statement of Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" (SFAS No. 144) in August and October 2001, respectively.

SFAS No. 141 requires the purchase method of accounting for business combinations initiated after June 30, 2001 and eliminates the pooling-of-interest method. The adoption of SFAS No. 141 had no material impact on the Company's consolidated financial statements.

Effective January 1, 2002, the Company adopted SFAS No. 142. Under the new rules, the Company will no longer amortize goodwill and other intangible assets with indefinite lives, but such assets will be subject to periodic testing for impairment. On an annual basis, and when there is reason to suspect that their values have been diminished or impaired, these assets must be tested for impairment, and write-downs to be included in results from operations may be necessary. SFAS No. 142 also requires the Company to complete a transitional goodwill impairment test six months from the date of adoption.

Any goodwill impairment loss recognized as a result of the transitional goodwill

Edgar Filing: TELKONET INC - Form 10KSB

impairment test will be recorded as a cumulative effect of a change in accounting principle no later than the end of fiscal year 2002. The adoption of SFAS No. 142 had no material impact on the Company's consolidated financial statements

SFAS No. 143 establishes accounting standards for the recognition and measurement of an asset retirement obligation and its associated asset retirement cost. It also provides accounting guidance for legal obligations associated with the retirement of tangible long-lived assets. SFAS No. 143 is effective in fiscal years beginning after June 15, 2002, with early adoption permitted. The Company expects that the provisions of SFAS No. 143 will not have a material impact on its consolidated results of operations and financial position upon adoption. The Company plans to adopt SFAS No. 143 effective January 1, 2003.

SFAS No. 144 establishes a single accounting model for the impairment or disposal of long-lived assets, including discontinued operations. SFAS No. 144 superseded Statement of Financial Accounting Standards No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of" (SFAS No. 121), and APB Opinion No. 30, "Reporting the Results of Operations - Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions". The Company adopted SFAS No. 144 effective January 1, 2002. The adoption of SFAS No. 144 had no material impact on Company's consolidated financial statements.

F-15

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE A-SUMMARY OF ACCOUNTING POLICIES (CONTINUED)

New Accounting Pronouncements (Continued)

In April 2002, the FASB issued Statement No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections." This Statement rescinds FASB Statement No. 4, "Reporting Gains and Losses from Extinguishment of Debt", and an amendment of that Statement, FASB Statement No. 64, "Extinguishments of Debt Made to Satisfy Sinking-Fund Requirements" and FASB Statement No. 44, "Accounting for Intangible Assets of Motor Carriers". This Statement amends FASB Statement No. 13, "Accounting for Leases", to eliminate an inconsistency between the required accounting for sale-leaseback transactions and the required accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. The Company does not expect the adoption to have a material impact to the Company's financial position or results of operations.

In June 2002, the FASB issued Statement No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." This Statement addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)." The provisions of this Statement are effective for exit or disposal activities that are initiated after December 31, 2002, with early application encouraged. The Company does not expect the adoption to have a material impact to the Company's

Edgar Filing: TELKONET INC - Form 10KSB

financial position or results of operations.

In October 2002, the FASB issued Statement No. 147, "Acquisitions of Certain Financial Institutions—an amendment of FASB Statements No. 72 and 144 and FASB Interpretation No. 9", which removes acquisitions of financial institutions from the scope of both Statement 72 and Interpretation 9 and requires that those transactions be accounted for in accordance with Statements No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets. In addition, this Statement amends SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets, to include in its scope long-term customer-relationship intangible assets of financial institutions such as depositor- and borrower-relationship intangible assets and credit cardholder intangible assets. The requirements relating to acquisitions of financial institutions is effective for acquisitions for which the date of acquisition is on or after October 1, 2002. The provisions related to accounting for the impairment or disposal of certain long-term customer-relationship intangible assets are effective on October 1, 2002. The adoption of this Statement did not have a material impact to the Company's financial position or results of operations as the Company has not engaged in either of these activities.

F-16

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE A—SUMMARY OF ACCOUNTING POLICIES (CONTINUED)

New Accounting Pronouncements (Continued)

In December 2002, the FASB issued Statement No. 148, "Accounting for Stock-Based Compensation—Transition and Disclosure", which amends FASB Statement 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 Statement 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 transition guidance and annual disclosure provisions of Statement 148 are effective for fiscal years ending after December 15, 2002, with earlier application permitted in certain circumstances. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. The adoption of this statement did not have a material impact on the Company's financial position or results of operations as the Company has not elected to change to the fair value based method of accounting for stock-based employee compensation.

In January 2003, the FASB issued Interpretation No. 46, "Consolidation of Variable Interest Entities." Interpretation 46 changes the criteria by which one company includes another entity in its consolidated financial statements. Previously, the criteria were based on control through voting interest. Interpretation 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity's activities or entitled to receive a majority of the entity's residual returns or both. A company that consolidates a variable interest entity is called the primary beneficiary of that entity. The consolidation requirements of Interpretation 46 apply immediately to variable

Edgar Filing: TELKONET INC - Form 10KSB

interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established. The Company does not expect the adoption to have a material impact to the Company's financial position or results of operations.

NOTE B - PROPERTY, PLANT AND EQUIPMENT

The Company's property and equipment at December 31, 2002 and 2001 consists of the following:

	2002	2001
	----	----
Office Equipment	\$ 58,514	\$ 42,005
Office Fixtures and Furniture	14,701	12,945
	-----	-----
Total	73,215	54,950
Accumulated Depreciation	(35,252)	(28,108)
	-----	-----
	\$ 37,963	\$ 26,842
	=====	=====

Depreciation expense included as a charge to income amounted to \$7,144, \$6,028, and \$35,252 for the year ended December 31, 2002, 2001, and from inception to December 31, 2002, respectively.

F-17

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE B - PROPERTY, PLANT AND EQUIPMENT (CONTINUED)

Impairment of Property and Equipment

During the year ended December 31, 2001, the Company recorded a charge for the impairment of certain property and equipment held and used by the Company because the estimated fair value of the assets was less than the carrying value. Considerable management judgment is necessary to estimate fair value. Accordingly, actual results could vary significantly from managements' estimates. Based upon the evaluation, the Company recognized an asset impairment loss of \$ 39,287 or \$ (.00) per share during the year ended December 31, 2001.

NOTE C - RELATED PARTY TRANSACTIONS

Edgar Filing: TELKONET INC - Form 10KSB

A company officer has advanced funds to the Company for working capital purposes. No formal repayment terms or arrangements exist. The net amount of advances due the officer at December 31, 2002 was \$4,830.

Significant shareholders of the Company have advanced funds to the Company for working capital purposes. The amount of the advances at December 31, 2002 and 2001 is \$125,500 and \$7,500, respectively. No formal repayment terms or arrangements exist.

NOTE D - NOTES PAYABLE

Notes payable at December 31, 2002 and 2001 consists of the following:

	2002

Note payable in monthly installments of interest only at 7.5% per annum, unsecured and guaranteed by a Company shareholder. Maturity date is in September 2002; the Company paid the debt in full in February 2003	\$ 60,
Note payable in monthly installments of interest only at the prime lending rate plus 1%, unsecured and guaranteed by a Company shareholder. The original maturity date of the loan was extended from March 2002 to March 2003	250,
	310,
Less: current portion	(310,

	\$
	=====

F-18

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE E - CONVERTIBLE PROMISSORY NOTES PAYABLE

A summary of convertible promissory notes payable at December 31, 2002 and 2001 is as follows:

	2002	2001
	----	----
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	\$ 1,689,100	\$ 940,000

Edgar Filing: TELKONET INC - Form 10KSB

Debt Discount - beneficial conversion feature, net of amortization of \$439,082 in 2002 and \$92,776 in 2001	(999,034)	(745,098)
Debt Discount - value attributable to warrants attached to notes, net of amortization of \$38,664 in 2002 and \$8,552 in 2001	(86,120)	(68,702)
	-----	-----
	603,946	126,200
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 December 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 \$.55 per share six months after issuance	472,900	--
Debt Discount - beneficial conversion feature, net of amortization of \$1,564 in 2002	(146,295)	--
Debt Discount - value attributable to warrants attached to notes, net of amortization of \$726 in 2002	(67,869)	--
	-----	-----
	258,736	--
	-----	-----
Total	\$ 862,682	\$ 126,200
	-----	-----
Less: current portion	--	--
	-----	-----
	\$ 862,682	\$ 126,200
	=====	=====

F-19

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE E - 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

Edgar Filing: TELKONET INC - Form 10KSB

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 4.25%, a dividend yield of 0%, and volatility of 21%. 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 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.

F-20

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE E - CONVERTIBLE PROMISSORY NOTES PAYABLE

Convertible Debentures (Continued)

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

Edgar Filing: TELKONET INC - Form 10KSB

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.

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 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.

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 \$480,036 and \$101,328 for the years ended December 31, 2002 and 2001, respectively.

F-21

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE F - CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock, with a par

Edgar Filing: TELKONET INC - Form 10KSB

value of \$.001 per share. As of 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 December 31, 2002, the Company has 15,721,131 shares of common stock issued and outstanding.

In January 2000, the Company issued 19,300 shares to its founders, in exchange for costs and services, valued at \$11,580.

In June 2000, the Company issued a total of 1,735 shares of common stock in a private placement to sophisticated investors, primarily in the United States in exchange for \$ 644,236 net of costs and fees. In July 2000 the Predecessor issued 190 shares of common stock in exchange for exercised warrants at \$375 per share, totaling \$71,250

In August 2000, the Company issued 21,775,345 shares of common stock in conjunction with the merger of Comstock Coal Company, Inc. In connection with the transaction, the Company retired 21,225 shares of previously issued Telkonet Communications, Inc common stock.

In October 2000, the Company issued 29,145 and 10,881 shares of common stock in exchange for exercised warrants with exercise prices of \$1.00 and \$0.40 per share, respectively.

In June 2001 and August 2001, the Company issued 260,000 and 40,000 shares of its common stock, respectively, in a private placement to sophisticated investors in exchange for \$150,000, net of costs and fees.

In January 2002, the Company re-organized its capital structure, whereby the Company agreed to purchase 8,936,244 shares of the Company's common stock held by the Founders and cancel certain vested options held by the Founders to purchase the Company's common stock, in exchange for the issuance of newly issued options to purchase 3,500,000 shares of the Company's common stock. The new stock options expire in January 2012, and have an exercise price of \$1.00 per share, which is in excess of the weighted average fair value of the Company's common stock at the grant dates. The canceled options had no intrinsic value at the award date and as a result, the Company did not incur a compensation cost in connection with the cancellation of the options. In connection with this transaction, the Company issued 5,250,000 shares of common stock to founders and canceled 13,480,961 shares of previously issued common stock.

In June and July 2002, two of the Founders exercised the stock options to purchase 2,000,000 shares of the Company's common stock. The Company entered into four promissory notes with principal amounts of \$250,000 each and two promissory notes with principal amounts of \$500,000 each with the two Founders to ensure payments for issued stock. The notes are due one year from the date of issuance. Interest will begin to accrue from and after the maturity dates on any unpaid principal balance at an interest rate of 6% per annum. During the year 2002, the Company received \$194,600 proceeds from the stock subscription. In December 2002, the Founders returned a total of 1,805,400 shares of common stock to the Company and the unpaid principal amount of the promissory notes was canceled accordingly.

F-22

Edgar Filing: TELKONET INC - Form 10KSB

NOTE F - CAPITAL STOCK (CONTINUED)

In February 2002, the Company issued 43,586 shares of common stock to its convertible debenture holders in exchange for interest of \$21,793.

In June 2002, the Company issued 154,388 shares of common stock to consultants for warrants exercised at prices ranging from \$.40 to \$1.00 per share in exchange for services, totaling \$138,722., which approximated the fair value of the shares issued during the period the services were completed and rendered. Compensation costs of \$ 138,722 were charged to income during the year ended December 31, 2002. In 2002, the Company issued 1,444,147 shares of common stock, or \$636,076 to sophisticated investors for warrants exercised at prices ranging from \$.40 to \$.50 per share.

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 G - 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 E ----- Number Exercisable
\$ 1.00	1,450,000	9.08	\$ 1.00	649,935

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
	=====	=====

Edgar Filing: TELKONET INC - Form 10KSB

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE G - STOCK OPTIONS AND WARRANTS (CONTINUED)

Employee Stock Options (Continued)

The weighted-average fair value of stock options granted to employees during the years ended December 31, 2002 and 2001 and the weighted-average significant assumptions used to determine those fair values, using a Black-Scholes option pricing model are as follows:

	2002	2001
	----	----
Significant assumptions (weighted-average):		
Risk-free interest rate at grant date	1.67%	4.25%
Expected stock price volatility	26%	21%
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 \$(3,989,321) and \$(0.23) in 2002 and \$(1,798,347) and \$(0.08) in 2001, 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.

	Options Outstanding				Options E
	Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)		Weighed Average Exercise Price
	\$1.00	1,555,000	8.93	\$ 1.00	1,298,829

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

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2001		
Granted	246,502	\$ 0.70
Exercised	-	-
Canceled or expired	-	-
	-----	-----
Outstanding at December 31, 2001	246,502	0.70

Edgar Filing: TELKONET INC - Form 10KSB

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
	=====	=====

F-24

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE G - STOCK OPTIONS AND WARRANTS (CONTINUED)

Non-Employee Stock Options (Continued)

The estimated value of the options granted to consultants was determined using the Black-Scholes option pricing model and the following assumptions: contractual term of 10 years, a risk free interest rate of 1.67%, a dividend yield of 0% and volatility of 26%. The amount of the expense charged to operations in connection with granting the options was \$452,459 and \$11,592 during 2002 and 2001, 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			Warrants Exercisable
	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighed Average Exercise Price	
\$.50	815,000	8.00	\$.50	815,000
\$.53	354,460	3.00	\$.53	354,460
\$1.00	2,362,000	3.00	\$ 1.00	2,362,000
	=====			=====
	3,531,460			3,531,460
	=====			=====

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

Edgar Filing: TELKONET INC - Form 10KSB

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
Canceled or expired	(13,990)	1.00
	-----	-----
Outstanding at December 31, 2002	3,531,460	\$ 0.84
	=====	=====

The estimated value of the compensatory warrants granted to non-employees in exchange for services and financing expenses 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 1.67%, 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 and services was \$170,330 and \$321,479 during 2002 and 2001, respectively. The Company also capitalized financing costs of \$86,474 and \$85,818 for compensatory warrants granted in connection with placement of convertible debentures for the year ended December 31, 2002 and 2001, respectively. The financing cost was amortized over the life (three years) of the convertible debenture.

F-25

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE H - INCOME TAXES

The Company has adopted Financial Accounting Standard No. 109 which requires the recognition of deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statement or tax returns. Under this method, deferred tax liabilities and assets are determined based on the difference between financial statements and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. Temporary differences between taxable income reported for financial reporting purposes and income tax purposes are insignificant.

For income tax reporting purposes, the Company's aggregate unused net operating losses approximate \$6,450,000 which expire through 2022, subject to limitations of Section 382 of the Internal Revenue Code, as amended. The deferred tax asset related to the carryforward is approximately \$2,193,000. The Company has provided a valuation reserve against the full amount of the net operating loss benefit, because in the opinion of management based upon the earning history of the Company, it is more likely than not that the benefits will not be realized.

Components of deferred tax assets as of December 31, 2002 are as follows:

Non Current:	
Net operating loss carryforward	\$ 2,193,000
Valuation allowance	(2,193,000)

Net deferred tax asset	\$ --
	=====

NOTE I - COMMITMENTS AND CONTINGENCIES

Edgar Filing: TELKONET INC - Form 10KSB

Lease Commitments

The Company leases office space on a year to year basis in Annapolis, Maryland for its corporate offices. Commitments for minimum rentals under non cancelable leases at December 31, 2002 are as follows:

2003	\$ 44,746

	\$ 44,746
	=====

Employment and Consulting Agreements

The Company has employment agreements with the Company's employees. In addition to salary and benefit provisions, the agreements include defined commitments should the employer terminate the employment with or without cause.

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

F-26

TELKONET, INC.
 (A DEVELOPMENT STAGE COMPANY)
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 DECEMBER 31, 2002 AND 2001

NOTE I - COMMITMENTS AND CONTINGENCIES (CONTINUED)

Litigation

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

NOTE J - LOSSES PER COMMON SHARE

The following table presents the computations of basic and dilutive loss per share:

	2002	2001	For the
	----	----	3, 199
			throu

Net loss available to common shareholders	\$ (3,778,488)	\$ (1,716,495)	
Basic and fully diluted loss per share	\$ (0.22)	\$ (0.08)	
Weighted average common shares outstanding	17,119,639	21,974,439	

Edgar Filing: TELKONET INC - Form 10KSB

NOTE K - GOING CONCERN MATTERS

The accompanying statements have been prepared on a going concern basis, which contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. As shown in the financial statements from November 3, 1999 (date of inception of Company), the Company incurred losses from operations of \$6,458,676. This factor among others may indicate that the Company will be unable to continue as a going concern for a reasonable period of time.

The Company's existence is dependent upon management's ability to develop profitable operations and resolve its liquidity problems. Management anticipates the Company will attain profitable status and improve its liquidity through the continued developing of its products, establishing a profitable market for the Company's products and additional equity investment in the Company. The accompanying consolidated financial statements do not include any adjustments that might result should the Company be unable to continue as a going concern.

In order to improve the Company's liquidity, the Company is actively pursuing additional equity financing through discussions with investment bankers and private investors. There can be no assurance the Company will be successful in its effort to secure additional equity financing.

If operations and cash flows continue to improve through these efforts, management believes that the Company can continue to operate. However, no assurance can be given that management's actions will result in profitable operations or the resolution of its liquidity problems.

F-27

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE L - RESTATEMENT OF FINANCIAL STATEMENTS

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

- o 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 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 The Company erroneously recorded impairment of property and equipment as research and development expense.

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

Edgar Filing: TELKONET INC - Form 10KSB

- 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).
- o Decrease the loss per share by \$.01 from \$(.09) to \$(.08) per share.
- o Decrease the deficiency accumulated during the development stage by \$289,645 from \$(2,969,833) to \$(2,680,188).
- o Decrease other assets by \$501,276 from \$688,950 to \$187,674.
- o Increase debt discount by \$813,800 from \$0 to \$813,800 (Note E).
- o Increase additional paid in capital by \$22,879 from \$2,221,154 to \$2,244,033.

Following are reconciliations of the Company's restatement of the Consolidated Balance Sheet as of December 31, 2001 and Consolidated Statement of Losses for the year ended 2001.

F-28

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE L - RESTATEMENT OF FINANCIAL STATEMENTS (CONTINUED)

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
CONSOLIDATED BALANCE SHEET
DECEMBER 31, 2001

	As Reported -----	Adjustment -----	R -----
ASSETS			
CURRENT ASSETS:			
Cash and equivalents	\$ 21,885		\$
Total current assets	21,885		
PROPERTY AND EQUIPMENT:			
Furniture and equipment, at cost	54,950		
Less: accumulated depreciation	28,108		

	26,842		
OTHER ASSETS:			
Financing costs, net of amortization	684,325	\$ (501,276)	
Prepaid expenses and deposits	4,625		

Edgar Filing: TELKONET INC - Form 10KSB

	688,950		
	\$ 737,677	\$ (501,276)	\$
	=====	=====	=====
LIABILITIES AND DEFICIENCY IN STOCKHOLDERS' EQUITY			
CURRENT LIABILITIES:			
Accounts payable and accrued expenses	\$ 116,741		\$
Notes payable	400,000		
Due to Shareholders	7,500		
	-----		-----
Total current liabilities	524,241		
Convertible debentures, net of discounts - including Related parties	940,000	\$ (813,800)	
COMMITMENTS AND CONTINGENCIES	--		
DEFICIENCY IN STOCKHOLDERS' EQUITY			
Common stock, par value \$.001 per share; 100,000,000 shares authorized; 21,115,371 shares issued and outstanding at December 31, 2001			
	22,115		
Additional paid-in-capital	2,221,154	22,879	
Accumulated deficit during development stage	(2,969,833)	289,645	(
	-----	-----	-----
Deficiency in stockholders' equity	(726,564)	312,524	
	-----	-----	-----
	\$ 737,677	\$ (501,276)	\$
	=====	=====	=====

F-29

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2002 AND 2001

NOTE L - RESTATEMENT OF FINANCIAL STATEMENTS (CONTINUED)

TELKONET, INC.
(A DEVELOPMENT STAGE COMPANY)
CONSOLIDATED STATEMENT OF LOSSES
FOR THE YEAR ENDED DECEMBER 31, 2001

	As Reported	Adjustments	Res
	-----	-----	-----
Costs and Expenses:			
Research & Development	\$ 160,115	\$ (39,287)	\$
Selling, General and Administrative	1,386,222		1,
Impairment of Property and Equipment	--	39,287	

Edgar Filing: TELKONET INC - Form 10KSB

Depreciation and Amortization	43,557	(12,760)	
	-----		-----
Total Operating Expense	1,589,894		1,
Loss from Operations	(1,589,894)		(1,
Other Income	1,257		
Interest Income (Expense)	(417,503)	276,885	(
Provision for Income Tax	--		
	-----		-----
	(416,246)		(
Net Loss	\$ (2,006,140)	289,645	\$ (1,
	=====	=====	=====
Loss per common share (basic and assuming dilution)	\$ (0.09)	\$ 0.01	\$
	=====	=====	=====
Weighted average common shares outstanding	21,974,439	21,974,439	21,

F-30