TELKONET INC
Form 10-Q/A
April 24, 2012

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

FORM 10-Q/A
(Amendment No. 1)

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

For the quarterly period ended June 30, 2011

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the transition period from __________ to __________.

Commission file number 001-31972

TELKONET, INC.

(Exact name of Issuer as specified in its charter)

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 104,349,507 shares of Common Stock ($.001 par value) as of April 11, 2012.

TELKONET, INC.

FORM 10-Q/A for the Quarter Ended June 30, 2011

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EXPLANATORY NOTE

This Quarterly Report on Form 10-Q/A for the six months ended June 30, 2011 amends and restates the unaudited condensed consolidated balance sheet of Telkonet, Inc. (the "Company") as of June 30, 2011, the unaudited condensed consolidated statements of operations for the three and six months ended June 30, 2011 and 2010, the unaudited condensed consolidated statement of stockholders' equity for the year ended December 31, 2010, the unaudited condensed consolidated statement of stockholders' equity for the period from January 1, 2011 through June 30, 2011 and the unaudited condensed consolidated statement of cash flows for the six months ended June 30, 2011 and 2010. The comparative condensed consolidated balance sheet as of December 31, 2010 has also been restated.

The Company's management has recommended, and its Audit Committee has concluded, that the Company's audited consolidated financial statements for the year ended December 31, 2010 as well as the unaudited interim condensed consolidated financial statements for 2011 and 2010 included in its Quarterly Reports on Form 10-Q for the quarters ended March 31, 2011, June 30, 2011 and September 30, 2011 needed to be restated as a result of certain adjustments and therefore could no longer be relied upon.

As is detailed in Note B of the notes to condensed consolidated financial statements in this Form 10-Q/A, the above referenced restatements are the result of corrections that management has determined are necessary as of December 31, 2010 and 2009 and for all periods previously reported for each of the three and six month periods ended June 30, 2011 for the following items:

- The Company had understated accrued sales tax, penalties, interest and related expenses.

- Incorrect application of Accounting Standards Codification (ASC) 450, Accounting for Contingencies, resulted in an understatement of accrued warranty and related expenses.

- Incorrect application of ASC 840, Accounting for Leases, resulted in an understatement of deferred lease liability and related rent expense.

- Errors related to improper recording of depreciation expense and related understatement of, accumulated depreciation.

- Errors related to improper recording of various accrued liabilities and expenses, as well as other current liabilities, resulting in a net understatement of such liabilities and related expenses.

- Additionally, certain reclassifications have been made to previously reported unaudited condensed consolidated financial statements.

This Form 10-Q/A should be read in conjunction with our Form 10Q/A's for the periods ending March 31, 2011 and September 30, 2011 and our filings made with the SEC subsequent to the filing of the original Form 10-Q. The following items have been amended (and conforming changes have been made where indicated as restated) as a result of the restatement:

Part I – Item 1 – Financial Statements

Part I – Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations

The restated consolidated financial statements as of December 31, 2010 and for the year ended December 31, 2010 will be included in our 2011 Form 10-K for the year ended December 31, 2011. The restatements of the other quarterly and year-to-date periods for 2010 and 2011 have been or will be included in our Form 10-Q/A's for the quarters ended March 31, 2011 and September 30, 2011.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TELKONET, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

	(Unaudited) June 30, 2011 (As Restated)	December 31, 2010 (As Restated)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 882,484	$ 136,030
Accounts receivable, net	1,245,055	799,185
Inventories	595,968	599,402
Prepaid expenses	231,237	163,327
Total current assets	2,954,744	1,697,944
Property and equipment, net	29,343	43,329
Other assets:		
Deferred financing costs, net	-	56,732
Goodwill	11,670,446	11,670,446
Intangible assets, net	1,862,817	1,983,657
Deposits	34,238	34,238
Total other assets	13,567,501	13,745,073
Total Assets	$ 16,551,588	$ 15,486,346
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,871,198	$ 2,402,950
Accrued liabilities and expenses	1,953,816	1,890,951
Note payable – current	85,768	47,536
Note payable – related party	-	25,114
Convertible debentures, net of debt discounts of $134,625	-	1,471,398
Derivative liability – current	-	619,698
Other current liabilities	70,065	151,035
Total current liabilities	3,980,847	6,608,682
Long-term liabilities:		
Derivative liability – long term	-	1,282,077
Deferred lease liability	98,218	82,802
Note payable – long term	928,322	252,464
Total long-term liabilities	1,026,540	1,617,343
Redeemable preferred stock:		

Redeemable preferred stock, 15,000,000 shares authorized; par value $.001 per share;				
Series A, 215 shares issued and outstanding at June 30, 2011 and December 31, 2010.		968,701		890,475
Series B, 538 shares issued and 533 shares outstanding at June 30, 2011, 267 shares issued and outstanding at December 31, 2010		1,363,222		653,371
Total redeemable preferred stock		2,331,923		1,543,846
Commitments and contingencies		-		-
Stockholders' Equity				
Common stock, par value $.001 per share; 190,000,000 shares authorized; 102,037,171 and 101,258,725 shares issued and outstanding at June 30, 2011 and December 31, 2010, respectively		102,039		101,261
Additional paid-in-capital		124,449,103		122,057,171
Accumulated deficit		(115,338,864)		(116,441,957)
Total stockholders' equity		9,212,278		5,716,475
Total Liabilities and Stockholders' Equity	$	16,551,588	$	15,486,346

See accompanying notes to the condensed consolidated financial statements

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TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	For The Three Months Ended June 30,		For The Six Months Ended June 30,	
	2011 (As Restated)	2010 (As Restated)	2011 (As Restated)	2010 (As Restated)
Revenues, net:				
Product	$ 1,776,888	$ 1,970,286	$ 3,127,960	$ 3,536,737
Recurring	1,151,048	1,122,371	2,282,675	2,073,029
Total Revenue	2,927,936	3,092,657	5,410,635	5,609,766
Cost of Sales:				
Product	1,017,894	938,305	1,726,164	1,789,482
Recurring	291,247	321,190	555,116	620,301
Total Cost of Sales	1,309,141	1,259,495	2,281,280	2,409,783
Gross Profit	1,618,795	1,833,162	3,129,355	3,199,983
Operating Expenses:				
Research and development	182,625	293,579	391,234	588,196
Selling, general and administrative	1,166,812	1,416,947	2,294,645	3,108,674
Depreciation and amortization	68,818	95,207	130,346	193,034
Total Operating Expenses	1,418,255	1,805,733	2,816,225	3,889,904
Income (Loss) from Operations	200,540	27,429	313,130	(689,921)
Other Income (Expenses):				
Interest expense, net	(23,740)	(165,265)	(213,974)	(341,921)
Gain on derivative liability	-	541,326	172,476	696,793
Gain on sale of product line	-	-	829,296	-
Gain (loss) on disposal of property and equipment	-	(100,744)	2,165	(100,744)
Total Other Income (Expense)	(23,740)	275,317	789,963	254,128
Income (Loss) Before Provision for Income Taxes	176,800	302,746	1,103,093	(435,793)
Provision for Income Taxes	-	-	-	-
Net Income (Loss)	176,800	302,746	1,103,093	(435,793)
Accretion of preferred dividends and discount	(170,800)	(39,347)	(313,867)	(78,460)
Net income (loss) attributable to common stockholders	$ 6,000	$ 263,399	$ 789,226	$ (514,253)

Net income per common share:				
Income per common share– basic	$ 0.00	$ 0.00	$ 0.01	$ 0.00
Income per common share - diluted	$ 0.00	$ 0.00	$ 0.01	$ 0.00
Weighted Average Common Shares Outstanding – basic	102,878,097	96,916,357	101,556,654	96,714,804
Weighted Average Common Shares Outstanding - diluted	104,404,580	97,140,595	103,083,137	96,714,804

See accompanying notes to the condensed consolidated financial statements

TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)
FOR THE YEAR ENDED DECEMBER 31, 2010

	Common Shares	Common Stock Amount	Additional Paid in Capital	Accumulated Deficit	Total Stockholders' Equity
Balance at January 1, 2010, as restated	96,563,771	$96,564	$120,194,142	$(114,262,940)	$6,027,766
Shares issued to directors and management at approximately $0.19 per share	3,919,821	3,920	1,093,746	-	1,097,666
Shares issued to directors and management at approximately $0.165 per share	224,410	225	36,775	-	37,000
Shares issued in exchange for services rendered at approximately $0.19 per share	550,723	552	77,143	-	77,695
Stock-based compensation expense related to employee stock options	-	-	132,386	-	132,386
Warrants issued with redeemable convertible preferred stock	-	-	394,350	-	394,350
Beneficial conversion feature of redeemable convertible preferred stock	-	-	394,350	-	394,350
Warrant repurchase and cancellation	-	-	(1,000)	-	(1,000)
Accretion of redeemable preferred stock discount	-	-	(135,638)	-	(135,638)
Accretion of redeemable preferred stock dividend	-	-	(129,083)	-	(129,083)
Net loss, as restated				(2,179,017)	(2,179,017)
Balance at December 31, 2010, as restated	101,258,725	$101,261	$122,057,171	$(116,441,957)	$5,716,475

See accompanying notes to the condensed consolidated financial statements

TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)
FOR THE SIX MONTHS FROM JANUARY 1, 2011 THROUGH JUNE 30, 2011

	Common Shares	Common Stock Amount	Additional Paid in Capital	Accumulated Deficit	Total Stockholders' Equity
Balance at January 1, 2011, as restated	101,258,725	$101,261	$122,057,171	$(116,441,957)	$5,716,475
Shares issued to directors and management at approximately $0.135 per share	409,056	409	55,091	-	55,500
Shares issued to directors for consulting fees at approximately $0.15 per share (1)	177,083	177	24,823	-	25,000
Shares issued on conversion of preferred stock at approximately $0.18 per share	192,307	192	24,808	-	25,000
Stock-based compensation expense related to employee stock options	-	-	15,988	-	15,988
Warrants issued with redeemable convertible preferred stock	-	-	427,895	-	427,895
Beneficial conversion feature of redeemable convertible preferred stock	-	-	427,895	-	427,895
Retirement of derivative liability related to warrant obligation	-	-	1,729,299	-	1,729,299
Accretion of redeemable preferred stock discount	-	-	(193,797)	-	(193,797)
Accretion of redeemable preferred stock dividend	-	-	(120,070)	-	(120,070)
Net income, as restated				1,103,093	1,103,093
Balance at June 30, 2011, as restated	102,037,171	$102,039	$124,449,103	$(115,338,864)	$9,212,278

See accompanying notes to the condensed consolidated financial statements

(1) Represents consulting fees earned by Mr. Davis in 2009, but the shares were not issued until after the election to Board of Directors

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

	For the Six Months Ended June 30, 2011 (As Restated)	For the Six Months Ended June 30, 2010 (As Restated)
Cash Flows from Operating Activities:		
Net income (loss)	$ 1,103,093	$ (435,793)
Adjustments to reconcile net income (loss) from operations to cash (used in) provided by operating activities:		
Amortization of debt discounts and financing costs	191,357	254,120
Gain on sale of product line	(829,296)	-
Gain on derivative liability	(172,476)	(696,793)
(Gain) loss on disposal of property and equipment	(2,165)	100,744
Stock based compensation expense	96,488	88,181
Depreciation	9,506	72,194
Amortization	120,840	120,840
Provision for doubtful accounts	(56,620)	31,879
Increase / decrease in:		
Accounts receivable, trade and other	(389,250)	(762,451)
Inventories	(117,270)	219,051
Prepaid expenses	(67,910)	(187,713)
Other current liabilities	(80,970)	42,212
Accounts payable, accrued liabilities & expenses, net	(468,887)	1,019,019
Deferred lease liability	15,416	21,494
Net Cash Used In Operating Activities	(648,144)	(113,016)
Cash Flows From Investing Activities:		
Proceeds on disposal of property and equipment	6,645	-
Proceeds from sale of product line	1,000,000	-
Net Cash Provided by Investing Activities	1,006,645	-
Cash Flows From Financing Activities:		
Repayment on line of credit	-	(288,417)
Proceeds from issuance of note payable	700,000	-
Payments on note payable	(35,910)	-
Payments on note payable – related party	(25,114)	-
Proceeds from issuance of redeemable preferred stock	1,355,000	-
Repayment of convertible debentures	(1,606,023)	-
Net Cash Provided By (Used In) Financing Activities	387,953	(288,417)
Net increase (decrease) in cash and cash equivalents	746,454	(401,433)
Cash and cash equivalents at the beginning of the period	136,030	503,870
Cash and cash equivalents at the end of the period	$ 882,484	$ 102,437

See accompanying notes to the condensed consolidated financial statements

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

	For the Six Months Ended June 30,	
	2011 (As Restated)	2010 (As Restated)
Supplemental Disclosures of Cash Flow Information:		
Cash transactions:		
Cash paid during the period for interest expense	$ 177,639	$ 177,564
Non-cash transactions:		
Issuance of common stock as consideration for accounts payable	$ -	$ 62,957
Issuance of note payable in conjunction with warrant cancellation	50,000	-
Beneficial conversion feature of redeemable convertible preferred stock	427,895	-
Value of warrants issued with redeemable convertible preferred stock	427,895	-
Accretion of discount on redeemable preferred stock	193,797	35,802
Accretion of dividend on redeemable preferred stock	120,070	42,658
Retirement of derivative liability related to warrant obligation	1,729,299	-
Conversion of preferred stock to common stock	25,000	-

See accompanying notes to the condensed consolidated financial statements

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011
(UNAUDITED)

NOTE A – SUMMARY OF ACCOUNTING POLICIES

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

General

The restated condensed consolidated balance sheet as of December 31, 2010 and the restated condensed consolidated statement of stockholders' equity for the year ended December 31, 2010 have been derived from the restated financial statements. The accompanying unaudited condensed consolidated financial statements of Telkonet, Inc. (the "Company") have been prepared in accordance with Rule S-X of the Securities and Exchange Commission (the "SEC") and with the instructions to Form 10-Q. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. However, the restated results from operations for the three and six month periods ended June 30, 2011 and 2010, are not necessarily indicative of the results that may be expected for the year ending December 31. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company's Form 2011 10-K to be filed hereafter with the SEC.

Business and Basis of Presentation

Telkonet, Inc., formed in 1999 and incorporated under the laws of the state of Utah, has evolved into a Clean Technology company that develops, manufactures and sells proprietary energy efficiency and SmartGrid networking technology. Prior to January 1, 2007, the Company was primarily engaged in the business of developing, producing and marketing proprietary equipment enabling the transmission of voice and data communications over a building's internal electrical wiring.

In March 2007, the Company acquired substantially all of the assets of Smart Systems International ("SSI"), a leading provider of energy management products and solutions to customers in the United States and Canada.

In March 2007, the Company acquired 100% of the outstanding membership units of EthoStream, LLC, a network solutions integration company that offers installation, sales and service to the hospitality industry. The EthoStream acquisition enabled Telkonet to provide installation and support for PLC products and third party applications to customers across North America.

In March 2011, the Company sold all its Series 5 PLC product line assets to Wisconsin-based Dynamic Ratings, Inc. under an Asset Purchase Agreement.

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

Going Concern

The accompanying condensed consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern. The Company has reported net income of $1,103,093 for the six month period ended June 30, 2011, accumulated deficit of $115,338,864 and total current liabilities in excess of current assets of $1,026,103 as of June 30, 2011. The accompanying financial statements do not include any adjustments that might result from the outcome of these uncertainties.

We continue to experience net operating losses and deficits in cash flows from operations. Our ability to continue as a going concern is subject to our ability to generate a profit and/or obtain necessary funding from outside sources, including by the sale of our securities or assets, or obtaining loans from financial institutions, where possible. Our continued net operating losses and the uncertainty regarding contingent liabilities cast doubt on our ability to meet such goals and the Company cannot make any representations for fiscal 2012 and beyond.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011
(UNAUDITED)

The Company believes that anticipated revenues from operations will be insufficient to satisfy its ongoing capital requirements for at least the next 12 months. If the Company's financial resources from operations are insufficient, the Company will require financing in addition to the funds received from the sale of the Series 5 product line in order to execute its operating plan and continue as a going concern. The Company cannot predict whether this additional financing will be in the form of equity or debt, or be in another form. The Company may not be able to obtain the necessary additional capital on a timely basis, on acceptable terms, or at all. In any of these events, the Company may be unable to implement its current plans for expansion, repay its debt obligations as they become due, or respond to competitive pressures, any of which circumstances would have a material adverse effect on its business, prospects, financial condition and results of operations.

Management intends to review the options for raising capital including, but not limited to, through asset-based financing, private placements, and/or disposition. Management believes that with this financing, the Company will be able to generate additional revenues that will allow the Company to continue as a going concern. There can be no assurance that the Company will be successful in obtaining additional funding.

Fair Value of Financial Instruments

The Company accounts for the fair value of financial instruments in accordance with Accounting Standards Codification (ASC) 820, which defines fair value for accounting purposes, established a framework for measuring fair value and expanded disclosure requirements regarding fair value measurements. Fair value is defined as an exit price, which is the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date. The degree of judgment utilized in measuring the fair value of assets and liabilities generally correlates to the level of pricing observability. Financial assets and liabilities with readily available, actively quoted prices or for which fair value can be measured from actively quoted prices in active markets generally have more pricing observability and require less judgment in measuring fair value. Conversely, financial assets and liabilities that are rarely traded or not quoted have less price observability and are generally measured at fair value using valuation models that require more judgment. These valuation techniques involve some level of management estimation and judgment, the degree of which is dependent on the price transparency of the asset, liability or market and the nature of the asset or liability. We have categorized our financial assets and liabilities that are recurring, at fair value into a three-level hierarchy in accordance with these provisions.

Goodwill and Other Intangibles

Goodwill represents the excess of the cost of businesses acquired over fair value or net identifiable assets at the date of acquisition. Goodwill is subject to a periodic impairment assessment by applying a fair value test based upon a two-step method. The first step of the process compares the fair value of the reporting unit with the carrying value of the reporting unit, including any goodwill. We utilize a discounted cash flow valuation methodology to determine the fair value of the reporting unit. If the fair value of the reporting unit exceeds the carrying amount of the reporting unit, goodwill is deemed not to be impaired in which case the second step in the process is unnecessary. If the carrying amount exceeds fair value, we perform the second step to measure the amount of impairment loss. Any impairment loss is measured by comparing the implied fair value of goodwill with the carrying amount of goodwill at the reporting unit, with the excess of the carrying amount over the fair value recognized as an impairment loss.

Long-Lived Assets

We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable in accordance with ASC 360-10. Recoverability is measured by comparison of the carrying amount to the future net cash flows which the assets are expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the projected future cash flows arising from the asset determined by management to be commensurate with the risk inherent to our current business model.

Income per Common Share

The Company computes earnings per share under ASC 260-10, Earnings Per Share. Basic net income per common share is computed by dividing net income by the weighted average number of outstanding shares of common stock. Diluted earnings per share is computed using the weighted average number of common and common stock equivalent shares outstanding during the period. There is no effect on diluted income per share since the common stock equivalents are anti-dilutive. Dilutive common stock equivalents consist of shares issuable the exercise of the Company's outstanding stock options and warrants.

Use of Estimates

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

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011
(UNAUDITED)

Income Taxes

The Company accounts for income taxes in accordance with ASC 740-10 “Income Taxes.” Under this method, deferred income taxes (when required) are provided based on the difference between the financial reporting and income tax bases of assets and liabilities and net operating losses at the statutory rates enacted for future periods. The Company has a policy of establishing a valuation allowance when it is more likely than not that the Company will not realize the benefits of its deferred tax assets in the future.

The Company has adopted the Financial Accounting Standards Board (“FASB”) issued ASC 740-10-25, which prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. ASC 740-10-25 also provides guidance on derecognition, classification, treatment of interest and penalties, and disclosure of such positions.

Revenue Recognition

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

We provide call center support services to properties installed by us and also to properties installed by other providers. In addition, we provide the property with the portal to access the Internet. We receive monthly service fees from such properties for our services and Internet access. We recognize the service fee ratably over the term of the contract. The prices for these services are fixed and determinable prior to delivery of the service. The fair value of these services is known due to objective and reliable evidence from contracts and standalone sales. We report such revenues as recurring revenues.

Stock Based Compensation

We account for our stock based awards in accordance with ASC 718-10, Compensation, which requires a fair value measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors, including employee stock options and restricted stock awards. We estimate the fair value of stock options granted using the Black-Scholes valuation model. This model requires us to make estimates and assumptions including, among other things, estimates regarding the length of time an employee will retain vested stock options before exercising them, the estimated volatility of our common stock price and the number of options that will be forfeited prior to vesting. The fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. Changes in these estimates and assumptions can materially affect the determination of the fair value of stock-based compensation and consequently, the related amount recognized in our consolidated statements of operations.

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. For 2011 and prior years, expected stock price volatility is based on the historical volatility of the Company's stock for the related vesting periods.

Stock-based compensation expense in connection with options granted to employees for the three and six months ended June 30, 2011 and 2010 was $7,994 and $15,988 and $46,780 and $88,181, respectively.

Deferred Lease Liability

Rent expense is recorded on a straight-line basis over the term of the lease. Rent escalations and rent abatement periods during the term of the lease create a deferred lease liability which represents the excess of cumulative rent expense recorded to date over the actual rent paid to date.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011
(UNAUDITED)

Reclassifications

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

NOTE B – RESTATEMENT OF CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The Company accounts for the correction of errors in previously issued financial statements in accordance with the provisions of ASC Topic 250, Accounting Changes and Error Corrections. In accordance with the disclosure provisions of ASC 250, when financial statements are restated to correct an error, an entity is required to disclose that its previously issued financial statements have been restated along with a description of the nature of the error, the effect of the correction on each financial statement line item and any per share amount affected for each prior period presented, and the cumulative effect on the accumulated deficit in the respective balance sheets as of the beginning of the earliest period presented.

Of the details to follow, the most significant adjustment was related to the Company's failure to assess, collect and remit sales tax in accordance with state and local sales and use tax regulations.

Throughout this Form 10-Q/A, all amounts presented from prior periods and prior period comparisons that have been corrected are labeled "As Restated" and reflect the balances and amounts on a restated basis. The specific line-item effect of the restatement on the Company's previously issued condensed consolidated financial statements as of June 30, 2011 and 2010 and the Company's previously issued consolidated financial statements as of December 31, 2010 and for the three and six months ended June 30, 2011 and 2010 as filed on Form 10-Q on August 8, 2011 are as follows:

The following is a summary of the restatements for the periods ended June 30:

	2011	
	For the Three Months Ended (Unaudited)	For the Six Months Ended (Unaudited)
Increase in sales tax, related penalties and interest	$ (43,118)	$ (79,679)
Incorrect application of ASC 840, Accounting for Leases, resulted in an overstatement of deferred lease liability	89,312	82,802
Decrease in depreciation expense related to recording depreciation expense in improper periods	17,417	34,834

Increase in expense related to improper recording of various accrued liabilities		-		(30,531)
Total increase in net income for the stated period	$	63,611	$	7,426

	2010			
	For the Three Months Ended (Unaudited)		For the Six Months Ended (Unaudited)	
Increase in sales tax, related penalties and interest	$	(47,312)	$	(85,820)
Incorrect application of ASC 840, Accounting for Leases, resulted in an understatement of deferred lease liability		(10,747)		(21,494)
Increase in depreciation expense related to recording depreciation expense in improper periods		(17,417)		(34,834)
Increase in expense related to improper recording of various accrued liabilities		(105,344)		(105,344)
Total decrease in net income and increase in net loss, respectively for the stated period	$	(180,820)	$	(247,492)

The net income (loss) per common share effect of each individual correction has not been reported individually due to the fact that there was no effect on the per share amounts.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011
(UNAUDITED)

	Effect on Condensed Consolidated Balance Sheets as of					
	June 30, 2011 (Unaudited)			December 31, 2010		
	As Previously Reported	As Restated	Effect of Correction	As Previously Reported	As Restated	Effect of Correction
Assets:						
Current assets:						
Prepaid expenses	$ 265,475	$ 231,237	$ (34,238)	$ 197,565	$ 163,327	$ (34,238)
Total current assets	2,988,982	2,954,744	(34,238)	1,732,182	1,697,944	(34,238)
Property and equipment, net	64,177	29,343	(34,834)	112,997	43,329	(69,668)
Other assets:						
Deposits	-	34,238	34,238	-	34,238	34,238
Total other assets	13,533,263	13,567,501	34,238	13,710,835	13,745,073	34,238
Total assets	16,586,422	16,551,588	(34,834)	15,556,014	15,486,346	(69,668)
Current liabilities:						
Accrued liabilities and expenses	1,110,529	1,953,816	843,287	1,157,873	1,890,951	733,078
Other current liabilities	89,063	70,065	(18,998)	170,033	151,035	(18,998)
Total current liabilities	3,156,558	3,980,847	824,289	5,894,602	6,608,682	714,080
Long-term liabilities:						
Deferred lease liability	98,218	98,218	-	-	82,802	82,802
Total long-term liabilities	1,026,540	1,026,540	-	1,534,541	1,617,343	82,802
Stockholders' equity:						
Additional paid-in-capital	124,387,048	124,449,103	62,055	121,995,117	122,057,171	62,054
Accumulated deficit	(114,417,686)	(115,338,864)	(921,178)	(115,513,353)	(116,441,951)	(928,604)
Total stockholders' equity	$ 10,071,401	$ 9,212,278	$ (859,123)	$ 6,583,025	$ 5,716,475	$ (866,550)

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TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011
(UNAUDITED)

Effect on Condensed Consolidated Statements of Operations

	Three Months ended June 30, 2011 (Unaudited)			Three Months ended June 30, 2010 (Unaudited)		
	As Previously Reported	As Restated	Effect of Correction	As Previously Reported	As Restated	Effect of Correction
Revenues, net						
Recurring	$ 1,151,048	$ 1,151,048	$ -	$ 1,213,115	$ 1,122,371	$ (90,744)
Total Revenue	2,927,936	2,927,936	-	3,183,401	3,092,657	(90,744)
Cost of Sales						
Product	1,017,894	1,017,894	-	1,012,124	938,305	(73,819)
Recurring	291,247	291,247	-	326,062	321,190	(4,872)
Total Cost of Sales	1,309,141	1,309,141	-	1,338,186	1,259,495	(78,691)
Gross Profit	1,618,795	1,618,795	-	1,845,215	1,833,162	(12,053)
Operating Expenses						
Research and development	184,207	182,625	(1,582)	264,049	293,579	29,530
Selling, general and administrative	1,224,178	1,166,812	(57,366)	1,304,845	1,416,947	112,102
Depreciation and amortization	86,235	68,818	(17,417)	77,790	95,207	17,417
Total Operating Expenses	1,494,620	1,418,255	(76,365)	1,646,684	1,805,733	159,049
Income (Loss) from Operations	124,175	200,540	76,365	198,531	27,429	(171,102)
Other Income (Expenses)						
Interest expense, net	(10,986)	(23,740)	(12,754)	(155,547)	(165,265)	(9,718)
Total Other Income (Expense)	(10,986)	(23,740)	(12,754)	285,035	275,317	(9,718)
Income (Loss) Before Provision for Income Taxes	113,189	176,800	63,611	483,566	302,746	(180,820)
Net Income (Loss)	113,189	176,800	63,611	483,566	302,746	(180,820)
	$ (57,611)	$ 6,000	$ 63,611	$ 444,219	$ 263,399	$ (180,820)

Net income (loss) attributable to common stockholders						
Net income per common share:						
Net income per common share – basic	$ 0.00	$ 0.00	$ 0.00	$ 0.00	$ 0.00	$ 0.00
Net income per common share – diluted	$ 0.00	$ 0.00	$ 0.00	$ 0.00	$ 0.00	$ 0.00
Weighted Average Common Shares Outstanding – basic	102,878,097	102,878,097	-	96,916,357	96,916,357	-
Weighted Average Common Shares Outstanding – diluted	104,404,580	104,404,580	-	97,140,595	97,140,595	-

The weighted average per share effect of these changes has not been reported individually due to the fact that there is no effect on the per share amounts.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011
(UNAUDITED)

Effect on Condensed Consolidated Statements of Operations

	Six Months ended June 30, 2011 (Unaudited)			Six Months ended June 30, 2010 (Unaudited)		
	As Previously Reported	As Restated	Effect of Correction	As Previously Reported	As Restated	Effect of Correction
Revenues, net						
Recurring	$ 2,282,675	$ 2,282,675	$ -	$ 2,230,704	$ 2,073,029	$ (157,675)
Total Revenue	5,410,635	5,410,635	-	5,767,441	5,609,766	(157,675)
Cost of Sales						
Product	1,726,164	1,726,164	-	1,911,907	1,789,482	(122,425)
Recurring	555,116	555,116	-	631,907	620,301	(11,606)
Total Cost of Sales	2,281,280	2,281,280	-	2,543,814	2,409,783	(134,031)
Gross Profit	3,129,355	3,129,355		3,223,627	3,199,983	(23,644)
Operating Expenses						
Research and development	371,318	391,234	19,916	529,900	588,196	58,296
Selling, general and administrative	2,310,722	2,294,645	(16,077)	2,995,584	3,108,674	113,090
Depreciation and amortization	165,180	130,346	(34,834)	158,200	193,034	34,834
Total Operating Expenses	2,847,220	2,816,225	(30,995)	3,683,684	3,889,904	206,220
Income (Loss) from Operations	282,135	313,130	30,995	(460,057)	(689,921)	(229,864)
Other Income (Expenses)						
Interest expense, net	(190,406)	(213,974)	(23,568)	(324,293)	(341,921)	(17,628)
Gain on derivative liability	172,477	172,476	(1)	-	-	-
Total Other Income (Expense)	813,532	789,963	(23,569)	271,756	254,128	(17,628)
Income (Loss) Before Provision for Income Taxes	1,095,667	1,103,093	7,426	(188,301)	(435,793)	(247,492)

Net Income (Loss)	1,095,667	1,103,093	7,426	(188,301)	(435,793)	(247,492)
Net income (loss) attributable to common stockholders	$ 781,800	$ 789,226	$ 7,426	$ (266,761)	$ (514,253)	$ (247,492)
Net income per common share:						
Net income per common share – basic	$ 0.01	$ 0.01	$ 0.00	$ 0.00	$ 0.00	$ 0.00
Net income per common share – diluted	$ 0.01	$ 0.01	$ 0.00	$ 0.00	$ 0.00	$ 0.00
Weighted Average Common Shares Outstanding – basic	101,475,906	101,556,654	80,748	96,714,804	96,714,804	-
Weighted Average Common Shares Outstanding – diluted	103,002,389	103,083,137	80,748	96,714,804	96,714,804	-

The weighted average per share effect of these changes has not been reported individually due to the fact that there is no effect on the per share amounts.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2011
(UNAUDITED)

	Effect on Condensed Consolidated Statements of Cash Flows					
	Six Months ended June 30, 2011 (Unaudited)			Six Months ended June 30, 2010 (Unaudited)		
	As Previously Reported	As Restated	Effect of Correction	As Previously Reported	As Restated	Effect of Correction
Net income (loss)	$ 1,095,667	$ 1,103,093	$ 7,426	$ (188,301)	$ (435,793)	$ (247,492)
Gain (loss) on derivative liability	(172,477)	(172,476)	1	(696,793)	(696,793)	-
Depreciation	44,340	9,506	(34,834)	37,360	72,194	34,834
Accounts payable, accrued expenses, net	(579,096)	(468,887)	110,209	827,855	1,019,019	191,164
Deferred lease liability	98,218	15,416	(82,802)	-	21,494	21,494

The financial statement restatement process included a comprehensive review and restatement of the condensed consolidated balance sheet as of January 1, 2010 to address all errors that arose in 2009 and prior periods. The net adjustments to stockholders' equity, resulting from this process and related error corrections was to increase accumulated deficit in stockholders' equity by $(521,459) from $(113,741,481) as reported to a restated amount of $(114,262,940). The corrections mainly consisted of sales and use tax expense and other accrued liabilities and expenses.

The primary components of the net corrections to the accumulated deficit at January 1, 2010 are as follows:

Non tax effected corrections:		
Increase in sales tax liability, penalties and interest	$	(449,453)
Increase in deferred lease liability		(55,085)
Increase in accrued warranty		(51,000)
Other unrecorded liabilities		34,079
Net adjustment to accumulated deficit	$	(521,459)

Due to the Company's accumulated net operating losses (NOLs) and related valuation allowance, there is no tax effect resulting from the restatement.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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NOTE C – NEW ACCOUNTING PRONOUNCEMENTS

In May 2011, the Financial Accounting Standards Board (FASB) issued FASB ASU No. 2011-04, "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs," which is now codified under FASB ASC Topic 820, "Fair Value Measurement." This new guidance provides common requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. generally accepted accounting principles ("GAAP") and International Financial Reporting Standards ("IFRSs"). Certain fair value measurement principles were clarified or amended in this ASU, such as the application of the highest and best use and valuation premise concepts. New and revised disclosure requirements include: quantitative information about significant unobservable inputs used for all Level 3 fair value measurements and a description of the valuation processes in place, as well as a qualitative discussion about the sensitivity of recurring Level 3 fair value measurements; public companies will need to disclose any transfers between Level 1 and Level 2 fair value measurements on a gross basis, including the reason(s) for those transfers; a requirement regarding disclosure on the highest and best use of a nonfinancial asset; and a requirement that all fair value measurements be categorized in the fair value hierarchy with disclosure of that categorization. FASB ASU No. 2011-04 will be effective on a prospective basis for public companies during interim and annual periods beginning after December 15, 2011. Early adoption by public companies is not permitted. We do not expect the adoption of this ASU to have an impact on our consolidated statements.

In September 2011, the FASB issued FASB ASU No. 2011-08, "Testing Goodwill for Impairment," which is now codified under FASB ASC Topic 350, "Intangibles — Goodwill and Other." This new guidance allows an entity to first assess qualitative factors to evaluate if the existence of events or circumstances leads to a determination it is necessary to perform the current two-step test. After assessing the totality of events or circumstances, if it is determined it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. Otherwise, the entity is required to perform Step 1 of the impairment test. An entity has the option to bypass the qualitative assessment for any reporting unit in any period and proceed directly to Step 1 of the two-step impairment test, and then resume performing the qualitative assessment in any subsequent period. Reporting units with zero or negative carrying amounts continue to be required to perform a qualitative assessment in place of Step 1 of the impairment test. The new guidance includes examples of events and circumstances an entity should consider in its evaluation of whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount, such as macroeconomic conditions; industry and market considerations; cost factors; overall financial performance; and other relevant entity-specific events. The examples of events and circumstances included in this ASU supersede the previous examples entities should have considered. FASB ASU No. 2011-08 is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. We do not expect the adoption of this ASU to have an impact on our consolidated statements.

NOTE D – INTANGIBLE ASSETS AND GOODWILL

Total identifiable intangible assets acquired and their carrying values at June 30, 2011 are:

	Cost	Accumulated Amortization	Net Book Value	Residual Value	Weighted Average Amortization

					Period (Years)
Amortized Identifiable Intangible Assets:					
Subscriber lists – EthoStream	$ 2,900,000	$ (1,037,183)	$ 1,862,817	$ -	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(1,037,183)	1,862,817	-	
Goodwill – EthoStream	5,796,430	-	5,796,430	-	
Goodwill – SSI	5,874,016	-	5,874,016	-	
Total	$ 14,570,446	$ (1,037,183)	$ 13,533,263	$ -	

Total identifiable intangible assets acquired and their carrying values at December 31, 2010 are:

	Cost	Accumulated Amortization	Net Book Value	Residual Value	Weighted Average Amortization Period (Years)
Amortized Identifiable Intangible Assets:					
Subscriber lists – EthoStream	$ 2,900,000	$ (916,343)	$ 1,983,657	$ -	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(916,343)	1,983,657	-	
Goodwill – EthoStream	5,796,430	-	5,796,430	-	
Goodwill – SSI	5,874,016	-	5,874,016	-	
Total	$ 14,570,446	$ (916,343)	$ 13,654,103	$ -	

Total amortization expense charged to operations for each of the three and six months ended June 30, 2011 and 2010 was $60,420 and $120,840, respectively.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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Estimated future amortization expense as of June 30, 2011 is as follows:

Remainder of 2011	$ 120,840
2012	241,680
2013	241,680
2014	241,680
2015 and after	1,016,937
Total	$ 1,862,817

The Company does not amortize goodwill. The Company recorded goodwill in the amount of $14,670,446 as a result of the acquisitions of EthoStream and SSI during the year ended December 31, 2007. The Company evaluates goodwill for impairment based on the fair value of the operating business units to which this goodwill relates at least once a year. The Company generally determines the fair value of a reporting unit using the income approach, which is based on the present value of estimated future cash flows.

NOTE E – ACCOUNTS RECEIVABLE

Components of accounts receivable as of June 30, 2011 and December 31, 2010 are as follows:

	June 30, 2011	December 31, 2010
Accounts receivable	$ 1,370,055	$ 974,185
Allowance for doubtful accounts	(125,000)	(175,000)
Accounts receivable, net	$ 1,245,055	$ 799,185

NOTE F – INVENTORY

Inventories as of June 30, 2011 and December 31, 2010 are as follows:

	June 30, 2011	December 31, 2010
Inventory, gross	$ 735,968	$ 799,402
Reserve for obsolescence	(140,000)	(200,000)
Inventory, net	$ 595,968	$ 599,402

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

NOTE G – LONG TERM DEBT

Senior Convertible Debenture

A summary of convertible debentures payable at June 30, 2011 and December 31, 2010 is as follows:

	June 30, 2011	December 31, 2010
Senior Convertible Debentures, accrue interest at 13% per annum and mature on May 29, 2011	$ -	$ 1,606,023
Debt Discount - beneficial conversion feature, net of accumulated amortization of $733,756 at December 31, 2010.	-	(73,208)
Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of $616,593 at December 31, 2010.	-	(61,417)
Total	-	1,471,398
Less: current portion		(1,471,398)
Total Long Term Portion	$ -	$ -

On March 4, 2011, the Company sold its Series 5 Power Line Carrier product line and related business assets to Dynamic Ratings, Inc. ("Dynamic Ratings"). The purchase price was $1,000,000 in cash. In connection with the sale, Dynamic Ratings lent the Company an additional $700,000 in the form of a 6% promissory note dated March 4, 2011. The Company used the proceeds to retire substantially all of its obligations under its $1.6 million senior convertible debenture due May 29, 2011 and to cancel the related warrants covering 11.7 million shares of the Company's common stock.

Business Loan

On September 11, 2009, the Company entered into a Loan Agreement in the aggregate principal amount of $300,000 with the Wisconsin Department of Commerce (the "Department"). The outstanding principal balance bears interest at the annual rate of 2%. Payment of interest and principal is to be made in the following manner: (a) payment of any and all interest that accrues from the date of disbursement commenced on January 1, 2010 and continued on the first day of each consecutive month thereafter through and including December 31, 2010; (b) commencing on January 1, 2011 and continuing on the first day of each consecutive month thereafter through and including November 1, 2016, the Company shall pay equal monthly installments of $4,426 each; followed by a final installment on December 1, 2016 which shall include all remaining principal, accrued interest and other amounts owed by the Company to the Department under the Loan Agreement. The Company may prepay amounts outstanding under the credit facility in whole or in part at any time without penalty. The credit facility is secured by substantially all of the Company's assets and the proceeds from this loan were used for the working capital requirements of the Company. The outstanding borrowing under the agreement at June 30, 2011 was $276,346.

Promissory Note #1

On March 4, 2011, the Company sold all its Series 5 PLC product line assets to Wisconsin-based Dynamic Ratings, Inc. ("Purchaser") under an Asset Purchase Agreement ("APA"). Per the APA, the Company signed an unsecured Promissory Note ("Note #1") due to Purchaser in the aggregate principal amount of $700,000. The outstanding principal balance bears interest at the annual rate of 6% and is due on March 31, 2014. Note #1 may be prepaid in whole or in part, without penalty at any time, however scheduled payments are due on June 30, 2012 and June 30, 2013. Payments shall be applied first to accrued but unpaid interest and then to principal. Note #1 contains certain earn-out provisions that encompass both the Company's and Purchaser's revenue volumes. Provided these provisions are met, the Company could potentially retire Note #1 prior to its expiration date. Payments not made when due, by maturity acceleration or otherwise, shall bear interest at the rate of 12% per annum from the date due until fully paid

Promissory Note #2

From the sale of its Series 5 PLC product line assets, the Company used the proceeds received to retire substantially all of its obligations under its $1.6 million senior convertible debenture due May 29, 2011 and to cancel the related warrants covering 11.7 million shares of the Company's common stock. In exchange for the early retirement of debt and cancellation of warrants, the Company provided the third party with an unsecured one-year promissory note ("Note #2") for $50,000. The outstanding principal balance bears interest at the annual rate of five and one-quarter 5.25% and is due on March 4, 2012. The monthly payment of principal and interest is $4,385. However Note #2 is due immediately if the Company (a) receives three million ($3,000,000) dollars in aggregate in new debt or equity financing, (b) attains one million ($1,000,000) dollars in EBITDA, as defined, for any reporting quarter or (c) becomes insolvent. The Note may be prepaid in whole or in part, without penalty at any time. Payments shall be applied first to accrued but unpaid interest and then to principal.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
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Aggregate maturities of long-term debt as of June 30, 2011 are as follows:

As of June 30,		Amount
2011 (Remainder of)	$	48,890
2012		61,253
2013		49,485
2014		750,483
2015 and thereafter		103,979
	$	1,014,090
Less: Current portion		(85,768)
Total Long term portion	$	928,322

NOTE H – REDEEMABLE PREFERRED STOCK

Series A

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

On November 16, 2009, the Company sold 215 shares of Series A with attached warrants to purchase an aggregate of 1,628,800 shares of the Company's common stock at $0.33 per share. The Series A shares were sold at a price per share of $5,000 and each Series A share is convertible into approximately 13,774 shares of common stock at a conversion price of $0.363 per share. The Company received $1,075,000 from the sale of the Series A shares. Since the Series A may ultimately be redeemable at the option of the holder, the carrying value of the preferred stock, net of discount and accumulated dividends, has been classified as redeemable preferred stock on the balance sheets at June 30, 2011 and December 31, 2010.

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

The charge to additional paid in capital for amortization of Series A discount and costs for the three and six months ended June 30, 2011 was $17,901 and $35,802, respectively.

For the three and six months ended June 30, 2011 we have accrued dividends in the amount of $21,212 and $42,424, respectively, and cumulative accrued dividends of $138,356. The accrued dividends have been charged to additional paid-in capital (since there is a deficit in retained earnings) and the net unpaid accrued dividends have been added to the carrying value of the Series A shares.

Series B

The Company has designated 567 shares of preferred stock as Series B Preferred Stock ("Series B"). Each share of Series B shall be convertible, at the option of the holder thereof, at any time, into shares of our Common Stock at an initial conversion price of $0.13 per share. In the event of a change of control (as defined in the purchase agreement with respect to the Series B), or at the holder's option, on November 19, 2014 and for a period of 180 days thereafter, provided that at least 50% of the shares of Series B issued on the Series B Original Issue Date remain outstanding as of November 19, 2014, and the holders of at least a majority of the then outstanding shares of Series B provide written notice requesting redemption of all shares of Series B, we are required to redeem the Series B for the purchase price plus any accrued but unpaid dividends. The Series B accrues dividends at an annual rate of 8% of the original purchase price, and shall be payable only when, as, and if declared by our Board of Directors.

On August 4, 2010, the Company sold 267 shares of Series B with attached warrants to purchase an aggregate of 5,134,626 shares of the Company's common stock at $0.13 per share. The Series B shares were sold at a price per share of $5,000 and each Series B share is convertible into approximately 38,461 shares of common stock at a conversion price of $0.13 per share. The Company received $1,335,000 from the sale of the Series B shares. Since the Series B may ultimately be redeemable at the option of the holder, the carrying value of the preferred stock, net of discount and accumulated dividends, has been classified as redeemable preferred stock on the balance sheets.

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In accordance with ASC 470 Topic “Debt”, a portion of the proceeds were allocated to the warrants based on their relative fair value, which totaled $394,350 using the Black Scholes option pricing model. Further, the Company attributed a beneficial conversion feature of $394,350 to the Series B shares based upon the difference between the effective conversion price of those shares and the closing price of the Company’s common stock on the date of issuance. The assumptions used in the Black-Scholes model are as follows: (1) dividend yield of 0%; (2) expected volatility of 123%, (3) weighted average risk-free interest rate of 1.76%, (4) expected life of approximately 4 years, and (5) estimated fair value of Telkonet common stock of $0.109 per share. The expected term of the warrants represents the estimated period of time until exercise and is based on historical experience of similar awards and giving consideration to the contractual terms. The amounts attributable to the warrants and beneficial conversion feature, aggregating $788,700, have been recorded as a discount and deducted from the face value of the Series B shares. The discount is being amortized over the period from issuance to November 19, 2014 (the initial redemption date) as a charge to additional paid-in capital (since there is a deficit in retained earnings).

On April 8, 2011, the Company sold 271 additional shares of Series B with attached warrants to purchase an aggregate of 5,211,542 shares of the Company’s common stock at $0.13 per share. The Series B shares were sold at a price per share of $5,000 and each Series B share is convertible into approximately 38,461 shares of common stock at a conversion price of $0.13 per share. The Company received $1,355,000 from the sale of the Series B shares. Since the Series B shares may ultimately be redeemable at the option of the holder, the carrying value of the Series B shares, net of discount and accumulated dividends, has been classified as redeemable preferred stock on the balance sheets.

In accordance with ASC 470 Topic “Debt”, a portion of the proceeds were allocated to the warrants based on their relative fair value, which totaled $427,895 using the Black Scholes option pricing model. Further, the Company attributed a beneficial conversion feature of $427,895 to the Series B shares based upon the difference between the effective conversion price of those shares and the closing price of the Company’s common stock on the date of issuance. The assumptions used in the Black-Scholes model are as follows: (1) dividend yield of 0%; (2) expected volatility of 129%, (3) weighted average risk-free interest rate of 0.26%, (4) expected life of approximately3.5 years, and (5) estimated fair value of Telkonet common stock of $0.12 per share. The expected term of the warrants represents the estimated period of time until exercise and is based on historical experience of similar awards and giving consideration to the contractual terms. The amounts attributable to the warrants and beneficial conversion feature, aggregating $855,790, have been recorded as a discount and deducted from the face value of the Series B shares. The discount is being amortized over the period from issuance to November 19, 2014 (the initial redemption date) as a charge to additional paid-in capital (since there is a deficit in retained earnings).

The charge to additional paid in capital for amortization of Series B discount and costs for the three and six months ended June 30, 2011 was $118,559 and $157,995, respectively.

For the three and six months ended June 30, 2011, we have accrued dividends for Series B in the amount of $51,298 and $77,646, respectively, and cumulative accrued dividends of $120,683. The accrued dividends have been charged to additional paid-in capital (since there is a deficit in retained earnings) and the net unpaid accrued dividends been added to the carrying value of the preferred stock.

NOTE I – CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock, with a par value of $.001 per share. As of June 30, 2011, the Company has 215 shares of Series A preferred stock issued and outstanding and 538 shares of Series B preferred stock issued and 533 shares outstanding. The Company has authorized 190,000,000 shares of common stock, with a par value of $.001 per share. As of June 30, 2011 and December 31, 2010, the Company has 102,037,171 and 101,258,725, respectively, shares of common stock issued and outstanding.

During the six months ended June 30, 2011, the Company issued 409,056 shares of common stock to directors and management for services performed through June 30, 2011. These shares were valued at $55,500, which approximated the fair value of the shares when they were issued. In addition, 177,083 shares were issued to a current member of the Company's Board of Directors for consulting fees incurred prior to, but not paid until after, his election to Board of Directors. These shares were valued at $25,000.

During the three and six months ended June 30, 2011, five shares of Series B redeemable preferred stock were converted to 192,307 shares of common stock.

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NOTE J – STOCK OPTIONS AND WARRANTS

Employee Stock Options

The Company maintains two stock option plans. The first plan initiated in the year 2000 and was established as a long term incentive plan for employees and consultants, including board of director members. The second plan was established in 2010 also as an incentive plan for officers, employees, non employee directors, prospective employees and other key persons. It is anticipated that providing such persons with a direct stake in the Company's welfare will assure a better alignment of their interests with those of the Company and its' stockholders.

The following table summarizes the changes in options outstanding and the related prices for the shares of the Company's common stock issued to employees of the Company under a non-qualified employee stock option plan.

	Options Outstanding			Options Exercisable	
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 1.00 - $1.99	1,783,800	2.17	$ 1.04	1,600,858	$ 1.04
$ 2.00 - 2.99	145,000	3.82	2.47	126,665	2.46
$ 3.00 - 3.99	40,000	4.71	3.09	40,000	3.09
$ 4.00 - 4.99	35,000	4.24	4.27	35,000	4.27
$ 5.00 - 5.99	30,000	3.89	5.43	30,000	5.43
	2,033,800	2.40	$ 1.31	1,832,523	$ 1.31

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

	Number of Shares		Weighted Average Price Per Share
Outstanding at January 1, 2010	6,120,883	$	1.56
Granted	-		-
Exercised	-		-
Cancelled or expired	(3,572,083)		1.62
Outstanding at December 31, 2010	2,548,800	$	1.57
Granted	-		-
Exercised	-		-
Cancelled or expired	(515,000)		2.69
Outstanding at June 30, 2011	2,033,800	$	1.31

The expected life of awards granted represents the period of time that they are expected to be outstanding. We determine the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules, exercise patterns and pre-vesting and post-vesting forfeitures. We estimate the volatility of our common stock based on the calculated historical volatility of our own common stock using the trailing 24 months of share price data prior to the date of the award. We base the risk-free interest rate used in the Black-Scholes option valuation model on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term equal to the expected life of the award. We have not paid any cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero in the Black-Scholes option valuation model. We use historical data to estimate pre-vesting option forfeitures and record share-based compensation for those awards that are expected to vest. In accordance with ASC 718-10, we adjust share-based compensation for changes to the estimate of expected equity award forfeitures based on actual forfeiture experience.

There were no options granted or exercised during the six months ended June 30, 2011 and 2010.

Total stock-based compensation expense in connection with options granted to employees recognized in the condensed consolidated statements of operations for the three and six months ended June 30, 2011 and 2010 was $7,994 and $41,401, and $15,988 and $88,181, 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's consultants. These options were granted in lieu of cash compensation for services performed.

Options Outstanding	Options Exercisable
Number	Number

Exercise Prices	Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Exercisable	Weighted Average Exercise Price
$ 1.00	425,000	.62	$ 1.00	425,000	$ 1.00

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

	Number of Shares		Weighted Average Price Per Share
Outstanding at January 1, 2010	675,000	$	1.00
Granted	-		-
Exercised	-		-
Canceled or expired	(250,000)		1.00
Outstanding at December 31, 2010	425,000	$	1.00
Granted	-		-
Exercised	-		-
Canceled or expired			-
Outstanding at June 30, 2011	425,000	$	1.00

There were no non-employee stock options vested during the periods ended June 30, 2011 and 2010.

Warrants

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

		Warrants Outstanding				Warrants Exercisable		
	Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)		Weighed Average Exercise Price	Number Exercisable		Weighted Average Exercise Price
$	0.13	10,346,168	4.46	$	0.13	10,346,168	$	0.13
	0.33	1,705,539	3.26		0.33	1,705,539		0.33
	0.60	800,000	1.85		0.60	800,000		0.60
	1.00	500,000	.53		1.00	500,000		1.00
	2.59	431,226	.12		2.59	431,226		2.59
	3.01	1,149,109	2.52		3.01	1,149,109		3.01
	4.17	359,712	1.06		4.17	359,712		4.17
		15,291,754	3.72	$	.59	15,291,754	$	.59

Transactions involving warrants are summarized as follows:

	Number of Shares		Weighted Average Price Per Share
Outstanding at January 1, 2010	12,158,941	$	1.60
Issued	12,819,897		0.28
Exercised	-	-	
Canceled or expired	(2,874,096)		3.29
Outstanding at December 31, 2010	22,104,742	$	.51
Issued	5,336,816	.20	
Exercised	-		-
Canceled or expired	(12,149,804)		.23
Outstanding at June 30, 2011	15,291,754	$ .59	

On April 8, 2011, the Company issued 271 shares of Series B Preferred Stock ("Series B") with attached warrants to purchase 5,211,542 shares of the Company's common stock at $0.13 per share. The Company issued 125,274 warrants during the six months ended June 30, 2011. These warrants were issued pursuant to anti-dilution provisions in existing warrant agreements that were triggered by the completion of the Series B preferred stock private placement.

The Company did not issue any warrants during the three or six months ended June 30, 2010.

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NOTE K – RELATED PARTIES

In connection with the Series A Preferred Stock private placement transaction, on November 16, 2009, the Company entered into an Executive Officer Reimbursement Agreement with each of (i) Jason L. Tienor, the Company's President and Chief Executive Officer, (ii) Richard J. Leimbach, the Company's then Chief Financial Officer, and (iii) Jeffrey J. Sobieski, the Company's Chief Operating Officer (collectively, the "Executive Officers"), pursuant to which the Executive Officers agreed to convert a portion of outstanding indebtedness of the Company owed to such Executive Officers into Series A shares and warrants pursuant to the Securities Purchase Agreement. Mr. Tienor converted $20,000 of outstanding indebtedness into four Series A convertible preferred stock (convertible into 55,096 shares of common stock) and warrants to purchase 30,304 shares of Common Stock. Mr. Leimbach converted $10,000 of outstanding indebtedness into two Series A convertible preferred stock (convertible into 27,548 shares of common stock) and warrants to purchase 15,152 shares of Common Stock. Mr. Sobieski converted $20,000 of outstanding indebtedness into four Series A convertible preferred stock (convertible into 55,096 shares of common stock) and warrants to purchase 30,304 shares of Common Stock.

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

NOTE L – COMMITMENTS AND CONTINGENCIES

Office Lease Obligations

The Company presently leases approximately 14,000 square feet of office space in Milwaukee, WI for its corporate headquarters. The Milwaukee lease expires in March 2020.

The Company presently leases 16,416 square feet of commercial office space in Germantown, MD. The lease commitments expire in December 2015. On July 15, 2011, Telkonet executed a sublease agreement for 11,626 square feet of its former corporate headquarters located in Germantown, MD. The sublease term will expire on January 31, 2013. The subtenant received a one month rent abatement and has the option to extend the sublease from January 31, 2013 to December 31, 2015.

Commitments for minimum rentals under non cancelable leases at June 30, 2011 are as follows:

2011 (Remainder of)	$	180,264
2012		384,651
2013		402,951
2014		414,267
2015 and thereafter		1,179.837
Total	$	2,561,970

Rental expenses charged to operations for the three and six months ended June 30, 2011 and 2010 are $152, 843 and $153,197 and $322,835 and $346,610, respectively.

Employment and Consulting Agreements

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

Jason Tienor, President and Chief Executive Officer, is employed pursuant to an employment agreement dated April 11, 2011. Mr. Tienor’s employment agreement is for a term expiring on April 10, 2012, is renewable at the agreement of the parties and provides for a base salary of $200,000 per year. As of the date of this filing, the employment agreement has not been renewed.

Jeff Sobieski, Chief Operating Officer, is employed pursuant to an employment agreement, dated April 11, 2011. Mr. Sobieski’s employment agreement is for a term expiring on April 10, 2012, is renewable at the agreement of the parties and provides for a base salary of $190,000 per year. As of the date of this filing, the employment agreement has not been renewed.

Litigation

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

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Tellabs, Inc. v. Telkonet, Inc.

Our landlord has filed a claim for unpaid rent in a case styled Tellabs, Inc. v. Telkonet, Inc. in the Circuit Court for Montgomery County, State of Maryland and was granted a judgment in March 2010 in the amount of $64,966. Pursuant to that judgment, we received a notice of eviction from our landlord for the unpaid rent. We sought to extend the date for eviction but were unable to negotiate a payment plan acceptable to the landlord and voluntarily vacated the space on May 3, 2010. Our landlord has filed an additional claim for unpaid rent and other expenses alleged to be due in a case styled Tellabs, Inc. v. Telkonet, Inc. in the Circuit Court for Montgomery County, State of Maryland. A settlement of $110,000 was agreed upon and the suit was dismissed on January 28, 2011. All amounts due were paid in full as of December 31, 2011.

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

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

On August 1, 2008, we timely filed an answer to the complaint denying the allegations. On February 27, 2009, the USPTO granted a reexamination request with respect to the patent in issue in this lawsuit. Based upon four highly relevant and material prior art references that had not been considered by the USPTO in its initial examination, it found a "substantial new question of patentability" affecting all claims of the patent in suit. On August 2, 2010, the USPTO issued a Final Office Action rejecting every claim of the patent in suit. If this action is upheld on appeal it will result in the elimination of all of the issues in the pending litigation. There is a possibility that the claims of the patent will be reinstated on appeal either in their original form or as amended.

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

The parties agreed to and the Court ordered a stay of the litigation pending the conclusion of the reexamination proceeding. The case was reopened in early 2012 based on the expectation that the USPTO will issue a reexamination certificate and as of March 16, 2012, a new judge was assigned to the case in view of the impending retirement of the originally assigned judge. A new schedule for the case is expected to be determined by the new judge.

Robert P. Crabb v Telkonet Inc.

On November 9, 2010, a former executive, Robert P. Crabb, served Telkonet, Inc. and Telkonet Communications, Inc. ("Telkonet") with a Complaint in the Circuit Court for Montgomery County, MD alleging (1) violation of Maryland’s Wage Payment and Collection Act (2) Breach of Contract and (3) Promissory Estoppel/Detrimental Reliance. The claims in his Complaint arose out of his retirement in September 2007. In terms of relief, Mr. Crabb sought "severance compensation" in the amount of $156,000, treble damages, interest, and attorneys’ fees. This lawsuit was resolved as part of a voluntary settlement prior to the scheduled four day jury trial beginning on December 12, 2011. On January 25, 2012, the Court entered the parties’ joint Stipulation of Dismissal.

Stephen L. Sadle v. Telkonet, Inc

On April 15, 2011, a former executive, Stephen L. Sadle, served Telkonet, Inc. and Telkonet Communications, Inc. ("Telkonet") with a Complaint in the Circuit Court for Montgomery County, MD alleging (1) Breach of Contract, (2) Promissory Estoppel/Detrimental Reliance and (3) violation of Maryland's Wage Payment and Collection Act. The three claims in his Complaint each arise out of his retirement in 2007. On May 27, 2011, the defendants filed a motion to dismiss Mr. Sadle's claims. On August 10, 2011, the court granted in full the Defendants' motion to dismiss.

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Specifically, the Court dismissed, with prejudice, Plaintiff's claim under the Maryland Wage Payment and Collection Act. However, as part of its Order, the Court permitted Plaintiff to amend his Complaint as to his Breach of Contract (Count II) and Promissory Estoppel/Detrimental Reliance (Count III) claims only within 30 days. On September 14, 2011, Mr. Sadle filed his First Amended Complaint. On September 30, 2011, Telkonet filed its Answer and Counterclaims for Negligence (based on a fiduciary duty) and Recoupment. Mr. Sadle has not yet filed an Answer to Telkonet’s counterclaims. The parties have exchanged written discovery and scheduled preliminary depositions. A hearing on the pending cross-motions for summary judgment was held on March 21, 2012.

In terms of relief, Mr. Sadle is seeking "severance compensation" in the amount of $195,000, treble damages, interest, and attorneys’ fees. Treble damages and attorneys’ fees are only available under the Maryland Wage Payment and Collection Act, however, and therefore should no longer be available to Mr. Sadle in light of the dismissal of that particular claim. Mr. Sadle's Complaint provides no specific accounting for the relief sought. The trial in this case is set for May 14, 2012.

Sales Tax – As Restated

The Company engaged a sales tax consultant to assist in determining the extent of its potential sales tax exposure. Based upon this analysis, management determined the Company had probable exposure for certain unpaid obligations, including interest and penalties, of approximately $921,000 including and prior to the period ended June 30, 2011. The Company has approximately $921,000 accrued as of June 30, 2011. The Company intends to manage the liability by (1) confirming if customer’s self-assessed and remitted tax to the applicable state(s) absent from our transactions (2) confirming if customers were subjected to a state audit and if so did it result in the customer paying tax absent from our transaction (3) invoicing customers for the back taxes and (4) establishing voluntary disclosure agreements with the applicable states, which establishes a maximum look-back period and payment arrangements. However, if the aforementioned methods prove unsuccessful and the Company is audited, there exists possible exposure up to an additional $620,000, not including applicable interest and penalty.

NOTE M – BUSINESS CONCENTRATION

For the period ended June 30, 2011, the Company did not have a customer with revenue greater to 10% of total revenues. Revenue from one (1) major customer approximated $658,109 or 11% of total revenues for the six months ended June 30, 2010. Total accounts receivable of $532,190 or 29% of total accounts receivable, was due from this customer as of June 30, 2010.

Purchases from two (2) major suppliers approximated $1,254,804, or 35%, of purchases, and two (2) major suppliers approximated $1,028,314, or 33%, of purchases, for the six months ended June 30, 2011 and 2010, respectively. Total accounts payable of approximately $149,055, or 7%, of total accounts payable, was due to these suppliers as of June 30, 2011, and $543,572, or 15%, of total accounts payable, was due to these suppliers as of June 30, 2010.

NOTE N – FAIR VALUE MEASUREMENTS

The financial assets of the Company measured at fair value on a recurring basis are cash equivalents and long-term marketable securities. The Company’s long term marketable securities are generally classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The Company's long-term investments are classified within Level 3 of the fair value hierarchy because they are valued using unobservable inputs, due to the fact that observable inputs are not available, or situations in which there is little, if any, market activity for the asset or liability at the measurement date. The Company's derivative liabilities and convertible debentures are classified within Level 3 of the fair value hierarchy because they are valued using inputs which are not actively observable, either directly or indirectly.

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2: Quoted prices in markets that are not active, or inputs which are observable, either directly or indirectly, for substantially the full term of the asset or liability; or

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and are unobservable.

The following table sets forth the Company's short and long-term investments as of December 31, 2010 which are measured at fair value on a recurring basis by level within the fair value hierarchy. These are classified based on the lowest level of input that is significant to the fair value measurement:

	Level 1	Level 2	Level 3	Total
Derivative liability	$ -	$ -	$ 1,901,775	$ 1,901,775
Total	$ -	$ -	$ 1,901,775	$ 1,901,775

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The table below sets forth a summary of changes in the fair value of the Company's Level 3 financial liabilities (derivative liability) for the six months ended June 30, 2011.

	2011
Balance at beginning of year	$1,901,775
Repayment of debt, cancellation of warrants and related derivative liability	(1,158,730)
Change in fair value of derivative liability	(172,476)
Retirement of derivative liability related to warrant obligation	(570,569)
Balance at end of period	$ -

NOTE O – SUBSEQUENT EVENTS

On July 15, 2011, Telkonet executed a sublease agreement for 11,626 square feet of its' former corporate headquarters located in Germantown, MD. The sublease term will expire on January 31, 2013. The subtenant received a one month rent abatement and has the option to extend the sublease from January 31, 2013 to December 31, 2015.

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

The following discussion and analysis of the Company's financial condition and results of operations should be read in conjunction with the accompanying restated condensed consolidated financial statements and related notes thereto for the quarter ended June 30, 2011, as well as the Company's restated condensed consolidated financial statements and related notes thereto and management's discussion and analysis of financial condition and results of operations, which will be included in the Company's 2011 Form 10-K. The discussion and analysis has been updated to reflect the results of the restatement described in the explanatory note to this report.

Business

Telkonet, Inc., formed in 1999 and incorporated under the laws of the state of Utah, is a Clean Technology company that designs, develops and markets proprietary energy efficiency and smart grid networking products and services. Our SmartEnergy, EcoSmart and Series 5 SmartGrid networking technologies enable us to provide innovative clean technology solutions and have helped position Telkonet as a leading Clean Technology provider.

Our Telkonet SmartEnergy, Networked Telkonet SmartEnergy and EcoSmart energy efficiency products incorporate our patented Recovery Time™ technology, providing continuous monitoring of climate and environmental conditions to dynamically adjust a room's temperature, accounting for the occupancy of the room. Our SmartEnergy and EcoSmart platforms maximize energy savings while at the same time ensuring occupant comfort and extending equipment life expectancy. This technology is particularly attractive to customers in the hospitality industry, as well as the education, healthcare and government/military markets, who are continually seeking ways to reduce costs and meet federal and state mandates without impacting building occupant comfort. By reducing energy consumption automatically when a space is unoccupied, our customers can realize significant cost savings without diminishing occupant comfort. This technology may also be integrated with property management systems and building automation systems and used in load shedding initiatives. This feature provides management companies and utilities enhanced opportunity for cost savings, environmental awareness and energy management. Telkonet's energy management systems are lowering heating, ventilation and air conditioning, or HVAC, costs in hundreds of thousands of rooms worldwide and qualify for state and federal energy efficiency and rebate programs.

The Series 5 SmartGrid networking technology allows commercial, industrial and consumer users to connect computers to a communications network using the existing low voltage electrical grid. The Series 5 SmartGrid networking technology uses powerline communications, or PLC, technology to transform existing electrical infrastructure into a communications backbone. Operating at 200 Mbps, the PLC platform offers a secure alternative in grid communications, transforming a traditional electrical distribution system into a "smart grid" that delivers electricity in a manner that can save energy, reduce cost and increase reliability.

On March 4, 2011, the Company sold its Series 5 Power Line Carrier product line and related business assets to Dynamic Ratings ("Dynamic Ratings"). The purchase price was $1,000,000 in cash. In connection with the sale, Dynamic Ratings lent the Company an additional $700,000 in the form of a 6% promissory note dated March 4, 2011. Concurrent with the sale, the Company entered into a Distributorship Agreement and a Consulting Agreement with Dynamic Ratings. Under the Distributorship Agreement, the Company was designated as a distributor of the Series 5 product to the non-utility sector and will receive preferred pricing for purchases of Series 5 product. Under the Consulting Agreement, the Company agreed to provide Dynamic Ratings with ongoing transition assistance and consulting services for the Series 5 product. The Distributorship Agreement and the Consulting Agreement have initial terms that expire on March 31, 2014 and March 31, 2013, respectively. Sales incentives and consulting compensation amounts payable to the Company under the Distributorship Agreement and the Consulting Agreement will be applied to pay the balance of the Promissory Note.

Telkonet's EthoStream Hospitality Network is now one of the largest high speed internet access (HSIA) solution providers in the world, with a customer base of more than 2,314 properties representing approximately 215,000 hotel rooms. This network provides Telkonet with the opportunity to market our energy efficiency solutions. In addition, more than 3.9 million users access the Internet monthly via the EthoStream Hospitality Network providing Telkonet with a growing captive audience for promotional relationships. The EthoStream Hospitality Network is backed by a 24/7 U.S.-based in-house support center that uses integrated, web-based management tools enabling proactive customer support.

We utilize direct and indirect sales channels in all areas of our business. With a growing Value-Added Reseller (VAR) network, we continue to broaden our reach throughout the industry. Utilizing key integrators and strategic partners, we've been able to increase penetration in each of our targeted markets. The impact of this effort is a growing percentage of Telkonet's business is driven by our indirect sales channels.

Our direct sales efforts target the hospitality, education, commercial, utility and government/military markets. Taking advantage of legislation, including the Energy Independence and Security Act of 2007, or EISA, and the Energy Policy Act of 2005, we've focused our sales efforts in areas with available public funding and incentives, such as rebate programs offered by utilities for efficiency upgrades. Through our proprietary platform, technology and partnerships with energy efficiency providers, we intend to position our company as a leading provider of energy management solutions.

Forward Looking Statements

In accordance with the Private Securities Litigation Reform Act of 1995, we can obtain a “safe-harbor” for forward-looking statements by identifying those statements and by accompanying those statements with cautionary statements which identify factors that could cause actual results to differ materially from those in the forward-looking statements. Accordingly, the following “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and “Quantitative and Qualitative Disclosures about Market Risk” may contain certain forward-looking statements regarding strategic growth initiatives, growth opportunities and management’s expectations regarding orders and financial results for 2011 and future periods. These forward-looking statements are based on current expectations and current assumptions which management believes are reasonable. However, these statements involve risks and uncertainties that could cause actual results to differ materially from any future results encompassed within the forward-looking statements. Factors that could cause or contribute to such differences include those risks affecting the Company’s business as described in the Company’s filings with the SEC, including the current reports on Form 8-K , which factors are incorporated herein by reference. The Company expressly disclaims a duty to provide updates to forward-looking statements, whether as a result of new information, future events or other occurrences.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. On an ongoing basis, we evaluate significant estimates used in preparing our condensed consolidated financial statements including those related to revenue recognition, guarantees and product warranties, stock based compensation and business combinations. We base our estimates on historical experience, underlying run rates and various other assumptions that we believe to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results could differ from these estimates. The following are critical judgments, assumptions, and estimates used in the preparation of the consolidated financial statements.

Revenue Recognition

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

We provide call center support services to properties installed by us and also to properties installed by other providers. In addition, we provide the property with the portal to access the Internet. We receive monthly service fees from such properties for our services and Internet access. We recognize the service fee ratably over the term of the contract. The prices for these services are fixed and determinable prior to delivery of the service. The fair value of these services is known due to objective and reliable evidence from contracts and standalone sales. We report such revenues as recurring revenue.

Fair Value of Financial Instruments

The Company accounts for the fair value of financial instruments in accordance with ASC 820, which defines fair value for accounting purposes, established a framework for measuring fair value and expand disclosure requirements regarding fair value measurements. Fair value is defined as an exit price, which is the price that would be received upon sale of an asset or paid upon transfer of a liability in an orderly transaction between market participants at the measurement date. The degree of judgment utilized in measuring the fair value of assets and liabilities generally correlates to the level of pricing observability. Financial assets and liabilities with readily available, actively quoted prices or for which fair value can be measured from actively quoted prices in active markets generally have more pricing observability and require less judgment in measuring fair value. Conversely, financial assets and liabilities that are rarely traded or not quoted have less price observability and are generally measured at fair value using valuation models that require more judgment. These valuation techniques involve some level of management estimation and judgment, the degree of which is dependent on the price transparency of the asset, liability or market and the nature of the asset or liability. We have categorized our financial assets and liabilities that are recurring, at fair value into a three-level hierarchy in accordance with these provisions.

New Accounting Pronouncements

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

Revenues

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

	Three Months Ended					
	June 30, 2011		June 30, 2010 (As Restated)		Variance (As Restated)	
Product	$ 1,776,888	61%	$ 1,970,286	64%	$ (193,398)	-10%
Recurring	1,151,048	39%	1,122,371	36%	28,677	3%
Total	$ 2,927,936	100%	$ 3,092,657	100%	$ (164,721)	-5%

	Six Months Ended					
	June 30, 2011		June 30, 2010 (As Restated)		Variance (As Restated)	
Product	$ 3,127,960	58%	$ 3,536,737	63%	$ (408,777)	-12%
Recurring	2,282,675	42%	2,073,029	37%	209,646	10%
Total	$ 5,410,635	100%	$ 5,609,766	100%	$ (199,131)	-4%

Product revenue

Product revenue principally arises from the sale and installation of SmartEnergy, SmartGrid and High Speed Internet Access equipment. These include TSE, Telkonet Series 5, Telkonet iWire, and wireless networking products. We market and sell to the hospitality, education, healthcare and government/military markets. The Telkonet Series 5 and the Telkonet iWire products consist of the Telkonet Gateways, Telkonet Extenders, the patented Telkonet Coupler, and Telkonet iBridges. The SmartEnergy product suite consists of thermostats, sensors, controllers, wireless networking products and a control platform. The HSIA product suite consists of gateway servers, switches and access points. Despite selling the Series 5 PLC product line and related business assets, the Company believes this will have an immaterial impact on revenue and profitability, since it represented less than 5% of its revenue base in 2010.

For the three and six months ended June 30, 2011, product revenue decreased by 10% and 12% respectively, when compared to the prior year periods. Product revenue in 2011 includes approximately $1.8 million attributed to the sale and installation of energy management products, and approximately $1.2 million for the sale and installation of HSIA products, and approximately $0.1 million attributable to the Telkonet Series 5 products. Since our sales of energy management and HSIA products are concentrated in the hospitality market, we have been impacted by a market reluctance to incur capital expenditures in the present economy. However, we believe the economy continues to demonstrate gradual signs of recovery and anticipate it will continue, albeit at a modest, uneven pace.

Recurring Revenue

The recurring revenue consists primarily of HSIA support services and advertising revenue. The Company recognizes revenue over the term of the service period. Advertising revenue is based on impression-based statistics for a given period from customer site visits to the Company's under the terms of advertising agreements entered into with third-parties. A component of our recurring revenue is derived from fees, less pay back costs, associated with approximately 1% of our hospitality customers who do not internally manage guest-related, internet transactions.

Beginning in the three month period ended March 31, 2011, pay back costs were booked directly against recurring revenue as opposed to cost of sales. For comparative purposes we have adjusted the three and six month periods ended June 30, 2010.

Recurring revenue includes approximately 2,314 hotels in our broadband network portfolio. We currently support over 215,000 HSIA rooms, with over 3.9 million monthly users. For the three and six months ended June 30, 2011, recurring revenue increased by 3% and 10% respectively when compared to the same periods of the prior year. The year to date increase in recurring revenue was primarily attributed to a new advertising program started in the first quarter of 2011.

Cost of Sales

	Three Months Ended					
	June 30, 2011		June 30, 2010 (As Restated)		Variance (As Restated)	
Product	$ 1,017,894	57%	$ 938,305	48%	$ 79,589	8%
Recurring	291,247	25%	321,190	29%	(29,943)	-9%
Total	$ 1,309,141	45%	$ 1,259,495	41%	$ 49,646	4%

	Six Months Ended					
	June 30, 2011		June 30, 2010 (As Restated)		Variance (As Restated)	
Product	$ 1,726,164	55%	$ 1,789,482	51%	$ (63,318)	-4%
Recurring	555,116	24%	620,301	30%	(65,185)	-11%
Total	$ 2,281,280	42%	$ 2,409,783	43%	$ (128,503)	-5%

Product Costs
Product costs include equipment and installation labor related to the sale of Telkonet SmartEnergy™ products, Telkonet Series 5™ products and the Telkonet iWire System™. For the three months ended June 30, 2011, product costs increased by 8% when compared to the prior year period, as a result of increased distribution costs. Product costs for the six months ended June 30, 2011, decreased by 4% when compared to the prior year period, a direct correlation to the decrease in product revenues.

Recurring Costs
For the three and six months ended June 30, 2011, recurring costs decreased by 9% and 11% respectively when compared to the prior year periods, due to increased efficiencies in providing support services to our EthoStream Hospitality Network. As we continue to add new HSIA customers to our portfolio, we may need to hire additional support center staff which may affect our recurring product costs and margins.

Gross Profit

	Three Months Ended					
	June 30, 2011		June 30, 2010 (As Restated)		Variance (As Restated)	
Product	$ 758,994	43%	$ 1,031,981	52%	$ (272,987)	-26%
Recurring	859,801	75%	801,181	71%	58,620	7%
Total	$ 1,618,795	55%	$ 1,833,162	59%	$ (214,367)	-12%

	Six Months Ended					
	June 30, 2011		June 30, 2010 (As Restated)		Variance (As Restated)	
Product	$ 1,401,796	45%	$ 1,747,255	49%	$ (345,459)	-20%
Recurring	1,727,559	76%	1,452,728	70%	274,831	19%
Total	$ 3,129,355	58%	$ 3,199,983	57%	$ (70,628)	-2%

Product Gross Profit

The gross profit on product revenue for the three and six months ended June 30, 2011 decreased by 26% and 20% , respectively, compared to the prior year periods as a result of decreased product sales and installations on energy management and HSIA sales.

Recurring Gross Profit

Our gross profit percentage associated with recurring revenue increased by 7% and 19% for the three and six months ended June 30, 2011, respectively. The increase was due to the growth in advertising revenue which yields greater margins.

Operating Expenses

	Three Months Ended			
	June 30, 2011 (As Restated)	June 30, 2010 (As Restated)	Variance (As Restated)	
Total	$ 1,418,255	$ 1,805,733	$ (387,478)	-21%

	Six Months Ended			
	June 30, 2011 (As Restated)	June 30, 2010 (As Restated)	Variance (As Restated)	
Total	$ 2,816,225	$ 3,889,904	$ (1,073,679)	-28%

During the three and six months ended June 30, 2011, operating expenses decreased by 21% and 28% , respectively, when compared to the prior year periods. These decreases are primarily the result of cost reduction efforts in areas of staffing, professional fees, financing fees and debt forgiveness plans. We do not anticipate any significant changes to operating expenses for the remainder of 2011, except as necessary to meet future growth opportunities.

Research and Development

	Three Months Ended			
	June 30, 2011 (As Restated)	June 30, 2010 (As Restated)	Variance (As Restated)	
Total	$ 182,625	$ 293,579	$ (110,954)	-38%

	Six Months Ended			
	June 30, 2011 (As Restated)	June 30, 2010 (As Restated)	Variance (As Restated)	
Total	$ 391,234	$ 588,196	$ (196,962)	-33%

Our research and development costs related to both present and future products are expensed in the period incurred. Current research and development costs are associated with product development and integration. The Company anticipates a continued decrease in research and development costs in the remainder of 2011 compared to 2010.

Selling, General and Administrative Expenses

	Three Months Ended			
	June 30, 2011 (As Restated)	June 30, 2010 (As Restated)	Variance (As Restated)	
Total	$ 1,166,812	$ 1,416,947	$ (250,135)	-18%

	Six Months Ended		
	June 30, 2011 (As Restated)	June 30, 2010 (As Restated)	Variance (As Restated)

Total	$	2,294,645	$	3,108,674	$	(814,029)	-26%

During the three and six months ended June 30, 2011, selling, general and administrative expenses decreased over the comparable prior year periods by approximately 18% and 26% , respectively. These decreases are primarily the result of cost reduction efforts in areas of staffing, professional fees, financing fees and debt forgiveness plans. We do not expect to see a significant increase in selling, general and administrative expenses for the remainder of 2011, except as necessary to meet future growth opportunities.

Liquidity and Capital Resources

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

Working Capital

Our working capital deficit decreased by $3,884,635 during the six months ended June 30, 2011 from a working capital deficit (current liabilities in excess of current assets) of $4,910,738 at December 31, 2010 to a working capital deficit of $1,026,103 at June 30, 2011. The decrease in working capital deficit for the six months ended June 30, 2011 is due to the retirement of a convertible debenture, the associated derivative liability and the retirement of two related party notes.

Business Loan

On September 11, 2009, we entered into a Loan Agreement to borrow an aggregate principal amount of $300,000 from the Wisconsin Department of Commerce ("Department"). The outstanding principal balance on the loan bears interest at the annual rate of 2.0% . Payment of interest and principal is to be made in the following manner: (a) payment of any and all interest that accrues from the date of disbursement commences on January 1, 2010 and continues on the first day of each consecutive month thereafter through and including December 31, 2010; (b) commencing on January 1, 2011 and continuing on the first day of each consecutive month thereafter through and including November 1, 2016, we are obligated to pay equal monthly installments of $4,426 each; followed by a final installment on December 1, 2016 which will include all remaining principal, accrued interest and other amounts owed by us to the Department under the Loan Agreement. We may prepay amounts outstanding under the loan in whole or in part at any time without penalty. The loan is secured by substantially all of our assets and the proceeds from this loan were used for our working capital requirements. The outstanding borrowing under the agreement at June 30, 2011 was $276,346.

On March 4, 2011, the Company sold its Series 5 Power Line Carrier product line and related business assets to Dynamic Ratings Inc., ("Dynamic Ratings"). The purchase price was $1,000,000 in cash. In connection with the sale Dynamic Ratings lent $700,000 in the form of a 6% promissory note (Promissory Note# 1) dated March 4, 2011. The Company used the proceeds received to retire substantially all of its obligations under its $1.6 million senior convertible debenture due May 29, 2011 and to cancel the related warrants covering 11.7 million shares of the Company's common stock. In exchange for the early retirement of debt and cancellation of warrants, the Company provided the lender with an unsecured one-year promissory note for $50,000 (Promissory Note# 2).

Promissory Note #1

On March 4, 2011, the Company sold all its Series 5 PLC product line assets to Wisconsin-based Dynamic Ratings, Inc. ("Purchaser") under an Asset Purchase Agreement ("APA"). Per the APA, the Company signed an unsecured Promissory Note ("Note #1") due to Purchaser in the aggregate principal amount of $700,000. The outstanding principal balance bears interest at the annual rate of 6% and is due on March 31, 2014. Note #1 may be prepaid in whole or in part, without penalty at any time, however scheduled payments are due on June 30, 2012 and June 30, 2013. Payments shall be applied first to accrued but unpaid interest and then to principal. Note #1 contains certain earn-out provisions that encompass both the Company's and Purchaser's revenue volumes. Provided these provisions are met, the Company could potentially retire Note #1 prior to its expiration date. Payments not made when due, by maturity acceleration or otherwise, shall bear interest at the rate of 12% per annum from the date due until fully paid.

Promissory Note #2

From the sale of its Series 5 PLC product line assets, the Company used the proceeds received to retire substantially all of its obligations under its $1.6 million senior convertible debenture due May 29, 2011 and to cancel the related warrants covering 11.7 million shares of the Company's common stock. In exchange for the early retirement of debt and cancellation of warrants, the Company provided the lender with an unsecured one-year promissory note ("Note #2") for $50,000. The outstanding principal balance bears interest at the annual rate of 5.25% and is due on March 4, 2012. However Note #2 is due immediately if the Company (a) receives three million ($3,000,000) dollars in aggregate in new debt or equity financing, (b) attains one million ($1,000,000) dollars in EBITDA for any reporting quarter or (3) becomes insolvent. The Note may be prepaid in whole or in part, without penalty at any time. Payments shall be applied first to accrued but unpaid interest and then to principal.

Proceeds from the issuance of Series B Preferred Stock

On April 8, 2011, the Company sold 271 shares of series B Preferred Stock with attached warrants to purchase 5,211,542 shares of common stock at $0.13 per share.

Cash flow analysis

Cash used in continuing operations was $648,144 and $113,016 during the periods ending June 30, 2011 and 2010, respectively. As of June 30, 2011, our primary capital needs included business strategy execution, inventory procurement and managing current liabilities.

We generated cash from investing activities of $1,006,645 and $0 during the periods ended June 30, 2011 and 2010, respectively. During the period ended March 31, 2011, the Company sold its Series 5 Power Line Carrier product line and related business assets for $1,000,000 in cash.

Cash provided from financing activities was $387,953 during the period ending June 30, 2011, compared to cash used in financing activities of $288,417 during the period ending June 30, 2010. The Company issued Series B preferred stock, sold the Series 5 PLC product line and repaid convertible debentures during 2011. The Company made repayments on our working capital line of credit used for inventory purchases of $288,417 in 2010.

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

Concurrent with the first quarter debenture retirement, the second quarter equity raise and our year to date operating results, the Company believes anticipated revenues and its' continued operational efficiencies will be sufficient to satisfy its ongoing capital and cash flow requirements for the remainder of fiscal 2011. However, the Company also believes there remains sufficient uncertainty, both in the economic environment and our current working capital deficit position, that the Company cannot make any representations for fiscal 2012.

Our prior independent registered public accountants stated in their report dated March 29, 2011 for the year ended December 31, 2010 that we have incurred operating losses in the past years , and that we are dependent upon management's ability to develop profitable operations and/or obtain necessary funding from outside sources, including by the sale of our securities, or obtaining loans from financial institutions, where possible. These factors, among others, raise substantial doubt about our ability to continue as a going concern. This may also affect our ability to obtain financing in the future.

Off-Balance sheet Arrangements

The Company has no other off-balance sheet arrangements other than its facility leases.

Acquisition or Disposition of Property and Equipment

During the six months ended June 30, 2011, there were no expenditures on fixed assets and costs of equipment under operating leases. The Company does not anticipate the sale or purchase of any significant property, plant or equipment during the next twelve months, other than computer equipment and peripherals to be used in the Company's day-to-day operations.

We presently lease two commercial office spaces in Germantown, MD totaling, in the aggregate, 16,400 square feet. Both leases expire in December 2015. On July 15, 2011, Telkonet executed a sublease agreement for 11,626 square feet of its' former corporate headquarters located in Germantown, MD. The sublease term will expire on January 31, 2013. The Subtenant received a one (1) month rent abatement and has the option to extend the sublease from January 31, 2013 to December 31, 2015.

Disclosure of Contractual Obligations

On March 4, 2011, the Company sold its Series 5 Power Line Carrier product line and related business assets to Dynamic Ratings ("Dynamic Ratings"). The purchase price was $1,000,000 in cash. In connection with the sale Dynamic Ratings lent $700,000 in the form of a 6% promissory note (Promissory Note# 1) dated March 4, 2011. The Company used the proceeds received to retire substantially all of its obligations under its $1.6 million senior convertible debenture due May 29, 2011 and to cancel the related warrants covering 11.7 million shares of the Company's common stock. In exchange for the early retirement of debt and cancellation of warrants, the Company provided the lender with an unsecured one-year promissory note for $50,000 (Promissory Note #2).

Promissory Note #1

On March 4, 2011, the Company sold all its Series 5 PLC product line assets to Wisconsin-based Dynamic Ratings, Inc. (“Purchaser”) under an Asset Purchase Agreement (“APA”). Per the APA, the Company signed a Promissory Note (“Note #1”) due to Purchaser in the aggregate principal amount of $700,000. The outstanding principal balance bears interest at the annual rate of 6% and is due on March 31, 2014. Note #1 may be prepaid in whole or in part, without penalty at any time, however scheduled payments are due on June 30, 2012 and June 30, 2013. Payments shall be applied first to accrued but unpaid interest and then to principal. Note #1 contains certain earn-out provisions that encompass both the Company’s and Purchaser’s revenue volumes. Provided these provisions are met, the Company could potentially retire Note #1 prior to its expiration date. Payments not made when due, by maturity acceleration or otherwise, shall bear interest at the rate of 12% per annum from the date due until fully paid.

Promissory Note #2

From the sale of its Series 5 PLC product line assets, the Company used the proceeds received to retire substantially all of its obligations under its $1.6 million senior convertible debenture due May 29, 2011 and to cancel the related warrants covering 11.7 million shares of the Company’s common stock. In exchange for the early retirement of debt and cancellation of warrants, the Company provided the third party with an unsecured one-year promissory note (“Note #2”) for $50,000. The outstanding principal balance bears interest at the annual rate of 5.25% and is due on March 4, 2012. However Note #2 is due immediately if the Company (a) receives three million ($3,000,000) dollars in aggregate in new debt or equity financing, (b) attains one million ($1,000,000) dollars in EBITDA for any reporting quarter or (3) becomes insolvent. The Note may be prepaid in whole or in part, without penalty at any time. Payments shall be applied first to accrued but unpaid interest and then to principal.

Item 4. Controls and Procedures.

Due to the lack of a segregation of duties and the failure to implement accounting controls, the Chief Executive Officer and Acting Chief Financial Officer concluded that our disclosure controls and procedures, as well as our controls over financial reporting, were ineffective as of the end of the period covered by this report. During the six months ended June 30, 2011, there was no change in the Company’s internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

Litigation

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

Tellabs, Inc. v. Telkonet, Inc.

Our landlord has filed a claim for unpaid rent in a case styled Tellabs, Inc. v. Telkonet, Inc. in the Circuit Court for Montgomery County, State of Maryland and was granted a judgment in March 2010 in the amount of $64,966. Pursuant to that judgment, we received a notice of eviction from our landlord for the unpaid rent. We sought to extend the date for eviction but were unable to negotiate a payment plan acceptable to the landlord and voluntarily vacated the space on May 3, 2010. Our landlord has filed an additional claim for unpaid rent and other expenses alleged to be due in a case styled Tellabs, Inc. v. Telkonet, Inc. in the Circuit Court for Montgomery County, State of Maryland. A settlement of $110,000 was agreed upon and the suit was dismissed on January 28, 2011. All amounts due were paid in full as of December 31, 2011.

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

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

On August 1, 2008, we timely filed an answer to the complaint denying the allegations. On February 27, 2009, the USPTO granted a reexamination request with respect to the patent in issue in this lawsuit. Based upon four highly relevant and material prior art references that had not been considered by the USPTO in its initial examination, it found a "substantial new question of patentability" affecting all claims of the patent in suit. On August 2, 2010, the USPTO issued a Final Office Action rejecting every claim of the patent in suit. If this action is upheld on appeal it will result in the elimination of all of the issues in the pending litigation. There is a possibility that the claims of the patent will be reinstated on appeal either in their original form or as amended.

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

The parties agreed to and the Court ordered a stay of the litigation pending the conclusion of the reexamination proceeding. The case was reopened in early 2012 based on the expectation that the USPTO will issue a reexamination certificate and as of March 16, 2012, a new judge was assigned to the case in view of the impending retirement of the originally assigned judge. A new schedule for the case is expected to be determined by the new judge.

Robert P. Crabb v. Telkonet Inc.

On November 9, 2010, a former executive, Robert P. Crabb, served Telkonet, Inc. and Telkonet Communications, Inc. ("Telkonet") with a Complaint in the Circuit Court for Montgomery County, MD alleging (1) violation of Maryland’s Wage Payment and Collection Act (2) Breach of Contract and (3) Promissory Estoppel/Detrimental Reliance. The claims in his Complaint arose out of his retirement in September 2007. In terms of relief, Mr. Crabb sought "severance compensation" in the amount of $156,000, treble damages, interest, and attorneys’ fees. This lawsuit was resolved as part of a voluntary settlement prior to the scheduled four day jury trial beginning on December 12, 2011. The parties executed a settlement agreement and general release on January 20, 2012 for $127,000. On January 25, 2012, the Court entered the parties’ joint Stipulation of Dismissal.

Stephen L. Sadle v. Telkonet, Inc

On April 15, 2011, a former executive, Stephen L. Sadle, served Telkonet, Inc. and Telkonet Communications, Inc. ("Telkonet") with a Complaint in the Circuit Court for Montgomery County, MD alleging (1) Breach of Contract, (2) Promissory Estoppel/Detrimental Reliance and (3) violation of Maryland's Wage Payment and Collection Act. The three claims in his Complaint each arise out of his retirement in 2007. On May 27, 2011, the defendants filed a motion to dismiss Mr. Sadle's claims. On August 10, 2011, the court granted in full the Defendants' motion to dismiss.

Specifically, the Court dismissed, with prejudice, Plaintiff's claim under the Maryland Wage Payment and Collection Act. However, as part of its Order, the Court permitted Plaintiff to amend his Complaint as to his Breach of Contract (Count II) and Promissory Estoppel/Detrimental Reliance (Count III) claims only within 30 days. On September 14, 2011, Mr. Sadle filed his First Amended Complaint. On September 30, 2011, Telkonet filed its Answer and Counterclaims for Negligence (based on a fiduciary duty) and Recoupment. Mr. Sadle has not yet filed an Answer to Telkonet’s counterclaims. The parties have exchanged written discovery and scheduled preliminary depositions. A hearing on the pending cross-motions for summary judgment was held on March 21, 2012.

In terms of relief, Mr. Sadle is seeking "severance compensation" in the amount of $195,000, treble damages, interest, and attorneys’ fees. Treble damages and attorneys’ fees are only available under the Maryland Wage Payment and Collection Act, however, and therefore should no longer be available to Mr. Sadle in light of the dismissal of that particular claim. Mr. Sadle's Complaint provides no specific accounting for the relief sought. The trial in this case is set for May 14, 2012.

Item 1A. Risk Factors.

There have been no material changes to risk factors previously disclosed in our most recently filed Annual Report in response to Item 1A of Form 10-K.

Item 2. Unregistered Sales of Equity Securities.

On June 30, 2011, the Company issued in aggregate, 198,200 shares to its independent directors, William H. Davis and Anthony J. Paoni in payment for their services as such during April, May and June of 2011. The shares were issued under the Company’s 2010 Stock Option and Incentive Plan prior to the Company’s filing of a registration statement on Form S-8 in connection with such plan. In addition, the Company issued 177,083 shares of common stock to Mr. Davis in connection with consulting services rendered by Mr. Davis prior to his election to the Company’s Board of Directors. The Company believes that each of these sales were a non public offering exempt from registration requirements pursuant to Section 4(2) of the Securities Act of 1933, as amended, based on among other factors, the limited number of offerees and their status as affiliates of the Company.

Item 6. Exhibits.

Exhibit Number	Description Of Document
10.1	Securities Purchase Agreement, dated April 8, 2011, by and among Telkonet, Inc. and the parties listed therein (incorporated by reference to the Company’s Form 8-K filed on April 13, 2011).
10.2	Registration Rights Agreement, dated April 8, 2011, by and among Telkonet, Inc. and the parties listed therein (incorporated by reference to the Company’s Form 8-K filed on April 13, 2011).
10.3	Employment Agreement, dated April 11, 2011 by and between Telkonet, Inc. and Jason L. Tienor (incorporated by reference to the Company’s Form 8-K filed on April 14, 2011).

10.4	Employment Agreement, dated April 11, 2011 by and between Telkonet, Inc. and Jeffrey J. Sobieski (incorporated by reference to the Company's Form 8-K filed on April 14, 2011).
31.1	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Jason L. Tienor
31.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Richard E. Mushrush
32.1	Certification of Jason L. Tienor pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Richard E. Mushrush pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Schema Document
101.CAL	XBRL Calculation Linkbase Document
101.DEF	XBRL Definition Linkbase Document
101.LAB	XBRL Label Linkbase Document
101.PRE	XBRL Presentation Linkbase Document

SIGNATURES

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

	Telkonet, Inc. Registrant	
Date: April 23, 2012	By:	/s/ Jason L. Tienor Jason L. Tienor Chief Executive Officer (principal executive officer)
Date: April 23, 2012	By:	/s/ Richard E. Mushrush Richard E. Mushrush Controller and Acting Chief Financial Officer (principal financial officer)