TELKONET INC
Form 10-Q
November 12, 2015

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2015

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 Registrant as specified in its charter)

Utah	87-0627421
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

20800 Swenson Drive, Suite 175, Waukesha, WI	53186
(Address of Principal Executive Offices)	(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 ¨

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

The number of shares outstanding of the registrant's common stock, par value $0.001 per share, as of October 31, 2015 is 127,054,848.

TELKONET, INC.

FORM 10-Q for the Nine Months Ended September 30, 2015

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TELKONET, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	September 30, 2015	**December 31, 2014**
ASSETS		
Current assets:		
Cash and cash equivalents	$1,095,703	$1,128,072
Restricted cash on deposit	31,267	63,000
Accounts receivable, net	2,383,005	1,460,422
Inventories, net	898,354	1,027,250
Prepaid expenses and other current assets	276,628	95,282
Total current assets	4,684,957	3,774,026
Property and equipment, net	113,840	131,750
Other assets:		
Goodwill	5,796,430	5,796,430
Intangible assets, net	835,677	1,016,937
Deposits	34,000	34,238
Deferred financing costs, net	19,371	33,582
Total other assets	6,685,478	6,881,187
Total Assets	$11,484,275	$10,786,963
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$1,810,552	$1,680,692
Accrued liabilities and expenses	1,276,261	1,090,025
Notes payable – current	151,848	279,740
Line of credit	961,771	628,204
Deferred revenues	150,596	120,754
Customer deposits	179,534	394,717
Total current liabilities	4,530,562	4,194,132
Long-term liabilities:		
Deferred lease liability	126,236	140,575
Notes payable – long term	13,161	114,212
Deferred income taxes	688,597	534,661

Total long-term liabilities	827,994	789,448
Redeemable preferred stock:		
15,000,000 shares authorized, par value $.001 per share		
Series A; 215 shares issued, 185 shares outstanding at December 31, 2014, preference in liquidation of $1,303,859 as of December 31, 2014	–	1,303,859
Total redeemable preferred stock	–	1,303,859
Commitments and contingencies		
Stockholders’ Equity		
Series A, par value $.001 per share; 215 shares issued, 185 shares outstanding at September 30, 2015, preference in liquidation of $1,359,226 as of September 30, 2015	1,340,566	–
Series B, par value $.001 per share; 538 shares issued, 55 shares outstanding at September 30, 2015 and December 31, 2014, preference in liquidation of $388,503 and $372,030 as of September 30, 2015 and December 31, 2014, respectively	382,951	372,030
Common stock, par value $.001 per share; 190,000,000 shares authorized; 127,054,848 shares issued and outstanding at September 30, 2015 and 125,035,612 issued and outstanding at December 31, 2014	127,054	125,035
Additional paid-in-capital	126,132,312	125,908,476
Accumulated deficit	(121,857,164)	(121,906,017)
Total stockholders’ equity	6,125,719	4,499,524
Total Liabilities and Stockholders’ Equity	$11,484,275	$10,786,963

See accompanying notes to the unaudited condensed consolidated financial statements

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TELKONET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	Three Months Ended		**Nine Months Ended**	
	September 30,		**September 30,**	
	2015	2014	2015	2014
Revenues, net:				
Product	$2,979,834	$3,122,164	$8,289,596	$8,251,764
Recurring	1,077,586	960,509	3,097,844	2,816,874
Total Net Revenue	4,057,420	4,082,673	11,387,440	11,068,638
Cost of Sales:				
Product	1,513,727	1,674,172	4,286,144	5,000,490
Recurring	253,394	266,136	727,665	783,521
Total Cost of Sales	1,767,121	1,940,308	5,013,809	5,784,011
Gross Profit	2,290,299	2,142,365	6,373,631	5,284,627
Operating Expenses:				
Research and development	373,710	347,344	1,128,596	962,849
Selling, general and administrative	1,512,080	1,267,968	4,785,045	4,096,314
Depreciation and amortization	67,494	69,525	205,515	205,711
Total Operating Expenses	1,953,284	1,684,837	6,119,156	5,264,874
Income from Operations	337,015	457,528	254,475	19,753
Other Income (Expenses):				
Interest income (expense), net	(16,283)	(6,072)	(50,786)	(24,796)
Total Other Income (Expense)	(16,283)	(6,072)	(50,786)	(24,796)
Income (Loss) Before Provision for Income Taxes	320,732	451,456	203,689	(5,043)
Provision for Income Taxes	51,312	68,706	154,836	171,330
Net Income (Loss)	269,420	382,750	48,853	(176,373)
Accretion of preferred dividends and discount	–	(36,166)	(18,253)	(107,890)
Net income (loss) attributable to common stockholders	$269,420	$346,584	$30,600	$(284,263)

Net income (loss) per common share:

Net income (loss) attributable to common stockholders per common share– basic	$0.00	$0.00	$0.00	$(0.00)
Net income (loss) attributable to common stockholders per common share – diluted	$0.00	$0.00	$0.00	$(0.00)
Weighted Average Common Shares Outstanding – basic	126,411,243	125,035,612	125,499,195	125,035,612
Weighted Average Common Shares Outstanding – diluted	128,929,552	126,814,401	125,539,532	125,035,612

See accompanying notes to the unaudited condensed consolidated financial statements

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TELKONET, INC.

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)

NINE MONTHS FROM JANUARY 1, 2015 THROUGH SEPTEMBER 30, 2015

	Series A Preferred Stock Shares	Series A Preferred Stock Amount	Series B Preferred Stock Shares	Series B Preferred Stock Amount	Common Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Equity
Balance at January 1, 2015	–	$–	55	$372,030	125,035,612	$125,035	$125,908,476	$(121,906,017)	$4,499,524
Shares issued to preferred stockholders for warrants exercised at $0.13 per share	–	–	–	–	2,019,236	2,019	260,481	–	262,500
Stock-based compensation expense related to employee stock options	–	–	–	–	–	–	10,983	–	10,983
Accretion of redeemable preferred stock dividends	–	18,454	–	10,921	–	–	(47,628)	–	(18,253)
Reclassification from temporary equity to permanent equity	185	1,322,112	–	–	–	–	–	–	1,322,112
Net income	–	–	–	–	–	–	–	48,853	48,853
Balance at September 30, 2015	185	$1,340,566	55	$382,951	127,054,848	$127,054	$126,132,312	$(121,857,164)	$6,125,719

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	Nine Months Ended September 30,	
	2015	2014
Cash Flows From Operating Activities:		
Net income (loss)	$48,853	$(176,373)
Adjustments to reconcile net income (loss) from operations to net cash (used in) provided by operating activities:		
Stock-based compensation expense	10,983	10,843
Amortization of deferred financing costs	14,211	–
Depreciation	24,255	24,451
Amortization	181,260	181,260
Provision for doubtful accounts, net of recoveries	583	(92,929)
Deferred income taxes	153,936	153,936
Changes in assets and liabilities:		
Accounts receivable	(923,166)	402,631
Inventories	128,896	(19,588)
Prepaid expenses and other current assets	(181,346)	76,220
Deposits and other long term assets	238	–
Accounts payable	129,860	90,925
Accrued liabilities and expenses	186,236	(557,376)
Deferred revenue	29,842	36,667
Customer deposits	(215,183)	224,205
Deferred lease liability	(14,339)	13,426
Net Cash (Used In) Provided By Operating Activities	(424,881)	368,298
Cash Flows From Investing Activities:		
Purchase of property and equipment	(6,345)	(120,667)
Change in restricted cash	31,733	319,000
Net Cash Provided By Investing Activities	25,388	198,333
Cash Flows From Financing Activities:		
Payments on notes payable	(228,943)	(198,729)
Proceeds from exercise of warrants	262,500	–
Net proceeds from line of credit	333,567	–
Net Cash Provided By (Used In) Financing Activities	367,124	(198,729)

Net (decrease) increase in cash and cash equivalents	(32,369)	367,902
Cash and cash equivalents at the beginning of the period	1,128,072	572,672
Cash and cash equivalents at the end of the period	$1,095,703	$940,574

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(UNAUDITED)

	Nine Months Ended September 30,	
	2015	2014
Supplemental Disclosures of Cash Flow Information:		
Cash transactions:		
Cash paid during the period for interest	$39,892	$25,661
Non-cash transactions:		
Accretion of discount on redeemable preferred stock	$–	$73,584
Accretion of dividends on redeemable preferred stock	47,628	71,839

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2015

(UNAUDITED)

NOTE A – BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

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

General

The accompanying unaudited condensed consolidated financial statements of Telkonet, Inc. (the "Company", "Telkonet") 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 results from operations for the nine months ended September 30, 2015, are not necessarily indicative of the results that may be expected for the year ending December 31, 2015. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated December 31, 2014 financial statements and footnotes thereto included in the Company's Form 10-K filed with the SEC.

Business and Basis of Presentation

Telkonet, Inc., formed in 1999 and incorporated under the laws of the State of Utah, is made up of two synergistic business divisions, EcoSmart Energy Management Technology and EthoStream High Speed Internet Access (HSIA) Network.

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

Going Concern

The accompanying 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 reported net income of $48,853 for the nine months ended September 30, 2015, had cash used in operating activities of $424,881, has an accumulated deficit of $121,857,164 and total current assets in excess of current liabilities of $154,395 as of September 30, 2015.

Although the Company had net income for the year ended December 31, 2014 and for the nine months ended September 30, 2015 and total current assets in excess of current liabilities of as of September 30, 2015, these results have not been achieved on a consistent basis. The Company s ability to continue as a going concern is subject to its ability to consistently generate a profit and positive operating cash flows and/or obtain necessary funding from outside sources, including by the sale of securities or assets, or obtaining loans from financial institutions, where possible. The Company may also experience net operating losses in the future and the uncertainty regarding contingent liabilities cast doubt on its ability to satisfy such liabilities and the Company cannot make any representations for fiscal 2015 and beyond. These matters raise doubt about the Company s ability to continue as a going concern. The financial statements do not include any adjustments that might result from the outcome of these uncertainties.

Anticipated cash flows from operations may be insufficient to satisfy the Company s ongoing capital requirements for at least the next 12 months. On September 30, 2014, the Company and its wholly-owned subsidiary, EthoStream, as co-borrowers (collectively, the Borrowers), entered into a Loan and Security Agreement (the Loan Agreement) with Heritage Bank of Commerce, a California state chartered bank (Heritage Bank), governing a new revolving credit facility in a principal amount not to exceed $2,000,000 (the Credit Facility). Availability of borrowings under the Credit Facility from time to time is subject to a borrowing base calculation based on the Company s eligible accounts receivable and eligible inventory each multiplied by an applicable advance rate, with an overall limitation tied to the Company s eligible accounts receivable. The Loan Agreement is available for working capital and other lawful general corporate purposes. The outstanding principal balance of the Credit Facility bears interest at the Prime Rate plus 3.00%. The Credit Facility matures on September 30, 2016, unless earlier accelerated under the terms of the Loan Agreement. The outstanding balance was $961,771 on the Credit Facility as of September 30, 2015 and the remaining available borrowing capacity was approximately $447,000 at September 30, 2015. As of September 30, 2015, the Company was in compliance with all financial covenants.

Management intends to review the options for raising additional capital including, but not limited to, asset-based or equity financing, private placements, and/or disposition of assets. Management believes that with additional financing, the Company will be able to generate additional revenues that will allow the Company to continue as a going concern.

In addition, any equity financing may be dilutive to stockholders and any additional debt financing would increase expenses and may involve restrictive covenants. There can be no assurance that the Company will be successful in obtaining additional funding. If the Company is unable to obtain additional funding or is required to raise it on undesirable terms, it may have a material adverse effect on the Company’s financial condition.

TELKONET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2015

(UNAUDITED)

Restricted Cash on Deposit

During 2014, the Company was awarded a contract with a bonding requirement. The Company satisfied this requirement during the year ended December 31, 2014 with cash collateral supported by an irrevocable standby letter of credit in the amount of $63,000. The Company continues to execute contracts with bonding requirements and maintains this cash collateral on deposit for current and future projects. The amount is presented as restricted cash on deposit on the condensed consolidated balance sheet as of September 30, 2015 and December 31, 2014. The outstanding balance as of September 30, 2015 and December 31, 2014 was $31,267 and $63,000, respectively.

Income (Loss) per Common Share

The Company computes earnings per share under ASC 260-10, “Earnings Per Share”. Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of shares outstanding of common stock. Diluted income (loss) per share is computed using the weighted average number of common and common stock equivalent shares outstanding during the year. Dilutive common stock equivalents consist of shares issuable upon the exercise of the Company's outstanding stock options and warrants. For the nine months ended September 30, 2015 and 2014, there were 7,413,635 and 11,290,139 shares of common stock underlying options and warrants excluded due to these instruments being anti-dilutive, respectively.

Use of Estimates

The preparation of financial statements in conformity with United States of America (U.S.) generally accepted accounting principles (GAAP) requires management to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Estimates are used when accounting for items and matters such as revenue recognition and allowances for uncollectible accounts

receivable, inventory obsolescence, depreciation and amortization, long-lived and intangible asset valuations, impairment assessments, taxes and related valuation allowance, income tax provisions, stock-based compensation, and contingencies. The Company believes that the estimates, judgments and assumptions are reasonable, based on information available at the time they are made. Actual results may differ from those estimates.

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 income tax assets in the future.

The Company adopted 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, the Company recognizes revenue in accordance with ASC 605-10, "Revenue Recognition" and ASC 605-10-S99 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. 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.

TELKONET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2015

(UNAUDITED)

Multiple-Element Arrangements (“MEAs”): The Company accounts for contracts that have both product and installation under the MEAs guidance in ASC 605-25. Arrangements under such contracts may include multiple deliverables, a combination of equipment and services. The deliverables included in the MEAs are separated into more than one unit of accounting when (i) the delivered equipment has value to the customer on a stand-alone basis, and (ii) delivery of the undelivered service element(s) is probable and substantially in the Company’s control. Arrangement consideration is then allocated to each unit, delivered or undelivered, based on the relative selling price of each unit of accounting based first on vendor-specific objective evidence (“VSOE”) if it exists, second on third-party evidence (“TPE”) if it exists and on estimated selling price (“ESP”) if neither VSOE or TPE exist.

- VSOE – In most instances, products are sold separately in stand-alone arrangements. Services are also sold separately through renewals of contracts with varying periods. The Company determines VSOE based on pricing and discounting practices for the specific product or service when sold separately, considering geographical, customer, and other economic or marketing variables, as well as renewal rates or stand-alone prices for the service element(s).

- TPE – If the Company cannot establish VSOE of selling price for a specific product or service included in a multiple-element arrangement, the Company uses third-party evidence of selling price. The Company determines TPE based on sales of comparable amount of similar product or service offered by multiple third parties considering the degree of customization and similarity of product or service sold.

- ESP – The estimated selling price represents the price at which the Company would sell a product or service if it were sold on a stand-alone basis. When neither VSOE nor TPE exists for all elements, the Company determines ESP for the arrangement element based on sales, cost and margin analysis, as well as other inputs based on the Company’s pricing practices. Adjustments for other market and Company-specific factors are made as deemed necessary in determining ESP.

When MEAs include an element of customer training, it is not essential to the functionality, efficiency or effectiveness of the MEA. Therefore the Company has concluded that this obligation is inconsequential and perfunctory. As such, for MEAs that include training, customer acceptance of said training is not deemed necessary in order to record the related revenue, but is recorded when the installation deliverable is fulfilled. Historically, training revenues have not been significant.

The Company provides call center support services to properties installed by the Company and also to properties installed by other providers. In addition, the Company provides the property with the portal to access the Internet. The Company receives monthly service fees from such properties for its services and Internet access. The Company recognizes 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 standalone executed contracts. The Company reports such revenues as recurring revenues.

Guarantees and Product Warranties

The Company records a liability for potential warranty claims in cost of sales at the time of sale. The amount of the liability is based on the trend in the historical ratio of claims to sales, the historical length of time between the sale and resulting warranty claim, new product introductions and other factors. The products sold are generally covered by a warranty for a period of one year. In the event the Company determines that its current or future product repair and replacement costs exceed its estimates, an adjustment to these reserves would be charged to earnings in the period such determination is made. For the nine months ended September 30, 2015 and the year ended December 31, 2014, the Company experienced returns of approximately 1% to 2% of materials included in the cost of sales. As of September 30, 2015 and December 31, 2014, the Company recorded warranty liabilities in the amount of $81,612 and $44,288, respectively, using this experience factor range.

Product warranties for the nine months ended September 30, 2015 and the year ended December 31, 2014 are as follows:

	September 30, 2015	December 31, 2014
Beginning balance	$ 44,288	$ 77,943
Warranty claims incurred	(41,876)	(45,710)
Provision charged to expense	79,200	12,055
Ending balance	$ 81,612	$ 44,288

TELKONET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2015

(UNAUDITED)

Lease Abandonment

On July 15, 2011, the Company executed a sublease agreement for approximately 12,000 square feet of commercial office space in Germantown, Maryland. Because the Company no longer has access to this subleased space, the Company recorded a charge of $59,937 in accrued liabilities and expenses related to this abandonment during 2011. On June 27, 2012 the subtenant exercised the option to extend the expiration of the term of the sublease from January 31, 2013 to December 31, 2015 and the Company recorded an additional charge of $132,174. The remaining liability at September 30, 2015 was $11,068 and at December 31, 2014 was $46,673.

NOTE B – NEW ACCOUNTING PRONOUNCEMENTS

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (ASU 2014-09), which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP. The guidance for this standard was initially effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period, however in August 2015 the FASB delayed the effective date of the standard for one full year. Companies will adopt the standard using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). The Company is currently evaluating the impact of its pending adoption of ASU 2014-09 on its consolidated financial statements and has not yet determined the method by which it will adopt the standard in 2018.

In June 2014, the FASB issued ASU No. 2014-12, Compensation-Stock Compensation (Topic 718). Under ASU No. 2014-12 an award with a performance target generally requires an employee to render service until the performance target is achieved. In some cases, however, the terms of an award may provide that the performance target could be achieved after an employee completes the requisite service period. That is, the employee would be eligible to vest in the award regardless of whether the employee is rendering service on the date the performance target is achieved. This ASU will be effective for reporting periods beginning after December 15, 2015. The Company does not believe this guidance will have a material impact on the Company's future statement of operations, financial position or cash flows.

In August 2014, the FASB issued ASU No. 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40), Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern which requires management to evaluate, in connection with preparing financial statements for each annual and interim reporting period, whether there are conditions or events, considered in the aggregate, that raise substantial doubt about an entity’s ability to continue as a going concern within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable) and provide related disclosures. ASU 2014-15 is effective for annual periods beginning after December 15, 2016 and thereafter. Early adoption is permitted. The Company is currently evaluating the impact of its pending adoption of ASU 2014-15 on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs. This ASU requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of the debt liability. In June 2015, at the Emerging Issues Task Force meeting, the FASB clarified that ASU 2015-03 does not address debt issuance costs related to revolving credit debt arrangements. In connection therewith, at the June 2015 meeting, the SEC staff announced that it would not object to the presentation of issuance costs related to revolving debt arrangements as an asset that is amortized over the term of the arrangement, which was codified by FASB in ASU 2015-15 in August 2015. Currently, the Company presents deferred financing costs related to its revolving credit facility as an asset in the consolidated balance sheets. ASU 2015-03 is effective for reporting periods beginning after December 15, 2015. The Company does not believe this guidance will have a material impact on the Company’s future statement of operations, financial position or cash flows.

In July 2015, the FASB issued ASU No. 2015-11, Inventory - Simplifying the Measurement of Inventory (Topic 330). This ASU requires inventory to be subsequently measured using the lower of cost and net realizable value, thereby eliminating the market value approach. Net realizable value is defined as the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation.
ASU 2015-11 is effective for reporting periods beginning after December 15, 2016 and is applied prospectively. Early adoption is permitted. The Company is currently evaluating the impact of its pending adoption of ASU 2015-11 on its consolidated financial statements.

TELKONET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2015

(UNAUDITED)

NOTE C – INTANGIBLE ASSETS AND GOODWILL

Total identifiable intangible assets acquired and their carrying values at September 30, 2015 are:

	Cost	**Accumulated Amortization**	Accumulated Impairment	Carrying Value	**Weighted Average Amortization Period (Years)**
Amortized Identifiable Intangible Assets:					
Subscriber lists – EthoStream	$2,900,000	$(2,064,323)	$–	$835,677	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(2,064,323)	–	835,677	
Goodwill – EthoStream	8,796,430	–	(3,000,000)	5,796,430	
Total Goodwill	8,796,430	–	(3,000,000)	5,796,430	
Total	$11,696,430	$(2,064,323)	$(3,000,000)	$6,632,107	

Total identifiable intangible assets acquired and their carrying values at December 31, 2014 are:

	Cost	**Accumulated Amortization**	Accumulated Impairment	Carrying Value	**Weighted Average Amortization Period (Years)**
Amortized Identifiable Intangible Assets:					

Subscriber lists – EthoStream	$2,900,000	$(1,883,063)	$–	$1,016,937	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(1,883,063)	–	1,016,937	
Goodwill – EthoStream	8,796,430	–	(3,000,000)	5,796,430	
Goodwill – SSI	5,874,016	–	(5,874,016)	–	
Total Goodwill	14,670,446	–	(8,874,016)	5,796,430	
Total	$17,570,446	$(1,883,063)	$(8,874,016)	$6,813,367	

Total amortization expense charged to operations for each of the three and nine months ended September 30, 2015 and 2014 was $60,420 and $181,260. The weighted average remaining amortization period for the subscriber list is 2.98 years.

Estimated future amortization expense as of September 30, 2015 is as follows:

Remainder of 2015	$60,420
2016	241,680
2017	241,680
2018	241,680
2019	50,217
Total	$835,677

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 Smart Systems International ("SSI") during the year ended December 31, 2007. The Company evaluates goodwill for impairment based on the fair value of the reporting units to which this goodwill relates at least once a year. The Company utilizes a discounted cash flow valuation methodology (income approach) to determine the fair value of the reporting unit. Since acquisition, the Company has written off $3,000,000 and $5,874,016 of goodwill for EthoStream and SSI, respectively.

TELKONET, INC.

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NOTE D – ACCOUNTS RECEIVABLE

Components of accounts receivable as of September 30, 2015 and December 31, 2014 are as follows:

	September 30, 2015	December 31, 2014
Accounts receivable	$2,404,222	$1,497,295
Allowance for doubtful accounts	(21,217)	(36,873)
Accounts receivable, net	$2,383,005	$1,460,422

NOTE E – INVENTORIES

Components of inventories as of September 30, 2015 and December 31, 2014 are as follows:

	September 30, 2015	December 31, 2014
Product purchased for resale	$1,064,704	$1,220,600
Reserve for obsolescence	(166,350)	(193,350)
Inventory, net	$898,354	$1,027,250

NOTE F – ACCRUED LIABILITIES AND EXPENSES

Accrued liabilities and expenses at September 30, 2015 and December 31, 2014 are as follows**:**

	September 30, 2015	December 31, 2014
Accrued liabilities and expenses	$410,997	$342,841
Accrued payroll and payroll taxes	489,287	345,589
Accrued sales taxes, penalties, and interest	293,845	353,260
Accrued interest	520	4,047
Product warranties	81,612	44,288
Total accrued liabilities and expenses	$1,276,261	$1,090,025

NOTE G – DEBT

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 is required to pay equal monthly installments of $4,426; 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 Loan Agreement in whole or in part at any time without penalty. The Loan Agreement was secured by substantially all of the Company's assets. On September 24, 2014, the Department signed a subordination agreement of all the Company's security interests. The proceeds from this loan were used for the working capital requirements of the Company. The Loan Agreement contains covenants which required, among other things, that the Company keep and maintain 75 existing full-time positions and create and fill 35 additional full-time positions in Milwaukee, Wisconsin by December 31, 2012. On June 18, 2012, the Department agreed to permanently waive all penalties associated with the Company's noncompliance with this covenant. The outstanding borrowings under the agreement as of September 30, 2015 and December 31, 2014 were $65,448 and $103,979, respectively.

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Promissory Note

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 (the "Note") due to Purchaser in the aggregate principal amount of $700,000. The outstanding principal balance bears interest at the annual rate of 6% and was originally due on March 31, 2014. The Note may be prepaid in whole or in part, without penalty at any time. 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. Effective April 30, 2013, Purchaser approved an amendment to certain terms of the Note. Telkonet commenced a monthly payment of principal and interest of $20,000 to be applied against the outstanding balance starting May 1, 2013. The interest rate remains unchanged at 6% and the maturity date was extended to January 1, 2016. During the nine months ended September 30, 2015, the Company made additional payments of $20,000 in aggregate beyond the required monthly payments of principal and interest. The outstanding principal balance of the Note as of September 30, 2015 and December 31, 2014 was $99,561 and $289,973, respectively.

Revolving Credit Facility

On September 30, 2014, the Company and its wholly owned subsidiary, EthoStream, as co-borrowers (collectively, the "Borrowers"), entered into a Loan and Security Agreement (the "Loan Agreement") with Heritage Bank of Commerce, a California state chartered bank ("Heritage Bank"), governing a new revolving credit facility in a principal amount not to exceed $2,000,000 (the "Credit Facility"). Availability of borrowings under the Credit Facility from time to time is subject to a borrowing base calculation based on the Company's eligible accounts receivable and eligible inventory each multiplied by an applicable advance rate, with an overall limitation tied to the Company's eligible accounts receivable. The Loan Agreement is available for working capital and other lawful general corporate purposes. The outstanding principal balance of the Credit Facility bears interest at the Prime Rate plus 3.00%, which was 6.25% at September 30, 2015 and December 31, 2014. The Credit Facility matures on September 30, 2016, unless earlier accelerated under the terms of the Loan Agreement. On October 9, 2014, as part of the Loan Agreement, Heritage Bank was granted a warrant to purchase 250,000 shares of Telkonet common stock. The warrant has an exercise price of $0.20 and expires October 9, 2021.

The Loan Agreement also contains financial covenants that place restrictions on, among other things, the incurrence of debt, granting of liens and sale of assets. The Loan Agreement also contains financial covenants that require the Borrowers to maintain a minimum EBITDA level, measured quarterly, and a minimum asset coverage ratio, measured monthly. A violation of any of these covenants could result in an event of default under the Loan Agreement. Upon the occurrence of such an event of default or certain other customary events of defaults, payment of any outstanding amounts under the Credit Facility may be accelerated and Heritage Bank's commitment to extend credit under the Loan Agreement may be terminated. The Loan Agreement contains other representations and warranties, covenants, and other provisions customary to transactions of this nature. As of September 30, 2015, the Company was in compliance with all financial covenants. The outstanding balance on the Credit Facility was $961,771 and $628,204 at September 30, 2015 and December 31, 2014 leaving an available borrowing base of approximately $447,000 and $241,000 at September 30, 2015 and December 31, 2014, respectively.

Aggregate annual future maturities of the Company's debt as of September 30, 2015 are as follows:

Years ended December 31,	Amount
2015 (remainder of)	$71,772
2016	93,237
	165,009
Less: Current portion	(151,848)
Notes payable long term	$13,161

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TELKONET, INC.

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NOTE H – 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 is convertible, at the option of the holder thereof, at any time, into shares of 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, the Company was required to redeem the Series A for the purchase price of $5,000 per share, plus any accrued but unpaid dividends. By way of the redemption option available to holders of the Company’s Series A shares having expired on May 18, 2015 with no Series A holders requesting redemption of their shares, the redemption feature at the option of the holders was eliminated, thereby, resulting in the reclassification of $1,322,112 from temporary equity, which was classified as “redeemable preferred stock” in the Company’s condensed consolidated balance sheets, to permanent equity during the three months ended June 30, 2015.

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. On November 19, 2014 and for a period of 180 days thereafter, the Series A were redeemable at the option of the holder and the carrying value of the preferred stock, net of discount and including accumulated dividends, had been classified as redeemable preferred stock on the condensed consolidated balance sheets. The redemption feature at the option of the holders expired, thereby, resulting in the reclassification from temporary equity to permanent equity during the three months ended June 30, 2015.

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 were 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) 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, were recorded as a discount and deducted from the face value of the preferred stock. The discount was 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) and an increase to the net income (loss) attributable to common stockholders.

The charge to additional paid in capital for amortization of Series A discount and costs for the three and nine months ended September 30, 2014 was $17,508 and $52,524, respectively.

For the three and nine months ended September 30, 2015 and 2014, the Company has accrued dividends for Series A in the amount of zero and $18,660 and $36,707 and $55,367, and cumulative accrued dividends of $434,226 and $360,199, respectively. The accrued dividends have been charged to additional paid-in capital (since there is a deficit in retained earnings) and an increase to the net income (loss) attributable to common stockholders and the net unpaid accrued dividends been added to the carrying value of the preferred stock.

Series B

The Company has designated 538 shares of preferred stock as Series B Preferred Stock (“Series B”). Each share of Series B is convertible, at the option of the holder thereof, at any time, into shares of common stock at an initial conversion price of $0.13 per share. As a result of the Series B conversions during the year ended December 31, 2013, the outstanding Series B shares will not become redeemable at the option of the holders. The Series B accrues dividends at an annual rate of 8% of the original purchase price, payable only when, as, and if declared by the 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. Up and until the quarter ended September 30, 2013, the Series B were redeemable at the option of the holder, the carrying value of the preferred stock, net of discount and including accumulated dividends, has been classified as redeemable preferred stock on the consolidated balance sheets. During the year ended December 31, 2013, shareholders converted 167 redeemable preferred shares issued on August 4, 2010, to, in aggregate, 6,423,072 shares of common stock.

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A portion of the proceeds was 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 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 were as follows: (1) dividend yield of 0%; (2) expected volatility of 123%, (3) weighted average risk-free interest rate of 1.76%, (4) expected term 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, were 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 addition