TELKONET INC
Form 10-Q
August 14, 2018
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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 June 30, 2018

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) 302-2299

(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, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. o

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 July 31, 2018 is 133,989,919.

TELKONET, INC.

FORM 10-Q for the Six Months Ended June 30, 2018

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TELKONET, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

	June 30, 2018	December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	$6,316,887	$8,385,595
Restricted cash on deposit	10,000	810,000
Accounts receivable, net	1,983,427	1,610,286
Inventories	982,568	1,259,536
Contract assets	353,684	–
Prepaid expenses and other current assets	596,104	143,566
Income taxes receivable	17,300	17,300
Total current assets	10,259,970	12,226,283
Property and equipment, net	278,120	304,170
Other assets:		
Deposits	17,130	17,130
Total other assets	17,130	17,130
Total Assets	$10,555,220	$12,547,583
LIABILITIES AND STOCKHOLDERS’ EQUITY		
Current liabilities:		
Accounts payable	$960,210	$978,207
Accrued liabilities and expenses	734,780	668,814
Line of credit	–	682,211
Contract liabilities - current	841,190	–
Deferred revenues - current	–	292,106
Customer deposits	–	124,380
Total current liabilities	2,536,180	2,745,718
Long-term liabilities:		

Contract liabilities – long term	205,820	–
Deferred revenues - long term	–	219,960
Deferred lease liability - long term	61,841	48,839
Total long-term liabilities	267,661	268,799
Commitments and contingencies		
Stockholders' Equity		
Series A, par value $.001 per share; 215 shares issued, 185 shares outstanding at June 30, 2018 and December 31, 2017, preference in liquidation of $1,562,848 and $1,526,141 as of June 30, 2018 and December 31, 2017, respectively	1,340,566	1,340,566
Series B, par value $.001 per share; 538 shares issued, 52 shares outstanding at June 30, 2018 and December 31, 2017, preference in liquidation of $424,583 and $414,258 as of June 30, 2018 and December 31, 2017, respectively	362,059	362,059
Common stock, par value $.001 per share; 190,000,000 shares authorized; 133,989,919 and 133,695,111 shares issued and outstanding at June 30, 2018 and December 31, 2017, respectively	133,989	133,695
Additional paid-in-capital	127,460,169	127,421,402
Accumulated deficit	(121,545,404)	(119,724,656)
Total stockholders' equity	7,751,379	9,533,066
Total Liabilities and Stockholders' Equity	$10,555,220	$12,547,583

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

	Three Months Ended		**Six Months Ended**	
	June 30,		**June 30,**	
	2018	2017	2018	2017
Revenues, net:				
Product	$2,820,805	$2,013,922	$4,324,463	$3,824,307
Recurring	153,357	110,201	254,895	213,043
Total Net Revenue	2,974,162	2,124,123	4,579,358	4,037,350
Cost of Sales:				
Product	1,376,729	1,065,914	2,370,966	2,073,959
Recurring	66,482	32,627	126,479	62,645
Total Cost of Sales	1,443,211	1,098,541	2,497,445	2,136,604
Gross Profit	1,530,951	1,025,582	2,081,913	1,900,746
Operating Expenses:				
Research and development	431,856	444,557	870,636	823,013
Selling, general and administrative	1,291,103	1,438,069	2,568,006	3,207,762
Depreciation and amortization	16,628	9,880	33,543	19,789
Total Operating Expenses	1,739,587	1,892,506	3,472,185	4,050,564
Operating Loss	(208,636)	(866,924)	(1,390,272)	(2,149,818)
Other Income (Expenses):				
Interest income (expense), net	4,054	4,428	1,524	(5,925)
Total Other Income (Expense)	4,054	4,428	1,524	(5,925)
Loss from Continuing Operations before Provision for Income Taxes	(204,582)	(862,496)	(1,388,748)	(2,155,743)
Provision for Income Taxes	2,000	6,910	2,000	7,901
Net loss from continuing operations	(206,582)	(869,406)	(1,390,748)	(2,163,644)
Discontinued Operations:				
Gain from sale of discontinued operations (net of tax)	–	–	–	6,384,871
Income from discontinued operations (net of tax)	–	18,855	–	590,657
Net income (loss) attributable to common stockholders	$(206,582)	$(850,551)	$(1,390,748)	$4,811,884

Net income (loss) per common share:

Basic - continuing operations	$(0.00)	$(0.01)	$(0.01)	$(0.02)
Basic - discontinued operations	$–	$0.00	$–	$0.05
Basic – net income (loss) attributable to common stockholders	$(0.00)	$(0.01)	$(0.01)	$0.04
Diluted - continuing operations	$(0.00)	$(0.01)	$(0.01)	$(0.02)
Diluted - discontinued operations	$–	$0.00	$–	$0.05
Diluted – net income (loss) attributable to common stockholders	$(0.00)	$(0.01)	$(0.01)	$0.04
Weighted Average Common Shares Outstanding – basic	133,989,919	133,015,191	133,843,329	132,894,833
Weighted Average Common Shares Outstanding –diluted	133,739,919	133,015,191	133,961,689	133,490,201

See accompanying notes to the unaudited condensed consolidated financial statements

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TELKONET, INC.

CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (UNAUDITED)

SIX MONTHS FROM JANUARY 1, 2018 THROUGH JUNE 30, 2018

	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 December 31, 2017	185	$1,340,566	52	$362,059	133,695,111	$133,695	$127,421,402	$(119,724,656)	$9,533,066
January 1, 2018, Cumulative effect of a change in accounting principle related to ASC 606, net of tax	–	–	–	–	–	–	–	(430,000)	(430,000)
Shares issued to directors	–	–	–	–	294,808	294	35,706	–	36,000
Stock-based compensation expense related to employee stock options	–	–	–	–	–	–	3,061	–	3,061
Net loss	–	–	–	–	–	–	–	(1,390,748)	(1,390,748)
Balance at June 30, 2018	185	$1,340,566	52	$362,059	133,989,919	$133,989	$127,460,169	$(121,545,404)	$7,751,379

See accompanying notes to the unaudited condensed consolidated financial statements

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TELKONET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

	For the Six Months Ended June 30,	
	2018	2017
Cash Flows from Operating Activities:		
Net income (loss)	$(1,390,748)	$4,811,884
Less: Net income from discontinued operations	–	(590,657)
Gain on sale of discontinued operations	–	(6,384,871)
Net loss from continuing operations	(1,390,748)	(2,163,644)
Adjustments to reconcile net (loss) from continuing operations to cash used in operating activities of continuing operations:		
Stock-based compensation expense	3,061	318,202
Shares issued to directors as compensation	36,000	72,000
Depreciation	33,543	19,789
Provision for doubtful accounts, net of recoveries	(75)	72,396
Changes in operating assets and liabilities:		
Accounts receivable	(373,066)	(140,141)
Inventories	276,968	74,559
Prepaid expenses and other current assets	(452,538)	(182,864)
Deposits and other long term assets	–	(17,130)
Accounts payable	(17,997)	(97,175)
Accrued liabilities and expenses	65,966	(76,498)
Contract liability	268,010	–
Deferred revenue	(512,066)	144,608
Related party payable	–	(97,127)
Customer deposits	(124,380)	159,975
Contract assets	(4,684)	–
Income tax payable	–	139,884
Deferred lease liability	13,002	3,098
Net Cash Used In Operating Activities of Continuing Operations	(2,179,004)	(1,770,068)
Net Cash Provided By Operating Activities of Discontinued Operations	–	517,242
Net Cash Used In Operating Activities	(2,179,004)	(1,252,826)
Cash Flows From Investing Activities:		
Purchase of property and equipment	(7,493)	(12,011)
Net proceeds from sale of subsidiary	–	11,805,220
Net Cash Used In Investing Activities of Continuing Operations	(7,493)	11,793,209
Cash Flows From Financing Activities:		

Net payments on line of credit	(682,211)	(1,062,129)
Net Cash Used In Financing Activities of Continuing Operations	(682,211)	(1,062,129)
Net increase (decrease) in cash and cash equivalents	(2,868,708)	9,478,254
Cash and cash equivalents at the beginning of the period	9,195,595	791,858
Cash, cash equivalents and restricted cash at the end of the period	$6,326,887	$10,270,112

See accompanying notes to the unaudited condensed consolidated financial statements

TELKONET, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

(UNAUDITED)

	Six Months Ended	
	June 30,	
	2018	2017
Supplemental Disclosures of Cash Flow Information:		
Cash transactions:		
Cash paid during the period for interest	$5,326	$11,173
Cash paid during the period for income taxes, net of refunds	–	8,151

See accompanying notes to the unaudited condensed consolidated financial statements

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TELKONET, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2018

(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 six months ended June 30, 2018, are not necessarily indicative of the results that may be expected for the year ending December 31, 2018. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated December 31, 2017 financial statements and footnotes thereto included in the Company's Form 10-K filed with the SEC. Refer to Note C – Revenue for the adoption of a new revenue recognition standard in the first quarter of 2018.

Business and Basis of Presentation

Telkonet, formed in 1999 and incorporated under the laws of the state of Utah, is the creator of the EcoSmart Platform of intelligent automation solutions designed to optimize energy efficiency, comfort and analytics in support of the emerging Internet of Things ("IoT").

In 2007, the Company acquired substantially all of the assets of Smart Systems International ("SSI"), which was a provider of energy management products and solutions to customers in the United States and Canada and the precursor to the Company's EcoSmart platform. The EcoSmart platform provides comprehensive savings, management reporting, analytics and virtual engineering of a customer's portfolio and/or property's room-by-room energy consumption. Telkonet has deployed more than a half million intelligent devices worldwide in properties within the hospitality, military, educational, healthcare and other commercial markets. The EcoSmart platform is rapidly being recognized as a leading solution for reducing energy consumption, operational costs and carbon footprints, and eliminating the need for new energy generation in these marketplaces – all while improving occupant comfort and convenience.

On March 28, 2017, the Company sold substantially all of the assets of its wholly-owned subsidiary, EthoStream LLC. Refer to Note M for further details.

The condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Telkonet Communications, Inc. The prior year accounts of EthoStream LLC have been classified as discontinued operations on the consolidated statement of operations and the consolidated statement of cash flows. All significant intercompany balances and transactions have been eliminated in consolidation.

Unless otherwise noted, all financial information in the consolidated financial statement footnotes reflect the Company's results from continuing operations.

Liquidity and Financial Condition

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.

The Company reported a net loss from continuing operations of $1,390,748 for the six months ended June 30, 2018, had cash used in operating activities from continuing operations of $2,179,004, had an accumulated deficit of $121,545,405 and total current assets in excess of current liabilities of $7,723,791 as of June 30, 2018.

Income (Loss) per Common Share

The Company computes earnings per share under Accounting Standards Codification (“ASC”) 260-10, “Earnings Per Share”. Basic net income (loss) per common share is computed using the treasury stock method, which assumes that the proceeds to be received on exercise of outstanding stock options and warrants are used to repurchase shares of the Company at the average market price of the common shares for the year. Dilutive common stock equivalents consist of shares issuable upon the exercise of the Company's outstanding stock options and warrants. For the six months ended June 30, 2018 and 2017, there were 3,557,399 and 5,701,800 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 assets, 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.

The U.S. Tax Cuts and Jobs Act (“Tax Act”) was enacted on December 22, 2017. The Tax Act makes broad complex changes to the U.S. tax code including, but not limited to, reducing the U.S. federal corporate tax rate from 35% to 21%, requiring companies to pay a one-time transition tax on earnings of certain foreign subsidiaries that were previously tax deferred, and creating new taxes on certain foreign sourced earnings and additional limitations on the deductibility of interest.

The SEC issued Staff Accounting Bulletin No. 118 (SAB 118) in December, 2017, to provide guidance on accounting for the effects of the Tax Act. SAB 118 provides for a measurement period of up to one year from the Tax Act enactment date for companies to complete their assessment of and accounting for those effects of the Tax Act. Under SAB 118, a company must first reflect the income tax effects of the Tax Act for which the accounting is complete in the period of the date of enactment. To the extent the accounting for other income tax effects is incomplete, but a reasonable estimate can be determined, companies must record a provisional estimate to be included in their financial statements. For any income tax effect for which a reasonable estimate cannot be determined, an entity must continue to apply ASC 740 based on the provisions of the tax laws in effect immediately prior to the Tax Act being enacted until such time as a reasonable estimate can be determined. The Company requires additional time to complete its analysis of the impacts of the Tax Act and therefore its accounting for the Tax Act is provisional but is a reasonable estimate based on available information. The Company will complete its analysis and finalize its accounting for this provisional estimate during the one year measurement period as prescribed by SAB 118.

Revenue from Contracts with Customers

Accounting Standards Codification Topic 606, Revenue from Contracts with Customers (“ASC 606, the Standard”) supersedes nearly all legacy revenue recognition guidance. ASC 606 outlines a comprehensive five-step revenue recognition model based on the principle that an entity should recognize revenue based on when it satisfies its performance obligations by transferring control of promised goods or services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for said goods or services.

Identify the customer contracts

The Company accounts for a customer contract under ASC 606 when the contract is legally enforceable. A contract is legally enforceable when all of the following criteria are met: (1) the contract has been approved by the Company and the customer and both parties are committed to perform their respective obligations, (2) the Company can identify each party's rights regarding goods or services transferred, (3) the Company can identify payment terms for goods or services transferred, (4) the contract has commercial substance, and (5) collectability of all the consideration to which the Company is entitled in exchange for the goods or services transferred is probable.

A contract does not exist if each party to the contract has the unilateral right to terminate a wholly unperformed contract without compensating the other party (or parties). Nearly all of the Company's contracts do not contain such mutual termination rights for convenience. All contracts are in written form.

Identify the performance obligations

The Company will enter into product only contracts that contain a single performance obligation related to the transfer of EcoSmart products to a customer.

The Company will also enter into certain customer contracts that encompass product and installation services, referred to as "turnkey" solutions. These contracts ultimately provide the customer with a solution that enhances the functionality of the customer's existing equipment. For this reason, the Company has determined that the product and installation services are not separately identifiable performance obligations, but in essence represent one, combined performance obligation ("turnkey").

The Company also offers post-installation support services to customers. Support services are considered a separate performance obligation.

Determine the transaction price

The Company generally enters into contracts containing fixed prices. It is not customary for the Company to include contract terms that would result in variable consideration. In the rare situation that a contract does include this type of provision, it is not expected to result in a material adjustment to the transaction price. The Company regularly extends pricing discounts; however, they are negotiated up front and adjust the fixed transaction price set out in the contract.

Customer contracts will typically contain upfront deposits that will be applied against future invoices, as well as customer retainage. The intent of any required deposit or retainage is to ensure that the obligations of either party are honored and follow customary industry practices. In addition, the Company will typically be paid in advance at the beginning of any support contracts, consistent with industry practices. None of these payment provisions are intended to represent significant implicit financing. The Company’s standard payment terms are thirty days from invoice date. Products are fully refundable when returned in their original packaging without damage or defacing less a restocking fee not to exceed fifty (50%) percent of the product’s price. Historical returns have shown to be immaterial. The Company offers a standard one-year assurance warranty. However customers can purchase an extended warranty. Under the new standard, extended warranties are accounted for as a service warranty, requiring the revenue to be recognized over the extended service periods. Contracts involving an extended warranty are immaterial and will continue to be combined with support revenue and recognized on a straight-line basis over the support revenue term.

Allocate the transaction price to the performance obligations

Revenues from customer contracts are allocated to the separate performance obligations based on their relative stand-alone selling price (“SSP”) at contract inception. The SSP is the price at which the Company would sell a promised good or service separately. The best evidence of an SSP is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. However, turnkey solutions are sold for a broad range of amounts resulting from, but not limited to, tiered discounting for value added resellers (“VAR”) based upon committed volumes and other economic factors. Due to the high variability of our pricing, the Company cannot establish a reliable SSP using observable data. Accordingly, the Company uses the residual approach to allocate the transaction price to performance obligations related to its turnkey solutions.

All support service agreements, whether single or multi-year terms, automatically renew for one-year terms at a suggested retail price (“SRP”). Support service renewals are consistently priced and therefore would support the use of SRP as the best estimate of an SSP for such performance obligations.

Recognize Revenue

The Company recognizes revenues from product only sales at a point in time, when control over the product has transferred to the customer. As the Company's principal terms of sale are FOB shipping point, the Company primarily transfers control and records revenue for product only sales upon shipment.

A typical turnkey project involves the installation and integration of 200-300 rooms in a customer-controlled facility and usually takes sixty days to complete. Since control over goods and services transfers to a customer once a room is installed, the Company recognizes revenue for turnkey solutions over time. The Company uses an outputs measure based on the number of rooms installed to recognize revenues from turnkey solutions.

Revenues from support services are recognized over time, in even daily increments over the term of the contract.

Deferred revenue includes deferrals for the monthly support service fees. Long-term deferred revenue represents support service fees that will be recognized as revenue after June 30, 2019.

Transition

The Company adopted ASC 606 using a modified retrospective approach to all contracts not completed as of January 1, 2018. Results for reporting periods beginning January 1, 2018 are presented under ASC 606, while prior period amounts were not adjusted and continue to be reported in accordance with the Company's historic accounting under Topic 605, Revenue Recognition. The Company recorded a net decrease to beginning retained earnings of $0.43 million as of January 1, 2018 due to the cumulative impact of adopting ASC 606. The impact to beginning retained earnings was primarily driven by the deferral of revenue for unfulfilled performance obligations related to the Company's turnkey solutions.

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 six months ended June 30, 2018 and the year ended December 31, 2017, the Company experienced returns of approximately 1% to 2% of materials included in the cost of sales. As of June 30, 2018 and December 31, 2017, the Company recorded warranty liabilities in the amount of $60,622 and $59,892, respectively, using this experience factor range.

Product warranties for the six months ended June 30, 2018 and the year ended December 31, 2017 are as follows:

	June 30, 2018	December 31, 2017
Beginning balance	$59,892	$95,540
Warranty claims incurred	(7,117)	(84,087)
Provision charged to expense	7,847	48,439
Ending balance	$60,622	$59,892

NOTE B – NEW ACCOUNTING PRONOUNCEMENTS

In February 2016, the FASB issued ASU No. 2016-02, Leases (“ASU 2016-02”). The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the statement of operations. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is currently evaluating the impact of its pending adoption of ASU 2016-02 on its consolidated financial statements. Upon adoption, the Company expects that the ROU asset and lease liability will be recognized in the balance sheets in amounts that will be material.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. ASU 2016-13 provides guidance for estimating credit losses on certain types of financial instruments, including trade receivables, by introducing an approach based on expected losses. The expected loss approach will require entities to incorporate considerations of historical information, current information and reasonable and supportable forecasts. ASU 2016-13 also amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The guidance is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The guidance requires a modified retrospective transition method and early adoption is permitted. The Company does not expect the adoption of ASU 2016-13 to have a material impact on its consolidated financial statements.

Management has evaluated other recently issued accounting pronouncements and does not believe that any of these pronouncements will have a significant impact on our consolidated financial statements and related disclosures.

Accounting Standards Recently Adopted

Effective January 1, 2018, the Company has adopted Accounting Standards Codification Topic 606, Revenue from Contracts with Customers ("ASC 606, the Standard"), which supersedes nearly all legacy revenue recognition guidance. ASC 606 outlines a comprehensive five-step revenue recognition model based on the principle that an entity should recognize revenue based on when an it satisfies its performance obligations by transferring control of promised goods or services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for said goods or services.

Effective January 1, 2018, the Company has adopted ASU No. 2016-18, Statement of Cash Flows: Restricted Cash, ("Update 2016-18"). Update 2016-18 provides guidance on the classification of restricted cash in the statement of cash flows. The amendments are effective for interim and annual periods beginning after December 15, 2017. The amendments in Update 2016-18 was adopted on a retrospective basis. Due to the adoption of ASU 2016-18, the cash, cash equivalents and restricted cash presented in the Condensed Consolidated Statement of Cash Flows for the six months ended June 30, 2018 and 2017 increased by $10,000 and $900,000 of restricted cash held as of June 30, 2018 and 2017, respectively.

NOTE C– REVENUE

The following table presents the Company's product and recurring revenues disaggregated by industry for the three months ended June 30, 2018.

	Hospitality	Education	Multiple Dwelling Units	Government	Total
Recurring	$133,468	$11,055	$8,834	$ –	$153,357
Product	2,061,985	645,658	47,636	65,526	2,820,805
	$2,195,453	$656,713	$56,470	$ 65,526	$2,974,162

The following table presents the Company’s product and recurring revenues disaggregated by industry for the six months ended June 30, 2018.

	Hospitality	Education	Multiple Dwelling Units	Government	Total
Recurring	$224,730	$21,310	$8,855	$ –	$254,895
Product	3,543,140	639,928	67,962	73,433	4,324,463
	$3,767,870	$661,238	$76,817	$ 73,433	$4,579,358

Sales taxes and other usage-based taxes are excluded from revenues.

Contract assets

Contracts are billed in accordance with the terms and conditions, either at periodic intervals or upon substantial completion. This can result in billing occurring subsequent to revenue recognition, resulting in contract assets. Contract assets are presented as current assets in the Condensed Consolidated Balance Sheet. The balance of contract assets as of June 30, 2018 and at the date of adoption of ASC 606 was $0.35 million and $0.35 million, respectively. There were approximately $0.1 million of costs incurred to fulfill a contract in the closing balance of contract assets.

Contract liabilities

Contracts are billed in accordance with the terms and conditions, either at periodic intervals or upon substantial completion. Often, the Company will require customers to pay a deposit upon contract signing that will be applied against work performed or products shipped. In addition, the Company will often invoice the full term of support at the start of the support period. Billings that occur prior to revenue recognition result in contract liabilities. As of June 30, 2018 and at the date of adoption of ASC 606, contract liabilities were $1.05 million and $0.78 million, respectively. The change in the contract liability balance during the six-month period ended June 30, 2018 is the result of cash payments received and billing in advance of satisfying performance obligations, less $0.79 million of revenue recognized during the period that was included in the contract liability balance at the date of adoption.

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Contract costs

Costs to fulfill a turnkey contract primarily relate to the materials cost and direct labor and are recognized proportionately as the performance obligation is satisfied. The Company will defer cost to fulfill a contract when materials have shipped (and control over the materials has transferred to the customer), but an insignificant amount of rooms have been installed. The Company will recognize any deferred costs in proportion to revenues recognized from the related turnkey contract. The Company does not expect deferred contract costs to be long-lived since a typical turnkey project takes sixty days to complete. Deferred contract costs are generally presented as other current assets in the condensed consolidated balance sheets.

The Company incurs incremental costs to obtain a contract in the form of sales commissions. These costs, whether related to performance obligations that extend beyond twelve months or not, are immaterial and will continue to be recognized in the period incurred within selling, general and administrative expenses.

The tables below present the impacts of our adoption of the new revenue standard on our income statement and balance sheet.

	For the Three Months Ended June 30, 2018		
	As Reported	**Balance Without Adoption of ASC 606**	**Effect of Change Higher/(Lower)**
Income Statement:			
Sales	$2,974,162	$3,054,562	$ (80,400)
Cost of Goods Sold	1,443,211	1,466,011	(22,800)
Net loss	$206,582	$148,982	$ 57,600

	For the Six Months Ended June 30, 2018		
	As Reported	**Balance Without Adoption of**	**Effect of Change Higher/(Lower)**

		ASC 606		
Income Statement:				
Sales	$4,579,358	$4,762,758	$ (183,400	)
Cost of Goods Sold	2,497,446	2,554,746	(57,300	)
Net loss	$1,390,748	$1,264,648	$ 126,100	

	As of June 30, 2018			
	As Reported	**Balance Without Adoption of ASC 606**	**Effect of Change Higher/(Lower)**	
Balance Sheet:				
Assets				
Contract Assets	$353,684	–	$ 353,684	
Inventories	982,568	1,164,932	(182,364	)
Liabilities				
Contract Liabilities	1,047,010	–	1,047,010	
Customer Deposits	–	66,226	(66,226	)
Deferred Revenue - Current	–	47,439	(47,439	)
Deferred Revenue – Long Term	–	205,925	(205.925	)
Equity				
Accumulated Deficit	–	556,100	$ (556,100	)

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The table below presents the cumulative effect of the changes made to our consolidated balance sheet as of January 1, 2018 after the adoption of ASU 2014-09.

	December 31, 2017	Transition Adjustments	**January 1, 2018**
Balance Sheet:			
Assets			
Contract Assets	–	110,000	$110,000
Inventories	777,202	239,000	1,016,202
Liabilities			
Contract Liabilities	–	779,000	779,000
Equity			
Accumulated Deficit	$(119,724,656)	(430,000)	$(120,154,656)

Remaining performance obligations

As of June 30, 2018, the aggregate amount of the transaction price allocated to remaining performance obligations was approximately $0.35 million. Except for support services, the Company expects to recognize 100% of the remaining performance obligations over the next six months.

NOTE D – ACCOUNTS RECEIVABLE

Components of accounts receivable as of June 30, 2018 and December 31, 2017 are as follows:

	June 30, 2018	December 31, 2017
Accounts receivable	$1,996,969	$1,632,459
Allowance for doubtful accounts	(13,542)	(22,173)
Accounts receivable, net	$1,983,427	$1,610,286

NOTE E – ACCRUED LIABILITIES AND EXPENSES

Accrued liabilities and expenses at June 30, 2018 and December 31, 2017 are as follows**:**

	June 30, 2018	December 31, 2017
Accrued liabilities and expenses	$387,920	$294,709
Accrued payroll and payroll taxes	243,908	230,931
Accrued sales taxes, penalties, and interest	42,330	83,282
Product warranties	60,622	59,892
Total accrued liabilities and expenses	$734,780	$668,814

NOTE F – DEBT

Revolving Credit Facility

The Heritage Bank Loan Agreement (the "Credit Facility") contains representations and warranties, covenants, and other provisions customary to transactions of this nature. As of June 30, 2018, the Company was in compliance with all financial covenants. The outstanding principal balance of the Credit Facility bears interest at the Prime Rate plus 3.00%, which was 8% at June 30, 2018 and 7.50% at December 31, 2017. The outstanding balance on the Credit Facility was zero and $682,211 at June 30, 2018 and December 31, 2017, respectively. The remaining available borrowing capacity was approximately $1,622,000 and $202,000 at June 30, 2018 and December 31, 2017, respectively.

On March 31, 2018, an amendment to the revolving credit facility with Heritage Bank was executed to amend certain terms of the Heritage Bank Loan Agreement. Among the terms of the amendment was that if the Company fails to comply with required EBITDA covenants as of any particular quarterly measurement date, the Company will be deemed to be in compliance as of the measurement date if the Company's unrestricted cash maintained at Heritage Bank is in excess of $5,000,000.

NOTE G – PREFERRED STOCK

Preferred stock carries certain preference rights as detailed in the Company's Amended Articles of Incorporation related to both the payment of dividends and as to payments upon liquidation in preference to any other class or series of capital stock of the Company. As of June 30, 2018, the liquidation preference of the preferred stock is based on the following order: first, Series B with a preference value of $424,583, which includes cumulative accrued unpaid dividends of $164,583, and second, Series A with a preference value of $1,562,848, which includes cumulative accrued unpaid dividends of $637,848. As of December 31, 2017, the liquidation preference of the preferred stock is based on the following order: first, Series B with a preference value of $414,258, which includes cumulative accrued unpaid dividends of $154,258, and second, Series A with a preference value of $1,526,141, which includes cumulative accrued unpaid dividends of $601,141.

NOTE H – CAPITAL STOCK

The Company has authorized 190,000,000 shares of common stock with a par value of $.001 per share. As of June 30, 2018 and December 31, 2017 the Company had 133,989,919 and 133,695,111 common shares issued and outstanding.

NOTE I – STOCK OPTIONS AND WARRANTS

Employee Stock Options

The Company maintains an equity incentive plan, (the "Plan"). The Plan was established in 2010 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 the Plan as of June 30, 2018.

Options Outstanding				Options Exercisable	
Exercise Prices	Number Outstanding	Weighted Average	Weighted Average	Number Exercisable	Weighted Average

		Remaining Contractual Life (Years)	Exercise Price		Exercise Price
$0.01 - $0.15	2,000,000	8.51	$ 0.14	2,000,000	$ 0.14
$0.16 - $0.99	1,307,399	4.98	0.20	1,127,399	0.20
	3,307,399	7.12	$ 0.16	3,127,399	$ 0.16

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

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2017	2,832,725	$ 0.18
Granted	3,000,000	0.14
Exercised	–	–
Cancelled or expired	(1,456,251)	0.17
Outstanding at December 31, 2017	4,376,474	$ 0.16
Granted	–	–
Exercised	–	–
Cancelled or expired	(1,069,075)	0.14
Outstanding at June 30, 2018	3,307,399	$ 0.16

There were zero and 3,000,000 options granted, 1,069,075 and zero options cancelled or expired and zero options exercised during the six months ended June 30, 2018 and 2017, respectively. 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, 2018 and 2017 was $1,531 and $3,516, respectively, and $3,061, and $318,202, respectively.

Warrants

The following table summarizes the changes in warrants outstanding and the related prices for the shares of the Company's common stock issued to non-employees of the Company.

	Warrants Outstanding			Warrants Exercisable	
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$ 0.20	250,000	3.27	$ 0.20	250,000	$ 0.20

Transactions involving warrants are summarized as follows:

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2017	300,000	$ 0.20
Issued	–	–
Exercised	–	–
Cancelled or expired	(50,000)	0.18
Outstanding at December 31, 2017	250,000	0.20
Issued	–	–
Exercised	–	–
Cancelled or expired	–	–
Outstanding at June 30, 2018	250,000	$ 0.20

There were no warrants granted, exercised, cancelled or forfeited during the six months ended June 30, 2018 and 2017.

NOTE J – RELATED PARTY TRANSACTIONS

During the six months ended June 30, 2018 and during the year ended December 31, 2017, the Company agreed to issue common stock in the amount of $36,000 and $144,000, respectively, to the Company's non-employee directors as compensation for their attendance and participation in the Company's Board of Director and committee meetings.

Upon execution of their employment agreements during the six months ended June 30, 2017, the CEO, CTO and former COO, were each granted 1,000,000 stock options at their fair market value and were scheduled to vest over a three year period. However, pursuant to their employment agreements, the stock options vested immediately upon the sale of the Company's subsidiary, EthoStream, in March 2017. Effective with the sale of the assets of EthoStream, the former COO was hired by DCI. In compliance with the terms of the former COO's stock option grant letter, the former COO's stock options were canceled during the six months ended June 30, 2018.

During the six months ended June 30, 2017, the CEO, CTO, and former COO, each earned a bonus of $29,250 that was contingent on the sale and sale price amount of EthoStream.

NOTE K – COMMITMENTS AND CONTINGENCIES

Office Lease Obligations

Commitments for minimum rentals under non-cancelable leases as of June 30, 2018 are as follows:

2018 (remainder of)	$104,543
2019	159,242
2020	164,903
2021	182,512
2022	190,141
2023 and thereafter	573,883
Total	$1,375,224

Rental expenses charged to operations for the three and six months ended June 30, 2018 and 2017 was $170,949 and $114,167, and $87,067 and $80,147 respectively.

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.

Sales Tax

The following table sets forth the change in the sales tax accrual as of June 30, 2018 and December 31, 2017:

	June 30, 2018	December 31, 2017
Balance, beginning of year	$83,282	$274,869
Sales tax collected	41,817	297,673
Provisions	23,181	(33,000)
Interest and penalties	–	(5,890)
Payments	(105,950)	(450,370)
Balance, end of period	$42,330	$83,282

NOTE L – BUSINESS CONCENTRATION

For the six months ended June 30, 2018, one customer represented approximately 11% of total net revenues. For the six months ended June 30, 2017, no single customer represented 10% or more of total net revenues. As of June 30, 2018, four customers accounted for approximately 54% of the Company's net accounts receivable. As of December 31, 2017, three customers accounted for approximately 54% of the Company's net accounts receivable.

Purchases from one supplier approximated $1,975,000, or 88%, of purchases for the six months ended June 30, 2018 and $1,439,000, or 84%, of purchases for the six months ended June 30, 2017. Total due to this supplier, net of deposits, was approximately $490,000, as of June 30, 2018, and $33,000 as of December 31, 2017.

NOTE M – DISCONTINUED OPERATIONS

During the year ended December 31, 2017, the Company, and EthoStream, entered into an Asset Purchase Agreement (the "Purchase Agreement") with DCI-Design Communications LLC ("DCI"), a Delaware limited liability company, whereby DCI acquired substantially all of the assets and certain liabilities of EthoStream for a base purchase price of $12,750,000. The Purchase Agreement provided that $900,000 of the $12,750,000 base purchase price was placed into an escrow account to support potential indemnification obligations of up to $800,000 and net working capital adjustments of up to $100,000. On April 06, 2018, the Company received the $800,000 disbursement from the funds held in escrow. The Company reclassified the balance from restricted cash to cash at March 31, 2018.

On March 29, 2017, pursuant to the terms and the conditions of the Purchase Agreement, the Company closed on the sale.

As of June 30, 2018 and December 31, 2017 there were no assets or liabilities of discontinued operations.

The following table summarizes the statements of operations information for discontinued operations.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
Revenues, net:				
Product	$–	$–	$–	$653,839
Recurring	–	–	–	925,837
Total Net Revenue	–	–	–	1,579,676
Cost of Sales:				
Product	–	(10,225)	–	414,604
Recurring	–	689	–	209,868
Total Cost of Sales	–	(9,536)	–	624,472
Gross Profit	–	9,536	–	955,204
Operating Expenses:				
Selling, general and administrative	–	(9,924)	–	252,110
Depreciation and amortization	–	–	–	60,420
Total Operating Expenses	–	(9,924)	–	312,530
Income from Discontinued Operations before Provision for Income Taxes	–	19,460	–	642,674
Provision for Income Taxes	–	605	–	52,017
Income from Discontinued Operations (net of tax)	$–	$18,855	$–	$590,657

The consolidated statements of cash flows do not present the cash flows from discontinued operations for investing activities or financing activities because there were no investing or financing activities associated with the discontinued operations in the periods ended June 30, 2018 and 2017.

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 condensed consolidated financial statements and related notes thereto for the three and six months ended June 30, 2018, as well as the Company's consolidated financial statements and related notes thereto and management's discussion and analysis of financial condition and results of operations in the Company's Form 10-K for the year ended December 31, 2017, filed with the US Securities and Exchange Commission (the "SEC") on April 2, 2018.

Business

Telkonet, Inc. (the "Company", "Telkonet"), formed in 1999 and incorporated under the laws of the state of Utah, is the creator of the EcoSmart Platform of intelligent automation solutions designed to optimize energy efficiency, comfort and analytics in support of the emerging Internet of Things ("IoT").

In October of 2016, the Company, under the direction and authority of the Board of Directors, committed to a plan to offer for sale EthoStream LLC ("EthoStream"), its wholly-owned High-Speed Internet Access ("HSIA") subsidiary. While EthoStream was one of the largest public HSIA providers in the world, providing services to more than 12.0 million users monthly across a network of approximately 1,800 locations, the Company focused on its higher growth potential EcoSmart Platform line. As a result of this decision to sell EthoStream, the operating results of EthoStream for the three and six months ended June 30, 2017 have been reclassified as discontinued operations in the condensed consolidated statement of operations and as assets and liabilities of discontinued operations. The sale closed on March 29, 2017.

The Company's direct sales effort targets the hospitality, education, commercial, utility and government/military markets. Taking advantage of legislation, including the Energy Independence and Security Act of 2007, or EISA, the Energy Policy Act of 2005, and the American Recovery and Reinvestment Act the Company is focusing its sales efforts in areas with available public funding and incentives, such as rebate programs offered by utilities for efficiency upgrades. Through the Company's proprietary platform, technology and partnerships with energy efficiency providers, the Company's management intends to position the Company as a leading provider of energy management solutions.

Forward-Looking Statements

In accordance with the Private Securities Litigation Reform Act of 1995, the Company 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” may contain certain forward-looking statements regarding strategic growth initiatives, growth opportunities and management’s expectations regarding orders and financial results for the remainder of 2018 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 and New Accounting Pronouncements

Please refer to the Company’s form 10K filed April 2, 2018 for critical accounting policies and estimates. For information regarding recent accounting pronouncements and their effect on the Company, see “New Accounting Pronouncements” in Note B 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, 2018		June 30, 2017		Variance	
Product	$2,820,805	95%	$2,013,922	95%	$806,883	40%
Recurring	153,357	5%	110,201	5%	43,156	39%
Total	$2,974,162	100%	$2,124,123	100%	$850,039	40%

	Six Months Ended June 30, 2018		June 30, 2017		Variance	
Product	$4,324,463	94%	$3,824,307	95%	$500,156	13%
Recurring	254,895	6%	213,043	5%	41,852	20%
Total	$4,579,358	100%	$4,037,350	100%	$542,008	13%

Product Revenue

Product revenue principally arises from the sale and installation of the EcoSmart energy management platform. The EcoSmart Suite of products consists of thermostats, sensors, controllers, wireless networking products switches, outlets and a control platform.

For the three and six months ended June 30, 2018, product revenue increased by 40% or $0.8 million and 13% or $0.5 million, respectively, when compared to the prior year. For the three months ended June 30, 2018, sales of actual product increased by $0.13 million and installation revenue increased by $0.64 million. The hospitality market comprised $2.06 million of product sales for the three months ended June 30, 2018, a $0.56 million increase from the prior year period. The education market sales for the three months ended June 30, 2018 increased $0.42 million to $0.65 million from $0.23 million for the prior year period. The Multiple Dwelling Unit (“MDU”) market decreased $0.15 million from $0.20 million for the three months ended June 30, 2017 to $0.05 million for the three months ended June 30, 2018. The hospitality market sales for the six months ended June 30, 2018 increased $0.63 million to $3.53 million from $2.9 million for the prior year period. The education market sales for the six months ended June 30, 2018 decreased $0.05 million to $0.65 million from $0.7 million for the prior year period and the MDU market sales for the six months ended June 30, 2018 decreased $0.23 million to $0.07 million from $0.3 million for the prior year period. The Company’s commitment to access distribution channels through resellers and value added distribution partners remained stable. Product revenue derived from channel partners increased $1.3 million for the six months ended June 30, 2018 compared to the prior year period.

Recurring Revenue

Recurring revenue is attributed to our call center support services. The Company recognizes revenue ratably over the service month for monthly support revenues and defers revenue for annual support services over the term of the service period. Recurring revenue consists of Telkonet's EcoCare service and support program.

For the three and six months ended June 30, 2018, recurring revenue increased by 39% and 20%, respectively, when compared to the prior year period.

Cost of Sales

	Three Months Ended					
	June 30, 2018		June 30, 2017		Variance	
Product	$1,376,729	49%	$1,065,914	53%	$310,815	29%
Recurring	66,482	43%	32,627	30%	33,855	104%
Total	$1,443,211	49%	$1,098,541	52%	$344,670	31%

	Six Months Ended					
	June 30, 2018		June 30, 2017		Variance	
Product	$2,370,966	55%	$2,073,959	54%	$297,007	14%
Recurring	126,479	50%	62,645	29%	63,834	102%
Total	$2,497,445	55%	$2,136,604	53%	$360,841	17%

Costs of Product Sales

Costs of product revenue include equipment and installation labor related to EcoSmart technology. For the three and six months ended June 30, 2018, product costs increased by 29% and 14%, respectively, compared to the prior year periods. For the three month comparison, the materials costs as a percentage of product sales increased by 37% compared to the comparable period. The cost of materials increased $0.29 million and inventory adjustments decreased $0.09 million. The Company’s use of outside contractors for installations increased resulting in a $0.11 million increase in contractor services costs. For the six month comparison, material costs increased $0.21 million, use of outside contractors for installations increased resulting in a $0.03 million increase in contractor services. These increases were partially offset by a $0.17 million adjustment in inventory costs.

Costs of Recurring Revenue

Recurring costs are comprised of labor and telecommunication services for our customer service department. For the three and six months ended June 30, 2018, recurring costs increased by 104% and 102%, respectively, when compared to the prior year periods. These variances were primarily due to salary, benefits and temporary staffing.

Gross Profit

	Three Months Ended					
	June 30, 2018		June 30, 2017		Variance	
Product	$1,444,076	51%	$948,008	47%	$496,068	52%
Recurring	86,875	57%	77,574	70%	9,301	12%
Total	$1,530,951	51%	$1,025,582	48%	$505,369	49%

	Six Months Ended					
	June 30, 2018		June 30, 2017		Variance	
Product	$1,953,497	45%	$1,750,348	46%	$203,149	12%
Recurring	128,416	50%	150,398	71%	(21,982)	(15%)
Total	$2,081,913	45%	$1,900,746	47%	$181,167	10%

Gross Profit on Product Revenue

Gross profit for the three and six months ended June 30, 2018 increased by 52% and 12%, respectively, when compared to the prior year periods. The actual gross profit percentage increased from 47% for the three months ended June 30, 2017 to 51% for the three months ended June 30, 2018. For the six months ended June 30, 2018 and 2017, the gross profit percentage decreased 1% from 46% at June 30, 2017 to 45% at June 30, 2018. The decrease was directly related to cost of goods sold and outside services.

Gross Profit on Recurring Revenue

The gross profit associated with recurring revenue increased by 12% and decreased by 15%, respectively, for the three and six months ended June 30, 2018 when compared to the prior year periods. For the three months ended June 30, 2018, the actual gross profit percentage decreased 13% compared to the prior year period, from 70% to 57%. For the six months ended June 30, 2018, the actual gross profit percentage decreased 21% compared to the prior year period, from 71% to 50%.

Operating Expenses

	Three Months Ended June 30,			
	2018	2017	Variance	
Total	$1,739,587	$1,892,506	$(152,919)	(8%)

	Six Months Ended June 30,			
	2018	2017	Variance	
Total	$3,472,185	$4,050,564	$(578,379)	(14%)

During the three and six months ended June 30, 2018, operating expenses decreased by 8% and 14%, respectively, when compared to the prior year periods as outlined below.

Research and Development

	Three Months Ended June 30,			
	2018	2017	Variance	
Total	$431,856	$444,557	$(12,701)	(3%)

	Six Months Ended June 30,			
	2018	2017	Variance	
Total	$870,636	$823,013	$47,623	6%

Research and development costs are related to both present and future products and are expensed in the period incurred. Current research and development costs are associated with product development and integration. During the three and six months ended June 30, 2018, research and development costs decreased by 3% and increased by 6%, respectively, when compared to the prior year periods. For the three month comparison, the variance is due to an approximate $0.02 million decrease in salaries along with an approximate $0.03 decrease in certification expenses, all partially offset by an increase of $0.05 million for consulting expenses. For the six month comparison the variance is due to a $0.12 million increase in consulting expenses, partially offset by a $0.05 decrease in certification expenses.

Selling, General and Administrative Expenses

	Three Months Ended June 30,			
	2018	2017	Variance	
Total	$1,291,103	$1,483,069	$(191,966)	(13%)

	Six Months Ended June 30,			
	2018	2017	Variance	
Total	$2,568,006	$3,207,762	$(639,756)	(20%)

During the three and six months ended June 30, 2018, selling, general and administrative expenses decreased over the prior year periods by 13% and 20%, respectively. For the three month comparison, due to the sale of EthoStream, the Company was able to decrease executive, accounting and sales salaries, wages and benefits of $0.05 million. An $0.08 million decrease was a result of the Company’s decision to not retain a marketing consulting firm. An $0.05 million decrease was the results of a decrease in bad debt expense.

For the six month comparison, due to the sale of EthoStream, the Company was able to decrease executive, accounting and sales salaries, wages and benefits of $0.16 million. A $0.09 million decrease was a result of the Company’s decision to not retain a marketing consulting firm. A $0.07 million decrease was the results of a decrease in bad debt expense. Additionally, a $0.32 million decrease was the results of a decrease in stock option expense.

Income from Discontinued Operations, Net of Tax

	Three Months Ended June 30,			
	2018	2017	Variance	
Total	$–	$18,885	$(18,885)	(100%)

Six Months Ended June 30,	
2018	2017