TELKONET INC
Form 10QSB
August 13, 2004

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

FORM 10QSB

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

For the period ended June 30, 2004

Commission file number 000-27305

TELKONET, INC.
(Name of Small Business Issuer in Its Charter)

Utah	87-0627421
(State of Incorporation)	(IRS Employer Identification No.)

20374 Seneca Meadows Parkway, Germantown, MD 20876
(Address of Principal Executive Offices)

(240) 912-1800
Issuer's Telephone Number

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 44,727,394 shares of Common Stock ($.001 par value) as of August 10, 2004.

Transitional small business disclosure format: Yes [ ] No [x]

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TELKONET, INC.

QUARTERLY REPORT ON FORM 10-QSB FOR THE
QUARTERLY PERIOD ENDING JUNE 30, 2004

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Item 1. Financial Statements (Unaudited)

TELKONET, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(Unaudited)

	June 30, 2004	De
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 18,276,979	
Accounts Receivable: trade and other, net of allowance for doubtful accounts of $20,300 and $7,000 at June 30, 2004 and December 31, 2003, respectively	132,677	
Inventory, net (Note F)	979,014	
Prepaid expenses and deposits	100,488	
Total current assets	19,489,158	
PROPERTY AND EQUIPMENT, AT COST:		
Furniture and equipment, at cost	586,720	
Less: accumulated depreciation	90,591	
Total property and equipment, net	496,129	

EQUIPMENT UNDER OPERATING LEASES, AT COST:	
Capitalized equipment, at cost	226,803
Less: accumulated depreciation	23,363
Total equipment under operating leases, net	203,440
OTHER ASSETS:	
Deposits	75,880
TOTAL ASSETS	$ 20,264,607
LIABILITIES AND STOCKHOLDERS' EQUITY	
CURRENT LIABILITIES:	
Accounts payable and accrued liabilities	$ 1,129,839
Customer deposits	15,871
Capital leases	3,166
Total current liabilities	1,148,876
LONG TERM LIABILITIES:	
Convertible debentures, net of discounts - including related parties (Note B)	121,890
Senior notes payable (Note C)	450,000
Deferred lease liability	10,303
Total long term liabilities	582,193
COMMITMENTS AND CONTINGENCIES	--
STOCKHOLDERS' EQUITY	
Preferred stock, par value $.001 per share; 15,000,000 shares authorized; none issued at June 30, 2004 and December 31, 2003 (Note E)	--
Common stock, par value $.001 per share; 100,000,000 shares authorized; 44,707,726 and 30,689,522 shares issued and outstanding at June 30, 2004 and December 31, 2003, respectively (Note E)	44,708
Additional paid-in-capital	39,624,607
Accumulated deficit	(21,135,777)
Stockholders' equity	18,533,538
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 20,264,607

See accompanying footnotes to the unaudited condensed consolidated financial information

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

For The Three Months Ended June 30, For The Six Month

	2004	2003	2004
Net Revenues	$ 271,903	$ --	$ 412,002
Cost of Sales	259,129	--	393,533
Gross Profit	12,774	--	18,469
Costs and Expenses:			
Research and Development	413,489	282,821	846,204
Selling, General and Administrative	1,808,796	1,173,675	3,162,987
Consulting Fees (Note E)	2,500,000	--	2,500,000
Non-Employee Stock Options and Warrants (Note D)	251,549	67,884	465,090
Depreciation and Amortization	32,710	48,589	47,700
Total Operating Expense	5,006,544	1,572,969	7,021,981
Loss from Operations	(4,993,770)	(1,572,969)	(7,003,512)
Other Income (Expenses):			
Interest Income	33,182	--	52,062
Interest Expense	(21,615)	(446,003)	(67,715)
Total Other Income (Expenses)	11,567	(446,003)	(15,653)
Loss Before Provision for Income Taxes	(4,982,203)	(2,018,972)	(7,019,165)
Provision for Income Tax	--	--	--
Net Loss	$ (4,982,203)	$ (2,018,972)	$ (7,019,165)
Loss per common share (basic and assuming dilution)	$ (0.11)	$ (0.13)	$ (0.18)
Weighted average common shares outstanding	43,465,142	15,827,613	39,042,528

See accompanying footnotes to the unaudited condensed consolidated financial information

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TELKONET, INC.
CONDENSED CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY
FOR THE PERIOD FROM JANUARY 1, 2004 TO JUNE 30, 2004
(UNAUDITED)

	Preferred Shares	Preferred Stock Amount	Common Shares	Common Stock Amount	Additi Paid Capi
BALANCE AT JANUARY 1, 2004	--	--	30,689,522	$ 30,690	$ 16,47

Shares issued for employee stock options exercised at approximately $1.02 per share	--	--	356,333	356	36
Shares issued in exchange for non-employee options exercised at $1.00 per share	--	--	255,416	255	25
Shares issued to consultants in exchange for services rendered at approximately $3.06 per share	--	--	40,000	40	12
Shares issued for senior note conversion at $2.10 per share (Note C)	--	--	1,209,038	1,209	2,53
Shares issued in connection with private placement at $2.00 per share, net of costs	--	--	6,387,600	6,388	12,72
Shares issued to consultants for warrants exercised at $2.54 per share	--	--	37,500	38	9
Shares issued to noteholders for warrants exercised at $1.00 per share	--	--	3,978,450	3,979	3,97
Shares issued to noteholders for cashless warrants exercised	--	--	203,751	203	
Shares issued for cashless exercise of underwriter warrants	--	--	165,116	165	
Shares issued in exchange for convertible debentures at $0.50 per share (Note B)	--	--	124,000	124	6
Shares issued in exchange for convertible debentures at $0.55 per share (Note B)	--	--	200,001	200	10
Shares issued in exchange for accrued interest on convertible debentures (Note B)	--	--	42,999	43	2
Shares issued to employees in exchange for services at approximately $2.97 per share	--	--	18,000	18	5
Write-off of beneficial conversion features and warrants attached to convertible debentures in connection with conversion of Debenture-1 and Series B debentures (Note B)	--	--	--	--	(13
Stock options and warrants granted to consultants in exchange for services rendered (Note D)	--	--	--	--	46
Shares issued to consultants in exchange for consulting fees at $2.50 per share	--	--	1,000,000	1,000	2,49
Net Loss	--	--	--	--	
BALANCE AT JUNE 30, 2004	--	$ --	44,707,726	$ 44,708	$ 39,62

See accompanying footnotes to the unaudited condensed consolidated financial information

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

	For The Six Months End	
	2004	
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss from operating activities	$ (7,019,165)	$
Adjustments to reconcile net loss from operations to cash used in operating activities		
Amortization of debt discount - beneficial conversion feature of convertible debentures	10,944	
Amortization of debt discount - value of warrants attached to convertible debentures	5,076	
Stock options and warrants issued in exchange for services rendered (Note D)	465,090	
Common stock issued in exchange for services rendered (Note E)	178,881	
Common stock issued in exchange for conversion of interest (Note B)	23,276	
Common stock issued in exchange for consulting fees	2,500,000	
Depreciation and amortization	47,699	
(Increase) decrease in:		
Accounts receivable	(74,481)	
Inventory	(370,498)	
Prepaid expenses and deposits	6,295	
Accounts payable and accrued expenses, net	499,987	
Deferred lease liability	10,303	
NET CASH (USED IN) OPERATING ACTIVITIES	(3,716,593)	
CASH FLOWS FROM INVESTING ACTIVITIES:		
Costs of equipment under operating leases	(192,915)	
Purchase of property and equipment, net	(400,389)	
NET CASH (USED IN) INVESTING ACTIVITIES	(593,304)	
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from sale of common stock, net of costs (Note E)	12,726,843	
Proceeds from (repayments of) stockholder advances	--	
Proceeds from issuance of convertible debentures, net of costs (Note B)	--	
Proceeds from issuance of senior notes, net of costs (Note C)	--	
Repayment of loans	--	
Proceeds from exercise of warrants attached to notes payable (Note E)	4,073,700	
Proceeds from exercise of employee and non-employee stock options and warrants	620,249	
Payment of capital leases	(11,834)	
NET CASH PROVIDED BY FINANCING ACTIVITIES	17,408,958	
NET INCREASE IN CASH AND EQUIVALENTS	13,099,061	
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD	5,177,918	

CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD	$ 18,276,979	$
	=============	=

See accompanying footnotes to the unaudited condensed consolidated financial information

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

	For The Six Months Ended Ju	
	2004	200
Supplemental Disclosures of Cash Flow Information		
Cash paid during the period for interest	$ 91,534	$ 10,4
Income taxes paid	--	
Non-cash transactions:		
Issuance of stock options and warrants in exchange for services rendered (Note D)	465,090	286,9
Issuance of stock warrants in exchange for financing costs (Note D)	--	87,2
Common stock issued for services rendered	178,881	76,7
Common stock issued in exchange for interest (Note B and E)	23,276	
Common stock issued in exchange for consulting services (Note E)	2,500,000	
Common stock issued in exchange for conversion of Senior Notes (Note C)	2,539,000	
Common stock issued in exchange for convertible debentures (Note B)	172,000	20,0
Notes payable issued in connection with capital lease	--	59,2
Write-off of beneficial conversion feature of conversion of debenture (Note B)	134,134	
Write-off of value of warrants attached to debenture in connection with conversion (Note B)	531	
Beneficial conversion feature on convertible debentures (Note B)	--	1,761,6
Value of warrants attached to convertible debentures (Note B)	--	265,4

See accompanying footnotes to the unaudited condensed consolidated financial information

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
JUNE 30, 2004
(UNAUDITED)

NOTE A - SUMMARY OF ACCOUNTING POLICIES

General

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the

United States of America for interim financial information and the instructions to Form 10-QSB. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Accordingly, the results from operations for the six-month period ended June 30, 2004, are not necessarily indicative of the results that may be expected for the year ended December 31, 2004. The unaudited condensed consolidated financial statements should be read in conjunction with the consolidated December 31, 2003 financial statements and footnotes thereto included in the Company's Form 10-KSB for the year ended December 31, 2003.

Basis of Presentation

Telkonet, Inc. (the "Company"), formerly Comstock Coal Company, Inc., was formed on November 3, 1999 under the laws of the state of Utah. The Company was a "development stage enterprise" (as defined in statement of Financial Accounting Standards No. 7) until December 31, 2003. The Company is engaged in the business of developing, producing and marketing proprietary equipment enabling the transmission of voice and data over electric utility lines.

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

Reclassification

Certain reclassifications have been made to conform prior periods' data to the current presentation. These reclassifications had no effect on reported losses.

Concentrations of Credit Risk

Financial instruments and related items, which potentially subject the Company to concentrations of credit risk, consist primarily of cash and cash equivalents. The Company places its cash and temporary cash investments with credit quality institutions. At times, such investments may be in excess of the FDIC insurance limit. The allowance for doubtful accounts was $20,300 and $7,000 at June 30, 2004 and December 31, 2003, respectively.

Stock Based Compensation

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure-an amendment of SFAS 123." This statement amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25 and related interpretations. Accordingly, compensation expense for stock options is measured as the excess, if any, of the fair market value of the Company's stock at the date of the grant over the exercise price of the related option. The Company has adopted the annual disclosure provisions of SFAS No. 148 in its financial reports for the year ended December 31, 2003 and has

adopted the interim disclosure provisions for its financial reports for the subsequent periods.

TELKONET, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL INFORMATION
JUNE 30, 2004
(UNAUDITED)

NOTE A - SUMMARY OF ACCOUNTING POLICIES

Stock Based Compensation (Continued)

Had compensation costs for the Company's stock options been determined based on the fair value at the grant dates for the awards, the Company's net loss and losses per share would have been as follows (transactions involving stock options issued to employees and Black-Scholes model assumptions are presented in Note D):

	For the three months ended June 30, 2004	2003	
Net loss - as reported	$ (4,982,203)	$ (2,018,972)	$
Add: Total stock based employee compensation expense as reported under intrinsic value method (APB. No. 25)	--	--	
Deduct: Total stock based employee compensation expense as reported under fair value based method (SFAS No. 123)	(1,672,345)	(1,129,199)	
Net loss - Pro Forma	$ (6,654,548)	$ (3,148,171)	$
Net loss attributable to common stockholders - Pro forma	$ (6,654,548)	$ (3,148,171)	$
Basic (and assuming dilution) loss per share - as reported	$ (0.11)	$ (0.13)	$
Basic (and assuming dilution) loss per share - Pro forma	$ (0.15)	$ (0.20)	$

Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with Staff Accounting Bulletin No. 104, REVENUE RECOGNITION ("SAB104"), which superceded Staff Accounting Bulletin No. 101, REVENUE RECOGNITION IN FINANCIAL STATEMENTS ("SAB101").

SAB 101 requires 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) collectibility 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 collectibility 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 Company defers any revenue for which the product has not been delivered or is subject to refund until such time that the Company and the customer jointly determine that the product has been delivered or no refund will be required.

SAB 104 incorporates Emerging Issues Task Force 00-21 ("EITF 00-21"), MULTIPLE-DELIVERABLE REVENUE ARRANGEMENTS. EITF 00-21 addresses accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets. The effect of implementing EITF 00-21 on the Company's consolidated financial position and results of operations was not significant.

For equipment under lease, revenue is recognized over the lease term for operating lease and rental contracts. All of the Company's leases are accounted for as operating leases. At the inception of the lease, no lease revenue is recognized and the leased equipment, together with the initial direct costs of installation and support are capitalized, appear on the balance sheet as "Equipment Under Operating Leases". The capitalized cost of this equipment is depreciated from two to three years, on a straight-line, basis down to the Company's original estimate of the projected value of the equipment at the end of the scheduled lease term (the "Residual"). Monthly lease payments are recognized as rental income.

NOTE B - CONVERTIBLE PROMISSORY NOTES PAYABLE

A summary of convertible promissory notes payable at June 30, 2004 and December 31, 2003 is as follows:

	June 30, 2004	December 31, 2003
Convertible notes payable ("Debenture-1"), in quarterly installments of interest only at 8% per annum, unsecured and due three years from the date of the note with the latest maturity May 2005; Noteholder has the option to convert unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of $.50 per share six months after issuance	$ --	$ 62,000
Debt Discount - beneficial conversion feature, net of accumulated amortization of $0 and $41,411 at June 30, 2004 and December 31, 2003, respectively	--	(24,718)
Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of $0 and $3,605 at June 30, 2004 and December 31, 2003, respectively	--	(2,116)
	--	35,166
Convertible notes payable ("Series B Debenture"), in quarterly installments of interest only at 8% per annum, unsecured and		

due three years from the date of the note with the latest maturity February 2006; Noteholder has the option to convert unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of $.55 per share six months after issuance	210,000	320,000
Debt Discount - beneficial conversion feature, net of accumulated amortization of $38,304 and $75,426 at June 30, 2004 and December 31, 2003, respectively	(60,188)	(180,546)
Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of $17,766 and $13,194 at June 30, 2004 and December 31, 2003, respectively	(27,922)	(31,415)
	121,890	108,039
Total	$ 121,890	$ 143,205
Less: current portion	--	--
	$ 121,890	$ 143,205

NOTE B - CONVERTIBLE PROMISSORY NOTES PAYABLE (CONTINUED)

Convertible Debentures

During the year ended December 31, 2001, the Company issued convertible promissory notes (the "Debenture-1") to Company officers, shareholders, and sophisticated investors in exchange for $940,000, exclusive of placement costs and fees. The Debenture-1 accrues interest at 8% per annum and is due and payable three years from the date of the note with the latest maturity date of November 2004. The noteholders have the option to convert any unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of $.50 per share beginning six months after issuance. In accordance with EMERGING ISSUES TASK FORCE ISSUE 98-5, ACCOUNTING FOR CONVERTIBLE SECURITIES WITH A BENEFICIAL CONVERSION FEATURES OR CONTINGENTLY ADJUSTABLE CONVERSION RATIOS ("EITF 98-5"), the Company recognized an imbedded beneficial conversion feature present in the Debenture-1 note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid in capital. The Company recognized and measured an aggregate of $837,874 of the proceeds, which is equal to the intrinsic value of the imbedded beneficial conversion feature, to additional paid in capital and a discount against the Debenture-1. The debt discount attributed to the beneficial conversion feature is amortized over the Debenture-1's maturity period (three years) as interest expense.

In connection with the placement of the Debenture-1 notes, the Company issued non-detachable warrants granting the holders the right to acquire, in the

aggregate, 940,000 shares of the Company's common stock at $1.00 per share. In accordance with EMERGING ISSUES TASK FORCE ISSUE 00-27, APPLICATION OF ISSUE NO. 98-5 TO CERTAIN CONVERTIBLE INSTRUMENTS ("EITF 00-27"), the Company recognized the value attributable to the warrants in the amount of $77,254 to additional paid-in capital and a discount against the Debenture-1. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 1.25%, a dividend yield of 0%, and volatility of 26%. The debt discount attributed to the value of the warrants issued is amortized over the Debenture-1's maturity period (three years) as interest expense.

During the year ended December 31, 2002, the Company issued the Debenture-1 to Company officers, shareholders, and sophisticated investors in exchange for $749,100, exclusive of placement costs and fees. The Debenture-1 accrues interest at 8% per annum and is due and payable three years from the date of the note with the latest maturity date of May 2005. Noteholders have the option to convert any unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of $.50 per share beginning six months after issuance.

In accordance with EITF 98-5, the Company recognized an imbedded beneficial conversion feature present in the Debenture-1 note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid in capital. The Company recognized and measured an aggregate of $693,018 of the proceeds, which is equal to the intrinsic value of the imbedded beneficial conversion feature, to additional paid-in capital and a discount against the Debenture-1. The debt discount attributed to the beneficial conversion feature is amortized over the Debenture-1's maturity period (three years) as interest expense.

In connection with the placement of the Debenture-1 notes in 2002, the Company issued non-detachable warrants granting the holders the right to acquire, in the aggregate, 749,100 shares of the Company's common stock at $1.00 per share. In accordance with EITF 00-27, the Company recognized the value attributable to the warrants in the amount of $56,082 to additional paid in capital and a discount against the Debenture-1. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 1.67%, a dividend yield of 0%, and volatility of 26%. The debt discount attributed to the value of the warrants issued is amortized over the Debenture-1's maturity period (three years) as interest expense.

NOTE B - CONVERTIBLE PROMISSORY NOTES PAYABLE (CONTINUED)

Series B Debentures

In 2002, the Company issued convertible promissory notes (the "Series B Debentures") to Company officers, shareholders, and sophisticated investors in exchange for $472,900, exclusive of placement costs and fees. The Series B Debentures accrue interest at 8% per annum and are due and payable three years from the date of the note with the latest maturity date of December 2005. Noteholders have the option to convert any unpaid note principal, together with accrued and unpaid interest, to the Company's common stock at a rate of $.55 per

share beginning six months after issuance.

In accordance with EITF 98-5, the Company recognized an imbedded beneficial conversion feature present in the Series B Debenture note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of $147,859 of the proceeds, which is equal to the intrinsic value of the imbedded beneficial conversion feature, to additional paid in capital and a discount against the Series B Debentures. The debt discount attributed to the beneficial conversion feature is amortized over the Series B Debentures maturity period (three years) as interest expense.

In connection with the placement of the Series B Debentures in 2002, the Company issued non-detachable warrants granting the holders the right to acquire, in the aggregate, 472,900 shares of the Company's common stock at $1.00 per share. In accordance with EITF 00-27 the Company recognized the value attributable to the warrants in the amount of $68,595 to additional paid in capital and a discount against the Series B Debentures. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 1.67%, a dividend yield of 0%, and volatility of 26%. The debt discount attributed to the value of the warrants issued is amortized over the Series B Debentures maturity period (three years) as interest expense.

In 2003, the Company issued convertible Series B Debentures to Company officers, shareholders, and sophisticated investors in exchange for $2,027,100, exclusive of placement costs and fees. The Series B Debentures accrue interest at 8% per annum and are payable and due three years from the date of the note with the latest maturity date of February 2006. Noteholders have the option to convert any unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of $.55 per share beginning six months after issuance.

In accordance with EITF 98-5, the Company recognized an imbedded beneficial conversion feature present in the Series B Debenture note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid-in capital. The Company recognized and measured an aggregate of $1,761,675 of the proceeds, which is equal to the intrinsic value of the imbedded beneficial conversion feature, to additional paid in capital and a discount against the Series B Debentures. The debt discount attributed to the beneficial conversion feature is amortized over the Series B Debentures maturity period (three years) as interest expense.

In connection with the placement of the Series B Debenture notes in 2003, the Company issued non-detachable warrants granting the holders the right to acquire, in the aggregate, 2,027,100 shares of the Company's common stock at $1.00 per share. In accordance with EITF 00-27, the Company recognized the value attributable to the warrants in the amount of $265,425 to additional paid in capital and a discount against the Series B Debentures. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 1.25%, a dividend yield of 0%, and volatility of 26%. The debt discount attributed to the value of the warrants issued is amortized over the Series B Debentures maturity period (three years) as interest expense.

NOTE B - CONVERTIBLE PROMISSORY NOTES PAYABLE (CONTINUED)

The Company amortized the Debenture 1 and the Series B Debenture debt discount attributed to the beneficial conversion feature and the value of the attached warrants and recorded non-cash interest expense of $16,020 and $611,039 for the six months ended June 30, 2004 and 2003, respectively.

During the year ended December 31, 2003, the Debenture-1 noteholders demanded registration of that number of common shares of the Company sufficient to cover the conversion of their debentures and exercise of the attached warrants. Accordingly, the Company notified the Series B Debenture noteholders, Senior noteholders (Note C) and warrant holders with piggy-back registration rights of their right to participate in the registration. During the year ended December 31, 2003, the Company issued an aggregate of 7,217,836 shares of common stock in connection with the conversion of $1,627,100 aggregate principal amount of the Debenture-1 and $2,180,000 aggregate principal amount of the Series B Debentures. The Company also issued an aggregate of 525,403 shares of common stock in exchange for accrued interest of $195,148 and $85,586 for Debenture 1 and Series B Debentures, respectively. During the six months ended June 30, 2004, the Company issued an aggregate of 324,001 shares of common stock in connection with the conversion of $62,000 aggregate principal amount of the Debenture-1 and $110,000 aggregate principal amount of the Series B Debentures. The Company also issued an aggregate of 42,999 shares of common stock in exchange for accrued interest of $23,276 for Debenture 1 and Series B Debentures (see Note E).

In connection with the conversion of Debenture-1 and Series B Debentures, the Company wrote off the unamortized debt discount attributed to the beneficial conversion feature and the value of the attached warrants in the amount of $2,046,479 and $296,470, respectively, as of December 31, 2003, and an additional $134,134 and $531, respectively, during the six months ended June 30, 2004.

NOTE C - SENIOR NOTES PAYABLE

In the second quarter of 2003, the Company issued Senior Notes to Company officers, shareholders, and sophisticated investors in exchange for $5,000,000, exclusive of placement costs and fees. The Senior Notes are denominated in units of $100,000, accrue interest at 8% per annum and are due three years from the date of issuance with the latest maturity date of June 2006. Attached to each Senior Note are warrants to purchase 125,000 shares of common stock. The warrants have a three-year contractual life and are exercisable immediately after the issuance of the Senior Note at an exercise price of $1.00 per share. The Senior Notes are secured by a first priority security interest in all intellectual property assets of the Company. The Company plans to use the proceeds from the Senior Notes for expansion of sales, marketing and strategic partnership programs, building required infrastructure and for working capital.

In September 2003, certain Senior noteholders elected to surrender their Senior Note as consideration for the exercise of warrants to purchase shares of common stock of the Company. The Company issued an aggregate of 2,011,000 restricted shares of common stock for warrants exercised at $1.00 per share, in exchange for $2,011,000 of Senior Notes. The aggregate value of the Senior Notes outstanding as of December 31, 2003, including accrued but unpaid interest, was $2,989,000.

In January 2004, certain note holders elected to convert $2,539,000 of their senior notes into Company restricted shares of common stock at a conversion price of $2.10 per share. The remaining outstanding senior notes as of June 30, 2004 after the conversion is $450,000.

NOTE D - STOCK OPTIONS AND WARRANTS

Employee Stock Options

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

NOTE D - STOCK OPTIONS AND WARRANTS (CONTINUED)

Employee Stock Options (Continued)

	Options Outstanding			Options E
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable
$1.00	6,301,000	8.09	$ 1.00	3,574,685
$1.01 - $1.99	900,000	9.24	$ 2.00	5,000
$2.00 - $2.99	977,000	9.38	$ 2.46	381,416
$3.00 - $3.99	492,000	9.69	$ 3.44	16,750
	8,670,000	8.87	$ 1.41	3,977,851

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

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2002	1,055,000	$ 1.00
Granted	3,335,000	1.00
Exercised	(1,000,000)	1.00
Canceled or expired	(1,440,000)	1.00
Outstanding at December 31, 2002 (as restated)	1,950,000	1.00
Granted	7,202,333	1.22
Exercised	(109,333)	1.01
Canceled or expired	(750,000)	1.00
Outstanding at December 31, 2003	8,293,000	$ 1.19
Granted	945,000	2.96
Exercised	(356,333)	1.02
Canceled or expired	(211,667)	1.60
Outstanding at June 30, 2004	8,670,000	$ 1.41

The weighted-average fair value of stock options granted to employees during the period ended June 30, 2004 and 2003 and the weighted-average significant assumptions used to determine those fair values, using a Black-Scholes option pricing model are as follows:

	2004	2003
Significant assumptions (weighted-average):		
Risk-free interest rate at grant date	1.01%	1.25%
Expected stock price volatility	35%	26%
Expected dividend payout	--	--
Expected option life-years (a)	10	10

(a) The expected option life is based on contractual expiration dates.

If the Company recognized compensation cost for the non-qualified employee stock option plan in accordance with SFAS No. 123, the Company's pro forma net loss and net loss per share would have been $(10,158,100) and $(0.26) for the six months ended June 30, 2004 and $(4,750,849) and $(0.30) for the six months ended June 30, 2003, respectively.

NOTE D - STOCK OPTIONS AND WARRANTS (CONTINUED)

Non-Employee Stock Options

The following table summarizes the changes in options outstanding and the related prices for the shares of the Company's common stock issued to the Company consultants. These options were granted in lieu of cash compensation for services performed.

	Options Outstanding			Options E
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighed Average Exercise Price	Number Exercisable
$ 1.00	3,012,084	8.43	$ 1.00	2,507,917

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

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2002	246,502	$ 0.70
Granted	2,455,000	1.00
Exercised	(1,146,502)	0.96
Canceled or expired	--	--
Outstanding at December 31, 2002	1,555,000	1.00

Granted	1,900,000	1.00
Exercised	(187,500)	0.96
Canceled or expired	--	--
Outstanding at December 31, 2003	3,267,500	$ 1.00
Granted	--	--
Exercised	(255,416)	1.00
Canceled or expired	--	--
Outstanding at June 30, 2004	3,012,084	$ 1.00

The estimated value of the non-employee stock options vested during the period ended June 30, 2004 was determined using the Black-Scholes option pricing model and the following assumptions: contractual term of 10 years, a risk free interest rate of 1.01%, a dividend yield of 0% and volatility of 35%. The amount of the expense charged to operations in connection with granting the options was $452,707 and $286,904 during the period ended June 30, 2004 and 2003, respectively.

Warrants

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

NOTE D - STOCK OPTIONS AND WARRANTS (CONTINUED)

Warrants (Continued)

	Warrants Outstanding			Warrants E
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighed Average Exercise Price	Number Exercisable
$ 1.00	655,900	1.34	$ 1.00	655,900
$ 2.54	12,500	1.92	$ 2.54	12,500
$ 2.97	35,000	1.92	$ 2.97	35,000
	703,400	1.38	$ 1.13	703,400

Transactions involving warrants are summarized as follows:

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2002	3,528,665	$ 0.67
Granted	1,667,460	0.87
Exercised	(1,650,675)	0.51
Canceled or expired	(13,990)	1.00
Outstanding at December 31, 2002	3,531,460	$ 0.84
Granted	8,591,800	1.01
Exercised	(6,963,770)	0.92
Canceled or expired	--	--
Outstanding at December 31, 2003	5,159,490	1.01
Granted	--	--
Exercised	(4,456,090)	1.02
Canceled or expired	--	--
Outstanding at June 30, 2004	703,400	$ 1.13

The Company did not grant any compensatory warrants to non-employees during the period ended June 30, 2004. The estimated value of previously granted warrants vested during the period ended June 30, 2004 was determined using the Black-Scholes option pricing model and the following assumptions: contractual term of 10 years, a risk free interest rate of 1.01%, a dividend yield of 0% and volatility of 35%. Compensation expense of $12,383 was charged to operations for the period ended June 30, 2004. The Company capitalized financing costs of $87,217 for compensatory warrants granted in connection with placement of convertible debentures during the period ended June 30, 2003. The financing cost was amortized over the life of the convertible debentures and all unamortized financing cost was expensed upon the conversion of the convertible debentures during the year ended December 31, 2003.

NOTE E - CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock, par value $.001 per share. As of June 30, 2004 and December 31, 2003, the Company has no preferred stock issued and outstanding. The Company has authorized 100,000,000 shares of common stock, par value $.001 per share. As of June 30, 2004 and December 31, 2003, the Company had 44,707,726 and 30,689,522 shares of common stock issued and outstanding, respectively.

During the period ended June 30, 2004, the Company issued 356,333 shares of common stock for an aggregate purchase price of $364,833 to certain employees upon exercise of employee stock options at approximately $1.02 per share. Additionally, the Company issued 255,416 shares of common stock for an aggregate purchase price of $255,416 to consultants upon exercise of non-employee stock options at approximately $1.00 per share.

NOTE E - CAPITAL STOCK

During the period ended June 30, 2004, the Company issued an aggregate of 40,000 shares of common stock, having an aggregate fair market value of $123,038, to consultants in exchange for services rendered, which approximated the fair value of the shares issued during the period services were completed and rendered.

The Company issued an aggregate of 1,209,038 of restricted shares of common stock upon the election of certain senior note holders (see Note C) to convert their senior notes into equity at a conversion price of $2.10 per share.

The Company issued 6,387,600 shares of its common stock for an aggregate purchase price of $12,726,843, net of costs and fees.

The Company issued an aggregate of 3,978,450 shares of common stock upon the exercise of warrants at approximately $1.00 per share and an aggregate of 203,751 shares of common stock in exchange for 253,203 outstanding warrants.

The Company issued an aggregate of 165,116 shares of common stock in exchange for 195,204 outstanding warrants. Additionally, the Company issued an aggregate of 37,500 shares of common stock to consultants pursuant to warrants exercised at $2.54 per share.

The Company issued an aggregate of 324,001 shares of common stock in connection with the conversion of $62,000 aggregate principal amount of the Debenture-1 and $110,000 aggregate principal amount of the Series B Debentures. The Company also issued an aggregate of 42,999 shares of common stock in exchange for accrued interest of $23,276 for Debenture 1 and Series B Debentures (Note B).

The Company issued an aggregate of 18,000 shares of common stock to employees in exchange for $55,843 of services rendered, which approximated the fair value of the shares issued during the period services were completed and rendered. Compensation costs of $55,843 were charged to operations.

In March 2004, the Company entered into consulting agreements (the "Agreements") with Aware Capital Consultants, Inc. and Scarborough, Ltd. ("Consultants"). Pursuant to the Agreements, the Company issued an aggregate of 1,000,000 shares of its restricted common stock to Consultants in exchange for professional services rendered and to be rendered. In accordance with EMERGING ISSUES TASK FORCE ISSUE 96-18, ACCOUNTING FOR EQUITY INSTRUMENTS THAT ARE ISSUED TO OTHER THAN EMPLOYEES FOR ACQUIRING, OR IN CONJUNCTION WITH SELLING, GOODS OR SERVICES ("EITF 96-18"), the measurement date to determine fair value was the date at which a commitment for performance by the counter party to earn the equity instrument was reached. The Company valued the shares issued for consulting services at the rate which represents the fair value of the services received which did not differ materially from the value of the stock issued. Compensation cost of $2,500,000 was charged to operations during the period ended June 30, 2004.

Share amounts presented in the consolidated balance sheets and consolidated statements of stockholders' equity reflect the actual share amounts outstanding for each period presented.

NOTE F - INVENTORIES

Inventories are stated at the lower of cost or market determined by the first-in, first-out (FIFO) method. Inventories primarily consist of Gateways, iBridges and Couplers, which are the significant components of the Telkonet solution. Components of inventories as of June 30, 2004 and December 31, 2003 are as follows:

	June 30, 2004	December 31, 2003
Raw Materials	$388,295	$374,794

Finished Goods	590,719	233,722
	$979,014	$608,516

Item 2. Management's Discussion and Analysis

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

Description of the Company

The Company was formed in 1999 to develop products for use in the powerline communications (PLC) industry. PLC products use existing electrical wiring in commercial buildings and residences to carry high speed data communications signals, including the Internet. Since the Company's formation, it has worked on the development and marketing of its PLC technology.

The Company's PLC technology, the "PlugPlus(TM)" product suite, consists of three separate components, the Gateway, the Coupler and the iBridge. The Gateway, the hub of the PlugPlus(TM) product suite, is a modular, self-contained unit that accepts data from an existing network on one port and distributes it via a second port. The Gateway integrates a communications processor that runs a series of proprietary applications under Linux. The signal generated by the Gateway can be directly coupled into low voltage wiring via the Coupler, which interfaces directly between the Gateway and the building's electrical panel. Multi-panel buildings typically require multiple Couplers, which are connected to the Gateway via inexpensive coaxial cable and concentrated using standard radio frequency splitters. A suite of software applications running on the Gateway can perform communications functions or system management functions. The iBridge serves as the user's network access device and connects to a user's personal computer through a standard Ethernet cable. The iBridge's AC line cord serves as its power source as well as its network interface. The Company also offers the eXtender, a fourth optional device, as part of its PlugPlus(TM) product suite. The eXtender is used to extend the reach of the Gateway in larger buildings or campus environments.

The PlugPlus(TM) product suite delivers data to the user at speeds in excess of 7 Mega bits per second (Mbps), with burst speeds of 12.6 Mbps. The PlugPlus(TM) product suite is installed by connecting an incoming broadband signal (DSL, TL, satellite or cable modem) into the Gateway and connecting the Gateway to a building's electrical panel using one or more Couplers. Once installed, the Gateway distributes the high-speed Internet signal throughout the entire existing network of electrical wires within the building. The user may access a high-speed Internet signal by plugging the iBridge into any electrical outlet and connecting a personal computer to the iBridge using the computer's built-in Ethernet port. Multiple personal computers connected to the iBridge can communicate with one another and can share a single broadband resource via the Gateway.

In September 2002, the Company confirmed through an independent, Federal Communications Commission (FCC) certified testing lab that its PLC product line meets the FCC technical requirements for Class A digital devices. In June 2003, the Company confirmed that its PLC product line also meets the requirements for Class B digital devices. As a result, no further testing of these products is required and the devices may be manufactured and marketed for commercial or residential use. The FCC permits the operation of unlicensed digital devices

that radiate radio frequency emissions if the manufacturer complies with certain equipment authorization procedures, technical requirements, marketing restrictions and product labeling requirements.

The Company has applied for patents that cover its unique technology and has utilized the recently announced advancements in transmission speeds to build its next generation of products that will be launched into the hospitality market. The Company continues to identify, design and develop enhancements to its core technologies that will provide additional functionality, diversification of application and desirability for current and future users. The Company intends to protect this intellectual property by filing additional patent applications.

In September 2003, the Company received approval from the U.S. Patent and Trademark Office for its "Method and Apparatus for Providing Telephonic Communication Services" patent. Notwithstanding the issuance of this patent, there can be no assurance that any of the Company 's current or future patent applications will be granted, or, if granted, that such patents will provide necessary protection for the Company's technology or its product offerings, or be of commercial benefit to the Company.

Forward Looking Statements

This report may contain "forward-looking statements," which represent the Company's expectations or beliefs, including, but not limited to, statements concerning industry performance and the Company's results, operations, performance, financial condition, plans, growth and strategies, which include, without limitation, statements preceded or followed by or that include the words "may," "will," "expect," "anticipate," "intend," "could," "estimate," or

"continue" or the negative or other variations thereof or comparable terminology. Any statements contained in this report or the information incorporated by reference that are not statements of historical fact may be deemed to be forward-looking statements within the meaning of Section 27(A) of the Securities Act of 1933 and Section 21(F) of the Securities Exchange Act of 1934. For such statements, the Company claims the protection of the safe harbor for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. These statements by their nature involve substantial risks and uncertainties, some of which are beyond the Company's control, and actual results may differ materially depending on a variety of important factors, many of which are also beyond the Company's control. You should not place undue reliance on these forward-looking statements, which speak only as of the date of this report. The Company does not undertake any obligation to update or release any revisions to these forward-looking statements to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events, except to the extent such updates and/or revisions are required by applicable law.

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

Revenues

As of December 31, 2003, the Company emerged from its development stage of operations. Accordingly, there were no revenues in the prior year comparable

period. However, during the three months ended June 30, 2004, the Company's revenues increased over the three months ended March 31, 2004 by $131,804 or 94%. This increase was due to the expansion of the sales staff in each of the business segments, increased Value Added Resellers (VAR's) in the Multi-Dwelling Unit segment and a significant increased in marketing. Additionally the Company began offering its Satellite Solution to the underserved rural markets where DSL, Cable and other ISP services are not available. The Company renewed its endorsed vendor agreement with Choice Hotels International and is also targeting those brand hotels which are under a mandate from Choice Hotels International to provide High Speed Internet Access (HSIA) to their guests within the next six months. Although revenues were not realized to date in the Government/Military and International markets, the Company has several pilot programs in place with the anticipation of full solution deployments.

Costs and expenses

Overall expenses, including the fee paid pursuant to the Agreements with the Consultants of $2,500,000 expensed during the quarter, increased for the three and six months ended June 30, 2004 over the comparable period in 2003 by $3,433,575 or 218% and $4,361,598 or 164%, respectively. The increase is principally due to an increase in payroll and related costs for development, sales and marketing and administrative functions, costs associated with non-employee stock options issued in connection with services rendered and costs associated with the American Stock Exchange listing. For the three and six months ended June 30, 2004, the operating expenses, excluding the fee paid pursuant to the Agreements with the Consultants, increased $933,575 or 59% and $1,861,598 or 70%, respectively.

Liquidity and Capital Resources

As of June 30, 2004, the Company's current assets exceeded current liabilities by $18,340,282. Of the total current assets of $19,489,158, cash represented $18,276,979 of this amount as of June 30, 2004.

While the Company believes it has sufficient capital to meet its working capital requirements for the next twelve months, additional financing may be required in order to meet growth opportunities in financing and/or investing activities. If additional capital is required and the Company is not successful in generating sufficient liquidity from operations or in raising sufficient capital resources on terms acceptable to the Company, this could have a material adverse effect on the Company's business, results of operations, liquidity and financial condition.

During the six months ended June 30, 2004, the Company filed a S-3 Registration Statement with the Securities and Exchange Commission to register 15,560,495 shares of its common stock. These shares were issued primarily in conjunction with the conversion of $2,539,000 Senior Notes into common stock at $2.10 per share in January 2004, a $12.8 million private placement closed in February 2004 and the conversion of debentures and exercise of warrants in March 2004. The registration statement was declared effective by the SEC on April 24, 2004.

Product Research and Development

Company-sponsored research and development costs related to both present and future products are expended in the period incurred. Total expenses for the three and six months ended June 30, 2004 increased over the comparable period in 2003 by $130,668 or 46% and $248,654 or 42%, respectively. This increase was primarily related to an increase in salaries and related costs associated with the addition of full-time employees and costs related to independent lab test

and certification.

Selling, General and Administrative

Selling, general and administrative expenses increased for the three and six months ended June 30, 2004 over the comparable period in 2003 by $635,121 or 54% and $1,469,191 or 87%, respectively. The increase is related to an increase in payroll and associated costs for management, sales and marketing resources, one-time costs associated with American Stock Exchange application fees, and increased legal and accounting fees associated with the Form S-3 Registration Statement.

Acquisition or Disposition of Plant and Equipment

During the three months ended June 30, 2004 fixed assets increased $400,389, which is primarily related to leasehold improvements associated with the Company's relocation of its corporate offices to Germantown, Maryland. The Company does not anticipate the sale or purchase of any significant property, plant or equipment during the next twelve months, other than purchases of leasehold improvements, computer equipment and peripherals to be used in the Company's day-to-day operations. During the three months ended June 30, 2004, the Company signed a lease to accommodate the expansion of its sales organization in White Marsh, Baltimore County, Maryland. The three-year lease provides 1,820 square feet and expires May 2007.

Number of Employees

As of June 30, 2004, the Company had 41 employees. In order for the Company to attract and retain quality personnel, the Company anticipates it will continue to offer competitive salaries to current and future employees. As the Company continues to expand, the Company will incur additional costs for personnel.

Trends, Risks and Uncertainties

The Company has sought to identify what it believes to be the most significant risks to its business, but cannot predict whether or to what extent any of such risks may be realized nor can there be any assurances that the Company has identified all possible risks that might arise. Investors should carefully consider all such risk factors in evaluating the Company's financial outlook.

TELKONET RECENTLY EMERGED FROM ITS DEVELOPMENT STAGE AND HAS NO OPERATING HISTORY ON WHICH TO BASE AN EVALUATION OF ITS CURRENT BUSINESS AND FUTURE PROSPECTS.

The Company recently emerged from its development stage. As a result, it has no operating history upon which to base an evaluation of its current business and future prospects. The Company has not generated substantial revenues since its inception. Because of the Company's lack of an operating history, management has limited insight into trends that may emerge and could materially adversely affect the Company's business. Prospective investors should consider the risks and difficulties the Company may encounter in its new and rapidly evolving market, especially given the Company's lack of operating history. These risks include the Company's ability to:

- market the PlugPlus(TM)product suite;

- build a customer base;
- generate revenues;
- compete favorably in a highly competitive market;
- access sufficient capital to support growth;
- recruit and retain qualified employees;
- introduce new products and services; and
- build technology and support systems.

THE COMPANY HAS A HISTORY OF OPERATING LOSSES AND AN ACCUMULATED DEFICIT AND EXPECTS TO CONTINUE TO INCUR LOSSES FOR THE FORESEEABLE FUTURE.

Since inception through June 30, 2004, the Company has incurred cumulative losses of $21,135,777 and has never generated enough funds through operations to support its business. The Company expects to continue to incur substantial operating losses through 2004. The Company's losses to date have resulted principally from:

- research and development costs relating to the development of the PlugPlus(TM)product suite;
- costs and expenses associated with manufacturing, distribution and marketing of the Company's products;
- general and administrative costs relating to the Company's operations; and
- interest expense related to the Company's indebtedness.

The Company is currently unprofitable and may never become profitable. Since inception, the Company has funded its research and development activities primarily from private placements of equity and debt securities, a bank loan and short term loans from certain of its executive officers. As a result of its substantial research and development expenditures and limited product revenues, the Company has incurred substantial net losses. The Company's ability to achieve profitability will depend primarily on its ability to successfully commercialize the PlugPlus(TM) product suite.

POTENTIAL FLUCTUATIONS IN OPERATING RESULTS COULD HAVE A NEGATIVE EFFECT ON THE PRICE OF THE COMPANY'S COMMON STOCK.

The Company's operating results may fluctuate significantly in the future as a result of a variety of factors, most of which are outside the Company's control, including:

- the level of use of the Internet;
- the demand for high-tech goods;
- the amount and timing of capital expenditures and other costs relating to the expansion of the Company's operations;
- price competition or pricing changes in the industry;

- technical difficulties or system downtime;
- economic conditions specific to the internet and communications industry; and
- general economic conditions.

The Company's quarterly results may also be significantly impacted by certain accounting treatment of acquisitions, financing transactions or other matters. Such accounting treatment could have a material impact on the Company's results of operations and have a negative impact on the price of the Company's common stock.

THE COMPANY'S DIRECTORS AND EXECUTIVE OFFICERS OWN A SUBSTANTIAL PERCENTAGE OF THE COMPANY'S ISSUED AND OUTSTANDING COMMON STOCK. THEIR OWNERSHIP COULD ALLOW THEM TO EXERCISE SIGNIFICANT CONTROL OVER CORPORATE DECISIONS.

As of June 30, 2004, the Company's officers and directors owned 15.2% of the Company's issued and outstanding common stock. This means that the Company's officers and directors, as a group, exercise significant control over matters upon which the Company's stockholders may vote, including the selection of the Board of Directors, mergers, acquisitions and other significant corporate transactions.

FURTHER ISSUANCES OF EQUITY SECURITIES MAY BE DILUTIVE TO CURRENT STOCKHOLDERS.

Although the funds raised in the Company's debenture offerings, the note offering and the private placement of common stock are being used for general working capital purposes, it is likely that the Company will be required to seek additional capital in the future. This capital funding could involve one or more types of equity securities, including convertible debt, common or convertible preferred stock and warrants to acquire common or preferred stock. Such equity securities could be issued at or below the then-prevailing market price for the Company's common stock. Any issuance of additional shares of the Company's common stock will be dilutive to existing stockholders and could adversely affect the market price of the Company's common stock.

THE EXERCISE OF OPTIONS AND WARRANTS OUTSTANDING AND AVAILABLE FOR ISSUANCE MAY ADVERSELY AFFECT THE MARKET PRICE OF THE COMPANY'S COMMON STOCK.

As of June 30, 2004, the Company had outstanding employee options to purchase a total of 8,670,000 shares of common stock at exercise prices ranging from $1.00 to $3.78 per share, with a weighted average exercise price of $1.41. As of June 30 2004, the Company had outstanding non-employee options to purchase a total of 3,012,084 shares of common stock at exercise prices of $1.00 per share. As of June 30, 2004, the Company had warrants outstanding to purchase a total of 703,400 shares of common stock at exercise prices ranging from $1.00 to $2.97 per share, with a weighted average exercise price of $1.12. In addition, as of June 30, 2004, the Company had 762,832 additional shares of common stock which may be issued in the future under the Telkonet, Inc. Stock Incentive Plan. The exercise of outstanding options and warrants and the sale in the public market of the shares purchased upon such exercise will be dilutive to existing stockholders and could adversely affect the market price of the Company's common stock.

THE POWERLINE COMMUNICATIONS INDUSTRY IS INTENSELY COMPETITIVE AND RAPIDLY EVOLVING.

The Company operates in a highly competitive, quickly changing environment, and the Company's future success will depend on its ability to develop and introduce new products and product enhancements that achieve broad market acceptance in commercial and governmental sectors. The Company will also need to respond effectively to new product announcements by its competitors by quickly introducing competitive products.

Delays in product development and introduction could result in:

- loss of or delay in revenue and loss of market share;
- negative publicity and damage to the Company's reputation and brand; and
- decline in the average selling price of the Company's products.

GOVERNMENT REGULATION OF THE COMPANY'S PRODUCTS COULD IMPAIR THE COMPANY'S ABILITY TO SELL SUCH PRODUCTS IN CERTAIN MARKETS.

FCC rules permit the operation of unlicensed digital devices that radiate radio frequency emissions if the manufacturer complies with certain equipment authorization procedures, technical requirements, marketing restrictions and product labeling requirements. Differing technical requirements apply to "Class A" devices intended for use in commercial settings, and "Class B" devices intended for residential use to which more stringent standards apply. An independent, FCC-certified testing lab has verified that the Company's PlugPlus(TM) product suite complies with the FCC technical requirements for Class A and Class B digital devices. No further testing of these devices is required and the devices may be manufactured and marketed for commercial and residential use. Additional devices designed by the Company for commercial and residential use will be subject to the FCC rules for unlicensed digital devices. Moreover, if in the future, the FCC changes its technical requirements for unlicensed digital devices, further testing and/or modifications of devices may be necessary. Failure to comply with any FCC technical requirements could impair the Company's ability to sell its products in certain markets and could have a negative impact on its business and results of operations.

PRODUCTS SOLD BY THE COMPANY'S COMPETITORS COULD BECOME MORE POPULAR THAN THE COMPANY'S PRODUCTS OR RENDER THE COMPANY'S PRODUCTS OBSOLETE.

The market for powerline communications products is highly competitive. The Company believes it has the only commercial solution for "in-building" distribution of broadband utilizing the electrical wiring infrastructure. Linksys Group, Inc. and Netgear, Inc. offer similar PLC solutions for the residential market. There can be no assurance that Linksys Group, Netgear or any other company will not develop PLC products that compete with the Company's products in the future. These potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources. These potential competitors may, among other things, undertake more extensive marketing campaigns, adopt more aggressive pricing policies, obtain more favorable pricing from suppliers and manufacturers and exert more influence on the sales channel than the Company can. As a result, the Company may not be able to compete successfully with these potential competitors and these potential competitors may develop or market technologies and products that are more widely accepted than those being developed by the Company or that would render the Company's products obsolete or noncompetitive. The Company anticipates that potential competitors will also intensify their efforts to penetrate the Company's target markets. These potential competitors may have more advanced technology, more extensive distribution channels, stronger brand names, bigger promotional budgets and larger customer bases than the Company does. These companies could devote more

capital resources to develop, manufacture and market competing products than the Company could. If any of these companies are successful in competing against the Company, its sales could decline, its margins could be negatively impacted, and the Company could lose market share, any of which could seriously harm the Company's business and results of operations.

THE FAILURE OF THE INTERNET TO CONTINUE AS AN ACCEPTED MEDIUM FOR BUSINESS COMMERCE COULD HAVE A NEGATIVE IMPACT ON THE COMPANY'S RESULTS OF OPERATIONS.

The Company's long-term viability is substantially dependent upon the continued widespread acceptance and use of the Internet as a medium for business commerce. The Internet has experienced, and is expected to continue to experience, significant growth in the number of users. There can be no assurance that the Internet infrastructure will continue to be able to support the demands placed on it by this continued growth. In addition, delays in the development or adoption of new standards and protocols to handle increased levels of Internet activity or increased governmental regulation could slow or stop the growth of the Internet as a viable medium for business commerce. Moreover, critical issues concerning the commercial use of the Internet (including security, reliability, accessibility and quality of service) remain unresolved and may adversely affect the growth of Internet use or the attractiveness of its use for business commerce. The failure of the necessary infrastructure to further develop in a timely manner or the failure of the Internet to continue to develop rapidly as a valid medium for business would have a negative impact on the Company's results of operations.

FAILURE OF THE COMPANY'S SERVICES AND PRODUCTS TO BE SUCCESSFUL IN THE MARKETPLACE COULD HAVE A NEGATIVE EFFECT ON THE COMPANY'S RESULTS OF OPERATIONS.

Since the Company is just emerging from its development stage, it does not know with any certainty whether its services and/or products will be accepted within the business marketplace. If the Company's services and/or products prove to be unsuccessful within the marketplace, or if the Company fails to attain market acceptance, it could have a negative effect on the Company's results of operations.

THE COMPANY MAY NOT BE ABLE TO OBTAIN PATENTS, WHICH COULD HAVE A MATERIAL ADVERSE EFFECT ON ITS BUSINESS.

The Company's ability to compete effectively in the powerline technology industry will depend on its success in acquiring suitable patent protection. The Company currently has several patents pending. The Company also intends to file additional patent applications that it deems to be economically beneficial. If the Company is not successful in obtaining patents, it will have limited protection against those who might copy its technology. As a result, the failure to obtain patents could negatively impact the Company's business and results of operations.

INFRINGEMENT BY THIRD PARTIES ON THE COMPANY'S PROPRIETARY TECHNOLOGY AND DEVELOPMENT OF SUBSTANTIALLY EQUIVALENT PROPRIETARY TECHNOLOGY BY THE COMPANY'S COMPETITORS COULD NEGATIVELY IMPACT THE COMPANY'S BUSINESS.

The Company's success depends partly on its ability to maintain patent and trade secret protection, to obtain future patents and licenses, and to operate without infringing on the proprietary rights of third parties. There can be no assurance that the measures the Company has taken to protect its intellectual property, including those integrated to its PlugPlus(TM) product suite, will prevent misappropriation or circumvention. In addition, there can be no assurance that any patent application, when filed, will result in an issued

patent, or that the Company's existing patents, or any patents that may be issued in the future, will provide the Company with significant protection against competitors. Moreover, there can be no assurance that any patents issued to, or licensed by, the Company will not be infringed upon or circumvented by others. Infringement by third parties on the Company's proprietary technology could negatively impact its business. Moreover, litigation to establish the validity of patents, to assert infringement claims against others, and to defend against patent infringement claims can be expensive and time-consuming, even if the outcome is in the Company's favor. The Company also relies to a lesser extent on unpatented proprietary technology, and no assurance can be given that others will not independently develop substantially equivalent proprietary information, techniques or processes or that the Company can meaningfully protect its rights to such unpatented proprietary technology. Development of substantially equivalent technology by the Company's competitors could negatively impact its business.

THE COMPANY DEPENDS ON A SMALL TEAM OF SENIOR MANAGEMENT, AND IT MAY HAVE DIFFICULTY ATTRACTING AND RETAINING ADDITIONAL PERSONNEL.

The Company's future success will depend in large part upon the continued services and performance of senior management and other key personnel. If the Company loses the services of any member of its senior management team, its overall operations could be materially and adversely affected. In addition, the Company's future success will depend on its ability to identify, attract, hire, train, retain and motivate other highly skilled technical, managerial, marketing, purchasing and customer service personnel when they are needed. Competition for these individuals is intense. The Company cannot ensure that it will be able to successfully attract, integrate or retain sufficiently qualified personnel when the need arises. Any failure to attract and retain the necessary technical, managerial, marketing, purchasing and customer service personnel could have a negative effect on the Company's financial condition and results of operations.

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Item 3. Controls and Procedures.

As of June 30, 2004, the Company performed an evaluation, under the supervision and with the participation of management, including the Chief Executive and Chief Financial Officers, of the effectiveness of the design and operation of its disclosure controls and procedures as defined in rules 13a - 15(c) and 15d - 15(c) under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, the Chief Executive and Chief Financial Officers concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information required to be included in the Company's periodic filings with the U.S. Securities and Exchange Commission. There were no significant changes in the Company's internal controls or in other factors that could significantly affect these internal controls subsequent to the date of the most recent evaluation.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings.

None

Item 2. Changes in Securities and Small Business Issuer Purchases of Equity Securities.

During the six months ended June 30, 2004, the Company issued an aggregate of 3,998,450 shares of common stock upon the exercise of warrants at approximately

$1.00 per share. The Company also issued an aggregate of 203,751 shares of common stock upon cashless exercise of 253,203 outstanding warrants which were exercisable at $1.00 per share.

During the six months ended June 30, 2004, the Company agreed to issue 18,000 shares of common stock to Ronald W. Pickett, the Company's Chief Executive Officer, pursuant to his employment agreement, dated January 30, 2004.

During the six months ended June 30, 2004, the Company issued an aggregate of 324,001 shares of common stock in connection with the conversion of $62,000 aggregate principal amount of the Debenture-1 and $110,000 aggregate principal amount of the Series B Debentures. The Company also issued an aggregate of 42,999 shares of common stock in exchange for accrued interest of $23,276 for the Debenture-1 and Series B Debentures.

Each of the foregoing sales of securities was effected in reliance on the exemption from registration provided by Section 4(2) of the Securities Act of 1933 and/or Rule 506 of Regulation D promulgated thereunder. Each of the foregoing sales was made to one or more "accredited investors," as such term is defined in the Securities Act of 1933.

During the six months ending June 30, 2004, the Company granted options to purchase 945,000 shares of common stock to certain employees of the Company. These options are exercisable at an average exercise price of $2.96 per share. In addition, during the six months ended June 30, 2004, the Company issued 356,333 shares of common stock upon exercise of employee stock options at an average exercise price of $1.02 and 255,416 shares of common stock upon exercise of options held by non-employees at an exercise price of $1.00. The options were issued pursuant to the Telkonet, Inc. Stock Incentive Plan. The shares of common stock underlying the options have been registered with the Securities and Exchange Commission on a Form S-8 Registration Statement.

Item 3. Defaults Upon Senior Securities.

None.

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

None.

Item 5. Other Information.

None.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

No.	Description
3.1	Articles of Incorporation of the Registrant (incorporated by reference to our Form 8-K (No. 000-27305), filed on August 30, 2000 and our Form S-8 (No. 333-47986), filed on October 16, 2000)
3.2	Bylaws of the Registrant (incorporated by reference to our Registration Statement on Form S-1 (No. 333 108307), filed on August 28, 2003)
4.1	Form of Series A Convertible Debenture (incorporated by reference to our Form 10-KSB (No. 000-27305), filed on March 31, 2003)

4.2	Form of Series A Non-Detachable Warrant (incorporated by reference to our Form 10- KSB (No. 000-27305), filed on March 31, 2003)
4.3	Form of Series B Convertible Debenture (incorporated by reference to our Form 10-KSB (No. 000-27305), filed on March 31, 2003)
4.4	Form of Series B Non-Detachable Warrant (incorporated by reference to our Form 10- KSB (No. 000-27305), filed on March 31, 2003)
4.5	Form of Senior Note (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
4.6	Form of Non-Detachable Senior Note Warrant (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
10.1	Amended and Restated Telkonet, Inc. Incentive Stock Option Plan (incorporated by reference to our Registration Statement on Form S-8 (No. 333-412), filed on April 17, 2002)
10.2	Employment Agreement by and between Telkonet, Inc. and Peter Larson, dated as of June 19, 2000 (incorporated by reference to our Form 8-K (No. 000-27305), filed on August 30, 2000)
10.3	Employment Agreement by and between Telkonet, Inc. and Stephen L. Sadle, dated as of June 19, 2000 (incorporated by reference to our Form 8-K (No. 000-27305), filed on August 30, 2000)
10.4	Amendment to Employment Agreement by and between Telkonet, Inc. and Stephen L. Sadle, dated as of April 24, 2002 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
10.5	Employment Agreement by and between Telkonet, Inc. and Stephen L. Sadle, dated as of January 18, 2003 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
10.6	Employment Agreement by and between Telkonet, Inc. and J. Gregory Fowler, dated as of January 30, 2002 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
10.7	Employment Agreement by and between Telkonet, Inc. and David S. Yaney, dated as of February 15, 2002 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
10.8	Employment Agreement by and between Telkonet, Inc. and Howard Lubert, dated as of January 1, 2003 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
10.9	Separation Agreement by and between Telkonet, Inc. and Howard Lubert, dated as of June 16, 2003 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
10.10	Employment Agreement by and between Telkonet, Inc. and Robert P. Crabb, dated as of January 18, 2003 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August

28, 2003)

10.11 Employment Agreement by and between Telkonet, Inc. and Ronald W. Pickett, dated as of January 30, 2003 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)

10.12 Employment Agreement by and between Telkonet, Inc. and E. Barry Smith, dated as of February 17, 2003 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)

24 Power of Attorney (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)

31.1 Certification of Ronald W. Pickett pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of E. Barry Smith pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Ronald W. Pickett pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of E. Barry Smith pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

(b) Reports on Form 8-K filed during the six months ended June 30, 2004.

i. On April 20, 2004, the Company filed a Current Report 8-K, to report the expansion of the Board of Directors by one seat, the resignation of Hugo DeCesaris from the Board of Directors, and the appointment of Dr. Thomas M. Hall and James L. Peeler to the Board of Directors.

ii. On May 19, 2004, the Company filed a Current Report 8-K, to report that an update letter was sent to shareholders announcing the status of sales and marketing developments.

iii. On May 26, 2004, the Company filed a Current Report 8-K, to report that the Company successfully pursued a delisting from the Berlin-Bremen Stock Exchange effective May 27, 2004.

SIGNATURES

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

Telkonet, Inc.
Registrant

Date: August 13, 2004

By: /s/ Ronald W. Pickett

Ronald W. Pickett
Chief Executive Officer