TELKONET INC
Form 10-K
March 31, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-K

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

For the fiscal year ended December 31, 2013

Commission file number: 001-31972

TELKONET, INC.

(Exact name of registrant as specified in its charter)

Utah	87-0627421
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
20800 Swenson Drive Suite 175, Waukesha, WI	53186
(Address of Principal Executive Offices)	(Zip Code)

(414) 223-0473

(Registrant’s Telephone Number, Including Area Code)

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

Title of each class	Name of each exchange on which registered
None	None

Securities Registered pursuant to section 12(g) of the Act: Common Stock, $.001 par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. o Yes x No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(b) of the Act. o Yes x No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities and Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. x Yes o No

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

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

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

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

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

Aggregate market value of the voting stock held by non-affiliates (based upon the closing sale price of $0.32 per share on the Over the Counter Bulletin Board) of the registrant as of June 28, 2013: $33,385,731.

Number of outstanding shares of the registrant's par value $0.001 common stock as of March 22, 2014: 125,035,612.

Parts I and II incorporate information by reference from the Annual Report to Shareholders for the fiscal year ended December 31, 2013. Part III is incorporated by reference from the Proxy Statement for the Annual Meeting of Shareholders to be held on June 12, 2014.

TELKONET, INC.

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PART I

ITEM 1. DESCRIPTION OF BUSINESS.

Some of the statements contained in this Annual Report on Form 10-K discuss future expectations, contain projections of results of operations or financial condition or state other "forward-looking" information. Those statements include statements regarding the intent, belief or current expectations of Telkonet, Inc. ("we," "us," "our" or the "Company") and our management team. Words such as "expects," "anticipates," "targets," "goals," "projects," "intends," "plans," "believes," "seeks," "estimates," "continues," "may," and variations of these words, as well as similar expressions, are intended to identify such forward-looking statements. In addition, any statements that refer to projections of our future financial performance, our anticipated growth, trends in our businesses, and other characterizations of future events or circumstances are forward-looking statements. Any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and actual results may differ materially from those projected in the forward-looking statements. These risks and uncertainties include but are not limited to those risks and uncertainties set forth in Item 1A of this report. In light of the significant risks and uncertainties inherent in the forward-looking statements included in this report, the inclusion of such statements should not be regarded as a representation by us or any other person that our objectives and plans will be achieved.

GENERAL

Business

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

ECOSMART ENERGY MANAGEMENT TECHNOLOGY

Our EcoSmart Suite of products (which include Telkonet's legacy "SmartEnergy" products) provides comprehensive savings, management and reporting of a building's room-by-room energy consumption. Telkonet's energy management products are currently installed in over 200,000 rooms in properties within the hospitality, military, educational and healthcare markets. The EcoSmart technology platform is rapidly being recognized as a leading solution-provider for reducing energy consumption and carbon footprints, and eliminating the need for new energy generation in these marketplaces – all whilst improving occupant comfort and convenience.

Controlling energy consumption can make a significant impact on a property owner's bottom line, as heating, ventilation and air conditioning ("HVAC") costs represent a substantial portion of a facility's overall utility bill. Hospitality is a key market for Telkonet. According to the EPA EnergySTAR for Hospitality analysis, the median hotel uses approximately 70,000 Btu/ft2 from all energy sources. On average, America's approximately 47,000 hotels spend $2,196 per available room each year on energy. This represents about 6 % of all operating costs. Through a strategic approach to energy efficiency, a 10 % reduction in energy consumption would have the same financial effect as increasing the average daily room rate by $0.62 in limited-service hotels and by $1.35 in full-service hotels.

Energy is very often wasted by heating and cooling rooms that are not occupied. These spaces with intermittent occupancy constitute Telkonet's target markets, and our experience, supported by independent research, suggests these rooms are unoccupied between 30% to 70% of the time.

Rooms with intermittent occupancy are most commonly found in the following market sectors:

- **Hospitality**: hotels, motels, resorts, casinos, etc.
- **Educational**: residence halls, dormitories, apartments and other campus living options. Also K-12 environments with distributed and portable classrooms.
- **Military**: residence halls, barracks, apartments and other campus living options.
- **Health care**: medical office buildings, assisted and independent living facilities.

Continually running HVAC equipment in vacant rooms also increases the maintenance overhead and shortens the equipment's working life. It all adds up to unnecessary waste and cost.

EcoSmart Suite of Energy Management Products

EcoSmart offers a product suite capable of creating a network of in-room energy management devices that can be configured to meet the requirements of most building environments. Telkonet can provide and install any combination of its proprietary intelligent thermostats, occupancy sensors, door contacts, lighting and plug load control devices. All products can be wirelessly networked to enhance energy efficiency and provide remote monitoring capability. Telkonet offers a modular approach that can be scaled from small deployments to portfolios of large properties - the heart of the network is the thermostat, once installed all other devices can be effortlessly added at any time.

EcoInsight - a programmable controllable thermostat with over 125 configurable settings used to control the efficiency of HVAC - heating, ventilating, and air conditioning systems.

EcoConnect - serves as coordinator of the devices connected to the energy management network, managing approximately 30-70 thermostats.

EcoCommander - a network-edge gateway server that provides real-time data aggregation, reporting and management of the EcoSmart product suite.

EcoView - a remote occupancy sensor that monitors rooms with ultra, high-sensitive sensors designed to detect motion, body heat, and ambient light level. All sensors are programmed to ensure accurate occupancy detection. EcoViews may be hardwired or communicate wirelessly.

EcoWave - a 2-component package that includes a revolutionary remote interface wireless thermostat (EcoAir) and powerful control solution offering distributed management over in-room HVAC units. The wireless EcoAir allows the user interface to be mounted in a convenient location with good visibility of the room to optimize occupancy detection.

EcoSwitch - an EcoSmart energy management product with the appearance of a traditional light switch. Turning lights off, even for a short time, saves energy and extends lamp life. The EcoSwitch stops the flow of electricity to lights, conserving electricity that would have otherwise been wasted on an empty space.

EcoGuard - has the ability to monitor and stop the flow of power to one or both outlets, based on occupancy, it can turn off lamps, televisions, appliances, and any other energy-consuming loads that are plugged in, preventing a property from consuming power in an empty room. The EcoGuard completely disconnects devices from the power supply, preventing lights and other in-room electronics from needlessly consuming energy.

EcoContact - a remote, wireless door/window contact with the ability to provide additional occupancy data and control HVAC operability when doors or windows are open.

EcoCentral Virtual Engineer Command Center - the Cloud-Based Energy Management Command Center offers comprehensive facility control from anywhere and a wealth of convenient features, including EcoSmart device control, cloud-based data backup, and the ability to process room access and comfort data into usable, actionable reports.

Intelligent Energy Management

Telkonet's EcoSmart energy management technology is a leading intelligent and advanced solution designed to deliver at all levels by controlling a building's HVAC usage and improving energy efficiency one room at a time, all data is presented on room-by-room basis, allowing very granular management of in-room energy use and environmental conditions. It achieves this by using a combination of wired and wireless technology components, including occupancy sensors and intelligent programmable thermostats connected with packaged terminal air conditioner ("PTAC") controllers or any other terminal equipment HVAC products, to adjust and maintain a room's temperature according to occupancy, eliminating wasteful heating and cooling of unoccupied rooms. All these things can be done from the thermostat or via any web-connected device, such as smart phones, tablets and laptop computers.

EcoSmart is an energy management system that delivers optimum, individual room energy savings without compromising occupant comfort, thanks to a proprietary technology – Recovery Time™.

Recovery Time™ Technology

All EcoSmart systems feature Recovery Time™, technology designed to maximize energy efficiency without sacrificing occupant comfort. When a room is occupied, the temperature selected by the occupant will be maintained by the EcoSmart system. However, whenever the occupancy sensor determines that the room is unoccupied, the system adjusts the room temperature using Recovery Time™. Unlike other systems, Recovery Time™ technology constantly performs calculations that evaluate how far each room's temperature can drift from the occupant's preferred setting ("set-point"), to harvest energy savings while still being able to return to the occupant's set-point within a pre-defined amount of time.

When determining the temperature setting, Recovery Time™ technology considers how long it will take to return the temperature to the occupant's setpoint once they return to their room. The temperature will only drift far enough to ensure the system will return to the occupant's preferred temperature setting within minutes upon their return to the room. The specific length of the recovery time is selected by property management at the time of the installation; however, it can be altered at any time by management.

How do others do it?

When the room is occupied the occupant selects a set-point. When the occupant leaves, the thermostat reverts to an energy-saving set-point which is a fixed number of degrees different than the occupant set-point (lower in winter and higher in summer). In some products the set-point is a fixed temperature selected by the property owner. The problem is that each room will take a different amount of time to return to the occupant set-point – variables such as the outdoor temperature and the room orientation to sun or wind will dramatically affect the length of time the HVAC unit has to run to recover the room temperature to set-point. Maintenance condition of the HVAC unit will also affect the time (a dirty filter or coil offers less heat transfer and will take longer and will cause unit to work harder). Other variables affect time as well, like whether the drapes are open or closed. The result is a very uneven distribution of temperatures from room to room and ultimately an unsatisfied occupant/guest.

EcoSmart Delivers Room-by-Room Savings

Telkonet's approach is different, since each room's environment is different; every room is evaluated independently in real-time to determine its energy efficient temperature, or setback. Recovery Time™ technology constantly calculates in real-time how far the room temperature can drift by taking into consideration all the environmental characteristics that impact the temperature in the room, including:

- The occupant's preferred temperature setting;
- The location of the room within the building;
- The window placement – facing the sun or shade;
- If the drapes are open or closed;
- If the climate is dry or humid;
- The varying weather conditions throughout the day; and
- The condition of the HVAC unit, such as age and efficiency.

Through the constant monitoring of the HVAC unit's ability to drive the temperature and the real-time adjustment of the setback temperature, rooms are never excessively hot or cold when an occupant returns to the room. The room will always be just minutes away from an occupant's desired comfort setting. As a result, Recovery Time™ technology delivers room-by-room, occupant-by-occupant savings.

Our EcoSmart platforms maximize energy reductions while at the same time ensuring occupant comfort, maximizing energy savings and extending equipment life expectancy – often by more than 40%. This technology is particularly attractive to customers in the hospitality industry, as well as the education, healthcare, public housing and government/military markets, who are continually seeking ways to reduce costs and meet federal and state mandates without impacting building occupant comfort. By reducing energy consumption automatically when a space is unoccupied utilizing the suite of EcoSmart energy management products, our customers are able to realize significant cost savings without diminishing occupant comfort.

Telkonet's EcoSmart technology may also be integrated with utility controls, property management systems and building automation systems to be used in load shedding initiatives using industry standard communication protocols to ensure widespread adoption and easy to use interfaces. This feature provides management companies and utilities enhanced opportunities for cost savings, environmental protections and energy management. Telkonet's energy management systems are lowering HVAC costs in hundreds of thousands of rooms worldwide and qualify for most state and federal energy efficiency and rebate programs.

Competitive Advantages

We believe our energy management platform, with our proprietary Recovery Time™ technology, delivers extensive benefits over competing products, including:

- Maximum energy savings - evaluating each room's environmental conditions, including room location, window placement, humidity, time-of-day, weather conditions, and operating efficiency of HVAC equipment;
- Longer life and reduced maintenance of HVAC units through reduced runtimes and proactive equipment monitoring;
- Increased occupant control & comfort;
- Simple to use and easy to read thermostat. Backlight friendly for visually impaired;
- Web-based access with extremely powerful yet simple to use EcoCentral web interface;
- Speed and ease of installation of in-room devices and network infrastructure;
- Extensive range of HVAC system compatibility;
- Adaptive learning and system programming;
- Utility-integrated events capabilities;
- Remote HVAC control network;

- 24/7 EcoCare remote monitoring and diagnostics services;
- Plug load, lighting and HVAC controls;
- Extensive 3rd-party integrations;
- Based on industry standard software and communication protocols (Linux, ZigBee); and
- Offers rapid return on investment, typical ROI of two to three years.

Our open, scalable and standards-based architecture allows the EcoSmart platform to integrate seamlessly with back-office management systems, property management systems, building automation systems and utility demand/response programs as well as additional third-party network architecture to recognize increased efficiency and savings. This approach enables the development of customized energy management deployments while protecting existing investments.

Based on these platform features and capabilities, we've been awarded, and continue to receive, contracts in the hospitality, military, educational, healthcare and utility industries. In addition, we believe that our relationships with utility-sponsored direct install and rebate-funded programs provide us with a significant advantage over our competitors in the commercial occupancy-based energy management market. Our direct go-to-market strategy, not encumbered by inflexible distribution agreements, offers further advantages in working with energy efficiency providers who support utilities in implementing energy efficiency and demand reduction programs.

Our EcoSmart platform has been developed to maximize energy efficiency and savings. Our technology allows users to decrease heating and cooling, lighting and plugload energy consumption and extend equipment life without diminishing occupant comfort. By providing Internet-based remote management over in-room energy efficiency, EcoSmart decreases the cost to operate an enterprise-wide system by improving the efficiency and operational effectiveness of onsite engineering resources.

Given the population growth in the United States and the increasing demand for energy, we believe additional energy-related infrastructure will be needed. We believe the use of Smart Grid technologies and energy efficiency management platforms are affordable alternatives to building additional power generation through leveraging existing resources and providing enhanced energy savings. While requiring investments that are not typical for most utilities, we believe the long-term savings resulting from these investments will outweigh the costs.

Industry and Market Overview

According to the U.S. Department of Energy, 18% of all the energy produced in the United States is employed to cool, heat, light, or accomplish other functions within commercial buildings. In an effort to remain competitive and manage expenses, governments, building owners, building tenants, and companies in general are looking for ways to become more efficient both fiscally and environmentally. The American Council for an Energy Efficient Economy reported that the cost of saving one unit of energy through energy efficiency is one-fifth (1/5) the cost required to generate that same unit of energy. As a result, we feel that the growth opportunities in the energy management market have just begun.

A 2011 report issued by Pike Research, titled, “Global Market for Energy Efficient Buildings to Surpass $100 Billion by 2017”, stated that the market for energy efficiency services and equipment is on the rise as national governments look to reduce energy consumption by improving the efficiency of the building stock. With buildings being one of the largest sources of energy consumption, the opportunity to improve efficiency is significant, ranging from high-efficiency HVAC systems to the utilization of energy-efficient lighting technologies to business models such as energy performance contracting as employed by energy service companies (“ESCOs”) around the world. According to the Pike report, the total market for energy efficiency in buildings will reach $103.5 billion by 2017, an increase of more than 50% from the 2011 market value of $67.9 billion.

Simply put, all industries are prime candidates for energy management and the industries that are most ripe for undertaking these initiatives are those that utilize energy “on-demand” or intermittently, such as those in the hospitality, educational, military and healthcare industries. Providing energy, and engaging the equipment to supply it, to those rooms and spaces only when occupied results in significant energy savings in addition to affording longer life and reduced maintenance to the HVAC systems.

COST OF ENERGY	**Electricity**	**District Heat**	**Fuel Oil**	**Natural Gas**
Educational Buildings ($8,111 million)	76%	7%	2%	15%
Healthcare Buildings	80%	N/A	1%	19%

($4,882 million)				
Office Buildings ($17,005 million)	87%	4%	1%	8%
Lodging Buildings ($5,228 million)	79%	N/A	3%	18%

Source: Energy Information Administration, 2003

Commercial Buildings Energy Consumption Survey

Education Industry

Telkonet's most rapidly emerging market is the educational industry as we continue to expand our presence in this marketplace through a concerted and focused approach, which involves strategic relationships with enterprise ESCOs throughout the USA. Telkonet partners with ESCOs to include our EcoSmart energy management platform for deployment within resident halls on university campuses. The ESCOs bundle our technology with other facility improvement measures designed to reduce operating costs across the entire campus, some of these initiatives provide attractive returns on customer investments, such as EcoSmart for dormitories and lighting upgrades, while others such as roofs and windows have poor returns on investment but are needed infrastructure improvements. ESCOs bundle these facility improvements into a project that has acceptable returns and meets state mandated guidelines. The ESCOs then structure self-funding financial transactions called “Performance Contracts” in which the savings are greater than the repayment costs. The ESCOs will typically guarantee the financial and operational performance in this type of engagement. This approach removes many of the capital funding issues that stand in the way of implementing energy efficient technologies and shifts the technology and performance risk from the institution to the ESCOs.

In July 2008, we entered into an agreement with New York University to implement Telkonet’s networked energy management platform to centrally manage energy consumption in its dormitories. Telkonet worked with the University to use its existing building infrastructure to remotely manage and track energy consumption. Approximately 4,000 rooms across 11 dormitories have been completed and have yielded run-time and energy consumption reductions, operational savings from reduced field labor expenses and extension of equipment lives. Since this time, we have grown our Educational deployments to include such customers as the University of California Davis, Northern Oklahoma College, the Massachusetts Institute of Technology, Kansas State University, Fordham University, West Point Military Academy and Columbia University.

The opportunities in this market are certainly not limited to higher education institutions. A report by EnergySTAR, a joint program of the U.S. Environmental Protection Agency and the U.S. Department of Energy, showed that our nation’s 17,450 K-12 schools spend more than $6 billion on energy and that as much as 30% of a district’s total energy is used inefficiently or unnecessarily.

We believe that our EcoSmart platform is an important tool for participants in the educational industry seeking to control student-related energy costs. We have focused our sales efforts on members of the educational industry who are seeking to expand their energy efficiency initiatives as well as the ESCOs who target the educational marketplace and have thus far had some success with at least one school district installing EcoSmart in each classroom throughout the district.

Hospitality Industry

According to EnergySTAR, the cost of energy for America's 47,000 hotels averages $2,196 per available room each year. As the cost of energy continues to increase, energy efficiency projects can provide an immediate and significant reduction in energy expenses. A 10% reduction in energy costs is equivalent to increasing revenue per available room by $0.60 for limited service hotels and by more than $2.00 for full-service hotels. With EcoSmart, Telkonet can also reduce equipment runtime in unoccupied rooms by 20 to 45% while maintaining guest comfort, making the solution uniquely suited for energy management projects in the hospitality market.

Any successful hotelier must focus on achieving the critical balance between guest comfort and operating margins--and maintaining this balance in the long-term. Telkonet's proprietary Recovery Time™ technology allows EcoSmart to maximize energy savings without compromising guest comfort. In fact, hoteliers with EcoSmart can guarantee an indoor environment unique for each property or brand, where each room returns to the guest set-point within six minutes, regardless of room assignment. This dynamic technology sets Telkonet apart from fixed setback energy management systems, where the setback temperature is a fixed temperature or a fixed deviation. Both fixed setback approaches make it extremely difficult to predict how long it will take the room to return to the set-point after the guest re-enters the room, resulting in potentially lower energy savings and uncomfortable room temperatures.

The green button option on Telkonet’s intelligent thermostat allows a more aggressive energy savings profile to be loaded when pressed by the occupant and is designed to engage occupants who are committed to green and sustainability. Some hotels reward pressing the button through the affinity program with special guest loyalty points.

Military Industry

With the Department of Defense (“DOD”) being the single largest energy consumer in the United States, accounting for about 90 percent of the federal government’s energy use and using over 30 million mega-watt hours of electricity per year, we view this market as strategically significant to Telkonet’s interests.

Our energy management platform is already successfully incorporated into the energy initiatives in several military housing sites, military academies and barracks. In October 2009, Executive Order 13514, "Federal Leadership in Environmental, Energy and Economic Performance," was signed and set into action numerous energy requirements in areas such as Sustainable Buildings and Communities, Greenhouse Gas Management and Pollution Prevention and Waste Reduction, among others. The American Recovery and Reinvestment Act (“ARRA”) has jump-started energy management throughout US government and military facilities by providing $4.26 billion in funding for the Department of Defense Facilities Sustainment, Restoration, and Modernization Program. Telkonet has benefited and continues to make use of ARRA funding and other government contracts to provide EcoSmart for use on military bases and other facilities, helping both the DOD and the government as a whole achieve their long-term energy efficiency goals.

Healthcare Industry

Healthcare is an additional emerging market for energy management as currently, healthcare organizations in the United States spend over $6.5 billion on energy each year and that number continues to rise to meet patients' needs. Although hospitals have many specific regulatory mandates, we have been working closely with operators and developers of healthcare support facilities, like medical office buildings, assisted living and other similar facilities, to integrate our EcoSmart energy management initiatives into efficiency opportunities supported by state and federal energy programs. These types of facilities offer a commercial environment similar to the hospitality or educational housing markets, and the increasing growth of the elderly and assisted living markets presents attractive potential for energy efficiency. This market is expected to grow rapidly over the next several years due to its energy savings capabilities. For example, hospital energy managers can use energy efficiency strategies to offset high costs caused by growing plug loads and rising energy prices. A typical 200,000-square-foot, 50-bed hospital in the U.S. annually spends $680,000—or roughly $13,611 per bed—on electricity and natural gas. By increasing energy efficiency, hospitals can improve the bottom line and free up funds to invest in new technologies and improve patient care.

Utility Industry

We believe that the utility industry is one of the fastest developing market segments in the United States. With more than $4.5 billion released to the industry through the ARRA for Smart Grid, the utility industry has become a growing percentage of our revenue, both through direct sales to utilities and partnerships with energy service companies executing state and local energy efficiency programs. Strategic relationships with regional ESCOs are key to the continued expansion of energy efficiency initiatives. In Pike's 2011 research report, it was estimated that the ESCO market will represent the largest segment of the energy efficient buildings industry in the coming years, with revenues more than doubling from $30.1 billion in 2011 to $66.0 billion worldwide by 2017, a projected compound annual growth rate of 14%.

We continue to strengthen our focus on our targeted market segments in order to expand market share and take advantage of existing incentives for energy management. We expect continued expansion in the space, and specifically in commercial segments due to increasing state and federal programs promoting energy efficiency. Our residential initiatives are also key to the future expansion of Telkonet's EcoSmart programs within the developing Smart Grid environment.

Public Housing

Another emerging market for Telkonet's energy management is public housing, which are properties owned and managed by the government. The tenants occupying these properties must meet specific eligibility requirements, and their utility bills are typically the government’s responsibility. Many of the ESCO clients that Telkonet supports today have dedicated teams pursuing opportunities with the owners and operators of government-subsidized housing. Our solutions are tailor made for these applications to conserve energy, enable remote monitoring control and improve occupant comfort.

Competition

We currently compete primarily within commercial and industrial markets, including the hospitality, education, healthcare, public housing, government, utility and military sectors. Within each target market, we offer savings through our intelligent energy management platform. Our products offer significant competitive and complementary benefits when compared with alternative offerings including Building Automation Systems (“BAS”) or Building Management Systems (“BMS”), static temperature occupancy-based systems, scheduling/programmable thermostats and high-efficiency HVAC systems.

We participate in a relatively small competitive field within the hospitality industry, with the majority of the energy management sales handled by fewer than seven manufacturers. The key competitors in the market segment are Onity, Inc., Inncom International Inc. and Schneider Electric, with each offering comparable products to our standalone and networked energy management platforms. Telkonet’s key differentiators in the hospitality segment include:

- Recovery Time™ technology;
- Mesh-networked platform;
- Integration with property and building management systems (PMS & BMS);
- Utility demand-based program integration; and
- Broad HVAC compatibility.

The educational space is a relatively new market for occupancy-based controls. We've introduced our EcoSmart platform for use within student dormitories, which traditionally had few, if any, controls. More recently we have also been requested to install our products into classrooms, which traditionally have been an environment for building automated systems or building management systems. Since the dormitory environment is very similar to the hospitality market, we believe we offer similarly scaled energy savings. Since the market is still in its infancy, very few comparable offerings have entered the market but competitors within the hospitality segment are beginning to respond. Our EcoSmart platform provides a significant advantage within the educational industry through:

- Reduced cost as compared to BAS/BMS systems;
- Ease of installation relative to traditional wired systems;
- Range of product compatibility;
- Centralized platform management with room by room performance reporting; and
- Data that is widely and easily available to promote student engagement.

The healthcare and government/military markets are very similar in scope when relating to energy management systems. A key differentiator in these environments is the specific implementation that is being considered. Each market utilizes BAS/BMS for wide scale energy management initiatives. When specifically addressing housing environments including elderly care and assisted living environments and military dormitories or barracks, Telkonet's EcoSmart platform is able to provide increased energy savings and efficiency. Competitors operating in the BAS/BMS space include Honeywell, Schneider Electric, Johnson Controls, Siemens, Trane and others, many of whom Telkonet partners with to provide a comprehensive and integrated energy management solution to effectively address energy efficiency opportunities in all types of facilities.

ETHOSTREAM HIGH SPEED INTERNET ACCESS (HSIA) NETWORK

EthoStream is one of the largest public High-Speed Internet Access ("HSIA") providers in the world, providing services to more than 8.0 million users monthly across a network of approximately 2,300 locations. With a wide range of product and service offerings and one of the most comprehensive management platforms available for HSIA networks, EthoStream offers solutions for any public access location.

EthoStream provides cutting-edge technology, proactive system monitoring and 24/7/365 in-house technical support--and will engineer a seamless browsing experience to produce quality network access for users. EthoStream has the ability to power mobile computing in any market, and can provide a complete family of wired, wireless, and custom-designed hybrid solutions to outfit diverse property types. From hospitality properties to university campuses, coffee shops to municipal buildings, the high-speed Internet access solutions EthoStream has developed are versatile enough to deploy in any venue. EthoStream offers customized gateway servers to provide solutions that are infinitely scalable and easily upgradable, giving all customers the benefit of future-proof connectivity.

Our EthoStream Gateway Server line provides industry-leading HSIA technology to the hospitality and public Internet access industry, with advanced features based on in-house product design and development, including the following:

· Dual ISP bandwidth aggregation for faster overall speed;

· ISP redundancy to eliminate network downtime;

· Enhanced quality of service;

· Real-time meeting room scheduling;

· Comprehensive service analytics;

· Standards-based monitoring and control; and

· Major franchise certified.

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We maintain a U.S.-based customer support center operating 24 hours a day, seven days a week, and employ a dedicated, in-house support team using integrated, web-based management tools enabling proactive industry-leading support. We believe our customer service offerings, along with established relationships through our vendor agreements with some of the largest hospitality franchises and management groups, distinguish us from our competitors in the hospitality HSIA industry. Current customers include:

- Benchmark Hospitality
- Choice Hotels International
- Crescent Hotels & Resorts
- Destination Hotels & Resorts
- Hilton Worldwide
- Hyatt Hotels & Resorts
- Intercontinental Hotels Group
- Kohler Hospitality
- Marcus Hotels & Resorts
- Marriott International
- Red Lion Hotels
- Shaner Hospitality
- Starwood Hotels & Resorts
- Summit Hotel Properties
- TMI Communications
- Worldmark by Wyndham
- Wyndham Hotels & Resorts

EthoStream Advantages

The Total Solution

EthoStream offers a complete package of services required for quality wired and wireless high-speed Internet access. Dedicated employees conduct site surveys, install equipment, and provide service after installation with on-site and remote support. EthoStream employs a knowledgeable, well-trained staff of support technicians, so users can rely on an in-house team to provide rapid, friendly assistance for any issue.

Properties Have Control over Their HSIA

EthoStream has a unique product at the core of every Internet solution: the Remote Management Console (“RMC”). This web-based management platform interacts in real-time with a property's EthoStream server and integrates directly with the support center in Milwaukee. The RMC allows managers to make instant changes to the entire high-speed Internet system and access information to generate usage reports.

Pro-active 24/7 In-House Support Team

Thanks to the unique capabilities of the RMC, EthoStream support representatives have an active presence at each location and can easily assist users with any issues that may arise. Rather than working from a script-based support program, the support center anticipates user needs and quickly resolves issues.

Custom-Designed Internet Solutions

By developing products and services within the Company instead of outsourcing, EthoStream ensures that customers receive only top-tier equipment. As engineers continue to improve product capabilities, technicians will remotely update product software on a monthly basis.

Competition

Telkonet's EthoStream Hospitality Network competes with a wide variety of companies in the hospitality industry ranging from media companies to traditional HSIA solution providers. Although this industry has many service providers, according to publicly available data, only a few HSIA service providers have significant customer bases. Those competitors include Guest-tek, Sonifi Solutions, iBahn and AT&T.

Market Outlook

We believe that growth of the EthoStream Hospitality Network will be derived from several key areas**:**

- New customer growth within the full-service hospitality market and through additional preferred vendor agreements with franchisors;
- Competitive customer acquisition through a superior product and service offering;
- Upgrading of EthoStream's approximately 2,300 customers due to aging equipment and standards; and
- Ongoing sales to current customers through integration of additional in-room technologies such as lighting, telephony, media centers and energy management products.

Series 5 Smart Grid

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

On March 4, 2011, the Company sold its Series 5 power line communications product line and related business assets to Dynamic Ratings, Inc. ("Dynamic Ratings"). The sales price was $1,000,000 in cash. In connection with the sale, Dynamic Ratings lent $700,000 to the Company in the form of a 6% promissory note dated March 4, 2011. Concurrently with the sale, the Company entered into a Distributorship Agreement and a Consulting Agreement with Dynamic Ratings. Under the Distributorship Agreement, the Company was designated as a distributor of the Series 5 product to non-utility markets and will receive preferred pricing for purchases of Series 5 product. Under the Consulting Agreement, the Company agreed to provide Dynamic Ratings with ongoing transition assistance and consulting services for the Series 5 product. The Consulting Agreement expired on March 31, 2013. The Distributorship Agreement had an initial term that was to expire on March 31, 2014, but was automatically renewed for one year.

Inventory

While we are dependent, in certain situations, on a limited number of vendors to provide certain inventory and components, we've not experienced significant problems or issues purchasing any essential materials, parts or components. We obtain the majority of our inventory from ATR Manufacturing, a Chinese company, which provides substantially all the manufacturing requirements for Telkonet's energy management platform.

Customers

We are neither limited to, nor reliant upon, a single or narrowly segmented customer base to derive our revenues. Our current primary focus is in the hospitality, commercial, education, utility, healthcare and government/military markets and expanding into the consumer market as part of our long term strategic growth.

For the years ended December 31, 2013 and 2012, no single customer represented 10% or more of our revenues. Recurring revenue distributed across a network of approximately 2,300 customers approximated $3,800,000 for the year ended December 31, 2013.

Intellectual Property

We acquired certain intellectual property by acquisition, including but not limited to, Patent No. D569, 279, titled "Thermostat." Patent No. D569279 issued by the USPTO in May 2008 was granted on the ornamental design of a thermostat device and expired in May 2013 . The expiration of this patent could allow third parties to launch competing products. While we viewed this patent as valuable, we do not view any single patent as material to the Company as a whole.

In addition, we currently have multiple patent applications under examination, and intend to file additional patent applications that we deem to be economically beneficial.

There can be no assurance that any of our current or future patent applications will be granted, or, if granted, that such patents will provide necessary protection for our technology or our product offerings, or be of commercial benefit to us.

Government Regulation

We are subject to regulation in the United States by the Federal Communications Commission, or FCC. 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.

Future products designed by us will require testing for compliance with FCC and CE compliance. Moreover, if in the future, the FCC or EU changes its technical requirements, further testing and/or modifications may be necessary in order to achieve compliance.

Research & Development

During the years ended December 31, 2013 and 2012, we spent $1,174,048 and $984,853, respectively, on research and development activities. In 2013 and 2012, research and development largely focused on the development of Telkonet's EcoSmart technology; in particular, expanding the product line to include the EcoGuard and EcoSwitch as well as enhancing existing components to serve a wider range of markets and customers. Several development efforts centered around integration of third party devices and software, in addition to continued enhancement of the EcoCentral web management system. The engineering behind the EcoSmart products requires continuous development to allow Telkonet to meet the latest standards for wireless and controls technologies.

The primary focus of development within the EthoStream division is related to adjustments required by Marriott-branded properties, including a special portal and system design architecture as well as enhanced reporting. These efforts resulted in a necessary certification and will be beneficial for all current and new full-service customers moving forward.

Other Information

Employees

As of March 21, 2014, we had 98 full-time employees. During 2013, significant positions filled included additional sales account executives, a marketing director and multiple engineering resources. We will continue to hire additional personnel as necessary to meet future operating requirements. We anticipate that we may need to hire additional staff in the areas of customer support, field services, engineering, sales and marketing, and administration.

Environmental Matters

We do not anticipate any material effect on our capital expenditures, earnings or competitive position due to compliance with government regulations involving environmental matters.

ITEM 1A. RISK FACTORS.

Our results of operations, financial condition and cash flows can be adversely affected by various risks. These risks include, but are not limited to, the principal factors listed below and the other matters set forth in this annual report on Form 10-K. You should carefully consider all of these risks.

Risks Relating to the Ownership of Our Common Stock

The market price of our common stock has been and may continue to be volatile.

The trading price of our common stock has been and may continue to be highly volatile and could be subject to wide fluctuations in response to various factors. Some of the factors that may cause the market price of our common stock to fluctuate include:

- fluctuations in our quarterly financial and operating results or the quarterly financial results of companies perceived to be similar to us;
- changes in estimates of our financial results or recommendations by securities analysts;
- potential deterioration of investor confidence resulting from material weaknesses in our internal control over financial reporting;
- our ability to settle sales tax obligations in a timely, cost-effective manner;
- our ability to raise and generate working capital to meet our obligations in the ordinary course of business;
- changes in general economic, industry and market conditions;
- failure of any of our products to achieve or maintain market acceptance;
- changes in market valuations of similar companies;
- failure of our products to operate as advertised;
- success of competitive products;
- changes in our capital structure, such as future issuances of securities or the incurrence of additional debt;

- announcements by us or our competitors of significant products, contracts, acquisitions or strategic alliances;
- regulatory developments in the United States, foreign countries or both;
- litigation involving our Company, our general industry or both;
- additions or departures of key personnel; and
- investors' general perception of us.

In addition, if the market for technology stocks or the stock market in general experiences a loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, financial condition or results of operations. If any of the foregoing occurs, it could cause our stock price to fall and may expose us to class action lawsuits that, even if unsuccessful, could be costly to defend and a distraction to management.

Anti-takeover provisions in our charter documents and Utah law could discourage delay or prevent a change of control of our Company and may affect the trading price of our common stock.

We are a Utah corporation and the anti-takeover provisions of the Utah Control Shares Acquisition Act may discourage, delay or prevent a change of control by limiting the voting rights of control shares acquired in a control share acquisition. In addition, our Amended and Restated Articles of Incorporation and bylaws may discourage, delay or prevent a change in our management or control over us that shareholders may consider favorable. Among other things, our Amended and Restated Articles of Incorporation and bylaws:

- authorize the issuance of "blank check" preferred stock that could be issued by our board of directors to thwart a takeover attempt;
- provide that vacancies on our board of directors, including newly created directorships, may be filled only by a majority vote of directors then in office, except a vacancy occurring by reason of the removal of a director without cause shall be filled by vote of the shareholders; and
- limit who may call special meetings of shareholders.

These provisions could have the effect of delaying or preventing a change of control, whether or not it is desired by, or beneficial to, our shareholders.

We do not currently intend to pay dividends on our common stock and, consequently, the ability to achieve a return on an investment in our common stock will depend on appreciation in the price of our common stock.

We do not expect to pay cash dividends on our common stock. Any future dividend payments are within the absolute discretion of our board of directors and will depend on, among other things, our results of operations, working capital requirements, capital expenditure requirements, financial condition, contractual restrictions, business opportunities, anticipated cash needs, provisions of applicable law and other factors that our board of directors may deem relevant. We may not generate sufficient cash from operations in the future to pay dividends on our common stock.

Our common stock is thinly traded and there may not be an active, liquid trading market for our common stock.

Our common stock is currently quoted on the Over the Counter Bulletin Board, or OTCBB. However, there is no guarantee that our common stock will be actively traded on the OTCBB, or that the volume of trading will be sufficient to allow for timely trades. Investors may not be able to sell their shares quickly or at the latest market price if trading in our stock is not active or if trading volume is limited. In addition, if trading volume in our common stock is limited, trades of relatively small numbers of shares may have a disproportionate effect on the market price of our common stock.

In addition, some aspects of the OTCBB may deter investors from purchasing our common stock, which can suppress trading in our common stock. For example, the OTCBB lacks the strict listing standards of a national stock exchange regarding corporate governance, a minimum stock price, and various matters which have to be approved by shareholders. The only requirement for inclusion in the OTCBB is that the issuer be current in its SEC reporting requirements, and that the issuer obligates itself to file periodic reports and otherwise comply with those provisions of the 1934 Act applicable to it. Shareholders of OTCBB companies frequently have difficulty in getting buy/sell orders filled promptly, and/or at expected prices. OTCBB companies generally have lower trading volume, which contributes to the illiquidity of investing in such companies. Trading activity on the OTCBB is not conducted as efficiently as trades of national stock exchange-listed securities. There are no automated systems for negotiating trades on the OTCBB, so trades must be conducted by telephone by a broker-dealer. In times of heavy market volume, the limitations of this process may increase the time it takes to make trades and the price of the stock may fluctuate in the interim. These factors may make it difficult for investors to buy additional shares or to sell the shares that they hold.

Our common stock is subject to "Penny Stock" restrictions.

As long as the price of our common stock remains at less than $5 per share, we will be subject to so-called penny stock rules which could decrease our stock's market liquidity. The SEC has adopted regulations which define a "penny stock" to include any equity security that has a market price of less than $5 per share or an exercise price of less than $5 per share, subject to certain exceptions. For any transaction involving a penny stock, unless exempt, the rules require the delivery to and execution by the retail customer of a written declaration of suitability relating to the penny stock, which must include disclosure of the commissions payable to both the broker/dealer and the registered representative and current quotations for the securities. Finally, the broker/dealer must send monthly statements disclosing recent price information for the penny stocks held in the account and information on the limited market in penny stocks. Those requirements could adversely affect the market liquidity of our common stock. There can be no assurance that the price of our common stock will rise above $5 per share so as to avoid these regulations.

Further issuances of equity securities may be dilutive to current stockholders.

It is possible that we 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 our common stock. Any issuance of additional shares of our common stock will be dilutive to existing stockholders and could adversely affect the market price of our common stock.

The exercise of conversion rights, options and warrants outstanding and available for issuance may adversely affect the market price of our common stock.

As of December 31, 2013, we had outstanding employee options to purchase a total of 1,735,225 shares of common stock at exercise prices ranging from $0.14 to $5.60 per share, with a weighted average exercise price of $0.47. As of December 31, 2013, we had warrants outstanding to purchase a total of 9,359,914 shares of common stock at exercise prices ranging from $0.13 to $3.00 per share, with a weighted average exercise price of $0.32. 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 our common stock.

Risks Related to Our Business

The industry within which we operate is intensely competitive and rapidly evolving.

We operate in a highly competitive, quickly changing environment, and our future success will depend on our ability to develop and introduce new products and product enhancements that achieve broad market acceptance in the markets within which we compete. We will also need to respond effectively to new product announcements by our 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; and

· negative publicity and damage to our reputation and the reputation of our product offerings; and

· decline in the average selling price of our products.

We have identified material weaknesses in our internal controls as of December 31, 2013 that, if not properly remediated, could result in material misstatements in our financial statements.

Based on an evaluation of our disclosure of internal controls and procedures as of December 31, 2013, our management has concluded that, as of such date, there were material weaknesses in our internal control over financial reporting relating to the need for a stronger internal control environment. A material weakness is a control deficiency, or a combination of control deficiencies, in internal control over financial reporting, such that there is a more than a remote likelihood that a material misstatement of annual or interim financial statements would not be prevented or detected. Until these material weaknesses in our internal control over financial reporting are remediated, there is reasonable possibility that material misstatements of our annual or interim consolidated financial statements could occur and not be prevented or detected by our internal controls in a timely manner.

Government regulation of our products could impair our ability to sell such products in certain markets.

The rules of the FCC, permit the operation of unlicensed digital devices that radiate radio frequency emissions if the manufacturer complies with certain equipment authorization procedures, technical requirements, marketing restrictions and product labeling requirements. 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 our iWire System 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 us 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 our ability to sell our products in certain markets and could have a negative impact on our business and results of operations.

Products sold by our competitors could become more popular than our products or render our products obsolete.

The market for our products and services is highly competitive. Some of our competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources. These 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 we can. As a result, we may not be able to compete successfully with these competitors, and these competitors may develop or market technologies and products that are more widely accepted than those being developed by us or that would render our products obsolete or noncompetitive. We anticipate that competitors will also intensify their efforts to penetrate our target markets. These competitors may have more advanced technology, more extensive distribution channels, stronger brand names, bigger promotional budgets and larger customer bases than we do. These companies could devote more capital resources to develop, manufacture and market competing products than we could. If any of these companies are successful in competing against us, our sales could decline, our margins could be negatively impacted, and we could lose market share, any of which could seriously harm our business, results of operations, and prospects.

Infringement by third parties on our proprietary technology and development of substantially equivalent proprietary technology by our competitors could negatively impact our business.

Our success depends partly on our 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 we have taken to protect our intellectual property rights, including intellectual property rights of third parties integrated into our Telkonet iWire System product suite and our EcoSmart suite of products will prevent misappropriation or circumvention. A patent associated with our Recovery Time™ technology expired in February 2014. To the extent any competitors are successful in creating competing technologies, this could have an adverse impact on our business and financial results. In addition, there can be no assurance that any patent application, when filed, will result in an issued patent, or that our existing patents, or any patents that may be issued in the future, will provide us with significant protection against competitors. Moreover, there can be no assurance that any patents issued to, or licensed by, us will not be infringed upon or circumvented by others. Infringement by third parties on our proprietary technology could negatively impact our 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 our favor. We also rely 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 we can meaningfully protect our rights to such unpatented proprietary technology. If our competitors develop substantially equivalent technology and we are unable to enforce any intellectual property rights with respect to such technology in a cost-effective manner or at all, our business and operations would suffer significant harm.

We may incur substantial damages due to litigation.

We cannot be certain that our products do not and will not infringe issued patents or other intellectual property rights of others. If it were determined that our products infringe the intellectual property rights of another, we could be required to pay substantial damages or be enjoined from licensing or using the infringing products or technology. Additionally, if it were determined that our products infringe the intellectual property rights of others, we would need to obtain licenses from these parties or substantially re-engineer our products in order to avoid infringement. We might not be able to obtain the necessary licenses on acceptable terms or at all, or to re-engineer our products successfully. Any of the foregoing could cause us to incur significant costs and prevent us from selling our products.

We depend on a small team of senior management and may have difficulty attracting and retaining additional personnel.

Our future success will depend in large part upon the continued services and performance of senior management and other key personnel. If we lose the services of any member of our senior management team, our overall operations could be materially and adversely affected. In addition, our future success will depend on our 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. We cannot ensure that we 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 our financial condition and results of operations.

Any acquisitions we make could result in difficulties in successfully managing our business and consequently harm our financial condition.

We may seek to expand by acquiring complementary businesses in our current or ancillary markets. We cannot accurately predict the timing, size and success of our acquisition efforts and the associated capital commitments that might be required. We expect to face competition for acquisition candidates, which may limit the number of acquisition opportunities available to us and may lead to higher acquisition prices. There can be no assurance that we will be able to identify, acquire or profitably manage additional businesses or successfully integrate acquired businesses, if any, without substantial costs, delays or other operational or financial difficulties. In addition, acquisitions involve a number of other risks, including:

- failure of the acquired businesses to achieve expected results;
- diversion of management's attention and resources to acquisitions;
- failure to retain key customers or personnel of the acquired businesses;
- disappointing quality or functionality of acquired equipment and people; and
- risks associated with unanticipated events, liabilities or contingencies.

Client dissatisfaction or performance problems at a single acquired business could negatively affect our reputation. The inability to acquire businesses on reasonable terms or successfully integrate and manage acquired companies, or the occurrence of performance problems at acquired companies, could result in dilution, unfavorable accounting treatment or one-time charges and difficulties in successfully managing our business.

Our inability to obtain capital, use internally generated cash or debt, or use shares of our common stock to finance our operations or future acquisitions could impair the growth and expansion of our business.

Reliance on internally generated cash or debt to finance our operations or complete acquisitions could substantially limit our operational and financial flexibility. The extent to which we will be able or willing to use shares of our common stock to consummate acquisitions will depend on the market value of our common stock which will vary, and our liquidity. Using shares of our common stock for this purpose also may result in significant dilution to our then existing stockholders. To the extent that we are unable to use our common stock to make future acquisitions, our ability to grow through acquisitions may be limited by the extent to which we are able to raise capital through debt or additional equity financings. No assurance can be given that we will be able to obtain the necessary capital to finance any acquisitions or our other cash needs. If we are unable to obtain additional capital on acceptable terms, we may be required to reduce the scope of any expansion or redirect resources committed to internal purposes. In addition to requiring funding for acquisitions, we may need additional funds to implement our internal growth and operating strategies or to finance other aspects of our operations. Our failure to: (i) obtain additional capital on acceptable terms; (ii) use internally generated cash or debt to complete acquisitions because it significantly limits our operational or financial flexibility; or (iii) use shares of our common stock to make future acquisitions, may hinder our ability to actively pursue any acquisitions.

Potential fluctuations in operating results could have a negative effect on the price of our common stock.

Our operating results may fluctuate significantly in the future as a result of a variety of factors, most of which are outside our 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 our operations;

· price competition or pricing changes in the industry;

· technical difficulties or system downtime;

· changes in governmental policies;

· economic conditions specific to the internet and communications industry; and

· general economic conditions.

Our financial 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 our results of operations and have a negative impact on the price of our common stock.

We rely on a limited number of third party suppliers. If these companies fail to perform or experience delays, shortages, or increased demand for their products or services, we may face shortages, increased costs, and may be required to suspend deployment of our products and services.

We depend on a limited number of third party suppliers to provide the components and the equipment required to deliver our solutions. If these providers fail to perform their obligations under our agreements with them or we are unable to renew these agreements, we may be forced to suspend the sale and deployment of our products and services and enrollment of new customers, which would have an adverse effect on our business, prospects, financial condition and operating results.

Our management and operational systems might be inadequate to handle our potential growth.

We may experience growth that could place a significant strain upon our management and operational systems and resources. Failure to manage our growth effectively could have a material adverse effect upon our business, results of operations and financial condition. Our ability to compete effectively and to manage future growth will require us to continue to improve our operational systems, organization and financial and management controls, reporting systems and procedures. We may fail to make these improvements effectively. Additionally, our efforts to make these improvements may divert the focus of our personnel. We must integrate our key executives into a cohesive management team to expand our business. If new hires perform poorly, or if we are unsuccessful in hiring, training and integrating these new employees, or if we are not successful in retaining our existing employees, our business may be harmed. To manage the growth we will need to increase our operational and financial systems, procedures and controls. Our current and planned personnel, systems, procedures and controls may not be adequate to support our future operations. We may not be able to effectively manage such growth, and failure to do so could have a material adverse effect on our business, financial condition and results of operations.

We may be affected if the United States participates in wars or military or other action or by international terrorism.

Involvement in a war or other military action or acts of terrorism may cause significant disruption to commerce throughout the world. To the extent that such disruptions result in (i) delays or cancellations of customer orders, (ii) a general decrease in consumer spending on information technology, (iii) our inability to effectively market and distribute our services or products or (iv) our inability to access capital markets, our business and results of operations could be materially and adversely affected. We are unable to predict whether the involvement in a war or other military action will result in any long-term commercial disruptions or if such involvement or responses will have any long-term material adverse effect on our business, results of operations, or financial condition.

Our exposure to the credit risk of our customers and suppliers may adversely affect our financial results.

We sell our products to customers that have in the past, and may in the future, experience financial difficulties. If our customers experience financial difficulties, we could have difficulty recovering amounts owed to us from these customers. While we perform credit evaluations and adjust credit limits based upon each customer's payment history and credit worthiness, such programs may not be effective in reducing our exposure to credit risk. We evaluate the collectability of accounts receivable, and based on this evaluation make adjustments to the allowance for doubtful accounts for expected losses. Actual bad debt write-offs may differ from our estimates, which may have a material adverse effect on our financial condition, operating results and cash flows.

Our suppliers may also experience financial difficulties, which could result in our having difficulty sourcing the materials and components we use in producing our products and providing our services. If we encounter such difficulties, we may not be able to produce our products for our customers in a timely fashion which could have an adverse effect on our results of operations, financial condition and cash flows.

Changes in the economy and credit markets may adversely affect our future results of operations.

Our operations and performance depend to some degree on general economic conditions and their impact on our customers' finances and purchase decisions. As a result of economic events, potential customers may elect to defer purchases of capital equipment items, such as the products we manufacture and supply. Additionally, the credit markets and the financial services industry are subject to change. While the ultimate outcome of these events cannot be predicted, it may have a material adverse effect on our customers' ability to fund their operations thus adversely impacting their ability to purchase our products or to pay for our products on a timely basis, if at all. These and other economic factors could have a material adverse effect on demand for our products, the collection of payments for our products and on our financial condition and operating results.

We may not be able to obtain payment and performance bonds, which could have a material adverse effect on our business.

Our ability to deploy our EcoSmart Suite of products into the energy management initiatives in federal funded or assisted projects may rely on our ability to obtain payment and performance bonds which may be an essential element to work orders for the installation of our products and services. If we are unable to obtain payment and performance bonds in a timely fashion as required by an applicable work order, we may not be entitled to payment under the work order until such bonds have been provided or until such a requirement is expressly waived. In addition, any delays due to a failure to furnish bonds may not entitle us to a price increase for the work or an extension of time to complete the work and may entitle the other party to terminate our work order without liability and to indemnify such party from damages suffered as a result of our failure to deliver the bonds and the termination of the work order. As a result, the failure to obtain bonds where required could negatively impact our business, results of operations, and prospects.

Risks Relating to Our Financial Results and Need for Financing

Our independent registered public accounting firm has expressed substantial doubt about our ability to continue as a going concern, which may hinder our ability to obtain future financing.

In its report dated March 31, 2014, our independent registered public accounting firm's report on our consolidated financial statements for the year ended December 31, 2013 included an explanatory paragraph relating to our ability to continue as a going concern based on our history of operating cash flow deficits, liquidity constraints and negative working capital. Our ability to continue as a going concern is subject to our ability to generate a profit, positive operating cash flows and/or obtain necessary funding from outside sources, including by the sale of our securities or assets, or to obtain loans from financial institutions, where possible. Our history of net operating losses and the uncertainty regarding contingent liabilities cast doubt on our ability to meet such goals.

We have a limited number of shares of common stock available for future issuance which could adversely affect our ability to raise capital or consummate acquisitions.

We are currently authorized to issue 190,000,000 shares of common stock under our Articles of Incorporation. As of March 15, 2014, we have issued 125,035,612 shares of common stock and have approximately 21,706,278 shares of common stock committed for issuance giving effect to the assumed exercise of all outstanding warrants and options and assumed conversion of preferred stock. Due to the limited number of authorized shares available for issuance and because of the significant competition for acquisitions, we may not able to consummate an acquisition until we increase the number of shares we are authorized to issue. To facilitate the possibility and flexibility of raising additional capital or the completion of potential acquisitions, we would need to seek stockholder approval to increase the number of our authorized shares of common stock. We can provide no assurance that we will succeed in amending our Articles of Incorporation to increase the number of shares of common stock we are authorized to issue.

We have a history of operating losses and an accumulated deficit and may incur losses in the foreseeable future.

Since inception through December 31, 2013, we have incurred cumulative losses of $121,948,847 and have never generated enough funds through operations to support our business. For the year ended December 31, 2013, we had an operating cash flow of $2,641. As of December 31, 2013, we have a working capital deficit (current liabilities in excess of current assets) of $570,401. Because of the numerous risks and uncertainties associated with our technology, the industry in which we operate, and other factors, we are unable to predict the extent of any future losses or if we will remain profitable. If we are unable to generate sufficient revenues from our operations to meet our working capital requirements, we expect to finance our future cash needs through public or debt financings. We cannot be certain that additional funding will be available on acceptable terms, or at all.

Our business activities might require additional financing that might not be obtainable on acceptable terms, if at all, which could have a material adverse effect on our financial condition, liquidity and our ability to operate going forward.

The actual amount of capital required to fund our operations and development may vary materially from our estimates. If our operations fail to generate the cash that we expect, we may have to seek additional capital to fund our business. If we are required to obtain additional funding in the future, we may have to sell assets, seek debt financing or obtain additional equity capital. In addition, any indebtedness we incur in the future could subject us to restrictive covenants limiting our flexibility in planning for, or reacting to changes in, our business. If we do not comply with such covenants, our lenders could accelerate repayment of our debt or restrict our access to further borrowings.

If we raise funds by selling more stock, your ownership in us will be diluted, and we may grant future investors rights superior to those of the common stock that you hold. If we are unable to obtain additional capital when needed, we may have to delay, modify or abandon some of our expansion plans. This could slow our growth, negatively affect our ability to compete in our industry and adversely affect our financial condition.

A significant portion of our total assets consists of goodwill and intangible assets, which are subject to periodic impairment analysis, and a significant impairment determination could have an adverse effect on our results of operations and financial condition even without a significant loss of revenue or increase in cash expenses attributable to such period.

In connection with the preparation of the Annual Report on Form 10-K, the management of the Company assessed and determined that the estimated carrying value of the Company's Smart Systems International reporting unit exceeded its estimated fair value. As a result, the Company recorded a material impairment charge of $2.8 million to goodwill for the year ended December 31, 2013. The impairment charge resulted in eliminating the remaining balance of Smart Systems International reporting unit asset. We have goodwill and intangible assets of approximately $5.8 million and $1.3 million, respectively, at December 31, 2013, resulting from past acquisitions. We evaluate this goodwill for impairment based on the fair value of the reporting units to which this goodwill relates at least once a year during the fourth quarter, or more frequently if conditions exist that indicate a potential impairment. This estimated fair value could change if we are unable to achieve operating results at the levels that have been forecasted, the market valuation of those reporting units decreases based on transactions involving similar companies, or there is a permanent, negative change in the market demand for the services offered by the reporting units. These changes could result in an additional impairment of the existing goodwill balance in the future that could require a material non-cash charge to our results of operations.

Our failure to comply with covenants under debt instruments could trigger prepayment obligations or other penalties.

Our failure to comply with the covenants under our debt instruments could result in an event of default, which, if not cured or waived, could result in us being required to repay these borrowings before their due date or could result in other penalties. If we are forced to refinance these borrowings on less favorable terms, our results of operations and financial condition could be adversely affected by increased costs and rates. On May 31, 2013, we entered into a Revolving Credit Facility (the "Agreement") with Bridge Bank, NA (the "Bank"). As of September 30 and December 31, 2013, we were in violation of a financial performance covenant under the Agreement. The outstanding balance at March 31, 2014 is $200,000. The Company is currently in negotiations with the Bank to modify the existing Agreement. See "Management's Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources" for more information regarding the Agreement.

If we fail to remain current on our reporting requirements, we could be removed from the OTC Bulletin Board, which would limit the ability of broker-dealers to sell our securities and the ability of stockholders to sell their securities in the secondary market.

Companies trading on the OTC Bulletin Board, such as us, must be reporting issuers under Section 12 of the Securities Exchange Act of 1934, as amended, or the Exchange Act, and must be current in their reports under Section 13 of the Exchange Act in order to maintain price quotation privileges on the OTC Bulletin Board. If we fail to remain current on our reporting requirements, we could be removed from the OTC Bulletin Board. As a result, the market liquidity for our securities could be severely adversely affected by limiting the ability of broker-dealers to sell our securities and the ability of stockholders to sell their securities in the secondary market.

We have debt agreements that contain certain events of default and are collateralized by substantially all of our assets.

We have a $300,000 loan agreement with the State of Wisconsin's Department of Commerce that matures in December 2016. Our debt agreement contains certain events of default, including, among other things, failure to pay, violation of covenants, and certain other expressly enumerated events. The State of Wisconsin holds a first priority security interest in our assets. If we were to trigger an event of default under the agreement, it would have a significant negative impact on our business.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

None.

ITEM 2. PROPERTIES.

The Company presently leases approximately 14,000 square feet of office space in Milwaukee, Wisconsin for its operations facility. The Milwaukee lease expires in March 2020.

The Company presently leases 16,416 square feet of commercial office space in Germantown, Maryland. The lease commitments expire in December 2015. On July 15, 2011, the Company executed a sublease agreement for 11,626 square feet of commercial office space in Germantown, Maryland and ceased utilizing this space for the Company's benefit. Because we no longer have access to this subleased space, we recorded a charge of $59,937 in accrued liabilities and expenses related to this abandonment during 2011. On June 27, 2012 the subtenant exercised the option to extend the expiration of the term of the sublease from January 31, 2013 to December 31, 2015 and we recorded an additional charge of $132,174 during the year ended December 31, 2012. The remaining liability at December 31, 2013 and 2012 was $91,981 and $135,975, respectively.

On October 7, 2013 the Company entered into a commercial office lease agreement. The 87 month lease, provides the Company approximately 6,362 square feet of office space in Waukesha, Wisconsin to be used for its corporate headquarters. The initial base rent is approximately $6,097 per month and the total minimum rental commitment under this lease is anticipated to be approximately $627,956.

ITEM 3. LEGAL PROCEEDINGS.

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

On July 1, 2008, Linksmart Wireless Technology, LLC, or Linksmart, filed a civil lawsuit in the Eastern District of Texas against EthoStream, LLC, our wholly-owned subsidiary and 22 other defendants (*Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc., et al*, U.S. District Court, for the Eastern District of Texas, Marshall Division, No. 2:08-cv-00264). This lawsuit alleged that the defendants' services infringed a wireless network security patent held by Linksmart.

Defendant Ramada Worldwide, Inc. provided us with notice of the suit and demanded that we defend and indemnify it pursuant to indemnification provisions of a vendor direct supplier agreement between EthoStream and WWC Supplier Services, Inc., a Ramada affiliate. After a review of that agreement, it was determined that EthoStream owed the duty to defend and indemnify with respect to services provided by Telkonet to Ramada and it assumed Ramada's defense.

The parties in the lawsuit agreed to and the Court ordered a stay of the litigation pending the conclusion of a reexamination proceeding in the U.S. Patent and Trademark Office relating to the patent involved in the lawsuit. The case was reopened in early 2012 based on the expectation that a reexamination certificate would be issued by the Patent Office. The reexamination certificate has been issued. After the case resumed, the parties agreed to a “transfer” of the case from the Eastern District of Texas to the Central District of California. To accomplish the “transfer,” with the agreement of the parties, the Texas case was dismissed and a new action was filed in California on April 5, 2012. (*Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc., et al*, U.S. District Court, for the Central District of California, Southern Division, No. SACV 12-522-JST).

On October 1, 2013, the Company entered into a settlement agreement with Linksmart. The Company has agreed to pay $115,000, payable in twelve installments of $9,583 due on the first of each month beginning October 1, 2013.

ITEM 4. MINE SAFETY DISCLOSURES.

None.

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

Our common stock is currently quoted on the OTC Bulletin Board under the symbol "TKOI."

The following table sets forth the quarterly high and low bid prices for our common stock for the years ended December 31, 2013 and 2012.

	High	Low
Year Ended December 31, 2013		
First Quarter	$0.34	$0.13
Second Quarter	0.33	0.17
Third Quarter	0.32	0.22
Fourth Quarter	0.28	0.16
Year Ended December 31, 2012		
First Quarter	$0.23	$0.14
Second Quarter	0.21	0.13
Third Quarter	0.21	0.12
Fourth Quarter	0.18	0.13

Record Holders

As of March 21, 2014, we had 206 record holders of our common stock and 125,035,612 shares of our common stock issued and outstanding.

Securities Authorized for Issuance Under Equity Compensation Plans

The following table provides information concerning securities authorized for issuance pursuant to equity compensation plans approved by the Company's stockholders and equity compensation plans not approved by the Company's stockholders as of December 31, 2013.

	Number of securities to	Weighted-average	Number of securities

	be issued upon exercise of outstanding options, warrants and rights	exercise price of outstanding options, warrants and rights	remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
	(a)	(b)	(c)
Equity compensation plans approved by security holders	1,735,225	$ 0.43	5,947,553
Equity compensation plans not approved by security holders	-	-	-
Total	1,735,225	$ 0.43	5,947,553

Dividend Policy

The Company has never paid dividends on its common stock and does not anticipate paying dividends in the foreseeable future. It is also subject to certain contractual restrictions on paying dividends on its common stock under the terms of its Series A and B preferred stock.

Unregistered Sales of Equity Securities and Use of Proceeds

None.

ITEM 6. SELECTED FINANCIAL DATA

This item is not applicable.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the accompanying financial statements and related notes thereto.

Critical Accounting Policies and Estimates

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

Revenue Recognition

For revenue from product sales, we recognize revenue in accordance with ASC 605-10, "Revenue Recognition" and ASC 605-10-S99 guidelines that require that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectability is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the selling prices of the products delivered and the collectability of those amounts. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. The guidelines also address the accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

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

- VSOE – Based on its pricing and discounting practices for the specific product or service when sold separately, considering geographical, customer, and other economic or marketing variables, as well as renewal rates or stand-alone prices for the service element(s).
- TPE – If we cannot establish VSOE of selling price for a specific product or service included in a multiple-element arrangement, we use third-party evidence of selling price. We determine TPE based on sales of comparable amount of similar product or service offered by multiple third parties considering the degree of customization and similarity of product or service sold.
- ESP – The estimated selling price represents the price at which we would sell a product or service if it were sold on a stand-alone basis. When neither VSOE nor TPE exists for all elements, we determine ESP for the arrangement element based on sales, cost and margin analysis, as well as other inputs based on our pricing practices. Adjustments for other market and Company-specific factors are made as deemed necessary in determining ESP.

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

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

Total revenues do not include sales tax as we consider ourselves a pass through conduit for collecting and remitting sales taxes.

Fair Value of Financial Instruments

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

Guarantees and Product Warranties

The Company records a liability for potential warranty claims. The amount of the liability is based on the trend in the historical ratio of claims to sales. 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. During the years ended December 31, 2013 and 2012, the Company experienced approximately between 1% and 4% of returns related to product warranties. As of December 31, 2013 and 2012, the Company recorded warranty liabilities in the amount of $77,943 and $69,743, respectively, using this experience factor range.

Stock Based Compensation

We account for our stock based awards in accordance with ASC 718, which requires a fair value measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors, including employee stock options and restricted stock awards.

We estimate the fair value of stock options granted using the Black-Scholes valuation model. This model requires us to make estimates and assumptions including, among other things, estimates regarding the length of time an employee will retain vested stock options before exercising them and the estimated volatility of our common stock price. The fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period. Changes in these estimates and assumptions can materially affect the determination of the fair value of stock-based compensation and consequently, the related amount recognized in our consolidated statements of operations.

Goodwill and Other Intangibles

In accordance with the accounting guidance on goodwill and other intangible assets, we perform an annual impairment test of goodwill at our reporting unit level and other intangible assets at our unit of account level, or more frequently if events or circumstances change that would more likely than not reduce the fair value of our reporting units below their carrying value. Amortization is recorded for other intangible assets with determinable lives using the straight line method over the 12 year estimated useful life. Goodwill is subject to a periodic impairment assessment by applying a fair value test based upon a two-step method. The first step of the process compares the fair value of the reporting unit with the carrying value of the reporting unit, including any goodwill. We utilize a discounted cash flow valuation methodology (income approach) to determine the fair value of the reporting unit. This approach is developed from management's forecasted cash flow data. If the fair value of the reporting unit exceeds the carrying amount of the reporting unit, goodwill is deemed not to be impaired. If the carrying amount exceeds fair value, we calculate an impairment loss. Any impairment loss is measured by comparing the implied fair value of goodwill to the carrying amount of goodwill at the reporting unit, with the excess of the carrying amount over the fair value recognized as an impairment loss.

Significant assumptions used in our goodwill impairment test at December 31, 2013 and 2012 included: expected revenue growth rates, reporting unit profit margins, working capital levels, discount rates of 12.4% and 12.9% for Ethostream and 21.8% and 17.5% for SSI, respectively, and a terminal value multiple. The expected future revenue growth rates and the expected reporting unit profit margins were determined after considering our historical revenue growth rates and reporting unit profit margins, our assessment of future market potential, and our expectations of future business performance. At December 31, 2013, the Company determined that the value of Smart Systems International's goodwill was impaired based upon management's assessment of operating results and forecasted discounted cash flow and has recorded an impairment charge of $2,774,016. The goodwill and intangible asset impairment charge was non-cash in nature and did not impact our liquidity, cash flows provided by operating activities or future operations.

Long-Lived Assets

We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable in accordance with ASC 360-10. Recoverability is measured by comparison of the carrying amount to the future net undiscounted cash flows which the assets are expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds its fair value.

Contingent Liabilities - Sales Tax

During 2012, the Company engaged a sales tax consultant to assist in determining the extent of its potential sales tax exposure. Based upon this analysis, management determined the Company had probable exposure for certain unpaid obligations, including interest and penalty, of approximately $1,100,000 including and prior to the year ended December 31, 2011. The Company had approximately $1,100,000 and $1,200,000 accrued for this exposure as of December 31, 2013 and 2012, respectively.

The Company continues to manage the liability by establishing voluntary disclosure agreements (VDAs) with the applicable states, which establishes a maximum look-back period and payment arrangements. However, if the aforementioned methods prove unsuccessful and the Company is examined or challenged by taxing authorities, there exists possible exposure of an additional $450,000, not including any applicable interest and penalties.

During 2012, the Company successfully executed and paid in full VDAs in five states totaling approximately $23,000 and is current with the subsequent filing requirements.

During 2013, the Company successfully executed and paid in full VDAs in fourteen states totaling approximately $263,000 and is current with the subsequent filing requirements. VDAs have been submitted with an additional fifteen states and the Company is awaiting notification of acceptance. Two states offer no voluntarily disclosure program.

EBITDA

The Company defines EBITDA as net income (loss), excluding income tax expense (benefit), interest expense, interest income, and depreciation and amortization expense. Management believes that certain non-GAAP financial measures may be useful in certain instances to provide additional meaningful comparisons between current results and results in prior operating periods. Adjusted earnings before interest, taxes, depreciation and amortization and other non-operating income and expenses ("Adjusted EBITDA") is a metric used by management and frequently used by the financial community. Adjusted EBITDA provides insight into an organization's operating trends and facilitates comparisons between peer companies, since interest, taxes, depreciation and amortization can differ greatly between organizations as a result of differing capital structures and tax strategies. Adjusted EBITDA excludes certain items that are unusual in nature or not comparable from period to period. While management believes that non-GAAP measurements are useful supplemental information, such adjusted results are not intended to replace our GAAP financial results.

RECONCILIATION OF NET INCOME (LOSS) TO ADJUSTED EBITDA

FOR THE YEARS ENDED DECEMBER 31,

(Unaudited)

	2013	2012
Net income (loss)	$(3,994,731)	$390,080
Interest expense, net	18,141	26,274
(Benefit) provision for income taxes	349,823	(31,271)
Depreciation and amortization	258,517	260,830
EBITDA	(3,368,250)	645,913
Adjustments:		
Gain on sale of product line	(41,902)	(15,408)
Impairment of goodwill	2,774,016	–
Stock-based compensation	89,565	201,643
Adjusted EBITDA	$(546,571)	$832,148

Results of Operations

Year Ended December 31, 2013 Compared to Year Ended December 31, 2012

Revenues

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

	Year Ended December 31,					
	2013		2012		Variance	
Product	$10,123,407	73%	$8,537,170	67%	$1,586,237	19%
Recurring	3,766,439	27%	4,221,206	33%	(454,767)	-11%
Total	$13,889,846	100%	$12,758,376	100%	$1,131,470	9%

Product revenue

Product revenue principally arises from the sale and installation of EcoSmart Suite of products, SmartGrid and High Speed Internet Access equipment. These include TSE, Telkonet Series 5, Telkonet iWire, and wireless networking products. We market and sell to the hospitality, education, healthcare and government/military markets. The Telkonet Series 5 and the Telkonet iWire products consist of the Telkonet Gateways, Telkonet Extenders, the patented Telkonet Coupler, and Telkonet iBridges. The EcoSmart Suite of products consist of thermostats, sensors, controllers, wireless networking products switches, outlets and a control platform. The HSIA product suite consists of gateway servers, switches and access points.

For the year ended December 31, 2013, product revenue increased $1.59 million when compared to the prior year. Product revenue in 2013 included approximately $5.00 million attributed to the sale and installation of energy management products, approximately $4.97 million for the sale and installation of HSIA products, and approximately $0.15 million attributable to the sale of Telkonet Series 5 Smart Grid products. The increase in product revenue can be attributed to management’s commitment of resources to sales and marketing efforts and personnel.

Recurring Revenue

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

Recurring revenue includes approximately 2,300 hotels in our broadband network portfolio. We currently support approximately 234,000 HSIA rooms, with approximately 8.0 million monthly users. For the year ended December 31, 2013, recurring revenue decreased by 11% when compared to the prior year. The decrease of recurring revenue was primarily attributed to a $0.15 million decrease in advertising revenue and a $0.30 million decrease due to a reduction of HSIA customers. The reduction of HSIA customers can be attributed to management's decision not to pursue renewing customer accounts with lower profit margins.

<u>Cost of Sales</u>

	Year ended December 31,					
	2013		2012		Variance	
Product	$6,034,294	60%	$4,726,241	55%	$1,308,053	28%
Recurring	1,069,558	28%	1,178,077	28%	(108,519)	-9%
Total	$7,103,852	51%	$5,904,318	46%	$1,199,534	20%

Costs of Product Sales

Costs of product sales include equipment and installation labor related to the sale of SmartGrid and broadband networking equipment, including EcoSmart technology and Telkonet iWire. For the year ended December 31, 2013, cost of product sales increased by 28% when compared to the prior year. The increase was attributed to the additional cost of materials associated with the increase in product sales as well as salaries and travel expenses associated with the installations.

Costs of Recurring Revenue

Recurring costs are comprised of labor and telecommunication services for our Customer Service department. For the year ended December 31, 2013, costs of recurring revenue decreased by 9% when compared to the prior year. This variance is partially attributed to $0.19 million decrease in Internet Service Provider costs. The majority of the decrease in costs of recurring revenue was associated with management's decision not to pursue renewing customer accounts with lower profit margins. The decrease was partially offset by an increase in salaries and wages.

<u>Gross Profit</u>

	Year ended December 31,		
	2013	2012	Variance

Product	$4,089,113	40%	$3,810,929	45%	$278,184	7%
Recurring	2,696,881	72%	3,043,129	72%	(346,248)	-11%
Total	$6,785,994	49%	$6,854,058	54%	$(68,064)	-1%

Gross Profit on Product Revenue

Gross profit on product revenue for the year ended December 31, 2013 increased by 7% compared to the prior year period. The variance was a result of increased product sales and installations. Gross profit as a percentage of sales decreased approximately 5% for the year ended December 31, 2013. The decrease is attributed to the lower margins on HSIA product compared to energy management product. HSIA product revenue grew by approximately $2.10 million for the year ended December 31, 2013.

Gross Profit on Recurring Revenue

For the year ended December 31, 2013, our gross profit decreased by 11% when compared to the prior year. The variance was mainly attributed to a $0.15 million decrease in advertising revenue which yields higher gross margins.

Operating Expenses

	Year ended December 31,			
	2013	2012	Variance	
Total	$10,454,663	$6,484,383	$3,970,280	61%

The Company's operating expenses are comprised of research and development, selling, general and administrative expenses, goodwill impairment and depreciation and amortization expense. During the year ended December 31, 2013, operating expenses increased by 61% when compared to the prior year. This increase is primarily related to a non-cash goodwill impairment charge on Smart Systems International of $2.77 million in 2013. Excluding this non-cash charge, operating expenses would have increased by $1.20 million or 18%.

Research and Development

	Year ended December 31,			
	2013	2012	Variance	
Total	$1,174,048	$984,853	$189,195	19%

Our research and development costs related to both present and future products are expensed in the period incurred. Total expenses for research and development increased by 19% for the year ended December 31, 2013. This increase is attributed to additional expenditures for salaries, consulting fees, and certification and testing costs associated with the continued development of our next generation energy efficiency products.

Selling, General and Administrative Expenses

	Year ended December 31,			
	2013	2012	Variance	
Total	$6,248,082	$5,238,700	$1,009,382	19%

Selling, general and administrative expenses increased for the year ended December 31, 2013 over the prior year by 19%. The majority of this increase was attributed to salaries and wages of approximately $0.40 million, commissions of approximately $0.17 million, the Linksmart Wireless Technology, LLC litigation settlement of approximately $0.12 million and bad debts of approximately $0.19 million.

Goodwill Impairment

	Year ended December 31,			
	2013	2012	Variance	
Total	$2,774,016	$ 0	$2,774,016	100%

During the year ended December 31, 2013, the Company recorded a $2.77 million goodwill impairment charge on Smart Systems International.

Liquidity and Capital Resources

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

Working Capital

Our working capital (current assets in excess of current liabilities) decreased by $985,050 during the year ended December 31, 2013 from a working capital surplus of $414,649 at December 31, 2012 to working a capital deficit of $570,401 at December 31, 2013.

Series A Preferred

The Company has designated 215 shares of preferred stock as Series A Preferred Stock ("Series A"). Under certain circumstances, on November 19, 2014 and for a period of 180 days thereafter, we may be required to redeem the shares of Series A for $5,000 per share plus any accrued but unpaid dividends. The aggregate redemption price payable to holders of shares of Series A will be payable by the Company in three equal annual installments. The first of these three installments will be due within 60 days of the requisite holders' written notice requesting redemption. For information regarding the Series A, please see Note I of the notes to consolidated financial statements.

Business Loan

On September 11, 2009, the Company entered into a Loan Agreement in the aggregate principal amount of $300,000 with the Wisconsin Department of Commerce (the "Department"). The outstanding principal balance bears interest at the annual rate of 2%. Payment of interest and principal is to be made in the following manner: (a) payment of any and all interest that accrues from the date of disbursement commenced on January 1, 2010 and continued on the first day of each consecutive month thereafter through and including December 31, 2010; (b) commencing on January 1, 2011 and continuing on the first day of each consecutive month thereafter through and including November 1, 2016, the Company shall pay equal monthly installments of $4,426; followed by a final installment on December 1, 2016 which shall include all remaining principal, accrued interest and other amounts owed by the Company to the Department under the Loan Agreement. The Company may prepay amounts outstanding under the credit facility in whole or in part at any time without penalty. The Loan Agreement is secured by substantially all of the Company's assets and the proceeds from this loan were used for the working capital requirements of the Company. The Loan Agreement contains covenants which required, among other things, that the Company keep and maintain 75 existing full-time positions and create and fill 35 additional full-time positions in Milwaukee, Wisconsin by December 31, 2012. On June 18, 2012, the Department agreed to permanently waive all penalties associated with the Company's noncompliance with this covenant. The outstanding borrowings under the agreement as of December 31, 2013 and 2012 were $154,463 and $203,947, respectively.

Promissory Note

On March 4, 2011, the Company sold all its Series 5 PLC product line assets to Wisconsin-based Dynamic Ratings, Inc. ("Purchaser") under an Asset Purchase Agreement ("APA"). Per the APA, the Company signed an unsecured Promissory Note (the "Note") due to Purchaser in the aggregate principal amount of $700,000. The outstanding principal balance bears interest at the annual rate of 6% and was originally due on March 31, 2014. The Note may be prepaid in whole or in part, without penalty at any time. The Note contains certain earn-out provisions that encompass both the Company's and Purchaser's revenue volumes. Amounts earned under the earn-out provisions were applied against the Note on June 30, 2012 and June 30, 2013. For the periods ended June 30, 2013 and June 30, 2012, the non-cash reduction of principal calculated under these provisions and applied to the Note was $41,902 and $15,408, respectively. Payments not made when due, by maturity acceleration or otherwise, shall bear interest at the rate of 12% per annum from the date due until fully paid. Effective April 30, 2013, Purchaser approved an amendment to certain terms of the Note. Telkonet commenced a monthly payment of principal and interest of $20,000 to be applied against the outstanding balance starting May 1, 2013. The interest rate remains unchanged at 6% and the maturity date was extended to January 1, 2016. The outstanding principal balance of the Note as of December 31, 2013 and 2012 was $506,024 and $684,592, respectively.

Revolving Credit Facility

On May 31, 2013, the Company entered into a Revolving Credit Facility (the “Agreement”) with Bridge Bank, NA, (the “Bank”) in a principal amount not to exceed $2,000,000. The Agreement is subject to a borrowing base that is equal to the sum of 80% of the Company’s eligible accounts receivable and 25% of the eligible inventory. On August 1, 2013 the Agreement was modified to include the eligible receivables and the eligible inventory of Ethostream. The Agreement is available for working capital and other lawful general corporate purposes. The outstanding principal balance of the facility bears interest at Prime Rate plus 2.75%. The Company’s borrowing base at December 31, 2013 was approximately $791,000 and the outstanding balance was zero. As of September 30 and December 31, 2013, the Company was in violation of a financial performance covenant. The outstanding balance at March 31, 2014 is $200,000. The Company is currently in negotiations with the Bank to modify the existing Agreement.

Cash flow analysis

Cash provided by operations was $2,641 during the year ended December 31, 2013 and cash used in operations was $188,985 during the year ended December 31, 2012. As of December 31, 2013, our primary capital needs included costs incurred to increase energy management sales, inventory procurement, funding performance bonds and managing current liabilities.

Cash used in investing activities was $407,577 during the year ended December 31, 2013 and cash provided by investing activities was $47,905 during the year ended December 31, 2012. During the year ended December 31, 2012, the Company was awarded a contract that included a bonding requirement. During the year ended December 31, 2013, the Company satisfied this requirement with cash collateral supported by an irrevocable standby letter of credit in the amount of $382,000.

Cash used in financing activities to repay indebtedness was $186,150 during the year ended December 31, 2013. Cash provided by financing activities was $343,747 during the year ended December 31, 2012. The Company received proceeds of $405,000 from the exercise of 3,115,390 Series B Convertible Redeemable Preferred Stock warrants for common stock during 2012.

We are working to manage our current liabilities while we continue to make changes in operations to improve our cash flow and liquidity position.

Our independent registered public accounting firm's report on our consolidated financial statements for the year ended December 31, 2013 includes an explanatory paragraph relating to our ability to continue as a going concern. We have incurred operating losses and operating cashflow deficits in past years and we are dependent upon our ability to continue profitable operations and/or obtain necessary funding from outside sources, including by the sale of our securities, or obtaining loans from financial institutions, where possible. These factors, among others, raise doubt about our ability to continue as a going concern and may also affect our ability to obtain financing in the future.

Management expects that global economic conditions will continue to present a challenging operating environment through 2014; therefore working capital management will continue to be a high priority for 2014.

The Company continues to manage the approximate $1,100,000 sales tax liability by establishing VDAs with the applicable states, which establish a maximum look-back period and payment arrangements. However, if the aforementioned methods prove unsuccessful and the Company is examined or challenged by taxing authorities, there exists possible exposure of an additional $450,000, not including any applicable interest and penalties.

During 2013, the Company successfully executed and paid in full VDAs in fourteen states totaling approximately $263,000 and is current with the subsequent filing requirements. The Company has submitted VDAs with an additional fifteen states and awaits notification of acceptance. Two states offer no voluntarily disclosure program. During 2012, the Company successfully executed and paid in full VDAs in five states totaling approximately $23,000 and is current with the subsequent filing requirements. The Company has submitted VDAs with an additional twenty-seven states and awaits notification of acceptance. The Company also confirmed that one customer had self-assessed, further reducing our liability and expense associated with that liability by approximately $151,000.

Inflation

We do not believe that inflation has had a material effect on our business, financial condition or results of operations. If our costs were to become subject to significant inflationary pressures, we may not be able to fully offset such higher costs through price increases. Our inability or failure to do so could adversely affect our business, financial condition and results of operations.

Off-Balance Sheet Arrangements

None.

New Accounting Pronouncements

See Note B of the Consolidated Financial Statements for a description of a new accounting pronouncement.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

This item is not applicable.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

See the Consolidated Financial Statements and Notes thereto commencing on Page F-1.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

On June 3, 2013, the Audit Committee of the Board of Directors of the Company dismissed Baker Tilly Virchow Krause, LLP (“Baker Tilly”) as the Company’s independent registered public accounting firm, and appointed BDO USA, LLP (“BDO”) as the Company’s new independent registered public accounting firm.

Baker Tilly’s reports on the Company’s consolidated financial statements for each of the fiscal years ended December 31, 2012 and 2011 did not contain an adverse opinion or disclaimer of opinion, nor were they qualified or modified as to audit scope, or accounting principle, except that the reports of Baker Tilly on the Company’s consolidated financial statements for each of fiscal year 2012 and fiscal year 2011 contained an explanatory paragraph, which noted that there was substantial doubt about the Company’s ability to continue as a going concern.

During the fiscal years ended December 31, 2012 and 2011, and the subsequent interim period through June 3, 2013, there were no disagreements between the Company and Baker Tilly on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to Baker Tilly’s satisfaction, would have caused them to make reference to the subject matter of the disagreement in connection with their reports on the financial statements of the Company for such years.

In connection with its audit of the Company's consolidated financial statements for the years ended December 31, 2012 and 2011, Baker Tilly noted in its required communications to the Company and the Audit Committee of the Board of Directors that they had found material weaknesses in the Company's internal control over financial reporting, noting internal controls necessary for the company to develop reliable financial statements did not exist. No other reportable events described in Item 304(a)(1)(v) of Regulation S-K occurred during the fiscal years ended December 31, 2012 and 2011 or during the subsequent interim period through June 03, 2013.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that material information required to be disclosed in our periodic reports filed under the Securities Exchange Act of 1934, as amended, or 1934 Act, is recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms and to ensure that such information is accumulated and communicated to our management, including our chief executive officer and chief financial officer as appropriate, to allow timely decisions regarding required disclosure. Due to the lack of a segregation of duties and the failure to implement adequate internal control over financial reporting, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures were ineffective as of the end of the period covered by this report.

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is designed to provide reasonable assurances regarding the reliability of financial reporting and the preparation of the financial statements of the Company in accordance with U.S. generally accepted accounting principles, or GAAP. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree or compliance with the policies or procedures may deteriorate.

With the participation of our Chief Executive Officer, our management conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2013 based on the framework in Internal Control—Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on our evaluation and the material weaknesses described below, management concluded that the Company did not maintain effective internal control over financial reporting as of December 31, 2013 based on the COSO framework criteria. Management has identified control deficiencies regarding the lack of segregation of duties, failure to implement adequate internal control over financial reporting and the need for a stronger internal control environment. Management of the Company believes that these material weaknesses are due to the small size of the Company's accounting staff. The small size of the Company's accounting staff may prevent adequate controls in the future, such as segregation of duties, due to the cost/benefit of such remediation. We do expect to retain additional personnel to remediate these control deficiencies in the future.

These control deficiencies could result in a misstatement of account balances resulting in a more than remote likelihood that a material misstatement to our financial statements may not be prevented or detected on a timely basis. Accordingly, we have determined that these control deficiencies as described above constitute material weaknesses.

In light of these material weaknesses, we performed additional analyses and procedures in order to conclude that our consolidated financial statements for the year ended December 31, 2013 and 2012 included in this Annual Report on Form 10-K were fairly stated in accordance with GAAP. Accordingly, management believes that despite our material weaknesses, our financial statements for the years ended December 31, 2013 and 2012 are fairly stated, in all material respects, in accordance with GAAP.

This annual report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to rules of the Securities and Exchange Commission that permit us to provide only management's report in this Annual Report on Form 10-K.

Changes in Internal Controls

During the year ended December 31, 2013, there have been no changes in our internal control over financial reporting that have materially affected or are reasonably likely to materially affect our internal controls over financial reporting.

ITEM 9B. OTHER INFORMATION.

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE.

Pursuant to General Instruction G(3), information on directors and executive officers of the Registrant and corporate governance matters is incorporated by reference from our definitive proxy statement for the annual shareholder meeting to be held on June 12, 2014.

Code of Ethics

The Board has approved, and Telkonet has adopted, a Code of Ethics that applies to all directors, officers and employees of the Company. A copy of the Company's Code of Ethics was filed as Exhibit 14 to the Company's Annual Report on Form 10-KSB for the year ended December 31, 2003 (filed with the Securities and Exchange Commission on March 30, 2004). In addition, the Company will provide a copy of its Code of Ethics free of charge upon request to any person submitting a written request to the Company's Chief Executive Officer.

ITEM 11. EXECUTIVE COMPENSATION.

Pursuant to General Instruction G(3), information on executive compensation is incorporated by reference from our definitive proxy statement for the annual shareholder meeting to be held on June 12, 2014.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS.

Pursuant to General Instructions G(3), information on security ownership of certain beneficial owners and management and related stockholder matters are incorporated by reference from our definitive proxy statement for the annual shareholder meeting to be held on June 12, 2014.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

Pursuant to General Instruction G(3), information on certain relationships and related transactions and director independence is incorporated by reference from our definitive proxy statement for the annual shareholder meeting to be held on June 12, 2014.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

Pursuant to General Instruction G(3), information on principal accounting fees and services is incorporated by reference from our definitive proxy statement for the annual shareholder meeting to be held on June 12, 2014.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES.

(a) Documents filed as part of this report.

(1) Financial Statements. The following financial statements are included in Part II, Item 8 of this Annual Report on Form 10-K:

Report of BDO USA, LLP on Consolidated Financial Statements as of and for the year ended December 31, 2013

Report of Baker Tilly Virchow Krause LLP on Consolidated Financial Statements as of and for the year ended December 31, 2012

Consolidated Balance Sheets as of December 31, 2013 and 2012

Consolidated Statements of Operations for the Years ended December 31, 2013 and 2012

Consolidated Statements of Stockholders' Equity for the Years ended December 31, 2013 and 2012

Consolidated Statements of Cash Flows for Years ended December 31, 2013 and 2012

Notes to Consolidated Financial Statements

(2) Financial Statement Schedules

Additional Schedules are omitted as the required information is inapplicable or the information is presented in the financial statements or related notes

(3) Exhibits required to be filed by Item 601 of Regulation S-K

See Exhibit Index located immediately following this Item 15

The exhibits filed herewith are attached hereto (except as noted) and those indicated on the Exhibit Index which are not filed herewith were previously filed with the Securities and Exchange Commission as indicated and are incorporated herein by reference.

EXHIBIT INDEX

The following exhibits are included herein or incorporated by reference:

Exhibit Number	**Description Of Document**
2.1	Asset Purchase Agreement by and between Telkonet, Inc. and Smart Systems International, dated as of February 23, 2007 (incorporated by reference to our Form 8-K filed on March 2, 2007)
2.2	Unit Purchase Agreement by and among Telkonet, Inc., EthoStream, LLC and the members of EthoStream, LLC dated as of March 15, 2007 (incorporated by reference to our Form 8-K filed on March 16, 2007)
2.3	Asset Purchase Agreement by and between Telkonet Inc. and Dynamic Ratings, Inc. dated as of March 4, 2011(incorporated by reference to our Form 8-K filed on March 9, 2011)
3.1	Articles of Incorporation of the Company (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 Company (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003
3.3	Amendment to Articles of Incorporation (incorporated by reference to our Form 8-K (No. 001-31972), filed November 18, 2009)
3.4	Amendment to the Articles of Incorporation (incorporated by reference to our Form 8-K filed on August 9, 2010)
3.5	Amendment to the Articles of Incorporation, (incorporated by reference to our Form 8-K filed on April 13, 2011)
3.6	Bylaws of the Registrant (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
3.7	Amendment to the Articles of Incorporation filed with the Secretary of State of Utah (incorporated by reference to our Form 8-K filed on April 8, 2011)
4.1	Senior Convertible Note by Telkonet, Inc. in favor of Portside Growth & Opportunity Fund (incorporated by reference to our Form 8-K (No. 001-31972), filed on October 31, 2005)
4.2	Warrant to Purchase Common Stock by Telkonet, Inc. in favor of Kings Road Investments Ltd. (incorporated by reference to our Form 8-K (No. 001-31972), filed on October 31, 2005)
4.3	Form of Warrant to Purchase Common Stock (incorporated by reference to our Current Report on Form 8-K (No. 001-31972), filed on September 6, 2006)
4.4	Form of Accelerated Payment Option Warrant to Purchase Common Stock (incorporated by reference to our Registration Statement on Form S-3 (No. 333-137703), filed on September 29, 2006)
4.5	Form of Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K (No. 001-31972) filed on May 12, 2008)
4.6	Promissory Note, dated September 11, 2009, by and between Telkonet Inc. and the Wisconsin Department of Commerce (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 17, 2009)
4.7	Form of Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K filed on November 18, 2009)
4.8	Form of Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K filed on August 9, 2009)
4.9	

	Promissory Note, dated March 4, 2011, issued by Telkonet Inc. to Dynamic Ratings, Inc (incorporated by reference to our Form 8-K filed on March 9, 2011)
4.10	Form of Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K filed on April 8, 2011)
10.1	Amended and Restated Stock Option Plan (incorporated by reference to our Registration Statement on Form S-8 (No. 333-161909), filed on September 14, 2009)
10.2	Loan Agreement, dated September 11, 2009, by and between Telkonet, Inc. and the Wisconsin Department of Commerce (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 17, 2009)
10.3	General Business Security Agreement, dated September 11, 2009, by and between Telkonet, Inc. and the Wisconsin Department of Commerce (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 17, 2009)
10.4	Series A Convertible Redeemable Preferred Stock Securities Purchase Agreement, dated November 16, 2009 (incorporated by reference to our Form 8-K filed on November 18, 2009)
10.5	Series A Convertible Redeemable Preferred Stock Registration Rights Agreement, dated November 16, 2009 (incorporated by reference to our Form 8-K filed on November 18, 2009)
10.6	Form of Executive Officer Reimbursement Agreement (incorporated by reference to our Form 8-K filed on November 18, 2009)
10.7	Form of Director and Officer Indemnification Agreement (incorporated by reference to our Form 10-K filed on March 31, 2010)
10.8	Series B Convertible Redeemable Preferred Stock Securities Purchase Agreement, dated August 4, 2010 (incorporated by reference to our Form 8-K filed on August 9, 2010)

10.9	Series B Convertible Redeemable Preferred Stock Registration Rights Agreement, dated August 4, 2010 (incorporated by reference to our Form 8-K filed on August 9, 2010)
10.10	Form of Executive Officer Reimbursement Agreement (incorporated by reference to our Form 8-K filed on August 9, 2010)
10.11	Form of Transition Agreement and Release (incorporated by reference to our Form 8-K filed on August 9, 2010)
10.12	2010 Stock Option and Incentive Plan (incorporated by reference to our Definitive Proxy Statement filed on September 29, 2010)
10.13	Distribution Agreement by and between, Telkonet Inc. and Dynamic Ratings, Inc., dated as of March 4, 2011(incorporated by reference to our Form 8-K filed on March 9, 2011)
10.14	Consulting Agreement by and between Telkonet Inc. and Dynamic Ratings, Inc, dated as of March 4, 2011 (incorporated by reference to our Form 8-K filed on March 9, 2011)
10.15	Securities Purchase Agreement, dated April 8, 2011, by and among Telkonet, Inc. and the parties listed therein, (incorporated by reference to our Form 8-K filed on April 8, 2011)
10.16	Registration Rights Agreement, dated April 8, 2011, by and among Telkonet, Inc. and the parties listed therein, (incorporated by reference to our Form 8-K filed on April 8, 2011)
*10.17	Employment Agreement by and between Telkonet, Inc. and Jason L. Tienor, dated as of May 1, 2013 (incorporated by reference to our Form 8-K filed May 14, 2013)
*10.18	Employment Agreement by and between Telkonet, Inc. and Jeffrey J. Sobieski, dated as of May 1, 2013 (incorporated by reference to our Form 8-K filed May 14, 2013)
*10.19	Employment Agreement by and between Telkonet, Inc. and Richard E. Mushrush, dated as of May 1, 2013 (incorporated by reference to our Form 8-K filed May 14, 2013)
*10.20	Employment Agreement by and between Telkonet, Inc. and Matthew P. Koch, dated as of May 1, 2013 (incorporated by reference to our Form 8-K filed May 14, 2013)
*10.21	Employment Agreement by and between Telkonet, Inc. and Gerrit J. Reinders, dated as of May 1, 2013 (incorporated by reference to our Form 8-K filed May 14, 2013)
10.22	Amendment to Consulting Agreement, dated April 30, 2013, by and between Telkonet, Inc. and Dynamic Ratings, Inc. (incorporated by reference to our Form 8-K filed June 6, 2013)
10.23	Business Financing Agreement, dated May 31, 2013, by and between Telkonet, Inc. and Bridge Bank N.A.(incorporated by reference to our Form 8-K filed June 6, 2013)
14	Code of Ethics (incorporated by reference to our Form 10-KSB (No. 001-31972), filed on March 30, 2004)
21	Telkonet, Inc. Subsidiaries (incorporated by reference to our Form 10-K (No. 001-31972) filed March 16, 2007)
23.1	Consent of BDO USA, LLP, Independent Registered Public Accounting Firm
23.2	Consent of Baker Tilly Virchow Krause LLP, Independent Registered Public Accounting Firm
31.1	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Jason L. Tienor
31.2	Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Richard E. Mushrush
32.1	Certification of Jason L. Tienor pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Richard E. Mushrush pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Schema Document
101.CAL	XBRL Calculation Linkbase Document
101.DEF	XBRL Definition Linkbase Document
101.LAB	XBRL Label Linkbase Document
101.PRE	XBRL Presentation Linkbase Document

* Indicates management contract or compensatory plan or arrangement.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Exchange Act, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

	TELKONET, INC.
Dated: March 31, 2014	/s/ Jason L. Tienor Jason L. Tienor
	Chief Executive Officer

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

Name	Position	Date
/s/ Jason L. Tienor Jason Tienor	Chief Executive Officer and Director (principal executive officer)	March 31, 2014
/s/ Richard E. Mushrush Richard E. Mushrush	Controller & Acting Chief Financial Officer (principal financial officer) (principal accounting officer)	March 31, 2014
/s/ / William H. Davis William H. Davis	Chairman of the Board	March 31, 2014
/s/ Glenn A. Garland Glenn A. Garland	Director	March 31, 2014
/s/ Tim S. Ledwick Tim S. Ledwick	Director	March 31, 2014

CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2013 AND 2012

FORMING A PART OF ANNUAL REPORT

PURSUANT TO THE SECURITIES EXCHANGE ACT OF 1934

TELKONET, INC.

TELKONET, INC.

Index to Financial Statements

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders

Telkonet, Inc.

Waukesha, Wisconsin

We have audited the accompanying consolidated balance sheet of Telkonet, Inc. (the “Company”) as of December 31, 2013 and the related consolidated statements of operations, stockholders’ equity, and cash flows for the year then ended. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Telkonet, Inc. as of December 31, 2013, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note A to the consolidated financial statements, the Company has a history of losses from operations, a working capital deficiency, and an accumulated deficit of $121,948,847 that raise substantial doubt about its ability to continue as a going concern. Management’s plans in regard to these matters are also described in Note A. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ BDO USA, LLP

Milwaukee, Wisconsin

March 31, 2014

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders, Audit Committee and Board of Directors

Telkonet, Inc.

Milwaukee, Wisconsin

We have audited the accompanying consolidated balance sheets of Telkonet, Inc. (the "Company") as of December 31, 2012 and the related consolidated statements of operations, stockholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of its internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company’s internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Telkonet, Inc. as of December 31, 2012 and the results of their operations and cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note A to the consolidated financial statements, the Company has a history of operating losses and negative cash flows from operations, and an accumulated deficit of $117,954,116 that raise substantial doubt about the Company's ability to continue as a going concern as of December 31, 2012. In order to sustain continued operations and meet its obligations, the Company is dependent on the availability of future funding and maintaining profitability. Management's plans in regard to these matters are also described in Note A. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Baker Tilly Virchow Krause, LLP

Milwaukee, Wisconsin

April 1, 2013

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TELKONET, INC.

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2013 AND 2012

	December 31, 2013	December 31, 2012
ASSETS		
Current assets:		
Cash and cash equivalents	$572,672	$1,163,758
Restricted cash on deposit	382,000	–
Accounts receivable, net	1,659,756	3,026,107
Inventories	939,382	654,912
Prepaid expenses	171,216	189,879
Total current assets	3,725,026	5,034,656
Property and equipment, net	44,638	35,898
Other assets:		
Goodwill	5,796,430	8,570,446
Intangible assets, net	1,258,617	1,500,297
Deposits	34,238	34,238
Total other assets	7,089,285	10,104,981
Total Assets	$10,858,949	$15,175,535
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$1,843,589	$1,967,030
Notes payable – current	265,985	74,611
Accrued liabilities and expenses	1,997,157	2,342,047
Deferred revenues	111,291	117,556
Customer deposits	77,405	118,763
Total current liabilities	4,295,427	4,620,007
Long-term liabilities:		
Deferred lease liability	130,920	133,609
Notes payable – long term	394,502	813,928
Deferred income taxes	335,275	–
Total long-term liabilities	860,697	947,537
Redeemable preferred stock:		
15,000,000 shares authorized, par value $.001 per share		
	1,165,625	1,041,837

Series A; 215 shares issued, 185 shares outstanding at December 31, 2013 and 2012, respectively, preference in liquidation of $1,229,832 and $1,176,076 as of December 31, 2013 and 2012, respectively		
Series B; 538 shares issued, 493 shares outstanding at December 31, 2012, preference in liquidation of $2,884,833 as of December 31, 2012	–	2,223,752
Total redeemable preferred stock	1,165,625	3,265,589
Commitments and contingencies		
Stockholders' Equity		
Series B preferred stock; 538 shares issued, 55 shares outstanding at December 31, 2013, preference in liquidation of $350,005 as of December 31, 2013	324,063	–
Common stock, par value $.001 per share; 190,000,000 shares authorized; 125,035,612 and 108,103,001 shares issued and outstanding at December 31, 2013 and December 31, 2012, respectively	125,035	108,103
Additional paid-in-capital	126,036,949	124,188,415
Accumulated deficit	(121,948,847)	(117,954,116)
Total stockholders' equity	4,537,200	6,342,402
Total Liabilities and Stockholders' Equity	$10,858,949	$15,175,535

See accompanying notes to consolidated financial statements.

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TELKONET, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

	2013	2012
Revenues, net:		
Product	$10,123,407	$8,537,170
Recurring	3,766,439	4,221,206
Total Net Revenues	13,889,846	12,758,376
Cost of Sales:		
Product	6,034,294	4,726,241
Recurring	1,069,558	1,178,077
Total Cost of Sales	7,103,852	5,904,318
Gross Profit	6,785,994	6,854,058
Operating Expenses:		
Research and development	1,174,048	984,853
Selling, general and administrative	6,248,082	5,238,700
Impairment of goodwill	2,774,016	–
Depreciation and amortization	258,517	260,830
Total Operating Expenses	10,454,663	6,484,383
(Loss) Income from Operations	(3,668,669)	369,675
Other (Expenses) Income:		
Interest income (expense), net	(18,141)	(26,274)
Gain on sale of product line	41,902	15,408
Total Other Income (Expense)	23,761	(10,866)
(Loss) Income Before Provision for Income Taxes	(3,644,908)	358,809
Provision (Benefit) for Income Taxes	349,823	(31,271)
Net (Loss) Income	(3,994,731)	390,080
Accretion of preferred dividends and discount	(905,977)	(897,638)
Net loss attributable to common stockholders	$(4,900,708)	$(507,558)
Net loss per common share:		
Net loss attributable to common stockholders per common share – basic	$(0.04)	$0.00
Net loss attributable to common stockholders per common share – diluted	$(0.04)	$0.00

Weighted Average Common Shares Outstanding – basic	114,670,433	105,788,739
Weighted Average Common Shares Outstanding – diluted	114,670,433	107,387,408

See accompanying notes to consolidated financial statements.

TELKONET, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

	Common Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Equity
Balance at January 1, 2012	104,349,507	$104,350	$124,483,163	$(118,344,196)	$6,243,317
Shares issued to directors and management at approximately $0.16 per share	638,104	637	101,363	–	102,000
Stock-based compensation expense related to employee stock options	–	–	99,643	–	99,643
Shares issued to preferred stockholders for warrants exercised at $0.13 per share	3,115,390	3,116	401,884	–	405,000
Accretion of redeemable preferred stock discount	–	–	(625,574)	–	(625,574)
Accretion of redeemable preferred stock dividends	–	–	(272,064)	–	(272,064)
Net income	–	–	–	390,080	390,080
Balance at December 31, 2012	108,103,001	$108,103	$124,188,415	$(117,954,116)	$6,342,402

See accompanying notes to the consolidated financial statements.

TELKONET, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (CONTINUED)

FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

	Series B Preferred Stock Shares	Series B Preferred Stock Amount	Common Shares	Common Stock Amount	Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Equity
Balance at January 1, 2013	–	$ –	108,103,001	$108,103	$124,188,415	$(117,954,116)	$6,342,402
Stock-based compensation expense related to employee stock options	–	–	–	–	89,565	–	89,565
Shares issued on conversion of preferred stock at approximately $0.13 per share	–	–	16,846,139	16,846	2,665,032	–	2,681,878
Shares issued for cashless Series B warrants exercised	–	–	86,472	86	(86)	–	–
Accretion of redeemable preferred stock discount	–	–	–	–	(705,170)	–	(705,170)
Accretion of redeemable preferred stock dividends	–	–	–	–	(200,807)	–	(200,807)
Reclassification from temporary equity to permanent equity	55	324,063	–	–	–	–	324,063

Net loss	–	–	–	–	–	(3,994,731)	(3,994,731)
Balance at December 31, 2013	55	$324,063	125,035,612	$125,035	$126,036,949	$(121,948,847)	$4,537,200

See accompanying notes to the consolidated financial statements.

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TELKONET, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

	2013	2012
Cash Flows from Operating Activities:		
Net (loss) income	$(3,994,731)	$390,080
Adjustments to reconcile net (loss) income from operations to cash provided by (used in) operating activities:		
Gain on sale of product line	(41,902)	(15,408)
Provision for lease loss	–	132,174
Stock-based compensation expense	89,565	201,643
Depreciation	16,837	19,150
Amortization	241,680	241,680
Provision for doubtful accounts	197,151	7,637
Deferred income taxes	335,275	–
Goodwill impairment	2,774,016	–
Changes in assets and liabilities:		
Accounts receivable	1,169,200	(1,727,733)
Inventories	(284,470)	(332,702)
Prepaid expenses	18,663	(32,214)
Accounts payable	(123,441)	718,644
Accrued liabilities and expenses	(344,890)	33,665
Deferred revenue	(6,265)	62,027
Customer deposits	(41,358)	97,399
Deferred lease liability	(2,689)	14,973
Net Cash Provided By (Used In) Operating Activities	2,641	(188,985)
Cash Flows From Investing Activities:		
Purchase of property and equipment	(25,577)	(43,095)
Deposits of restricted cash	(382,000)	91,000
Net Cash (Used In) Provided By Investing Activities	(407,577)	47,905
Cash Flows From Financing Activities:		
Payments on notes payable	(186,150)	(61,253)
Proceeds from exercise of warrants	–	405,000
Net Cash (Used In) Provided By Financing Activities	(186,150)	343,747
Net (decrease) increase in cash and cash equivalents	(591,086)	202,667
Cash and cash equivalents at the beginning of the year	1,163,758	961,091
Cash and cash equivalents at the end of the year	$572,672	$1,163,758

See accompanying notes to consolidated financial statements.

TELKONET, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

FOR THE YEARS ENDED DECEMBER 31, 2013 AND 2012

	2013	2012
Supplemental Disclosures of Cash Flow Information:		
Cash transactions:		
Cash paid during the year for interest	$29,064	$18,320
Cash paid during the year for income taxes	9,967	28,729
Non-cash transactions:		
Accretion of discount on redeemable preferred stock	705,170	625,574
Accretion of dividends on redeemable preferred stock	200,807	272,064
Conversion of preferred stock to common stock	2,681,878	–

See accompanying notes to consolidated financial statements.

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TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2013 AND 2012

NOTE A – SUMMARY OF ACCOUNTING POLICIES

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

Business and Basis of Presentation

Telkonet, Inc. (the "Company"), formed in 1999 and incorporated under the laws of the state of Utah, is made up of two synergistic business divisions, EcoSmart Energy Management Technology and EthoStream High Speed Internet Access (HSIA) Network. Prior to January 1, 2007, the Company was primarily engaged in the business of developing, producing and marketing proprietary equipment enabling the transmission of voice and data communications over a building's internal electrical wiring.

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

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

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

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

Going Concern

The accompanying consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America, which contemplate continuation of the Company as a going concern. The Company reported a net loss of $3,994,731 for the year ended December 31, 2013, and has an accumulated deficit of $121,948,847 and total current liabilities in excess of current assets of $570,401 as of December 31, 2013.

Our ability to continue as a going concern is subject to our ability to consistently generate a profit and positive operating cash flows and/or obtain necessary funding from outside sources, including by the sale of our securities or assets, or obtaining loans from financial institutions, where possible. We may also experience net operating losses in the future and the uncertainty regarding contingent liabilities cast doubt on our ability to satisfy such liabilities and the Company cannot make any representations for fiscal 2014 and beyond. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of these uncertainties.

Anticipated cash flows from operations may be insufficient to satisfy the Company’s ongoing capital requirements for at least the next 12 months. In May 2013, the Company entered into a Revolving Credit Facility, the principal not to exceed $2,000,000. This credit facility is available for working capital and other lawful business purposes. The Company’s borrowing base at December 31, 2013 was approximately $791,000 and the outstanding balance was zero. As of September 30 and December 31, 2013, the Company was in violation of a financial performance covenant. The outstanding balance at March 31, 2014 is $200,000. The Company is currently in negotiations with the Bank to modify the existing Agreement.

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

Concentrations of Credit Risk

Financial instruments and related items, which potentially subject the Company to concentrations of credit risk, consist primarily of cash, cash equivalents and trade receivables. The Company places its cash and temporary cash investments with credit quality institutions. At times, such investments may be in excess of the FDIC insurance limit.

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TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2013 AND 2012

Cash and Cash Equivalents

The Company considers all highly liquid debt instruments purchased with an original maturity date of three months or less to be cash equivalents.

Restricted Cash on Deposit

During 2012, the Company was awarded a contract with a bonding requirement. The Company satisfied this requirement during the year ended December 31, 2013, with cash collateral supported by an irrevocable standby letter of credit in the amount of $382,000 which expires September 30, 2014, however, the Company can be released prior to expiration if the Company has satisfied all obligations. The amount is presented as restricted cash on deposit on the consolidated balance sheets. During March 2014, the Company satisfied all obligations related to the bonding requirement and the cash was released.

Accounts Receivable

The Company records allowances for doubtful accounts based on customer-specific analysis and general matters such as current assessment of past due balances and economic conditions. The Company writes off accounts receivable when they become uncollectible. The allowance for doubtful accounts was $156,966 and $70,807 at December 31, 2013 and 2012. Management identifies a delinquent customer based upon the delinquent payment status of an outstanding invoice, generally greater than 30 days past due date. The delinquent account designation does not trigger an accounting transaction until such time the account is deemed uncollectible. The allowance for doubtful accounts is determined by examining the reserve history and any outstanding invoices that are over 30 days past due as of the end of the reporting period. Accounts are deemed uncollectible on a case-by-case basis, at management's discretion based upon an examination of the communication with the delinquent customer and payment history. Typically, accounts are only escalated to "uncollectible" status after multiple attempts at collection have proven unsuccessful.

Property and Equipment

In accordance with ASC 360 "*Property Plant and Equipment"*, property and equipment is stated at cost and is depreciated using the straight-line method over the estimated useful lives of the assets. The estimated useful lives range from 2 to 10 years.

Fair Value of Financial Instruments

Our financial instruments include cash and cash equivalents, restricted cash on deposit, accounts receivable, accounts payable, notes payable, and certain accrued liabilities. The carrying amounts of these assets and liabilities approximate fair value due to the short maturity of these instruments, except for the notes payable. The carrying amount of the notes payable approximates fair value due to the interest rate and terms approximating those available to us for similar obligations.

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

- Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2: Quoted prices in markets that are not active, or inputs which are observable, either directly or indirectly, for substantially the full term of the asset or liability; or
- Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and are unobservable.

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2013 AND 2012

Goodwill and Other Intangibles

In accordance with the accounting guidance on goodwill and other intangible assets, we perform an annual impairment test of goodwill and other intangible assets at our reporting unit level, or more frequently if events or circumstances change that would more likely than not reduce the fair value of our reporting units below their carrying value. Amortization is recorded for other intangible assets with determinable lives using the straight line method over the 12 year estimated useful life. Goodwill is subject to a periodic impairment assessment by applying a fair value test based upon a two-step method. The first step of the process compares the fair value of the reporting unit with the carrying value of the reporting unit, including any goodwill. We utilize a discounted cash flow valuation methodology to determine the fair value of the reporting unit. This approach is developed from management's forecasted cash flow data. If the fair value of the reporting unit exceeds the carrying amount of the reporting unit, goodwill is deemed not to be impaired. If the carrying amount exceeds fair value, we calculate an impairment loss. Any impairment loss is measured by comparing the implied fair value of goodwill to the carrying amount of goodwill at the reporting unit, with the excess of the carrying amount over the fair value recognized as an impairment loss.

Long-Lived Assets

We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable in accordance with ASC 360-10. Recoverability is measured by comparison of the carrying amount to the future net cash flows which the assets are expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds their fair value.

Inventories

Inventories consist of routers, switches and access points for Ethostream's internet access solution and thermostats, sensors and controllers for Telkonet's EcoSmart product suite. These inventories are purchased for resale and do not include manufacturing labor and overhead. Inventories are stated at the lower of cost or market determined by the first in, first out (FIFO) method. The Company's inventories are subject to technological obsolescence. Management evaluates the net realizable value of its inventories on a quarterly basis and records a provision for estimated losses based upon changes in demand and new product introductions.

Income (Loss) per Common Share

The Company computes earnings per share under ASC 260-10, “Earnings Per Share”. Basic net income (loss) per common share is computed by dividing net loss by the weighted average number of shares outstanding of common stock. Diluted income (loss) per share is computed using the weighted average number of common and common stock equivalent shares outstanding during the year. Dilutive common stock equivalents consist of shares issuable upon the exercise of the Company's outstanding stock options and warrants. For the years ended December 31, 2013 and 2012, there were 11,095,139 and 10,512,394 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) require management to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Estimates are used when accounting for items and matters such as revenue recognition and allowances for uncollectible accounts receivable, inventory obsolescence, depreciation and amortization, long-lived and intangible asset valuations, impairment assessments, taxes and related valuation allowance, income tax provisions, stock-based compensation, and contingencies. We believe 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.

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2013 AND 2012

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

Revenue Recognition

For revenue from product sales, we recognize revenue in accordance with ASC 605-10, "Revenue Recognition" and ASC 605-10-S99 guidelines that require that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectability is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the selling prices of the products delivered and the collectability of those amounts. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. The guidelines also address the accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

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

- VSOE – Based on its pricing and discounting practices for the specific product or service when sold separately, considering geographical, customer, and other economic or marketing variables, as well as renewal rates or stand-alone prices for the service element(s).

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

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

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

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

Sales Taxes

Unless provided with a resale or tax exemption certificate, the Company assesses and collects sales tax on sales transactions and records the amount as a liability. It is recognized as a liability until remitted to the applicable state. Total revenues do not include sales tax as we consider ourselves a pass through conduit for collecting and remitting sales taxes.

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 years ended December 31, 2013 and 2012, the Company experienced returns of approximately 1% to 4% of material’s included in the cost of sales. As of December 31, 2013 and 2012, the Company recorded warranty liabilities in the amount of $77,943 and $69,743, respectively, using this experience factor range.

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TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2013 AND 2012

Product warranties for the years ended December 31 is as follows:

	2013	2012
Beginning balance	$69,743	$104,423
Warranty claims incurred	(9,106)	(66,278)
Provision charged to expense	17,306	31,598
Ending balance	$77,943	$69,743

Advertising

The Company follows the policy of charging the costs of advertising to expenses as incurred. The Company incurred $21,499 and $6,778 in advertising costs during the years ended December 31, 2013 and 2012, respectively.

Research and Development

The Company accounts for research and development costs in accordance with the ASC 730-10, “Research and Development”. Under ASC 730-10, all research and development costs must be charged to expense as incurred. Accordingly, internal research and development costs are expensed as incurred. Third-party research and development costs are expensed when the contracted work has been performed or as milestone results have been achieved. Company-sponsored research and development costs related to both present and future products are expensed in the period incurred. Total expenditures on research and product development for 2013 and 2012 were $1,174,048 and $984,853, respectively.

Stock-Based Compensation

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

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. For 2013 and prior years, expected stock price volatility is based on the historical volatility of the Company's stock for the related vesting periods.

Stock-based compensation expense in connection with options granted to employees for the year ended December 31, 2013 and 2012 was $89,565 and $99,643, respectively.

Deferred Lease Liability

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

Lease Abandonment

On July 15, 2011, the Company executed a sublease agreement for approximately 12,000 square feet of commercial office space in Germantown, Maryland and ceased utilizing this space for the Company's benefit. Because we no longer have access to this subleased space, we have recorded a charge of $59,937 in accrued liabilities and expenses related to this abandonment during 2011. On June 27, 2012, the subtenant exercised the option to extend the expiration term of the sublease from January 31, 2013 to December 31, 2015 and we recorded an additional charge of $132,174. The remaining liability at December 31, 2013 and 2012 was $91,981 and $135,975, respectively.

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2013 AND 2012

Reclassifications

Certain amounts previously reported have been reclassified to conform to the current presentation.

NOTE B – NEW ACCOUNTING PRONOUNCEMENT

In July 2013, the Financial Accounting Standards Board ("FASB") issued ASU No. 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists (a consensus of the FASB Emerging Issues Task Force), which applies to the presentation of unrecognized tax benefits as a liability on the balance sheet when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose. This ASU is effective prospectively for fiscal years (and interim reporting periods within those years) beginning after December 15, 2013. The Company is currently reviewing the provisions of this ASU but does not expect it to have a material effect on the Company's financial condition, results of operations, and cash flows.

NOTE C – INTANGIBLE ASSETS AND GOODWILL

Total identifiable intangible assets acquired and their carrying values at December 31, 2013 are:

	Cost	Accumulated Amortization	Accumulated Impairment	Carrying Value	Weighted Average Amortization Period (Years)

Amortized Identifiable Intangible Assets:					
Subscriber lists – EthoStream	$2,900,000	$(1,641,383)	$–	$1,258,617	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(1,641,383)	–	1,258,617	
Goodwill – EthoStream	8,796,430	–	(3,000,000)	5,796,430	
Goodwill – SSI	5,874,016	–	(5,874,016)	-	
Total Goodwill	14,670,446	–	(8,874,016)	5,796,430	
Total	$17,570,446	$(1,641,383)	$(8,874,016)	$7,055,047	

Total identifiable intangible assets acquired and their carrying values at December 31, 2012 are:

	Cost	**Accumulated Amortization**	**Accumulated Impairment**	**Carrying Value**	**Weighted Average Amortization Period (Years)**
Amortized Identifiable Intangible Assets:					
Subscriber lists – EthoStream	$2,900,000	$(1,399,703)	$–	$1,500,297	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(1,399,703)	–	1,500,297	
Goodwill – EthoStream	8,796,430	–	(3,000,000)	5,796,430	
Goodwill – SSI	5,874,016	–	(3,100,000)	2,774,016	
Total Goodwill	14,670,446	–	(6,100,000)	8,570,446	
Total	$17,570,446	$(1,399,703)	$(6,100,000)	$10,070,743	

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2013 AND 2012

Total amortization expense charged to operations for the years ended December 31, 2013 and 2012 was $241,680 per year.

Estimated future amortization expense as of December 31, 2013 is as follows:

Years Ended December 31,	
2014	$241,680
2015	241,680
2016	241,680
2017	241,680
2018	241,680
2019	50,217
Total	$1,258,617

The Company does not amortize goodwill. The Company recorded goodwill in the amount of $14,670,446 as a result of the acquisitions of EthoStream and SSI during the year ended December 31, 2007. The Company evaluates goodwill for impairment based on the fair value of the reporting units to which this goodwill relates at least once a year. We utilize a discounted cash flow valuation methodology (income approach) to determine the fair value of the reporting unit. At December 31, 2011, the Company determined that a portion of the value for Smart Systems International's goodwill was impaired based upon management's assessment of operating results and forecasted discounted cash flow and wrote off $3,100,000 in connection with the impairment. At December 31, 2013, the Company determined that the remainder of Smart Systems International's goodwill was impaired based upon management's assessment of operating results and forecasted discounted cash flow and recorded an additional impairment charge of $2,774,016. Since acquisition, the Company has written off $3,000,000 and $5,874,016 of goodwill for Ethostream and Smart Systems International, respectively.

Significant assumptions used in our goodwill impairment test at December 31, 2013 and 2012 included: expected revenue growth rates, reporting unit profit margins, working capital levels, discount rates of 12.4% and 12.9% for Ethostream and 21.8% and 17.5% for SSI, respectively, and a terminal value multiple. The expected future revenue growth rates and the expected reporting unit profit margins were determined after considering our historical revenue growth rates and operating unit profit margins, our assessment of future market potential, and our expectations of future business performance.

The carrying value of our goodwill could change if the Company is unable to achieve operating results at the levels that have been forecasted, or if there is a permanent, negative change in the market demand for the services offered by the Company. These changes could result in an impairment of the existing goodwill balance that could require an additional material non-cash charge to our results of operations.

NOTE D – ACCOUNTS RECEIVABLE

Components of accounts receivable as of December 31, 2013 and 2012 are as follows:

	2013	2012
Accounts receivable	$1,816,722	$3,096,914
Allowance for doubtful accounts	(156,966)	(70,807)
Accounts receivable, net	$1,659,756	$3,026,107

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TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2013 AND 2012

NOTE E – INVENTORIES

Components of inventories as of December 31, 2013 and 2012 are as follows:

	2013	2012
Product purchased for resale	$997,332	$768,812
Reserve for obsolescence	(57,950)	(113,900)
Inventory, net	$939,382	$654,912

NOTE F – PROPERTY AND EQUIPMENT

The Company’s property and equipment as of December 31, 2013 and 2012 consists of the following:

	2013	2012
Telecommunications and related equipment	$–	$117,637
Development test equipment	45,752	113,787
Computer software	55,677	189,033
Leasehold improvements	2,675	2,675
Office equipment	20,706	351,302
Office fixtures and furniture	36,515	237,811
Total	161,325	1,012,245
Accumulated depreciation	(116,687)	(976,347)
Total property and equipment	$44,638	$35,898

Depreciation expense included as a charge to income was $16,837 and $19,150 for the years ended December 31, 2013 and 2012, respectively.

NOTE G – ACCRUED LIABILITIES AND EXPENSES

Accrued liabilities and expenses as of December 31, 2013 and 2012 are as follows:

	2013	2012
Accrued liabilities and expenses	$405,073	$717,731
Accrued payroll and payroll taxes	430,871	345,384
Accrued sales taxes, penalties, and interest	1,080,482	1,188,136
Accrued interest	2,788	21,053
Product warranties	77,943	69,743
Total accrued liabilities and expenses	$1,997,157	$2,342,047

NOTE H – LONG-TERM DEBT

Business Loan

On September 11, 2009, the Company entered into a Loan Agreement in the aggregate principal amount of $300,000 with the Wisconsin Department of Commerce (the “Department”). The outstanding principal balance bears interest at the annual rate of 2%. Payment of interest and principal is to be made in the following manner: (a) payment of any and all interest that accrues from the date of disbursement commenced on January 1, 2010 and continued on the first day of each consecutive month thereafter through and including December 31, 2010; (b) commencing on January 1, 2011 and continuing on the first day of each consecutive month thereafter through and including November 1, 2016, the Company is required to pay equal monthly installments of $4,426; followed by a final installment on December 1, 2016 which shall include all remaining principal, accrued interest and other amounts owed by the Company to the Department under the Loan Agreement. The Company may prepay amounts outstanding under the credit facility in whole or in part at any time without penalty. The Loan Agreement is secured by substantially all of the Company’s assets and the proceeds from this loan were used for the working capital requirements of the Company. The Loan Agreement contains covenants which required, among other things, that the Company keep and maintain 75 existing full-time positions and create and fill 35 additional full-time positions in Milwaukee, Wisconsin by December 31, 2012. On June 18, 2012, the Department agreed to permanently waive all penalties associated with the Company’s noncompliance with this covenant. The outstanding borrowings under the agreement as of December 31, 2013 and 2012 were $154,463 and $203,947, respectively.

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Promissory Note

On March 4, 2011, the Company sold all its Series 5 PLC product line assets to Wisconsin-based Dynamic Ratings, Inc. (“Purchaser”) under an Asset Purchase Agreement (“APA”). Per the APA, the Company signed an unsecured Promissory Note (the “Note”) due to Purchaser in the aggregate principal amount of $700,000. The outstanding principal balance bears interest at the annual rate of 6% and was originally due on March 31, 2014. The Note may be prepaid in whole or in part, without penalty at any time. The Note contains certain earn-out provisions that encompass both the Company’s and Purchaser’s revenue volumes. Amounts earned under the earn-out provisions were applied against the Note on June 30, 2012 and June 30, 2013. For the quarters ended June 30, 2013 and June 30, 2012, the non-cash reduction of principal calculated under these provisions and applied to the Note was $41,902 and $15,408, respectively. Payments not made when due, by maturity acceleration or otherwise, shall bear interest at the rate of 12% per annum from the date due until fully paid. Effective April 30, 2013, Purchaser approved an amendment to certain terms of the Note. Telkonet commenced a monthly payment of principal and interest of $20,000 to be applied against the outstanding balance starting May 1, 2013. The interest rate remains unchanged at 6% and the maturity date was extended to January 1, 2016. The outstanding principal balance of the Note as of December 31, 2013 and 2012 was $506,024 and $684,592, respectively.

Revolving Credit Facility

On May 31, 2013, the Company entered into a Revolving Credit Facility (the “Agreement”) with Bridge Bank, NA, (the “Bank”) in a principal amount not to exceed $2,000,000. The Agreement is subject to a borrowing base that is equal to the sum of 80% of the Company’s eligible accounts receivable and 25% of the eligible inventory. On August 1, 2013 the Agreement was modified to include the eligible receivables and the eligible inventory of Ethostream. The Agreement is available for working capital and other lawful general corporate purposes. The outstanding principal balance of the facility bears interest at Prime Rate plus 2.75%. The Company’s borrowing base at December 31, 2013 was approximately $791,000 and the outstanding balance was zero. As of September 30 and December 31, 2013, the Company was in violation of a financial performance covenant. The outstanding balance at March 31, 2014 is $200,000. The Company is currently in negotiations with the Bank to modify the existing Agreement.

Aggregate annual future maturities of long-term debt as of December 31, 2013 are as follows:

Years ending December 31,	Amount
2014	$ 265,985
2015	280,295
2016	114,207
	660,487
Less: Current portion	(265,985)
Notes payable long-term	$ 394,502

NOTE I – REDEEMABLE PREFERRED STOCK

Series A

The Company has designated 215 shares of preferred stock as Series A Preferred Stock ("Series A"). Each share of Series A is convertible, at the option of the holder thereof, at any time, into shares of our Common Stock at an initial conversion price of $0.363 per share. In the event of a change of control (as defined in the purchase agreement with respect to the Series A), or at the holder's option, on November 19, 2014 and for a period of 180 days thereafter, provided that at least 50% of the shares of Series A issued on the Series A Original Issue Date remain outstanding as of November 19, 2014, and the holders of at least a majority of the then outstanding shares of Series A provide written notice requesting redemption of all shares of Series A, we are required to redeem the Series A for the purchase price of $5,000 per share, plus any accrued but unpaid dividends. The aggregate redemption price payable to holders of shares of Series A will be payable by the Company in three equal annual installments. The first of these three installments will be due within 60 days of the requisite holders' written notice requesting redemption. The Series A accrues dividends at an annual rate of 8% of the original purchase price, payable only when, as, and if declared by the Board of Directors of Telkonet.

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

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

The charge to additional paid in capital for amortization of Series A discount and costs for the years ended December 31, 2013 and 2012 was $70,032 and $74,614, respectively.

For the years ended December 31, 2013 and 2012, we have accrued dividends for Series A in the amount of $74,027 and $74,228, respectively, and as of December 31, 2013 and 2012 there are cumulative accrued dividends of $304,832 and $251,076, respectively. The accrued dividends have been charged to additional paid-in capital (since there is a deficit in retained earnings) and an increase to the net loss attributable to common stockholders and the net unpaid accrued dividends been added to the carrying value of the preferred stock.

Series B

The Company has designated 538 shares of preferred stock as Series B Preferred Stock ("Series B"). Each share of Series B is convertible, at the option of the holder thereof, at any time, into shares of our Common Stock at an initial conversion price of $0.13 per share. As a result of the Series B conversions during the year ended December 31, 2013, the outstanding Series B shares will not become redeemable at the option of the holders. The Series B accrues dividends at an annual rate of 8% of the original purchase price, payable only when, as, and if declared by our Board of Directors.

On August 4, 2010, the Company sold 267 shares of Series B with attached warrants to purchase an aggregate of 5,134,626 shares of the Company's common stock at $0.13 per share. The Series B shares were sold at a price per share of $5,000 and each Series B share is convertible into approximately 38,461 shares of common stock at a conversion price of $0.13 per share. The Company received $1,335,000 from the sale of the Series B shares. Up and until the quarter ended September 30, 2013, the Series B were redeemable at the option of the holder, the carrying value of the preferred stock, net of discount and including accumulated dividends, has been classified as redeemable preferred stock on the consolidated balance sheets. During the year ended December 31, 2013, shareholders converted 167 redeemable preferred shares issued on August 4, 2010, to, in aggregate, 6,423,072 shares of common stock.

A portion of the proceeds was allocated to the warrants based on their relative fair value, which totaled $394,350 using the Black-Scholes option pricing model. Further, the Company attributed a beneficial conversion feature of $394,350 to the Series B preferred shares based upon the difference between the effective conversion price of those shares and the closing price of the Company's common stock on the date of issuance. The assumptions used in the Black-Scholes model were as follows: (1) dividend yield of 0%; (2) expected volatility of 123%, (3) weighted average risk-free interest rate of 1.76%, (4) expected term of approximately 4 years, and (5) estimated fair value of Telkonet common stock of $0.109 per share. The expected term of the warrants represents the estimated period of time until exercise and is based on historical experience of similar awards and giving consideration to the contractual terms. The amounts attributable to the warrants and beneficial conversion feature, aggregating $788,700, were recorded as a discount and deducted from the face value of the preferred stock. The discount is being amortized over the period from issuance to November 19, 2014 (the initial redemption date) as a charge to additional paid-in capital (since there is a deficit in retained earnings). During the year ended December 31, 2013, the remaining portion of the discount of approximately $123,100 was accelerated and recognized immediately as a charge to additional paid-in capital and accretion of preferred stock discounts and an increase to the net loss attributable to common stockholders for the 167 redeemable preferred shares converted to common stock.

On April 8, 2011, the Company sold 271 additional shares of Series B with attached warrants to purchase an aggregate of 5,211,542 shares of the Company's common stock at $0.13 per share. The Series B shares were sold at a price per share of $5,000 and each Series B share is convertible into approximately 38,461 shares of common stock at a conversion price of $0.13 per share. The Company received $1,355,000 from the sale of the Series B shares. During the year ended December 31, 2013, all 271 of the redeemable preferred shares issued on April 8, 2011, were converted to, in aggregate, 10,423,067 shares of common stock.

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As a result of the Series B conversions during the year ended December 31, 2013, fewer than 50% of the Series B shares issued on the Series B Original Issuance Date remain outstanding, and the balance of the outstanding Series B shares will not become redeemable at the option of the holders. The redemption feature at the option of the holders is eliminated, thereby, resulting in the reclassification of $324,063 from temporary equity, which was classified as “redeemable preferred stock” in the Company’s consolidated balance sheets, to permanent equity.

A portion of the proceeds were allocated to the warrants based on their relative fair value, which totaled $427,895 using the Black-Scholes option pricing model. Further, the Company attributed a beneficial conversion feature of $427,895 to the Series B shares based upon the difference between the effective conversion price of those shares and the closing price of the Company’s common stock on the date of issuance. The assumptions used in the Black-Scholes model are as follows: (1) dividend yield of 0%; (2) expected volatility of 129%, (3) weighted average risk-free interest rate of 0.26%, (4) expected life of approximately 3.5 years, and (5) estimated fair value of Telkonet common stock of $0.12 per share. The expected term of the warrants represents the estimated period of time until exercise and is based on historical experience of similar awards and giving consideration to the contractual terms. The amounts attributable to the warrants and beneficial conversion feature, aggregating $855,790, have been recorded as a discount and deducted from the face value of the Series B shares. The discount is being amortized over the period from issuance to November 19, 2014 (the initial redemption date) as a charge to additional paid-in capital (since there is a deficit in retained earnings). During the year ended December 31, 2013, the remaining discount of approximately $261,300 was accelerated and recognized immediately as a charge to additional paid-in capital and accretion of preferred stock discounts upon the 271 redeemable preferred stock conversions to common stock.

The charge to additional paid in capital for amortization of Series B discount and costs for the years ended December 31, 2013 and 2012 was $635,138 and $550,960, respectively.

For the years ended December 31, 2013 and 2012, we have accrued dividends for Series B in the amount of $126,780 and $197,836, respectively, and cumulative accrued dividends of $75,005 and $419,833 as of December 31 2013 and 2012, respectively. The accrued dividends have been charged to additional paid-in capital (since there is a deficit in retained earnings) and the net unpaid accrued dividends been added to the carrying value of the preferred stock. During the year ended December 31, 2013, accrued dividends in the amount of $491,878 were written down and credited back to additional paid-in capital upon the redeemable preferred share conversions to common 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. Liquidation preference of the preferred stock is based on the following order: first, Series B with a preference value of $350,005 and second, Series A with a preference value of $1,229,832. Both series of preferred stock are equal in their dividend preference over common stock.

NOTE J – CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock (designated and undesignated), with a par value of $.001 per share. The Company has designated 215 shares as Series A preferred stock and 538 shares as Series B preferred stock. At December 31, 2013 and 2012, there were 185 shares of Series A outstanding. At December 31, 2013 and December 31, 2012, there were 55 and 493 shares of Series B outstanding, respectively.

The Company has authorized 190,000,000 shares of common stock with a par value of $.001 per share. As of December 31, 2013 and 2012 the Company has 125,035,612 and 108,103,001 common shares issued and outstanding, respectively.

During the year ended December 31, 2013, 438 shares of Series B redeemable preferred stock were converted to, in aggregate, 16,846,139 shares of common stock.

During the year ended December 31, 2013, 86,472 warrants were exercised to an equal number of common shares. These warrants were originally granted to the Company's placement agent in lieu of cash compensation for services performed or financing expenses in connection with the placement of the April 2011 Series B convertible preferred stock issuance.

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During the year ended December 31, 2012, the Company issued 638,104 shares of common stock to directors and management for services performed through December 31, 2012. These shares were valued at $102,000, which approximated the fair value of the shares when they were issued.

During the year ended December 31, 2012, 3,115,390 of Series B preferred stock warrants were exercised to an equal number of common shares at an exercise price of $0.13 per share. Proceeds received from these exercised warrants were $405,000.

NOTE K – STOCK OPTIONS AND WARRANTS

Employee Stock Options

The Company maintains an equity incentive plan 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 Company considers employee stock options a component of the compensation package necessary to attract, retain and motivate key employees. The value of these options is dependent upon an increase in the Company's stock price relative to the exercise price, which is determined on the date of grant.

The following table summarizes the changes in options outstanding and the related exercise prices for the stock options issued to employees of the Company under the Plan.

Options Outstanding	Options Exercisable
Number	Number

Exercise Prices	Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Exercisable	Weighted Average Exercise Price
$0.01 - $0.15	175,000	3.82	$ 0.14	175,000	$ 0.14
$0.16 - $0.99	1,420,225	8.73	0.18	1,195,225	0.18
$1.00 - $5.99	140,000	2.45	3.29	140,000	3.29
	1,735,225	7.73	$ 0.43	1,510,225	$ 0.47

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

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2012	685,000	$ 1.45
Granted	915,642	0.19
Exercised	–	–
Cancelled or expired	(320,000)	1.16
Outstanding at December 31, 2012	1,280,642	$ 0.62
Granted	504,583	0.18
Exercised	–	–
Cancelled or expired	(50,000)	2.69
Outstanding at December 31, 2013	1,735,225	$ 0.43

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

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The following table summarizes the assumptions used to estimate the fair value of options granted during the years ended December 2013 and 2012, using the Black-Scholes option-pricing model:

	2013	2012
Expected life of option (years)	10	10
Risk-free interest rate	1.72%	1.64-2.22%
Assumed volatility	124%	95-105%
Expected dividend rate	0	0
Expected forfeiture rate	6%	17%

The total estimated fair value of the options granted during the years ended December 31, 2013 and 2012 was $86,672 and $152,667. The total fair value of underlying shares related to options that vested during the years ended December 31, 2013 and 2012 was $124,208 and $85,041. Future compensation expense related to non-vested options at December 31, 2013 was $30,352 and will be recognized over the next 3.75 years. The aggregate intrinsic value of the vested options was zero as of December 31, 2013 and 2012. Total stock-based compensation expense recognized in the consolidated statements of operations for the years ended December 31, 2013 and 2012 was $89,565 and $99,643, respectively.

Non-Employee Stock Options

There were no non-employees stock options issued or outstanding at December 31, 2013 or 2012.

Warrants

The following table summarizes the changes in warrants outstanding and the related exercise prices for the warrants 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
$ 0.13	7,230,778	2.11	$ 0.13	7,230,778	$ 0.13
0.33	1,628,800	0.88	0.33	1,628,800	0.33
3.00	500,336	1.61	3.00	500,336	3.00
	9,359,914	1.87	$ 0.32	9,359,914	$ 0.32

Transactions involving warrants are summarized as follows:

	Number of Shares	Weighted Average Exercise Price
Outstanding at January 1, 2012	14,921,920	$ 0.50
Issued	–	–
Exercised	(3,115,390)	0.13
Canceled or expired	(976,114)	2.20
Outstanding at December 31, 2012	10,830,416	$ 0.45
Issued	–	–
Exercised	(86,472)	0.13
Canceled or expired	(1,384,030)	1.36
Outstanding at December 31, 2013	9,359,914	$ 0.32

The Company did not issue any warrants during the years ended December 31, 2013 and 2012. During the year ended December 31, 2013, 86,472 warrants were exercised. These warrants were originally granted to the Company's placement agent in lieu of cash compensation for services performed or financing expenses in connection with the placement of convertible preferred stock.

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NOTE L – RELATED PARTY TRANSACTIONS

In connection with a customer contract that required bonding, William H. Davis, the Company's Board Chairman and Jason L. Tienor, the Company's Chief Executive Officer and President, each signed a General Indemnity Agreement dated July 5, 2013 and July 8, 2013, pledging personal property on behalf of the Company. The General Indemnity Agreement indemnifies the surety company for certain losses incurred by the surety company for the benefit of the Company. As consideration for the assumption of the Indemnification Obligations by Messrs. Davis and Tienor, the Company agreed to compensate each in the amount of $20,000, grossed up to accommodate their 2013 federal income tax liability associated with the payments. The amounts owed to Messrs. Davis and Tienor as of December 31, 2013 were $10,000 and $17,000, respectively.

From time to time the Company may receive advances from certain of its officers in the form of salary deferment, cash advances to meet short term working capital needs. These advances may not have formal repayment terms or arrangements. During the years ended December 31, 2013 and 2012, there were no such arrangements.

NOTE M – INCOME TAXES

The Company follows ASC 740-10 "Income Taxes" which requires the recognition of deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statement or tax returns. Under this method, deferred tax liabilities and assets are determined based on the difference between financial statements and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse.

A reconciliation of tax expense computed at the statutory federal tax rate on income (loss) from operations before income taxes to the actual income tax (benefit) / expense is as follows:

	2013	2012
Tax provision (benefit) computed at the statutory rate	$(1,239,269)	$121,995

State taxes	5,849	9,330
Book expenses not deductible for tax purposes	19,572	12,968
Other	526	990
	(1,213,321)	145,283
Change in valuation allowance for deferred tax assets	1,563,145	(176,554)
Income tax (benefit) provision	$349,823	$(31,271)

During 2013, approximately $2,400,000 of state net operating loss carryforwards expired and the Company lowered its effective state tax rate. The aggregate effect of these items resulted in a reduction to the allowance of approximately $200,000.

Deferred income taxes include the net tax effects of net operating loss (NOL) carry forwards and the temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets are as follows:

	2013	2012
Deferred Tax Assets:		
Net operating loss carryforwards	$31,686,463	$33,384,938
Intangibles	1,277,631	259,953
Credits	–	–
Other	872,796	1,207,240
Total deferred tax assets	33,836,890	34,852,131
Deferred Tax Liabilities:		
Intangibles	(335,275)	–
Other	–	–
Total deferred tax liabilities	(335,275)	–
Valuation allowance	(33,836,890)	(34,852,131)
Net deferred tax liabilities	$(335,275)	$–

A valuation allowance is recorded when it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of the deferred tax assets depends on the ability of the Company to generate sufficient taxable income of the appropriate character in the future and in the appropriate taxing jurisdictions. As of December 31, 2013 and December 31, 2012, the Company’s valuation allowance, established for the tax benefit that may not be realized, totaled approximately $33,800,000 and $34,900,000, respectively. The decrease in the valuation allowance is related to state net operating losses that expired as of December 31, 2013.

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At December 31, 2013 the Company had net operating loss carryforwards of approximately $88,600,000 and $53,800,000 for federal and state income tax purposes which will expire at various dates from 2014 – 2033.

The Company's NOL and tax credit carryovers may be significantly limited under Section 382 of the Internal Revenue Code (IRC). NOL and tax credit carryovers are limited under Section 382 when there is a significant "ownership change" as defined in the IRC. During 2005 and in prior years, the Company may have experienced such ownership changes that could have imposed such limitations.

The limitation imposed by Section 382 would place an annual limitation on the amount of NOL and tax credit carryovers that can be utilized. When the Company completes the necessary studies, the amount of NOL carryovers available may be reduced significantly. However, since the valuation allowance fully reserves for all available carryovers, the effect of the reduction would be offset by a reduction in the valuation allowance.

The Company files income tax returns in the U.S. federal jurisdiction and various state jurisdictions. The Company is generally no longer subject to U.S. federal income tax examinations by tax authorities for years before 2007 and various states before 2007. Although these years are no longer subject to examination by the Internal Revenue Service (IRS) and various state taxing authorities, net operating loss carryforwards generated in those years may still be adjusted upon examination by the IRS or state taxing authorities if they have been or will be used in a future period.

The Company follows the provisions of uncertain tax positions as addressed in FASB Accounting Standards Codification 740-10-65-1. The Company recognized no liability for unrecognized tax benefits. The Company has no tax positions at December 31, 2013 and 2012 for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. The Company recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expense. No such interest or penalties were recognized during the periods presented. The Company had no accruals for interest and penalties at December 31, 2013. The Company's utilization of any net operating loss carryforwards may be unlikely due to its continuing losses.

NOTE N – COMMITMENTS AND CONTINGENCIES

Office Leases Obligations

In October 2013, the Company entered into a lease agreement for 6,362 square feet of commercial office space in Waukesha, Wisconsin for its corporate headquarters. The Waukesha lease expires in April 2021.

The Company presently leases approximately 14,000 square feet of office space in Milwaukee, Wisconsin for its operations facility. The Milwaukee lease expires in March 2020.

The Company presently leases 16,416 square feet of commercial office space in Germantown, Maryland. The lease commitments expire in December 2015. On July 15, 2011, Telkonet executed a sublease agreement for 11,626 square feet of the office space in Germantown, Maryland. The subtenant received one month rent abatement and had the option to extend the sublease from January 31, 2013 to December 31, 2015. On June 27, 2012 the subtenant exercised the option to extend the expiration of the term of the sublease from January 31, 2013 to December 31, 2015.

Commitments for minimum rentals under non-cancelable leases as of December 31, 2013 are as follows:

Years ending December 31,	
2014	$459,994
2015	494,806
2016	245,274
2017	251,740
2018	258,381
2019 and thereafter	422,182
Total	$2,132,377

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Expected rent payments to be received under sublease agreement as of December 31, 2013 are as follows:

Years ending December 31,	
2014	$134,872
2015	138,919
Total	$273,791

Rental expense charged to operations for the years ended December 31, 2013 and 2012 was $532,598 and $537,107, respectively. Rental income received for the years ended December 31, 2013 and 2012 was $131,111 and $127,126, respectively.

Employment and Consulting Agreements

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

Jason L. Tienor, President and Chief Executive Officer, is employed pursuant to an employment agreement with us dated May 1, 2013. Mr. Tienor's employment agreement has a term of two (2) years, which may be extended by mutual agreement of the parties thereto, and provides, among other things, for an annual base salary of $206,000 per year and bonuses and benefits based on our internal policies and participation in our incentive and benefit plans.

Jeffrey J. Sobieski, Chief Technology Officer, is employed pursuant to an employment agreement with us dated May 1, 2013. Mr. Sobieski's employment agreement has a term of two (2) years, which may be extended by mutual agreement of the parties thereto, and provides for a base salary of $195,700 per year and bonuses and benefits based upon our internal policies and participation in our incentive and benefit plans.

Gerrit J. Reinders, Executive Vice President-Global Sales and Marketing, is employed pursuant to an employment agreement, dated May 1, 2013. Mr. Reinder's employment agreement is for a term expiring on May 1, 2014, is renewable at the agreement of the parties and provides for a base salary of at least $154,500 per year.

In addition to the foregoing, stock options are periodically granted to employees under the Company's 2010 equity incentive plan at the discretion of the Compensation Committee of the Board of Directors. Executives of the Company are eligible to receive stock option grants, based upon individual performance and the performance of the Company as a whole.

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.

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

On July 1, 2008, Linksmart Wireless Technology, LLC, or Linksmart, filed a civil lawsuit in the Eastern District of Texas against EthoStream, LLC, our wholly-owned subsidiary and 22 other defendants (*Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc., et al*, U.S. District Court, for the Eastern District of Texas, Marshall Division, No. 2:08-cv-00264). This lawsuit alleged that the defendants' services infringed a wireless network security patent held by Linksmart.

Defendant Ramada Worldwide, Inc. provided us with notice of the suit and demanded that we defend and indemnify it pursuant to a vendor direct supplier agreement between EthoStream and WWC Supplier Services, Inc., a Ramada affiliate. After a review of that agreement, it was determined that EthoStream owed the duty to defend and indemnify with respect to services provided by Telkonet to Ramada and it assumed Ramada's defense.

The parties in the lawsuit agreed to and the Court ordered a stay of the litigation pending the conclusion of a reexamination proceeding in the U.S. Patent and Trademark Office relating to the patent involved in the lawsuit. The case was reopened in early 2012 based on the expectation that a reexamination certificate would be issued by the Patent Office. The reexamination certificate has been issued. After the case resumed, the parties agreed to a "transfer" of the case from the Eastern District of Texas to the Central District of California. To accomplish the "transfer," with the agreement of the parties, the Texas case was dismissed and a new action was filed in California on April 5, 2012. (*Linksmart Wireless Technology, LLC v. T-Mobile USA, Inc., et al*, U.S. District Court, for the Central District of California, Southern Division, No. SACV 12-522-JST).

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TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2013 AND 2012

On October 1, 2013, the Company entered into a settlement agreement with Linksmart. The Company has agreed to pay $115,000, payable in twelve installments of $9,583 due on the first of each month beginning October 1, 2013. The balance remaining at December 31, 2013 was $86,250 and is in accounts payable on the accompanying consolidated balance sheet.

Indemnification Agreements

On March 31, 2010, the Company entered into Indemnification Agreements with director William H. Davis, and executives Jason L. Tienor, President and Chief Executive Officer and Jeffrey J. Sobieski, then Chief Operating Officer. On November 3, 2010, the Company entered into an Indemnification Agreement with Richard E. Mushrush, then Acting Chief Financial Officer.

The Indemnification Agreements provide that the Company will indemnify the Company's officers and directors, to the fullest extent permitted by law, relating to, resulting from or arising out of any threatened, pending or completed action, suit or proceeding, or any inquiry or investigation by reason of the fact that such officer or director (i) is or was a director, officer, employee or agent of the Company or (ii) is or was serving at the request of the Company as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise if he acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the Company, and, with respect to any criminal action or proceeding, had no reasonable cause to believe his or her conduct was unlawful. In addition, the Indemnification Agreements provide that the Company will make an advance payment of expenses to any officer or director who has entered into an Indemnification Agreement, in order to cover a claim relating to any fact or occurrence arising from or relating to events or occurrences specified in this paragraph, subject to receipt of an undertaking by or on behalf of such officer or director to repay such amount if it shall ultimately be determined that he is not entitled to be indemnified by the Company as authorized under the Indemnification Agreement.

Sales Taxes

During 2012, the Company engaged a sales tax consultant to assist in determining the extent of its potential sales tax exposure. Based upon this analysis, management determined the Company had probable exposure for certain unpaid obligations, including interest and penalty, of approximately $1,100,000 including and prior to the year ended December 31, 2011. The Company has approximately $1,100,000 and $1,200,000 accrued for this exposure as of December 31, 2013 and 2012, respectively.

The Company continues to manage the liability by establishing voluntary disclosure agreements (VDAs) with the applicable states, which establishes a maximum look-back period and payment arrangements. However, if the aforementioned methods prove unsuccessful and the Company is examined or challenged by taxing authorities, there exists possible exposure of an additional $450,000, not including any applicable interest and penalties.

During 2012, the Company successfully executed and paid in full VDAs in five states totaling approximately $23,000 and is current with the subsequent filing requirements.

During 2013, the Company successfully executed and paid in full VDAs in fourteen states totaling approximately $263,000 and is current with the subsequent filing requirements. It has submitted VDAs with an additional fifteen states and awaits notification of acceptance. Two states offer no voluntarily disclosure program.

The following table sets forth the change in the sales tax accrual during the years ended December 31:

	2013	2012
Balance, Beginning of year	$1,188,133	$1,068,314
Sales tax collected	409,782	277,374
Provisions	(138,352)	(119,255)
Interest and penalties	7,342	32,696
Payments	(386,423)	(70,996)
Balance, End of year	$1,080,482	$1,188,133

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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NOTE O – BUSINESS CONCENTRATION

For the years ended December 31, 2013 and 2012, no single customer represented 10% or more of our total net revenues.

Purchases from two suppliers approximated $2,700,000, or 68%, of total purchases for the year ended December 31, 2013 and approximated $2,600,000, or 73%, of total purchases for the year ended December 31, 2012. Total due to these suppliers, net of deposits, was $525,464 and $384,099 as of December 31, 2013 and 2012, respectively.

NOTE P – SUBSEQUENT EVENT

In 2014, the Company purchased approximately $120,000 of furniture and fixtures to furnish its new corporate office located in Waukesha, Wisconsin. These assets will be depreciated over their respective estimated useful lives.