TELKONET INC
Form 10-K
March 31, 2015

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, 2014

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 $0.19 per share on the Over the Counter Bulletin Board) of the registrant as of June 30, 2014: $22,926,069.

Number of outstanding shares of the registrant's par value $0.001 common stock as of March 22, 2015: 125,035,612.

Parts I and II incorporate information by reference from the Annual Report to Shareholders for the fiscal year ended December 31, 2014. Part III is incorporated by reference from the Proxy Statement for the Annual Meeting of Shareholders to be held on June 11, 2015.

TELKONET, INC.

FORM 10-K

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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 the creator of the EcoSmart Platform of in-room automation solutions integrated to optimize energy efficiency, comfort and analytics to support the emerging Internet of Things ("IoT"). Telkonet's business is based on two synergistic divisions, its EcoSmart division offering intelligent automation solutions and EthoStream division providing the underlying networking technology.

ECOSMART

Our EcoSmart Platform is comprised of four main components.

- **EcoSmart Suite:** is the suite of hardware products designed and developed to provide management reporting, analytics and control over individual and grouped energy consumption.

- **EcoCentral Virtual Engineer:** is the cloud-based management platform that provides Telkonet's remote monitoring, management reporting and analytics over the deployed EcoSmart products.

- **EcoCare:** is Telkonet's full offering of professional services including 24/7 monitoring, engineering analytics and reporting, project and relationship management and onsite support.

- **EcoMobile:** are the native iOS and Android applications that Telkonet provides to its partners, customers and end users to provision, manage and access EcoSmart deployments and functionality.

The EcoSmart Platform provides comprehensive savings, management reporting, analytics and virtual engineering of a customer's portfolio and/or property's room-by-room energy consumption. Telkonet has deployed more than a half million intelligent devices worldwide in properties within the hospitality, military, educational, healthcare and other commercial markets. The EcoSmart Platform is rapidly being recognized as a leading solution for reducing energy consumption, operational costs and carbon footprints, and eliminating the need for new energy generation in these marketplaces – all 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.[1] On average, America's approximately 53,000 hotels spend $2,196 per available room each year on energy.[2] 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 $0.60 in limited-service hotels and by $2.00 in full-service hotels.

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[1] Facility Type: Hotels & Motels - http://www.energystar.gov/ia/business/EPA_BUM_CH12_HotelsMotels.pdf

[2] AH&LA 2013 At-a-Glance Statistical Figures - http://www.ahla.com/content.aspx?id=36332

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Energy is very often wasted through the lighting, powering, heating and cooling of unoccupied spaces. These spaces with intermittent occupancy constitute Telkonet's target markets, and our experience, supported by independent research and customer data, suggests these rooms are unoccupied as much as 70% of the time.

EcoSmart Suite

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 to create an intelligent automated environment. All products can be wirelessly networked to enhance energy efficiency, provide remote monitoring capability and develop increased analytical savings based on the in-room performance. 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 and controllable wired thermostat with over 125 configurable settings used to control the efficiency of HVAC.

- **EcoConnect:** serves as Zigbee to Ethernet coordinator of the devices connected to the energy management network, managing approximately 30 - 70 device connections each.

- **EcoCommander:** EcoSmart's network-edge gateway server that provides real-time proactive data aggregation, analytics, reporting and management of the EcoSmart product suite.

- **EcoSense:** 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. EcoSense may be hardwired or programmed to communicate wirelessly and may be battery operated or utilize external power.

- **EcoWave:** a 2-component package that includes a revolutionary remote interface wireless thermostat (EcoAir) and powerful mechanical control solution (EcoSource) 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 and can be battery operated or utilize external power.

- **EcoSwitch:** an EcoSmart energy management product with the appearance of a traditional 'rocker' 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 control 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 and other consumption measures when doors or windows are open.

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EcoCentral Virtual Engineer

Telkonet's EcoSmart Platform functions as a comprehensive solution for intelligent automation and energy management. The platform has a well-developed upgrade path with the final and complete version of the platform offering real-time control and analytics provided through a cloud computing platform called EcoCentral Virtual Engineer. EcoCentral earns its name through its ability to direct user resources where they add the most value. From monitoring equipment operation to determine where engineering efforts are needed to notifying staff when performance is degrading, EcoCentral creates a comprehensive tool for providing insight and access into EcoSmart Platform deployments either individually or across an entire portfolio.

EcoCare

EcoCare is Telkonet's complete offering of professional services including call support, repair and replacement services, periodic reporting, communication with customers' utility and ISP partners and more. Telkonet provides three static packages of EcoCare services as well as allows customers to create their own package of services ala carte. EcoCare allows EcoSmart customers to ensure that they continue to recognize the savings estimated and benefit from the intended return on investment (ROI). Standard EcoCare contracts range from three to five years and have automatic renewal terms built into the individual contract.

EcoMobile

Telkonet's EcoMobile tools provide native iOS and Android applications for use by partners, customers and guests. These mobile tools extend the value of the EcoSmart Platform and give greater functionality and more efficient commissioning and deployment abilities to the user. We have identified where, by providing more accessibility, we can create additional charged-for services that increase customer savings, improve guest experience and integrate more fully with customer environments to create a tight relationship with our customers.

Target Markets

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.

- **Public Housing**: apartments, campus living, dormitories and other.

Continually powered equipment and appliances in vacant rooms also increases the maintenance overhead and shortens its' working life. As a result, building owners and managers experience unnecessary waste and cost.

Intelligent Energy Management

Telkonet's EcoSmart energy management platform is a leading intelligent and advanced automation solution designed to deliver at all levels by controlling a building's lighting, plugload and HVAC usage and improving energy efficiency one room at a time. All data may be presented on a grouped, property or room-by-room basis, allowing very granular management of in-room energy use and environmental conditions. The platform 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, managed wireless light switches and in wall electrical plugs to adjust and maintain energy consumption including a room's temperature according to occupancy, eliminating wasteful heating and cooling of unoccupied rooms. All these things can be done from the in-room devices or via any web-connected device, such as smart phones, tablets and laptop computers.

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

Recovery Time Technology

All EcoSmart's solution features 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 individual 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 set-point 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?

The occupant selects a set-point when the room is occupied. 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 the 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, 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 intelligent automation 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 run times 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 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.[3] 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 are in their infancy.

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.[4] 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 ($4,882 million)	80%	N/A	1%	19%
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

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[3] Center for Climate and Energy Efficiency - http://www.c2es.org/technology/overview/buildings

[4] Global Market for Energy Efficient Buildings to Surpass $100 Billion by 2017 - http://www.navigantresearch.com/newsroom/global-market-for-energy-efficient-buildings-to-surpass-100-billion-by-2017

Education Industry

Telkonet's most rapidly emerging market is the educational industry where continue to expand our presence in this space 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 residence 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 4,100 rooms across 12 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, North Carolina State University, University of Akron, University of Notre Dame, Fordham University, West Point Military Academy, Columbia University, University of Wisconsin-Oshkosh and others.

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.[5]

We believe that our EcoSmart Platform is an important tool for participants in the education industry seeking to control student-related energy costs. We have focused our sales efforts on members of the education 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 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.[6] 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. The Company has proven that its EcoSmart Platform can deliver a return on investment in less than three years for hospitality customers.

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.

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[5] https://www.energystar.gov/ia/news/downloads/K-12_Challenge.pdf

[6] http://www4.eere.energy.gov/alliance/sites/default/files/uploaded-files/better-buildings-alliance-annual-report-2013.pdf

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.[7]

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.[8] The American Recovery and Reinvestment Act ("ARRA") 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 benefited and continues to make use of government 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 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.[9] 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 ARRA for programs related to Smart Grids, 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 platform 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 paid for by government programs. 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.

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[7] http://en.wikipedia.org/wiki/Energy_usage_of_the_United_States_military

[8] https://www.whitehouse.gov/administration/eop/ceq/sustainability

[9] http://www.epa.gov/statelocalclimate/local/topics/commercial-industrial.html

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 automation 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 some level of comparable products to our standalone and networked products. Telkonet's key differentiators in the hospitality segment include:

· Recovery Time technology;

· Mesh-networked environment;

· Comprehensive four-part 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 facilities 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.

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
- Cobblestone Hotels

- 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
- White Lodging Services
- 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.

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 contract manufacture the majority of our inventory with ATR Manufacturing, a Chinese company, which provides substantially all the manufacturing requirements for Telkonet's energy management platform. For our HSIA networks, we obtain the majority of our inventory from WAV, Inc.

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, 2014 and 2013, 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, 2014.

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 will expire in May of 2022. 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 ("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 European Commission ("EC") standards. Moreover, if in the future, the FCC or EC 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, 2014 and 2013, we spent $1,312,488 and $1,174,048, respectively, on research and development activities. Telkonet's EcoSmart related development efforts in 2014 and continuing into 2015 are focused on three major areas. The first is around continuous software improvements to maintain compatibility with changing industry equipment and standards as well as moving towards a more mobile platform. The second area is a focus on development with third party device providers for integrated solutions. The growth in connected devices is driving demand for a smart hotel room with many devices working together. This new smart room requires working closely with strategic partners to build a more tightly integrated solution. The final area we continue to focus on is new product development. Telkonet is preparing new product releases and is continuing to innovate with hardware development beyond its current EcoSmart Platform.

The focus of EthoStream during 2014 and continuing into 2015 has been in both software and infrastructure improvements to better support and grow its customer base. Development efforts have focused on portal design changes and hotel property management system interface enhancements to attract new brands. The development of new updated web based management tools will be necessary to maintain our competitiveness. Continuous development of EthoStream's EGS platform will be required by several brands to maintain compliance as an approved vendor.

Other Information

Employees

As of March 20, 2015, we had 100 full-time employees. During 2014, significant positions filled included a director of field services, a director of sales and marketing, a channel account manager and a director of engineering. 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 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 in response to 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, 2014, we had outstanding employee options to purchase a total of 1,930,225 shares of common stock at exercise prices ranging from $0.14 to $5.60 per share, with a weighted average exercise price of $0.40. As of December 31, 2014, we had warrants outstanding to purchase a total of 7,915,533 shares of common stock at exercise prices ranging from $0.13 to $3.00 per share, with a weighted average exercise price of $0.27. 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, 2014 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, 2014, 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, 2015, our independent registered public accounting firm's report on our consolidated financial statements for the year ended December 31, 2014 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 22, 2015, we have issued 125,035,612 shares of common stock and have approximately 14,509,303 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, 2014, we have incurred cumulative losses of $121,906,017 and have never generated enough funds through operations to support our business. For the year ended December 31, 2014, we had an operating cash flow deficit of $4,601. As of December 31, 2014, we have a working capital deficit (current liabilities in excess of current assets) of $420,106. 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 2013 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 $1.0 million, respectively, at December 31, 2014, resulting from past acquisitions. We evaluate this goodwill for impairment based on the fair value of the reporting unit 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 the reporting unit 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 unit. 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, 2013 and up to May 31, 2014, we were in violation of a financial performance covenant under the Agreement. The Bank had chosen not to exercise any default provisions. On May 31, 2014, the Company and the Bank mutually agreed to terminate the Agreement and the Company paid the remaining outstanding principal balance of $50,000.

On September 30, 2014, the Company and its wholly owned subsidiary, EthoStream LLC, as co-borrowers (collectively, the “Borrowers”), entered into a Loan and Security Agreement (the “Loan Agreement”) with Heritage Bank of Commerce, a California state chartered bank (“Heritage Bank”), governing a new revolving credit facility in a principal amount not to exceed $2,000,000 (the “Credit Facility”). See “Management’s Discussion and Analysis of Financial Condition and Results of Operations -- Liquidity and Capital Resources” for more information regarding the Loan 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.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

None.

ITEM 2. PROPERTIES.

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.

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 infringe 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 owes the duty to defend and indemnify with respect to services provided by Telkonet to Ramada and it assumed Ramada's defense.

On October 1, 2013, the Company entered into a settlement agreement with Linksmart. The Company 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 was paid in full at September 30, 2014.

Eric Sprangers v. Telkonet, Inc. and Ethostream, LLC

On or about April 23, 2014, Eric Sprangers filed a complaint against Telkonet, Inc. and Ethostream, LLC (the "Companies") in the United States District Court for the Eastern District of Wisconsin. The Complaint, filed by Sprangers on behalf of himself and a putative class of allegedly similarly situated employees of the Companies, claims that the Companies failed to pay him and the putative class members overtime compensation in violation of the federal Fair Labor Standards Act ("FLSA"). Among other things, the complaint seeks payment to the putative class members of back overtime, liquidated damages and penalties as provided in the FLSA, and an award of costs and attorneys' fees. On or about May 22, 2014, the Companies filed an answer to the complaint in which the Companies deny that they failed to pay overtime compensation in violation of the FLSA. On July 25, 2014, Sprangers accepted a Rule 68 offer of judgment that was made by the Companies on July 11, 2014 in the amount of $10,000, plus an additional amount for attorneys' fees, costs and expenses to be determined by the Court. On September 12, 2014, the Court ordered judgment consistent with the accepted offer of judgment. The additional attorney fees were $9,939. Per the judgment, the offer and attorney fees were to be paid in two installments, September 23, 2014 and October 23, 2014. The Company complied with the judgment.

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, 2014 and 2013.

	High	**Low**
Year Ended December 31, 2014		
First Quarter	$0.30	$0.20
Second Quarter	0.24	0.17
Third Quarter	0.19	0.13
Fourth Quarter	0.18	0.12
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

Record Holders

As of March 22, 2015, we had 204 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, 2014.

	Number of securities to	**Weighted-average**	**Number of securities**

	be issued upon exercise of outstanding options, warrants and rights (a)	exercise price of outstanding options, warrants and rights (b)	remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	1,930,225	$ 0.40	5,747,553
Equity compensation plans not approved by security holders	–	–	–
Total	1,930,225	$ 0.40	5,747,553

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 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 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 605-25. Arrangements under such contracts may include multiple deliverables, a combination of equipment and services. The deliverables included in the MEAs are separated into more than one unit of accounting when (i) the delivered equipment has value to the customer on a stand-alone basis, and (ii) delivery of the undelivered service element(s) is probable and substantially in 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 – In most instances, products are sold separately in stand-alone arrangements. Services are also sold separately through renewals of contracts with varying periods. We determine VSOE based on pricing and discounting practices for the specific product or service when sold separately, considering geographical, customer, and other economic or marketing variables, as well as renewal rates or stand-alone prices for the service element(s).

- TPE – If 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, 2014 and 2013, the Company experienced approximately between 1% and 3% of returns related to product warranties. As of December 31, 2014 and 2013, the Company recorded warranty liabilities in the amount of $44,288 and $77,943, respectively, using this experience factor range.

Income Taxes

The Company accounts for income taxes in accordance with ASC 740-10. 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.

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 included: expected revenue growth rates, reporting unit profit margins, working capital levels, discount rates of 12.4% for Ethostream and 21.8% 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. At December 31, 2013, the carrying value of Smart Systems International goodwill was fully written down to zero.

Significant assumptions used in our goodwill impairment test at December 31, 2014 for Ethostream included: expected revenue growth rates, reporting unit profit margins, working capital levels, discount rates of 10.8% 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. We performed our annual goodwill impairment test and determined that there was no impairment, since the fair value of the EthoStream reporting unit substantially exceeded the carrying value.

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 $353,000 and $1,100,000 accrued for this exposure as of December 31, 2014 and 2013, 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 $200,000, not including any applicable interest and penalties.

Prior to 2014, the Company successfully executed and paid in full VDAs in nineteen states totaling approximately $286,000 and is current with the subsequent filing requirements.

During 2014, the Company successfully executed and paid in full VDAs in twelve states totaling approximately $407,000 and is current with the subsequent filing requirements.

EBITDA

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 ("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 is one of the measures used for determining our debt covenant compliance. 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)

	2014	**2013**
Net income (loss)	$42,830	$(3,994,731)
Interest expense, net	40,273	18,141
Provision for income taxes	201,853	349,823
Depreciation and amortization	275,236	258,517
EBITDA	560,192	(3,368,250)
Adjustments:		
Gain on sale of product line	–	(41,902)
Impairment of goodwill	–	2,774,016
Stock-based compensation	15,046	89,565
Adjusted EBITDA	$575,238	$(546,571)

Results of Operations

Year Ended December 31, 2014 Compared to Year Ended December 31, 2013

<u>Revenues</u>

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

	Year Ended December 31,					
	2014		2013		Variance	
Product	$10,973,544	74%	$10,123,407	73%	$850,137	8%
Recurring	3,822,987	26%	3,766,439	27%	56,548	2%
Total	$14,796,531	100%	$13,889,846	100%	$906,685	7%

Product revenue

Product revenue principally arises from the sale and installation of EcoSmart energy management platform, SmartGrid and High Speed Internet Access equipment. The EcoSmart Suite of products consists 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. We market and sell to the hospitality, education, healthcare and government/military markets.

For the year ended December 31, 2014, product revenue increased $0.85 million, or 8% when compared to the prior year. Product revenue in 2014 included approximately $5.98 million attributed to the sale and installation of energy management platform products, approximately $4.99 million for the sale and installation of HSIA products. $0.58 million of the $0.85 million increase in product revenue can be attributed to sales from channel partnerships and value added resellers. The Company has been making a concerted effort to increase channel partner relationships and expects this trend to continue.

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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, Telkonet's EcoCare service and support program 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 237,000 HSIA rooms, with approximately 8.0 million monthly users. For the year ended December 31, 2014, recurring revenue increased $0.06 million or by 2% when compared to the prior year. The increase of recurring revenue was primarily attributed to a $0.13 million increase in support revenue offset by a $0.06 million reduction of advertising revenue. The support revenue increase is due to the rollout of the Company's EcoCare service and support program for the EcoSmart Suite of products.

Cost of Sales

	Year ended December 31,					
	2014		2013		Variance	
Product	$6,504,630	59%	$6,034,294	60%	$470,336	8%
Recurring	1,053,215	28%	1,069,558	28%	(16,343)	-2%
Total	$7,557,845	51%	$7,103,852	51%	$453,993	6%

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, 2014, cost of product sales increased by 8% 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, 2014, costs of recurring revenue decreased by 2% when compared to the prior year. The majority of the decrease was for salaries and wages.

Gross Profit

	Year ended December 31,					
	2014		2013		Variance	
Product	$4,468,914	41%	$4,089,113	40%	$379,801	9%
Recurring	2,769,772	72%	2,696,881	72%	72,891	3%
Total	$7,238,686	49%	$6,785,994	49%	$452,692	7%

Gross Profit on Product Revenue

Gross profit on product revenue for the year ended December 31, 2014 increased by 9% compared to the prior year period. The variance was a result of increased product sales and installations. Gross profit as a percentage of sales increased a fraction of a percentage point for the year ended December 31, 2014.

Gross Profit on Recurring Revenue

For the year ended December 31, 2014, our gross profit increased by 3% when compared to the prior year. The variance was mainly attributed to a decrease in support staff wages and benefits.

Operating Expenses	Year ended December 31,			
	2014	2013	Variance	
Total	$6,953,730	$10,454,663	$(3,500,933)	-33%

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, 2014, operating expenses decreased by 33% when compared to the prior year. This decrease 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 decreased by $0.73 million or 9%.

Research and Development

	Year ended December 31,			
	2014	2013	Variance	
Total	$1,312,488	$1,174,048	$138,440	12%

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 12% for the year ended December 31, 2014. This increase is attributed to additional wages and salaries of $0.14 million, the Company hired a Director of Engineering during 2014. Costs of $0.01 million is associated with the development of our EcoTouch and EcoConnect Plus next generation products.

Selling, General and Administrative Expenses

	Year ended December 31,			
	2014	2013	Variance	
Total	$5,366,006	$6,248,082	$(882,076)	-14%

Selling, general and administrative expenses decreased for the year ended December 31, 2014 over the prior year by 14%. Bad debt expense decreased $0.27 million, the majority due to a $0.10 million bad debt write off in 2013 and the subsequent recovery of that write off in 2014. A decrease in sales and use tax by approximately $0.48 million due to the Company settling twelve VDA's with various states. Legal fees decreased due to the Linksmart Wireless Technology, LLC litigation settlement of approximately $0.12 million in 2013 and accounting fees decreased $0.12 million. Bonus and stock option expense decreased by $0.16 million. These decreases were offset by increases in rent of $0.09 million attributed to the Waukesha, WI lease, commissions of $0.10 million and director fees of $0.04 million.

Goodwill Impairment

	Year ended December 31,			
	2014	2013	Variance	
Total	$–	$2,774,016	$(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.

Provision for Income Taxes

	Year ended December 31,			
	2014	2013	Variance	
Total	$201,853	$349,823	$(147,970)	-46%

During the year ended December 31, 2013, the Company recorded a $0.35 million deferred tax liability from timing differences between book and tax amortization of goodwill. The decrease is attributed to the relative amount of tax amortization of goodwill recognized in each year.

Liquidity and Capital Resources

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

Working Capital

Our working capital deficit (current assets in excess of current liabilities) improved by $150,295 during the year ended December 31, 2014 from a working capital deficit of $570,401 at December 31, 2013 to a working capital deficit of $420,106 at December 31, 2014.

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 would be payable by the Company in three equal annual installments. The first of these three installments would 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 is required to pay equal monthly installments of $4,426; followed by a final installment on December 1, 2016 which shall include all remaining principal, accrued interest and other amounts owed by the Company to the Department under the Loan Agreement. The Company may prepay amounts outstanding under the Loan Agreement in whole or in part at any time without penalty. The Loan Agreement was secured by substantially all of the Company's assets. On September 24, 2014, the Department signed a subordination agreement of all the Company's security interests. The proceeds from this loan were used for the working capital requirements of the Company. The Loan Agreement contains covenants which required, among other things, that the Company keep and maintain 75 existing full-time positions and create and fill 35 additional full-time positions in Milwaukee, Wisconsin by December 31, 2012. On June 18, 2012, the Department agreed to permanently waive all penalties associated with the Company's noncompliance with this covenant. The outstanding borrowings under the agreement as of December 31, 2014 and 2013 were $103,979 and $154,463, 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 year ended December 31, 2013, the non-cash reduction of principal calculated under these provisions and applied to the Note was $41,902. 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, 2014 and 2013 was $289,973 and $506,024, 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 was subject to a borrowing base that was 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 was available for working capital and other lawful general corporate purposes. As of December 31, 2013 and March 31, 2014, the Company was in violation of a financial performance covenant. Although the Company’s violation of the financial performance covenant constituted a default under the Agreement, the Bank did not pursue any remedies under the default provisions of the Agreement. On May 31, 2014, the Company and the Bank mutually agreed to terminate the Agreement and the Company paid the remaining outstanding principal balance of $50,000.

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

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

Cash flow analysis

Cash used in continuing operations was $4,601 during the year ended December 31, 2014 and cash provided by operations was $2,641 during the year ended December 31, 2013. As of December 31, 2014, our primary capital needs included costs incurred to increase energy management sales, inventory procurement, funding performance bonds and managing current liabilities.

Cash provided by investing activities was $198,333 during the year ended December 31, 2014 and cash used in investing activities was $407,577 during the year ended December 31, 2013, respectively. During the year ended December 31, 2012, the Company was awarded a contract with 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. In 2014, the Company satisfied all obligations related to the bonding requirement and the cash was released. During the year ended December 31, 2014, the Company purchased approximately $120,668 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.

Cash provided by financing activities was $361,669 during the year ended December 31, 2014. Cash borrowed from the line of credit was $628,204 and cash used in financing activities to repay indebtedness was $266,535. Cash used in financing activities to repay indebtedness was $186,150 during the year ended December 31, 2013.

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, 2014 includes an explanatory paragraph relating to our ability to continue as a going concern. Although we reported net income for 2014, we have incurred operating losses and operating cash flow 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 along with competition will continue to present a challenging operating environment through 2015; therefore working capital management will continue to be a high priority for 2015.

The Company continues to manage the approximate $353,000 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 $200,000, not including any applicable interest and penalties.

Prior to 2014, the Company successfully executed and paid in full VDAs in nineteen states totaling approximately $286,000 and is current with the subsequent filing requirements.

During 2014, the Company successfully executed and paid in full VDAs in twelve states totaling approximately $407,000 and is current with the subsequent filing requirements. In addition, the Company executed VDAs with three other states and has established payment plans with these states.

On November 19, 2014, greater than 50% of the shares of Series A issued on the Series A Original Issue Date, November, 16, 2009, remained outstanding. For a period of 180 days thereafter, if the holders of at least a majority of the 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 would be payable by the Company in three equal annual installments with the first of these three installments due within 60 days of the requisite holders' written notice requesting redemption. As of December 31, 2014, the aggregate redemption price was $1,303,859.

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 new accounting pronouncements.

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.

This item is not applicable.

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, 2014 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, 2014 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 hire 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, 2014 and 2013 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, 2014 and 2013 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, 2014, 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 11, 2015.

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 11, 2015.

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 11, 2015.

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 11, 2015.

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 11, 2015.

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 years ended December 31, 2014 and 2013

Consolidated Balance Sheets as of December 31, 2014 and 2013

Consolidated Statements of Operations for the Years ended December 31, 2014 and 2013

Consolidated Statements of Stockholders' Equity for the Years ended December 31, 2014 and 2013

Consolidated Statements of Cash Flows for Years ended December 31, 2014 and 2013

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 31, 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 Amended and Restated Articles of Incorporation (incorporated by reference to our Form 8-K (No. 001-31972), filed November 18, 2009)
3.4	Amendment to Amended and Restated Articles of Incorporation (incorporated by reference to our Form 8-K filed on August 9, 2010)
3.5	Amendment to Amended and Restated 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, 2010)
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 13, 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)

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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 Director 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 13, 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 13, 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 15, 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 15, 2013)
*10.19	Employment Agreement by and between Telkonet, Inc. and Richard E. Mushrush, dated as of May 1, 2014 (incorporated by reference to our Form 8-K filed May 14, 2014)
*10.20	Employment Agreement by and between Telkonet, Inc. and Matthew P. Koch, dated as of May 1, 2014 (incorporated by reference to our Form 8-K filed May 14, 2014)
*10.21	Employment Agreement by and between Telkonet, Inc. and Gerrit J. Reinders, dated as of May 1, 2014 (incorporated by reference to our Form 8-K filed May 14, 2014)
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 May 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)
10.24	Loan and Security Agreement, dated September 30, 2014, by and between Telkonet, Inc. and Heritage Bank of Commerce(incorporated by reference to our Form 8-K filed October 2, 2014)
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
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, 2015	/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, 2015
/s/ Richard E. Mushrush Richard E. Mushrush	Controller & Acting Chief Financial Officer (principal financial officer) (principal accounting officer)	March 31, 2015
/s/ / William H. Davis William H. Davis	Chairman of the Board	March 31, 2015
/s/ Tim S. Ledwick Tim S. Ledwick	Director	March 31, 2015
/s/ Kellogg L. Warner Kellogg L. Warner	Director	March 31, 2015
/s/ Jeffrey P. Andrews Jeffrey P. Andrews	Director	March 31, 2015

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CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2014 AND 2013

FORMING A PART OF ANNUAL REPORT

PURSUANT TO THE SECURITIES EXCHANGE ACT OF 1934

TELKONET, INC.

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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 sheets of Telkonet, Inc. (the "Company") as of December 31, 2014 and 2013 and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the two years in the period ended December 31, 2014. 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 audits.

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 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 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 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. at December 31, 2014 and 2013, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2014, 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 $121,906,017 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, 2015

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TELKONET, INC.

CONSOLIDATED BALANCE SHEETS

DECEMBER 31, 2014 AND 2013

	December 31, 2014	December 31, 2013
ASSETS		
Current assets:		
Cash and cash equivalents	$1,128,072	$572,672
Restricted cash on deposit	63,000	382,000
Accounts receivable, net	1,460,422	1,659,756
Inventories, net	1,027,250	939,382
Prepaid expenses	95,282	171,216
Total current assets	3,774,026	3,725,026
Property and equipment, net	131,750	44,638
Other assets:		
Goodwill	5,796,430	5,796,430
Intangible assets, net	1,016,937	1,258,617
Deposits	34,238	34,238
Deferred financing costs, net	33,582	–
Total other assets	6,881,187	7,089,285
Total Assets	$10,786,963	$10,858,949
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$1,680,692	$1,843,589
Accrued liabilities and expenses	1,090,025	1,997,157
Notes payable – current	279,740	265,985
Line of credit	628,204	–
Deferred revenues	120,754	111,291
Customer deposits	394,717	77,405
Total current liabilities	4,194,132	4,295,427
Long-term liabilities:		
Deferred lease liability	140,575	130,920
Notes payable – long term	114,212	394,502
Deferred income taxes	534,661	335,275
Total long-term liabilities	789,448	860,697
Redeemable preferred stock:		

15,000,000 shares authorized, par value $.001 per share		
Series A; 215 shares issued, 185 shares outstanding at December 31, 2014 and 2013, respectively, preference in liquidation of $1,303,859 and $1,229,832 as of December 31, 2014 and 2013, respectively	1,303,859	1,165,625
Total redeemable preferred stock	1,303,859	1,165,625
Commitments and contingencies		
Stockholders' Equity		
Series B; 538 shares issued, 55 shares outstanding at December 31, 2014 and 2013, respectively, preference in liquidation of $372,030 and $350,005 as of December 31, 2014 and 2013, respectively	372,030	324,063
Common stock, par value $.001 per share; 190,000,000 shares authorized; 125,035,612 shares issued and outstanding at December 31, 2014 and 2013, respectively	125,035	125,035
Additional paid-in-capital	125,908,476	126,036,949
Accumulated deficit	(121,906,017)	(121,948,847)
Total stockholders' equity	4,499,524	4,537,200
Total Liabilities and Stockholders' Equity	$10,786,963	$10,858,949

See accompanying notes to consolidated financial statements

TELKONET, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

	2014	2013
Revenues, net:		
Product	$10,973,544	$10,123,407
Recurring	3,822,987	3,766,439
Total Net Revenues	14,796,531	13,889,846
Cost of Sales:		
Product	6,504,630	6,034,294
Recurring	1,053,215	1,069,558
Total Cost of Sales	7,557,845	7,103,852
Gross Profit	7,238,686	6,785,994
Operating Expenses:		
Research and development	1,312,488	1,174,048
Selling, general and administrative	5,366,006	6,248,082
Impairment of goodwill	–	2,774,016
Depreciation and amortization	275,236	258,517
Total Operating Expenses	6,953,730	10,454,663
Income (Loss) from Operations	284,956	(3,668,669)
Other (Expenses) Income:		
Interest income (expense), net	(40,273)	(18,141)
Gain on sale of product line	–	41,902
Total Other (Expenses) Income	(40,273)	23,761
Income (Loss) Before Provision for Income Taxes	244,683	(3,644,908)
Provision for Income Taxes	201,853	349,823
Net Income (Loss)	42,830	(3,994,731)
Accretion of preferred dividends and discount	(138,233)	(905,977)
Net loss attributable to common stockholders	$(95,403)	$(4,900,708)
Net loss per common share:		
Net loss attributable to common stockholders per common share – basic	$(0.00)	$(0.04)
Net loss attributable to common stockholders per common share – diluted	$(0.00)	$(0.04)

Weighted Average Common Shares Outstanding – basic	125,035,612	114,670,433
Weighted Average Common Shares Outstanding – diluted	125,035,612	114,670,433

See accompanying notes to consolidated financial statements

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TELKONET, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

	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 STOCKHOLDERS' EQUITY (CONTINUED)

FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

	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, 2014	55	$324,063	125,035,612	$125,035	$126,036,949	$(121,948,847)	$4,537,200
Stock-based compensation expense related to employee stock options	–	–	–	–	15,046	–	15,046
Accretion of redeemable preferred stock discount	–	25,942	–	–	(90,149)	–	(64,207)
Accretion of redeemable preferred stock dividends	–	22,025	–	–	(96,051)	–	(74,026)
Value of warrants issued in conjunction with line of credit	–	–	–	–	37,897	–	37,897
Value of warrants issued for consulting	–	–	–	–	4,784	–	4,784
Net income	–	–	–	–	–	42,830	42,830
Balance at December 31, 2014	55	$372,030	125,035,612	$125,035	$125,908,476	$(121,906,017)	$4,499,524

See accompanying notes to the consolidated financial statements

TELKONET, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

	2014	2013
Cash Flows from Operating Activities:		
Net income (loss)	$42,830	$(3,994,731)
Adjustments to reconcile net income (loss) from operations to cash (used in) provided by operating activities:		
Gain on sale of product line	–	(41,902)
Stock-based compensation expense	15,046	89,565
Amortization of deferred financing costs	9,100	–
Depreciation	33,556	16,837
Amortization	241,680	241,680
Provision for doubtful accounts, net of recoveries	(76,910)	197,151
Deferred income taxes	199,386	335,275
Goodwill impairment	–	2,774,016
Changes in assets and liabilities:		
Accounts receivable	276,244	1,169,200
Inventories	(87,868)	(284,470)
Prepaid expenses	75,934	18,663
Accounts payable	(162,897)	(123,441)
Accrued liabilities and expenses	(907,132)	(344,890)
Deferred revenue	9,463	(6,265)
Customer deposits	317,312	(41,358)
Deferred lease liability	9,655	(2,689)
Net Cash (Used In) Provided By Operating Activities	(4,601)	2,641
Cash Flows From Investing Activities:		
Purchase of property and equipment	(120,668)	(25,577)
Change in restricted cash	319,000	(382,000)
Net Cash Provided By (Used In) Investing Activities	198,332	(407,577)
Cash Flows From Financing Activities:		
Proceeds from line of credit	628,204	–
Payments on notes payable	(266,535)	(186,150)
Net Cash Provided By (Used In) Financing Activities	361,669	(186,150)
Net increase (decrease) in cash and cash equivalents	555,400	(591,086)
Cash and cash equivalents at the beginning of the year	572,672	1,163,758
Cash and cash equivalents at the end of the year	$1,128,072	$572,672

See accompanying notes to consolidated financial statements

TELKONET, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

FOR THE YEARS ENDED DECEMBER 31, 2014 AND 2013

	2014	2013
Supplemental Disclosures of Cash Flow Information:		
Cash transactions:		
Cash paid during the year for interest	$39,014	$29,064
Cash paid during the year for income taxes, net of refunds	1,420	9,967
Non-cash transactions:		
Accretion of discount on redeemable preferred stock	90,149	705,170
Accretion of dividends on redeemable preferred stock	96,051	200,807
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, 2014 AND 2013

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”, “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.

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

In 2007, the Company acquired 100% of the outstanding membership units of EthoStream, LLC (“EthoStream”). EthoStream is one of the largest public 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.

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 net income of $42,830 and a net loss of $3,994,731 for the years ended December 31, 2014 and 2013, respectively, and has an accumulated deficit of $121,906,017 and total current liabilities in excess of current assets of $420,106 as of December 31, 2014.

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 2015 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. On September 30, 2014, the Company and its wholly-owned subsidiary, EthoStream LLC, as co-borrowers (collectively, the “Borrowers”), entered into a Loan and Security Agreement (the “Loan Agreement”) with Heritage Bank of Commerce, a California state chartered bank (“Heritage Bank”), governing a new revolving credit facility in a principal amount not to exceed $2,000,000 (the “Credit Facility”). Availability of borrowings under the Credit Facility from time to time is subject to a borrowing base calculation based on the Company’s eligible accounts receivable and eligible inventory each multiplied by an applicable advance rate, with an overall limitation tied to the Company’s eligible accounts receivable. The Loan Agreement is available for working capital and other lawful general corporate purposes. The outstanding principal balance of the Credit Facility bears interest at the Prime Rate plus 3.00%. The Credit Facility matures on September 30, 2016, unless earlier accelerated under the terms of the Loan Agreement. The outstanding balance was $628,204 on the Credit Facility as of December 31, 2014 and the remaining available borrowing capacity was approximately $241,000 at December 31, 2014. There exists a possibility the Company may not meet a certain required covenant for the period ending March 31, 2015. We have notified Heritage Bank about the possible violation and are in negotiations regarding remedies in the event this violation occurs.

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2014 AND 2013

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.

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 was to expire September 30, 2014, or sooner if the Company satisfied all obligations under the arrangement. The amount is presented as restricted cash on deposit on the consolidated balance sheet as of December 31, 2013. In March 2014, the Company satisfied all obligations related to the bonding requirement and the cash was released.

During 2014, the Company was again awarded a contract with a bonding requirement. The Company satisfied this requirement during the year ended December 31, 2014 with cash collateral supported by an irrevocable standby letter of credit in the amount of $63,000 which is to expire December 31, 2015, or sooner if the Company satisfies all obligations under the arrangement. The amount is presented as restricted cash on deposit on the consolidated balance sheet as of December 31, 2014.

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 $36,873 and $156,966 at December 31, 2014 and 2013, respectively. 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 Accounting Standards Codification (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, line of credit, 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 line of credit and notes payable. The carrying amount of the line of credit and notes payable approximates fair value due to the interest rate and terms approximating those available to us for similar obligations.

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2014 AND 2013

The Company accounts for the fair value of financial instruments in accordance with ASC 820, which defines fair value for accounting purposes, established a framework for measuring fair value and 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.

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 platform. 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 income (loss) by the weighted average number of shares outstanding of common stock. Diluted income (loss) per share is computed using the weighted average number of common and common stock equivalent shares outstanding during the year. Dilutive common stock equivalents consist of shares issuable upon the exercise of the Company's outstanding stock options and warrants. For the years ended December 31, 2014 and 2013, there were 9,845,758 and 11,095,139 shares of common stock underlying options and warrants excluded due to these instruments being anti-dilutive, respectively.

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2014 AND 2013

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.

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 605-25. Arrangements under such contracts may include multiple deliverables, a combination of equipment and services. The deliverables included in the MEAs are separated into more than one unit of accounting when (i) the delivered equipment has value to the customer on a stand-alone basis, and (ii) delivery of the undelivered service element(s) is probable and substantially in 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 – In most instances, products are sold separately in stand-alone arrangements. Services are also sold separately through renewals of contracts with varying periods. We determine VSOE based on pricing and discounting practices for the specific product or service when sold separately, considering geographical, customer, and other economic or marketing variables, as well as renewal rates or stand-alone prices for the service element(s).

- TPE – If 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.

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2014 AND 2013

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, 2014 and 2013, the Company experienced returns of approximately 1% to 3% of material’s included in the cost of sales. As of December 31, 2014 and 2013, the Company recorded warranty liabilities in the amount of $44,288 and $77,943, respectively, using this experience factor range.

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

	2014	2013

Beginning balance	$77,943	$69,743
Warranty claims incurred	(45,710)	(9,106)
Provision charged to expense	12,055	17,306
Ending balance	$44,288	$77,943

Advertising

The Company follows the policy of charging the costs of advertising to expenses as incurred. The Company incurred $15,021 and $21,499 in advertising costs during the years ended December 31, 2014 and 2013, 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 2014 and 2013 were $1,312,488 and $1,174,048, 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.

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2014 AND 2013

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 2014 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, 2014 and 2013 was $15,046 and $89,565, 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, 2014 and 2013 was $46,673 and $91,981, respectively.

NOTE B – NEW ACCOUNTING PRONOUNCEMENTS

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 was effective for reporting periods beginning after December 15, 2013. The Company applied this guidance in the current year and did not have a material impact on the Company's statement of operations, financial position or cash flows.

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (ASU 2014-09), which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP. The standard is effective for annual periods beginning after December 15, 2016, and interim periods therein, using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). We are currently evaluating the impact of our pending adoption of ASU 2014-09 on our consolidated financial statements and have not yet determined the method by which we will adopt the standard in 2017.

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

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

NOTE C – INTANGIBLE ASSETS AND GOODWILL

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

	Cost	**Accumulated Amortization**	**Accumulated Impairment**	**Carrying Value**	**Weighted Average Amortization Period (Years)**
Amortized Identifiable Intangible Assets:					
Subscriber lists – EthoStream	$2,900,000	$(1,883,063)	$–	$1,016,937	12.0
Total Amortized Identifiable Intangible Assets	2,900,000	(1,883,063)	–	1,016,937	
Goodwill – EthoStream	8,796,430	–	(3,000,000)	5,796,430	
Goodwill – SSI	5,874,016	–	(5,874,016)	–	
Total Goodwill	14,670,446	–	(8,874,016)	5,796,430	
Total	$17,570,446	$(1,883,063)	$(8,874,016)	$6,813,367	

Total 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 amortization expense charged to operations for the years ended December 31, 2014 and 2013 was $241,680 per year.

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Estimated future amortization expense as of December 31, 2014 is as follows:

Years Ended December 31,	
2015	$241,680
2016	241,680
2017	241,680
2018	241,680
2019	50,217
Total	$1,016,937

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, 2009 and 2008, the Company determined that a portion of the value of EthoStream's goodwill had been impaired based upon management's assessment of operating results and forecasted discounted cash flow and wrote off $1,000,000 and $2,000,000, respectively, of its value. 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 included: expected revenue growth rates, reporting unit profit margins, working capital levels, discount rates of 12.4% for EthoStream and 21.8% 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.

Significant assumptions used in our goodwill impairment test at December 31, 2014 for EthoStream included: expected revenue growth rates, reporting unit profit margins, working capital levels, discount rate of 10.8% 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.

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 remaining 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, 2014 and 2013 are as follows:

	2014	2013
Accounts receivable	$1,497,295	1,816,722
Allowance for doubtful accounts	(36,873)	(156,966)
Accounts receivable, net	$1,460,422	$1,659,756

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NOTE E – INVENTORIES

Components of inventories as of December 31, 2014 and 2013 are as follows:

	2014	2013
Product purchased for resale	$1,220,600	$997,332
Reserve for obsolescence	(193,350)	(57,950)
Inventory, net	$1,027,250	$939,382

NOTE F – PROPERTY AND EQUIPMENT

The Company's property and equipment as of December 31, 2014 and 2013 consists of the following:

	2014	2013
Development test equipment	$45,752	$45,752
Computer software	55,677	55,677
Leasehold improvements	2,675	2,675
Office equipment	20,706	20,706
Office fixtures and furniture	157,183	36,515
Total	281,993	161,325
Accumulated depreciation	(150,243)	(116,687)
Total property and equipment	$131,750	$44,638

Depreciation expense included as a charge to income was $33,556 and $16,837 for the years ended December 31, 2014 and 2013, respectively.

NOTE G – ACCRUED LIABILITIES AND EXPENSES

Accrued liabilities and expenses as of December 31, 2014 and 2013 are as follows**:**

	2014	2013
Accrued liabilities and expenses	$342,841	$405,073
Accrued payroll and payroll taxes	345,589	430,871
Accrued sales taxes, penalties, and interest	353,260	1,080,482
Accrued interest	4,047	2,788
Product warranties	44,288	77,943
Total accrued liabilities and expenses	$1,090,025	$1,997,157

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 Loan Agreement in whole or in part at any time without penalty. The Loan Agreement was secured by substantially all of the Company's assets. On September 24, 2014, the Department signed a subordination agreement of all the Company's security interests. The proceeds from this loan were used for the working capital requirements of the Company. The Loan Agreement contains covenants which required, among other things, that the Company keep and maintain 75 existing full-time positions and create and fill 35 additional full-time positions in Milwaukee, Wisconsin by December 31, 2012. On June 18, 2012, the Department agreed to permanently waive all penalties associated with the Company's noncompliance with this covenant. The outstanding borrowings under the agreement as of December 31, 2014 and 2013 were $103,979 and $154,463, 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 year ended December 31, 2013, the non-cash reduction of principal calculated under these provisions and applied to the Note was $41,902. 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, 2014 and 2013 was $289,973 and $506,024, 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 was subject to a borrowing base that was 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 was available for working capital and other lawful general corporate purposes. As of December 31, 2013 and March 31, 2014, the Company was in violation of a financial performance covenant. Although the Company's violation of the financial performance covenant constituted a default under the Agreement, the Bank did not pursue any remedies under the default provisions of the Agreement. On May 31, 2014, the Company and the Bank mutually agreed to terminate the Agreement and the Company paid the remaining outstanding principal balance of $50,000.

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

The Loan Agreement contains customary covenants that place restrictions on, among other things, the incurrence of debt, granting of liens and sale of assets. The Credit Agreement also contains financial covenants that require the Borrowers to maintain a minimum EBITDA level, measured quarterly, and a minimum asset coverage ratio, measured monthly. A violation of any of these covenants could result in an event of default under the Loan Agreement. Upon the occurrence of such an event of default or certain other customary events of defaults, payment of any outstanding amounts under the Credit Facility may be accelerated and Heritage Bank’s commitment to extend credit under the Loan Agreement may be terminated. The Loan Agreement contains other representations and warranties, covenants, and other provisions customary to transactions of this nature. As of December 31, 2014, the Company was in compliance with the financial covenants that required the Company to maintain a minimum EBITDA level and minimum asset coverage ratio. The outstanding balance on the Credit Facility is $628,204 at December 31, 2014 leaving an available borrowing base of approximately $241,000. There exists a possibility the Company may not meet a certain required covenant for the period ending March 31, 2015. We have notified Heritage Bank about the possible violation and are in negotiations regarding remedies in the event this violation occurs.

Aggregate annual future maturities of long-term debt as of December 31, 2014 are as follows:

Years ending December 31,	Amount
2015	$279,740
2016	114,212
	393,952
Less: Current portion	(279,740)
Notes payable long-term	$114,212

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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 a 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, November, 16, 2009, 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 would be payable by the Company in three equal annual installments with the first of these three installments 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 including accumulated dividends, has been classified as redeemable preferred stock on the consolidated balance sheets.

A portion of the proceeds were allocated to the warrants based on their relative fair value, which totaled $287,106 using the Black Scholes option pricing model. Further, the Company attributed a beneficial conversion feature of $70,922 to the Series A preferred shares based upon the difference between the effective conversion price of those shares and the closing price of the Company's common stock on the date of issuance. The assumptions used in the Black-Scholes model were as follows: (1) dividend yield of 0%; (2) expected volatility of 123%, (3) weighted average risk-free interest rate of 2.2%, (4) expected life of 5 years, and (5) fair value of Telkonet common stock of $0.24 per share. The expected term of the warrants represents the estimated period of time until exercise and is based on historical experience of similar awards and giving consideration to the contractual terms. The amounts attributable to the warrants and beneficial conversion feature, aggregating $358,028, were recorded as a discount and deducted from the face value of the preferred stock. The discount was 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, 2014 and 2013 was $64,207 and $70,032, respectively.

For the years ended December 31, 2014 and 2013, we have accrued dividends for Series A in the amount of $74,026 and $74,027, respectively and cumulative accrued dividends of $378,859 and $304,832 as of December 2014 and 2013, respectively. The accrued dividends have been charged to additional paid-in capital and an increase to the net loss attributable to common stockholders (since there is a deficit in retained earnings) 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 a 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, had been classified as redeemable preferred stock on the consolidated balance sheets. During the year ended December 31, 2013, shareholders converted 167 redeemable preferred shares issued on August 4, 2010, to, in aggregate, 6,423,072 shares of common stock.

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

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, August 4, 2010, 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 during the year ended December 31, 2013.

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, 2014 and 2013 was $25,942 and $635,138, respectively.

For the years ended December 31, 2014 and 2013, we have accrued dividends for Series B in the amount of $22,025 and $126,780, respectively, and cumulative accrued dividends of $97,030 and $75,005 as of December 31 2014 and 2013, 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 $372,030 and second, Series A with a preference value of $1,303,859. Both series of preferred stock are equal in their dividend preference over common stock.

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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, 2014 and 2013, there were 185 shares of Series A and 55 shares of Series B outstanding.

The Company has authorized 190,000,000 shares of common stock with a par value of $.001 per share. As of December 31, 2014 and 2013 the Company has 125,035,612 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.

NOTE K – STOCK OPTIONS AND WARRANTS

Employee Stock Options

The Company maintains an equity incentive plan, (the "Plan"). The Plan was established in 2010 as an incentive plan for officers, employees, non-employee directors, prospective employees and other key persons. It is anticipated that providing such persons with a direct stake in the Company's welfare will assure a better alignment of their interests with those of the Company and its stockholders.

The following table summarizes the changes in options outstanding and the related prices for the shares of the Company's common stock issued to employees of the Company under the Plan as of December 31, 2014.

Options Outstanding				Options Exercisable	
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
$0.01 - $0.15	175,000	2.82	$ 0.14	175,000	$ 0.14
$0.16 - $0.99	1,620,225	7.98	0.18	1,284,791	0.18
$1.00 - $5.60	135,000	1.53	3.29	135,000	3.29
	1,930,225	7.06	$ 0.40	1,594,791	$ 0.44

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

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2013	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
Granted	200,000	0.19
Exercised	–	–
Cancelled or expired	(5,000)	3.50
Outstanding at December 31, 2014	1,930,225	$ 0.40

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 2014 and 2013, using the Black-Scholes option-pricing model:

	2014	2013
Expected life of option (years)	10	10
Risk-free interest rate	2.77%	1.72%
Assumed volatility	110%	124%
Expected dividend rate	0	0
Expected forfeiture rate	0%	6%

The total estimated fair value of the options granted during the years ended December 31, 2014 and 2013 was $35,298 and $86,672. The total fair value of underlying shares related to options that vested during the years ended December 31, 2014 and 2013 was $15,047 and $124,208. Future compensation expense related to non-vested options at December 31, 2014 was $48,695 and will be recognized over the next 3.41 years. The aggregate intrinsic value of the vested options was zero as of December 31, 2014 and 2013. Total stock-based compensation expense recognized in the consolidated statements of operations for the years ended December 31, 2014 and 2013 was $15,046 and $89,565, respectively.

Non-Employee Stock Options

There were no non-employees stock options issued or outstanding at December 31, 2014 or 2013.

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	1.11	$ 0.13	7,230,778	$ 0.13
0.18	50,000	2.91	0.18	50,000	0.18
0.20	250,000	6.77	0.20	250,000	0.20
3.00	384,755	0.83	3.00	384,755	3.00
	7,915,533	1.29	$ 0.27	7,915,533	$ 0.27

Transactions involving warrants are summarized as follows:

	Number of Shares	Weighted Average Exercise Price
Outstanding at January 1, 2013	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
Issued	300,000	0.20
Exercised	–	–
Canceled or expired	(1,744,381)	0.51
Outstanding at December 31, 2014	7,915,533	$ 0.27

The Company issued 300,000 warrants during the year ended December 31, 2014. 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 certain 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 $29,000, grossed up to accommodate their 2013 and 2014 federal income tax liability associated with the payments.

On July 17, 2014, Messer's Davis and Tienor each signed a General Indemnity Agreement pledging personal property on behalf of the Company for another customer contract that required bonding. The Company agreed to compensate each in the amount of $9,000, grossed up to accommodate their 2014 federal income tax liability associated with the payments. The amounts owed to Messrs. Davis and Tienor as of December 31, 2014 were $6,000 and $18,090 recorded in accounts payable and accrued expense respectively on the accompanying consolidated balance sheet. 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, 2014 and 2013, 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:

	2014	2013
Tax provision (benefits) computed at the statutory rate	$83,192	$(1,239,269)
State taxes	(26,756)	5,849
Book expenses not deductible for tax purposes	20,846	19,572
Expired capital losses	(176,627)	–
Other	(345)	526
	(99,690)	(1,213,322)
Change in valuation allowance for deferred tax assets	301,543	1,563,145
Income tax expense	$201,853	$349,823

During 2014, approximately $200,000 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 $20,000.

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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:

	2014	2013
Deferred Tax Assets:		
Net operating loss carry forwards	$31,909,052	$31,686,463
Intangibles	1,141,121	1,277,631
Other	728,937	872,796
Total deferred tax assets	33,779,110	33,836,890
Deferred Tax Liabilities:		
Intangibles	(534,661)	(335,275)
Total deferred tax liabilities	(534,661)	(335,275)
Valuation allowance	(33,779,110)	(33,836,890)
Net deferred tax assets	$(534,661)	$(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, 2014 and 2013, the Company’s valuation allowance, established for the tax benefit that may not be realized, totaled approximately $33,780,000 and $33,840,000, respectively. The overall decrease in the valuation allowance is related to federal and state loss carryforwards that expired as of December 31, 2014, less federal and state losses generated for the year ended December 31, 2014.

At December 31, 2014 the Company had net operating loss carryforwards of approximately $89,700,000 and $46,900,000 for federal and state income tax purposes which will expire at various dates from 2015 – 2034.

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 impos ed 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 2010 and various states before 2010. 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 change in the liability for unrecognized tax benefits. The Company has no tax positions at December 31, 2014 or 2013 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, 2014 or 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.

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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, 2014 are as follows:

Years ending December 31,

2015	$494,806
2016	245,274
2017	251,740
2018	258,381
2019	265,305
2020 and thereafter	156,877
Total	$1,672,383

Expected rent payments to be received under sublease agreement as of December 31, 2014 are $138,919 for the year ended December 31, 2015.

Rental expenses charged to operations for the years ended December 31, 2014 and 2013 was $642,277 and $532,598, respectively. Rental income received for the year ended December 31, 2014 and 2013 was $136,666 and $131,111, 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, 2014. Mr. Reinder's employment agreement is for a term expiring on May 1, 2015, 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 infringe a wireless network security patent held by Linksmart.

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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.

On October 1, 2013, the Company entered into a settlement agreement with Linksmart. The Company 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 was paid in full at September 30, 2014.

Eric Sprangers v. Telkonet, Inc. and Ethostream, LLC

On or about April 23, 2014, Eric Sprangers filed a complaint against Telkonet, Inc. and Ethostream, LLC (the "Companies") in the United States District Court for the Eastern District of Wisconsin. The Complaint, filed by Sprangers on behalf of himself and a putative class of allegedly similarly situated employees of the Companies, claims that the Companies failed to pay him and the putative class members overtime compensation in violation of the federal Fair Labor Standards Act ("FLSA"). Among other things, the complaint seeks payment to the putative class members of back overtime, liquidated damages and penalties as provided in the FLSA, and an award of costs and attorneys' fees. On or about May 22, 2014, the Companies filed an answer to the complaint in which the Companies deny that they failed to pay overtime compensation in violation of the FLSA. On July 25, 2014, Sprangers accepted a Rule 68 offer of judgment that was made by the Companies on July 11, 2014 in the amount of $10,000, plus an additional amount for attorneys' fees, costs and expenses to be determined by the Court. On September 12, 2014, the Court ordered judgment consistent with the accepted offer of judgment. The additional attorney fees were $9,939. Per the judgment, the offer and attorney fees were to be paid in two installments, September 23, 2014 and October 23, 2014. The Company complied with the judgment.

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 $353,000 and $1,100,000 accrued for this exposure as of December 31, 2014 and 2013, 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 $200,000, not including any applicable interest and penalties.

Prior to 2014, the Company successfully executed and paid in full VDAs in nineteen states totaling approximately $286,000 and is current with the subsequent filing requirements.

During the year ended December 31, 2014, the Company successfully executed and paid in full VDAs in twelve states totaling approximately $407,000 and is current with the subsequent filing requirements.

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

	2014	2013
Balance, Beginning of year	$1,080,482	$1,188,133
Sales tax collected	426,599	409,782
Provisions	(599,295)	(138,352)
Interest and penalties	–	7,342
Payments	(554,526)	(386,423)
Balance, End of year	$353,260	$1,080,482

NOTE O – BUSINESS CONCENTRATION

For the years ended December 31, 2014 and 2013, no single customer represented 10% or more of our total net revenues.

As of December 31, 2014, one customer accounted for 13% of the Company’s net accounts receivable. As of December 31, 2013, one customer accounted for 28% of the Company’s net accounts receivable.

Purchases from two suppliers approximated $3,700,000, or 76%, of total purchases for the year ended December 31, 2014 and approximately $2,700,000, or 68%, of total purchases for the year ended December 31, 2013. Total due to these suppliers, net of deposits, was $750,084 and $525,464 as of December 31, 2014 and 2013, respectively.

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