TELKONET INC
Form 10-K
March 16, 2007

**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

Commission file number: 000-27305

**TELKONET, INC.**
(Exact name of registrant as specified in its charter)

| Utah | 87-0627421 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (IRS Employee Identification No.) |

20374 Seneca Meadows Parkway
Germantown, MD 20876
(Address of principal executive offices)

(240) 912-1800
(Issuer's telephone number)

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

Indicate by check mark if the registrant is a well-know seasoned issuer, as defined in Rule 405 of the Securities Act. __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. __ 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 ___No

Check 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.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See the definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

___ Large Accelerated Filer _X_ Accelerated Filer ___ Non-Accelerated Filer

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

Aggregate market value of the voting stock held by non-affiliates of the registrant as of March 1, 2007: $136,993,170. Number of outstanding shares of the registrant's par value $0.001 common stock as of March 1, 2007: 57,002,301.

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## PART I

## ITEM 1. DESCRIPTION OF BUSINESS.

### GENERAL

***Business***

Telkonet, Inc., formed in 1999, develops and markets technology for the transmission of high-speed voice, video and data communications over the existing electrical wiring within a building. Telkonet has made definitive inroads into the Powerline communication (PLC) market and established the "leading" position for in-building commercial communication solutions.

Through the Company's majority-owned subsidiary Microwave Satellite Technologies (MST), the Company is able to offer quadruple play ("Quad-Play") services to multi-tenant unit ("MTU") and multi-dwelling unit ("MDU") residential, hospitality and commercial properties. These Quad- Play services include video, voice, high-speed internet and wireless fidelity ("Wi-Fi") access.

The Company's recent acquisition of Ethostream, LLC, a leading high speed wireless internet and technology provider for the hospitality industry (as described in greater detail below under "Segment Reporting"), will enable Telkonet to provide installation and support for PLC products and third party applications to customers across North America. The Company's new operating division represented by the assets acquired from Smart Systems International, a leading provider of energy management products and solutions (as described in greater detail below under "Segment Reporting") will permit the Company to offer new energy management products and solutions to its customers in the United States and Canada.

As a result of Telkonet's acquisition of Smart Systems International and EthoStream, the Company can now provide hospitality owners with a greater return on investment on technology investments. Hotel owners can leverage the Telkonet iWire System™ platform to support wired and wireless Internet access and, in the future, to support a networked energy management system. With the synergy of Ethostream, LLC's centralized remote monitoring and management platform extending over HSIA, digital video surveillance and energy management, hospitality owners will have a complete technology offering based on Telkonet's core PLC system as the infrastructure backbone, demonstrating true technology convergence.

The Company's offices are located at 20374 Seneca Meadows Parkway, Germantown, Maryland 20876. The reports that the Company files pursuant to the Securities Exchange Act of 1934 can be found at the Company's web site at www.telkonet.com.

### Segment Reporting

We classify our operations in two reportable segments: the Telkonet Segment and the MST Segment

***Telkonet Segment ("Telkonet")***

Through the revolutionary Telkonet iWire System™ , Telkonet utilizes proven PLC technology to deliver commercial high-speed Broadband access from an IP "platform" that is easy to deploy, reliable and cost-effective by leveraging a building's existing electrical infrastructure. The building's existing electrical wiring becomes the backbone of the local area network, which converts virtually every electrical outlet into a high-speed data port without the costly installation of additional wiring or major disruption of business activity.

The Telkonet iWire System™ offers a viable and cost-effective alternative to the challenges of hardwiring and wireless local area networks (LANs). Telkonet's products are designed for use in commercial and residential applications, including multi-dwelling units and the hospitality and government markets. Applications supported by the Telkonet "platform" include, but are not limited to, VoIP telephones, internet connectivity, local area networking, video conferencing, closed circuit security surveillance and a host of other information services.

Telkonet's Product has been installed in all present target market segments. Government and regulatory certifications have been obtained to sell the product internationally. Telkonet has been shipping PLC products since 2003, initially targeting the multi-hospitality unit (MHU) market followed by the multi-dwelling unit (MDU) market as well as the Government and Public Sector markets. Telkonet employs both direct and indirect sales model to distribute and support product on a worldwide basis.

On March 9, 2007, the Company acquired substantially all of the assets of Smart Systems International (SSI), a leading provider of energy management products and solutions to customers in the United States and Canada for cash and Company common stock having an aggregate value of $7,000,000. The purchase price was comprised of $875,000 in cash and 2,227,273 shares of the Company's common stock. The Company is obligated to register the stock portion of the purchase price on or before May 15, 2007 and 1,090,000 shares are being held in an escrow account for a period of one year following the closing from which certain potential indemnification obligations under the purchase agreement may be satisfied. The aggregate number of shares held in escrow is subject to adjustment upward or downward depending upon the trading price of the Company's common stock during the one year period following the closing date.

On March 15, 2007, the Company acquired 100% of the outstanding membership units of Ethostream, LLC, a network solutions integration company that offers installation, sales and service to the hospitality industry. The Ethostream, LLC acquisition will enable Telkonet to provide installation and support for PLC products and third party applications to customers across North America. The purchase price of $11,756,097 was comprised of $2.0 million in cash and 3,459,609 shares of the Company's common stock. The entire stock portion of the purchase price is being held in escrow to satisfy certain potential indemnification obligations of the sellers under the purchase agreement. The shares held in escrow are distributable over the three years following the closing. The aggregate number of shares issuable to the sellers is subject to downward adjustment in the event the Company's common stock trades at or above a price of $4.50 per share for twenty consecutive trading days during the one year period following the closing.

**Competition**

Telkonet is a member of the HomePlug(TM) Powerline Alliance, an industry trade group that engages in marketing and educational initiatives and sets standards and specifications for products in the powerline communications industry.

The HomePlug(TM) Powerline Alliance has grown over the past year and now includes many well recognized brands in the networking and communications industries. These include Linksys (a Cisco company), Intel, GE, Motorola, Netgear, Sony and Samsung. With the exception of Motorola, who recently introduced a commercial product, these companies do not presently represent a direct competitive threat to Telkonet since they only market and sell their products in the residential sector.

There can be no assurance that other companies will not develop PLC products that compete with Telkonet's products in the future. They all have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources than Telkonet. These potential competitors may, among other things, undertake more extensive marketing campaigns, adopt more aggressive pricing policies, obtain more favorable pricing from suppliers and manufacturers and exert more influence on the sales channel than Telkonet can. As a result, Telkonet may not be able to compete successfully with these potential competitors and these potential competitors may develop or market technologies and products that are more widely accepted than those being developed by Telkonet or that would render Telkonet's products obsolete or noncompetitive.

Management has focused its sales and marketing efforts primarily on the commercial sector, which includes office buildings, hotels, schools, shopping malls, commercial buildings, multi-dwelling units, government facilities, and any other commercial facilities that have a need for Internet access and network connectivity. Telkonet has also focused on establishing relationships with value added resellers. Telkonet continues to examine, select and approach entities with existing distribution channels that will be enhanced by Telkonet's offerings. Telkonet also intends to focus future sales and marketing efforts in Europe, South America, Asia and the Pacific Rim.

**Raw Materials**

Telkonet has not experienced any significant or unusual problems in the purchase of raw materials or commodities. While Telkonet is dependent, in certain situations, on a limited number of vendors to provide certain raw materials and components, it has not experienced significant problems or issues purchasing any essential materials, parts or components. Telkonet obtains the majority of its raw materials from the following suppliers: Avnet Electronics Marketing, Digi-Key Corporation, Intellon Corporation, and Parkview Metal Products. In addition, Superior Manufacturing Services, a U.S. based company, provides substantially all the manufacturing and assembly requirements for Telkonet.

**Customers**

Telkonet is neither limited to, nor reliant upon, a single or narrowly segmented consumer base from which it derives its revenues. Presently, Telkonet is not dependent on any particular customer under contract. However, Telkonet's sale of certain rental contract agreements to Hospitality Leasing Corporation represented approximately 18.0% of total revenues in each of 2005 and 2006. Telkonet's primary focus is in the commercial, government and international markets.

**Intellectual Property**

Telkonet has applied for patents that cover the unique technology integrated into the Telkonet iWire System™ product suite. Telkonet also continues to identify, design and develop enhancements to its core technologies that will provide additional functionality, diversification of application and desirability for current and future users of the Telkonet iWire System™ product suite.

In January 2003, Telkonet received Federal Communications Commission (FCC) approval to market the Telkonet iWire SystemTM product suite. 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. An independent, FCC-certified testing lab has verified the Company's Gateway complies with the FCC technical requirements for Class A digital devices. No further testing of this device is required and the device may be manufactured and marketed for commercial use.

In December 2003, Telkonet received approval from the U.S. Patent and Trademark Office for its "Method and Apparatus for Providing Telephonic Communication Services" Patent No.: 6,668,058. This invention covers the utilization of an electrical power grid, for a concentration of electrical power consumers, and use of existing consumer power lines to provide for a worldwide voice and data telephony exchange

In March 2005, Telkonet received final certification of its Telkonet iWire System™ product suite from European Union (EU) authorities, which certification was required before Telkonet could sell and permanently install products in EU countries. As a result of the certification, Telkonet products that will be sold and installed in EU countries will bear the Conformite Europeene (CE) mark, a symbol that demonstrates that the product has met the EU's regulatory standards and is approved for sale within the EU. Telkonet now has satisfied the governmental requirements for product safety and certification in the EU and is free to sell and install the Telkonet iWire System™ product suite in the EU.

In June 2005, Telkonet received the National Institute of Standards and Technology (NIST) Federal Information Processing Standard (FIPS) 140-2 validation for the Gateway. In July 2005, Telkonet received FIPS 140-2 validation for the eXtender and iBridge. The U.S. federal government requires, as a condition to purchasing certain information processing applications, that such applications receive FIPS 140-2 validation. U.S. federal agencies use FIPS 140-2 compliant products for the protection of sensitive information. As a result of the foregoing validations, as of July 2005, all of Telkonet's powerline carrier products have satisfied all governmental requirements for security certification and are eligible for purchase by the U.S. federal government. In addition to the foregoing, Canadian provincial authorities use FIPS 140-2 compliant products for the protection of sensitive designate information. The Communications-Electronics Security Group (CESG) also has stated that FIPS 140-2 compliant products meet its security criteria for use in data traffic categorized as "Private." CESG is part of the United Kingdom's National Technical Authority for Information Assurance, which is a government agency responsible for validating the security of information processing applications for the government of the United Kingdom, financial institutions, healthcare organizations, and international governments, among others.

In November 2005, Telkonet received the Norma Official Mexicana (NOM) certification, enabling Telkonet to sell the iWire System™ product suite in Mexico. NOM certification is required for Telkonet's products to be sold in Mexico, and no further certifications are required to sell the Telkonet iWire System™ product suite in Mexico.

In December 2005, the United States Patent and Trademark Office issued Patent No: 6,975,212 titled "Method and Apparatus for Attaching Power Line Communications to Customer Premises". The patent covers the method and apparatus for modifying a three-phase power distribution network in a building in order to provide data communications by using a PLC signal to an electrical central location point of the power distribution system. Telkonet's Coupler technology enables the conversion of electrical outlets into high-speed data ports without costly installation, additional wiring, or significant disruption of business activity. The Coupler is an integral component of the Telkonet iWire System™ product suite.

In August 2006, the United States Patent and Trademark Office issued Patent No: 7,091,831, titled "Method and Apparatus for Attaching Power Line Communications to Customer Premises". The patented technology incorporates a safety disconnect circuit breaker into the Telkonet Coupler, creating a single streamlined unit. In doing so, installation of the Telkonet iWire System(TM) is faster, more efficient, and more economical than with separate disconnect switches, delivering optimal signal quality. The Telkonet Integrated Coupler Breaker patent covers the unique technique used for interfacing and coupling its communication devices onto the three-phase electrical systems that are predominant in commercial buildings.

In January 2007, the United States Patent and Trademark Office issued Patent No: 7,170,395 titled “Methods and Apparatus for Attaching Power Line Communications to Customer Premises” for Delta phase power distribution system applications, which are prevalent in the maritime industry, shipboard systems, along with that of heavy industrial plants and facilities.

Assumed through the acquisition of SSI, the United States Patent and Trademark Office issued Patent No: 5,395,042 in March 1995 titled “Apparatus and Method for automatic climate control” calculates and records the amount of time needed for the thermostat to return the room temperature to the occupant’s set point once a person re-enters the room

In addition Telkonet currently has multiple patent applications under examination, and intends to file additional patent applications covering a wide range of technologies including that of improved network topologies and techniques for imposing LANs over existing wired infrastructures.

Telkonet has also filed multiple Patent Cooperation Treaty (PCT) patent applications, which have been used to file national patent applications in foreign countries including the European Union, Japan, China, Russia, India and others.

Notwithstanding the issuance of these patents, there can be no assurance that any of Telkonet’s current or future patent applications will be granted, or, if granted, that such patents will provide necessary protection for the Company’s technology or its product offerings, or be of commercial benefit to the Company.

**Government Regulation**

We are subject to regulation in the United States by the FCC. FCC rules permit the operation of unlicensed digital devices that radiate radio frequency (RF) emissions if the manufacturer complies with certain equipment authorization procedures, technical requirements, marketing restrictions and product labeling requirements. An independent, FCC-certified testing lab has verified that the Company’s our PLC product line complies with the FCC technical requirements for 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.

In Europe and other overseas markets, Telkonet’s products are subject to safety and RF emissions regulations adopted by the European Union (EU) for Information Technology Equipment. In March 2005, the Company received final Conformite Europeene (CE) certification, which is required for the Company to freely market and sell its products within the EU. As a result of the certification, Telkonet’s products sold and installed in EU countries will bear the CE marking, a symbol that demonstrates that the product has met the EU’s regulatory standards and is approved for sale in the EU. The Restriction of Hazardous Substances Directive (RoHS) directive took effect in the EU on July 1, 2006. This directive restricts the use of six hazardous materials in the manufacture of various types of electronic and electrical equipment. It is closely linked with the Waste Electrical and Electronic Equipment Directive (WEEE) which sets collection, recycling and recovery targets for electrical goods and is part of a legislative initiative to solve the problem of huge amounts of toxic e-waste. Telkonet has taken the appropriate measures to be fully compliant with both of these directives.

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

**Research and Development**

During the years ended December 31, 2006, 2005 and 2004, Telkonet spent $1,925,746, $2,096,104, and $1,852,309, respectively, on research and development activities. In 2006, research and development activities were focused on the development of Telkonet's next generation product. In 2005, research and development activities included (a) QoS for VoIP service for both commercial and FIPS 140-2 product applications, (b) design of the next generation high-speed development platform, (c) design, prototype & release of the Integrated Coupler Breaker product line, (d) design & development of the second generation automated test equipment for manufacturing, (e) automated SQA regression testing. In 2004, research and development activities included (a) development of a further cost-reduced ("G3") iBridge/eXtender, (b) router software development, and (c) advanced encryption support.

**Long Term Investments**

Amperion, Inc.

On November 30, 2004, Telkonet entered into a Stock Purchase Agreement (“Agreement”) with Amperion, Inc. ("Amperion"), a privately held company. Amperion is engaged in the business of developing networking hardware and software that enables the delivery of high-speed broadband data over medium-voltage power lines. Pursuant to the Agreement, the Company invested $500,000 in Amperion in exchange for 11,013,215 shares of Series A Preferred Stock for an equity interest of approximately 4.7%. Telkonet accounted for this investment under the cost method, as the Company does not have the ability to exercise significant influence over operating and financial policies of the investee.

It is the policy of Telkonet to regularly review the assumptions underlying the operating performance and cash flow forecasts in assessing the carrying values of the investment. Telkonet identifies and records impairment losses on investments when events and circumstances indicate that such decline in fair value is other than temporary. Such indicators include, but are not limited to, limited capital resources, limited prospects of receiving additional financing, and limited prospects for liquidity of the related securities. Telkonet determined that its investment in Amperion was impaired based upon forecasted discounted cash flow. Accordingly, Telkonet wrote-off $92,000 and $400,000 of the carrying value of its investment through a charge to operations during the year-ended December 31, 2006 and 2005, respectively. The remaining value of Telkonet’s investment in Amperion is $8,000 and $100,000 at December 31, 2006 and 2005, respectively, and the amount at December 31, 2006, represents the current fair value.

BPL Global, Ltd.

On February 4, 2005, the Company’s Board of Directors approved an investment in BPL Global, Ltd. (“BPL Global”), a privately held company. Telkonet funded an aggregate of $131,000 as of December 31, 2005 and additional $44 during the year of 2006. This investment represents an equity interest of approximately 4.67% at December 31, 2006. BPL Global is engaged in the business of developing broadband services via power lines through joint ventures in the United States, Asia, Eastern Europe and the Middle East. Telkonet accounted for this investment under the cost method, as the Company does not have the ability to exercise significant influence over operating and financial policies of the investee. Telkonet reviewed the assumptions underlying the operating performance and cash flow forecasts in assessing the carrying values of the investment. The fair value of Telkonet's investment in BPL Global, Ltd. amounted $131,044 and $131,000 as of December 31, 2006 and 2005, respectively.

**Backlog**

As of March 1, 2007 and 2006, revenues to be recognized under non-cancelable leases and service contracts in the hospitality market of approximately $1,331,000 and $2,411,000, respectively. Additionally, Telkonet has a commitment to deploy the Telkonet iWire System™ at 50 properties for a major resort company which deployment represents revenue of approximately $1,100,000 over a 3 year term.

In conjunction with the acquisition of Smart Systems International on March 9, 2007, Telkonet assumed certain purchase orders relating to a major utilities energy management initiative provided through the two selected providers. The current order backlog amounts to approximately $500,000 and the estimated remaining program value amounts to $3,000,000 for products and services to be provided through 2008.

In conjunction with the acquisition of Ethostream, LLC on March 15, 2007, Telkonet acquired support contracts and monthly services for more than 1500 hotels which is expected to generate approximately $2,000,000 annual recurring support and internet advertising revenue.

***MST Segment ("MST")***

MST is a communications service provider offering quadruple play ("Quad-Play") services to multi-tenant unit ("MTU") and multi-dwelling unit ("MDU") residential, hospitality and commercial properties. These Quad-Play services include video, voice, high-speed internet and wireless fidelity ("Wi-Fi") access. In addition, MST currently offers or plans to offer a variety of next-generation telecommunications solutions and services including satellite installation, video conferencing, surveillance/security and energy management, and other complementary professional services.

*NuVisions™*

MST currently offers digital television service through DISH Network, a national satellite television provider, under its private label NuVisions™ brand of services. The NuVisions TV offering currently includes over 500 channels of video and audio programming, with a large high definition (more than 40 channels) and ethnic offering (over 100 channels from 17 countries) available in the market today. MST also offers its NuVisions Broadband high speed internet service and NuVisions Digital Voice telephone service to multi-family residences and commercial properties. MST delivers its broadband based services using terrestrial fiber optic links and in February 2005, began deployment in New York City of a proprietary wireless gigabit network that connects properties served in a redundant gigabit ring - a virtual fiber optic network in the air.

*Wi-Fi Network*

MST has constructed a large NuVisions Wi-Fi footprint in New York City intended to create a ubiquitous citywide Wi-Fi network. NuVisions Wi-Fi offers Internet access in the southern-half of Central Park, Riverside Park from 60th to 79th Streets, Dag Hammarskjold Plaza, and the United Nations Plaza. In addition, MST provides NuVisions Wi-Fi service in and around Trump Tower on Fifth Avenue, Trump World Tower on First Avenue, the Trump Place properties located on Riverside Boulevard, Trump Palace, Trump Parc, Trump Parc East as well as portions of Roosevelt Island surrounding the Octagon residential community. MST currently has plans to deploy additional Wi-Fi "Hot Zones" throughout New York City and continue to enlarge its Wi-Fi footprint as new properties are served.

*Internet Protocol Television ("IPTV")*

In fourth quarter of 2006, MST invested in an IPTV platform to deploy in 2007. IPTV is a method of distributing television content over IP that enables a more user-defined, on-demand and interactive experience than traditional cable or satellite television. The IPTV service delivers traditional cable TV programming and enables subscribers to surf the Internet, receive on-demand content, and perform a host of Internet-based functions via their TV sets.

**Competition**

The home entertainment and video programming industry is competitive, and MST expects competition to intensify in the future. MST faces its most significant competition from the franchised cable operators. In addition, MST's competition includes other satellite providers, telecom providers and off-air broadcasters.

*Hardwired Franchised Cable System*

Cable companies currently dominate the market in terms of subscriber penetration, the number of programming services available, audience ratings and expenditures on programming. However, satellite services are gaining market share which MST believes will provide it with the opportunity to acquire and consolidate a subscriber base by providing a high quality signal at a comparable or reduced price to many cable operators' current service.

*Other Operators*

MST's next largest competitors are other operators who build and operate communications systems such as satellite master antenna television systems, commonly known as SMATV, or private cable headend systems, which generally serve condominiums, apartment and office complexes and residential developments. MST also competes with other national DBS operators such as EchoStar.

*Off-Air Broadcasters*

A majority of U.S. households that are not serviced by cable operators are serviced only by broadcast networks and local television stations (“off-air broadcasters”). Off-air broadcasters send signals through the air, which are received by traditional television antennas. Signals are accessible to anyone with an antenna and programming is funded by advertisers. Audio and video quality is limited and service can be adversely affected by weather or by buildings blocking a signal.

*Traditional Telephone Companies*

Traditional telephone companies such as Verizon and AT&T have recently diversified their service offerings to compete with traditional franchised cable companies in a triple-play market. Although their subscriber growth is currently smaller than franchise cable companies, these traditional phone companies are developing video offerings such as Verizon's FIOS product. These phone companies have in the past also been resellers of DIRECTV and EchoStar video programming, however, rarely in the multi-dwelling unit market. In the future, video offerings from traditional phone companies may become a significant competitor in the MDU market.

**Customers/Strategy**

MST's customer base and strategy is to target and cultivate a subscriber base that will demand high margin products including, video, IPTV, VoIP, high-speed Internet and Wi-Fi services.

MST currently maintains service agreements with approximately 20 MDU and MTU properties. Generally, under the terms of a service agreement, MST provides either (i) "bulk services," which may include one or all of a bundle of products and services, at a fixed price per month to the owner of the MDU or MTU property, and contract with individual residents for enhanced services, such as premium cable channels, for a monthly fee or (ii) contract with individual residents of the MDU property for one or more basic or enhanced services for a monthly fee. These agreements typically include a revenue sharing arrangement with property owners, whereby the property owner is entitled to a share of the revenues derived from subscribers who reside at the MDU/MTU property**.** These revenue sharing arrangements are either based upon a fix amount per subscriber or based on a percentage, typically between 7-10%, of the monthly fees MST charges residents for its services. MST believes that its complementary products and services allows for future growth and as such are designed and integrated with scalability in mind.

**Governmental Regulation**

*Federal Regulation*

MST's systems do not use or traverse public rights-of-way and thus are exempt from the comprehensive regulation of cable systems under the Federal Communications Act of 1934, as amended (the "Communications Act"). Because its systems are subject to minimal federal regulation, MST has greater pricing freedom and is not required to serve any customer whom it does not choose to serve, and management believes that MST has significantly more competitive flexibility than do the franchised cable systems. Management believes that these regulatory advantages help to make MSTs' private systems competitive with larger franchised cable systems.

On October 5, 1992, Congress enacted the Cable Consumer Protection and Competition Act of 1992 (the "1992 Cable Act"), which imposed additional regulation on traditional franchised cable operators and permits regulation of rates in markets in which there is no "effective competition", as defined in the 1992 Cable Act, and directed the FCC to adopt comprehensive new federal standards for local regulation of certain rates charged by traditional franchised cable operators. Conversely, the legislation also provides for deregulation of traditional hardwire cable in a given market where effective competition is shown to exist. Rates charged by private cable operators, typically already lower than traditional franchise cable rates, are not subject to regulation under the 1992 Cable Act.

In February 1996, Congress passed the Telecommunications Act of 1996 (the "1996 Act"), which substantially amended the Communications Act. The 1996 Act contains provisions intended to increase competition in the telephone, radio, broadcast television, and hardwire and wireless cable television businesses. This legislation has altered, and management believes will continue to alter, federal, state, and local laws and regulations affecting the communications industry, including certain of the services MST provides.

Under the federal copyright laws, permission from the copyright holder generally must be secured before a video program may be retransmitted. Section 111 of the Copyright Act establishes the cable compulsory license pursuant to which certain "cable systems" are entitled to engage in the secondary transmission of broadcast programming without the prior permission of the holders of copyrights in the programming. In order to do so, a cable system must secure a compulsory copyright license. Such a license may be obtained upon the filing of certain reports with and the payment of certain licensing fees to the U.S. Copyright Office. Private cable operators, such as MST, may rely on the cable compulsory license with respect to the secondary transmission of broadcast programming. Management does not expect the licensing fees to have a material adverse effect on MST's business.

Under the retransmission consent provisions of the 1992 Cable Act, multichannel video programming distributors, including, but not limited to, franchised and private cable operators, seeking to retransmit certain commercial television broadcast signals, notwithstanding the cable compulsory license, must first obtain the permission of the broadcast station in order to retransmit the station's signal. However, private cable systems, unlike franchised cable systems, are not required under the FCC's "must carry" rules to retransmit local television signals. Although there can be no assurances that MST will be able to obtain requisite broadcaster consents, management believes, in most cases, MST will be able to do so for little or no additional cost.

On November 29, 1999, Congress enacted the Satellite Home Viewer Improvement Act of 1999 (“SHVIA”), which amended the Satellite Home Viewer Act. SHVIA permits DBS operators to transmit local television signals into local markets. SHVIA generally seeks to place satellite operators on an equal footing with cable television operators in regards to the availability of television broadcast programming. SHVIA amends the Copyright Act and other applicable laws and regulations in order to clarify the terms and conditions under which a DBS operator may retransmit local and distant broadcast television stations to subscribers. The law was intended to promote the ability of satellite services to compete with cable television systems and to resolve disputes that had arisen between broadcasters and satellite carriers regarding the delivery of broadcast television station programming to satellite service subscribers. As a result of SHVIA, television stations are generally entitled to seek carriage on any DBS operator's system providing local service in their respective markets. SHVIA creates a statutory copyright license applicable to the retransmission of broadcast television stations to DBS subscribers located in their markets. Although there is no royalty payment obligation associated with this license, eligibility for the license is conditioned on the satellite carrier's compliance with applicable laws, regulations and FCC rules governing the retransmission of such “local” broadcast television stations to satellite service subscribers. Noncompliance with such laws, regulations and/or FCC requirements could subject a satellite carrier to liability for copyright infringement. SHVIA was extended and re-enacted by the Satellite Home Viewer Extension and Reauthorization Act (“SHVERA”) in December of 2004.

MST is not directly subject to rate regulation or certification requirements by the FCC or state public utility commissions because its equipment installation and sales agent activities do not constitute the provision of common carrier or cable television services. As a private cable operator, MST is not subject to regulation as a DBS provider, but primarily relies upon its third-party programming aggregators to procure all necessary re-transmission consents and other programming rights under the Communications Act and the Copyright Act.

*State and Local Cable System Regulation*

MST does not anticipate that its deployment of video programming services will be subject to state or local franchise laws primarily due to the fact that its facilities do not use or traverse public rights-of-way. Although MST may be required to comply with state and local property tax, environmental laws and local zoning laws, management does not anticipate that compliance with these laws will have any material adverse impact on MST’s business.

*Preferential Access Right*

MST generally negotiates exclusive rights to provide satellite services singularly or in competition with competing cable providers, and also negotiates, where possible, “rights-of-first-refusal” to match price and terms of third-party offers to provide other communication services in buildings where it has negotiated broadcast access rights. Management believes that these preferential rights of entry are generally enforceable under applicable law. However, current trends at the state and federal level suggest that the future enforceability of these provisions may be uncertain. The FCC has recently issued an order prohibiting telecommunications service providers from negotiating exclusive contracts with owners of commercial MDU properties, although it deferred determination in a pending rulemaking whether to render existing exclusive access agreements unenforceable, or to extend this prohibition to residential MDUs due to an inadequate administrative record. Although it is open to question whether the FCC has statutory and constitutional authority to compel mandatory access, there can be no assurance that it will not attempt to do so. Any such action may undermine the exclusivity provisions of MST’s rights of entry on the one hand, but would also open up many other properties to which MST could provide a competing service. There can be no assurance that future state or federal laws or regulations will not restrict MST’s ability to offer access payments, limit MDU owners' ability to receive access payments or prohibit MDU owners from entering into exclusive agreements, any of which could have a material adverse effect on MST’s business.

*Regulation of the High-Speed lnternet and Wi-Fi Business*

ISPs, including Internet access providers, are largely unregulated by the FCC or state public utility commissions at this time (apart from federal, state and local laws and regulations applicable to business in general). However, there can be no assurance that this business will not become subject to regulatory restraints. Also, although the FCC has rejected proposals to impose additional costs and regulations on ISPs to the extent they use local exchange telephone network facilities, such change may affect demand for Internet related services. No assurance can be given that changes in current or future regulations adopted by the FCC or state regulators or other legislative or judicial initiatives relating to Internet services would not have a material adverse effect on MST's business.

*Regulation of the VoIP Business*

IP-based voice services are currently exempt from the reporting and pricing restrictions placed on common carriers by the FCC. However, there are several state and federal regulatory proceedings further defining what specific service offerings qualify for this exemption. Due to the growing acceptance and deployment of VoIP services, the FCC and a number of state public service commissions are conducting regulatory proceedings that could affect the regulatory duties and rights of entities that provide IP-based voice applications. There is regulatory uncertainty as to the imposition of traditional retail, common carrier regulation on VoIP products and services.

**Long Term Investments**

MST maintains an investment in Interactivewifi.com, LLC a privately held company. This investment represents an equity interest of approximately 50% at December 31, 2006. Interactivewifi.com is engaged in providing internet and related services to customers throughout metropolitan New York, including the Nuvisions internet services. MST accounted for this investment under the cost method, as MST does not have the ability to exercise significant influence over operating and financial policies of the investee. Telkonet reviewed the assumptions underlying the operating performance and cash flow forecasts in assessing the carrying values of the investment. The fair value of MST's investment in Interactivewifi.com amounted to approximately $55,000 as of December 31, 2006.

**Backlog**

The MST subscriber portfolio includes approximately 20 MDU properties with bulk service agreements and/or access licenses to service the individual subscribers in metropolitan New York. The remaining terms of the access agreements provide MST access rights from 7 to 15 years with the final agreement expiring in 2016 and the revenues to be recognized under non-cancelable bulk agreements provide a minimum of $1,800,000 in revenue through 2013.

***Other information***

***Employees***

As of March 1, 2007, the Company had 104 full time employees comprised of 69 full time employees of Telkonet and 27 employees of MST. The Company anticipates that it will hire additional key staff throughout 2007 in the areas of business development, sales and marketing, and engineering.

Following the acquisition of SSI and Ethostream, LLC on March 9, 2007 and March 15, 2007, respectively, the Company had 177 full time employees.

***Environmental Matters***

The Company does not anticipate any material effect on its capital expenditures, earnings or competitive position due to compliance with government regulations involving environmental matters.

***Financial Information About Geographic Areas***

To date, the majority of the Company's revenue has been derived in the United States, although the Company continues to expand a growing portion of our revenue from international sales. International sales as a percentage of total revenue represented 19% and 25% in 2006 and 2005, respectively. Our international sales are concentrated in Canada, Latin America and Western Europe and we continue to expand into other markets worldwide. The table below sets forth our net revenue by major geographic region.

| | Year Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2006 | Percentage Change | | 2005 | Percentage Change | 2004 |
| United States | $ 4,508,478 | 141% | $ | 1,871,241 | 197% | $ 630,957 |
| Worldwide | 672,850 | 9% | | 617,082 | 812% | 67,695 |
| Total | $ 5,181,328 | 108% | $ | 2,488,323 | 256% | $ 698,652 |

**ITEM 1A. RISK FACTORS.**

The Company's 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.

*The Company has a history of operating losses and an accumulated deficit and expects to continue to incur losses for the foreseeable future.*

Since inception through December 31, 2006, the Company has incurred cumulative losses of $70,424,669 and has never generated enough funds through operations to support its business. Additional capital may be required in order to provide working capital requirements for the next twelve months. The Company's losses to date have resulted principally from:

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

The Company is currently unprofitable and may never become profitable. Since inception, the Company has funded its research and development activities primarily from private placements of equity and debt securities, a bank loan and short term loans from certain of its executive officers. As a result of its substantial research and development expenditures and limited product revenues, the Company has incurred substantial net losses. The Company's ability to achieve profitability will depend primarily on its ability to successfully commercialize the Telkonet iWire SystemTM product suite. If the Company is not successful in generating sufficient liquidity from operations or in raising sufficient capital resources on terms acceptable to the Company, this could have a material adverse effect on the Company's business, results of operations, liquidity and financial condition.

*Potential fluctuations in operating results could have a negative effect on the price of the Company's common stock.*

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

- the level of use of the Internet;
- the demand for high-tech goods;
- the amount and timing of capital expenditures and other costs relating to the expansion of the Company's operations;
- price competition or pricing changes in the industry;
- technical difficulties or system downtime;
- economic conditions specific to the internet and communications industry; and

· general economic conditions.

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

*The Company's directors and executive officers own a substantial percentage of the Company's issued and outstanding common stock. Their ownership could allow them to exercise significant control over corporate decisions.*

As of March 1, 2007, the Company's officers and directors owned 17.8% of the Company's issued and outstanding common stock. This means that the Company's officers and directors, as a group, exercise significant control over matters upon which the Company's stockholders may vote, including the selection of the Board of Directors, mergers, acquisitions and other significant corporate transactions.

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

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

*The exercise of options and warrants outstanding and available for issuance may adversely affect the market price of the Company's common stock.*

As of December 31, 2006, the Company had outstanding employee options to purchase a total of 8,520,929 shares of common stock at exercise prices ranging from $1.00 to $5.97 per share, with a weighted average exercise price of $2.06. As of December 31, 2006, the Company had outstanding non-employee options to purchase a total of 1,815,937 shares of common stock at an exercise price of $1.00 per share. As of December 31, 2006, the Company had warrants outstanding to purchase a total of 4,557,850 shares of common stock at exercise prices ranging from $2.59 to $4.87 per share, with a weighted average exercise price of $4.20. The exercise of outstanding options and warrants and the sale in the public market of the shares purchased upon such exercise will be dilutive to existing stockholders and could adversely affect the market price of the Company's common stock.

*The powerline communications industry is intensely competitive and rapidly evolving.*

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

Delays in product development and introduction could result in:

· loss of or delay in revenue and loss of market share;

· negative publicity and damage to the Company's reputation and brand; and

· decline in the average selling price of the Company's products.

*The communication industry is intensely competitive and rapidly evolving.*

The Company operates in a highly competitive, quickly changing environment, and our future success will depend on our ability to develop and introduce new services and service enhancements that achieve broad market acceptance in MDU and commercial sectors. The Company 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;

· negative publicity and damage to our reputation and brand; and

· decline in the selling price of our products and services.

Additionally, new companies are constantly entering the market, thus increasing the competition. This could also have a negative impact on our ability to obtain additional capital from investors. Larger companies who have been engaged in our industry business for substantially longer periods of time may have access to greater resources. These companies may have greater success in the recruitment and retention of qualified employees, as well as in conducting their operations, which may give them a competitive advantage. In addition, actual or potential competitors may be strengthened through the acquisition of additional assets and interests. If the Company is unable to compete effectively or adequately respond to competitive pressures, this may materially adversely affect our results of operation and financial condition. Large companies including Direct TV, EchoStar, Time Warner, Cablevision and Verizon are active in our markets in the provision and distribution of communications services and we will also have to compete with such companies.

*The Company is not large enough to negotiate cable television programming contracts as favorable as some of our larger competitors.*

Programming costs are generally directly related to the number of subscribers to which the programming is provided, with discounts available to large traditional cable operatores and direct broadcast satallite (DBS) providers based on their high subscriber levels. As a result, larger cable and DBS systems generally pay lower per subscriber programming costs. The Company has attempted to obtain volume discounts from our suppliers. Despite these efforts, we believe that our per subscriber programming costs are significantly higher than large cable operatores and DBS providers with which we compete in some of our markets. This may put us at a competitive disadvantage in terms of maintaining our operating results while remaining competitive with prices offered by these providers. In addition, as programming agreements come up for renewal, the Company cannot assure you that we will be able to renew these agreements on comparable or favorable terms. To the extent that we are unable to reach agreement with a programmer on terms that we believe are reasonable, we may be forced to remove programming from our line-up, which could result in a loss of customers.

*Government regulation of the Company's products could impair the Company's ability to sell such products in certain markets.*

FCC rules permit the operation of unlicensed digital devices that radiate radio frequency emissions if the manufacturer complies with certain equipment authorization procedures, technical requirements, marketing restrictions and product labeling requirements. Differing technical requirements apply to "Class A" devices intended for use in commercial settings, and "Class B" devices intended for residential use to which more stringent standards apply. An independent, FCC-certified testing lab has verified that the Company's Telkonet's 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 the Company for commercial and residential use will be subject to the FCC rules for unlicensed digital devices. Moreover, if in the future, the FCC changes its technical requirements for unlicensed digital devices, further testing and/or modifications of devices may be necessary. Failure to comply with any FCC technical requirements could impair the Company's ability to sell its products in certain markets and could have a negative impact on its business and results of operations.

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*Products sold by the Company's competitors could become more popular than the Company's products or render the Company's products obsolete.*

The market for powerline communications products is highly competitive. The HomePlug(TM) Powerline Alliance has grown over the past year and now includes many well recognized brands in the networking and communications industries. These include Linksys (a Cisco company), Intel, GE, Motorola, Netgear, Sony and Samsung. With the exception of Motorola, who recently introduced a commercial product, these companies do not presently represent a direct competitive threat to the Company since they only market and sell their products in the residential sector. There can be no assurance that other companies will not develop PLC products that compete with the Company's products in the future. Some of these potential competitors have longer operating histories, greater name recognition and substantially greater financial, technical, sales, marketing and other resources. These potential competitors may, among other things, undertake more extensive marketing campaigns, adopt more aggressive pricing policies, obtain more favorable pricing from suppliers and manufacturers and exert more influence on the sales channel than the Company can. As a result, the Company may not be able to compete successfully with these potential competitors and these potential competitors may develop or market technologies and products that are more widely accepted than those being developed by the Company or that would render the Company's products obsolete or noncompetitive. The Company anticipates that potential competitors will also intensify their efforts to penetrate the Company's target markets. These potential competitors may have more advanced technology, more extensive distribution channels, stronger brand names, bigger promotional budgets and larger customer bases than the Company does. These companies could devote more capital resources to develop, manufacture and market competing products than the Company could. If any of these companies are successful in competing against the Company, its sales could decline, its margins could be negatively impacted, and the Company could lose market share, any of which could seriously harm the Company's business and results of operations.

*The failure of the internet to continue as an accepted medium for business commerce could have a negative impact on the Company's results of operations.*

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

*The Company may not be able to obtain patents, which could have a material adverse effect on its business.*

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

*Infringement by third parties on the Company's proprietary technology and development of substantially equivalent proprietary technology by the Company's competitors could negatively impact the Company's business.*

The Company's success depends partly on its ability to maintain patent and trade secret protection, to obtain future patents and licenses, and to operate without infringing on the proprietary rights of third parties. There can be no assurance that the measures the Company has taken to protect its intellectual property, including those integrated to its Telkonet iWire System™ product suite, will prevent misappropriation or circumvention. In addition, there can be no assurance that any patent application, when filed, will result in an issued patent, or that the Company's existing patents, or any patents that may be issued in the future, will provide the Company with significant protection against competitors. Moreover, there can be no assurance that any patents issued to, or licensed by, the Company will not be infringed upon or circumvented by others. Infringement by third parties on the Company's proprietary technology could negatively impact its business. Moreover, litigation to establish the validity of patents, to assert infringement claims against others, and to defend against patent infringement claims can be expensive and time-consuming, even if the outcome is in the Company's favor. The Company also relies to a lesser extent on unpatented proprietary technology, and no assurance can be given that others will not independently develop substantially equivalent proprietary information, techniques or processes or that the Company can meaningfully protect its rights to such unpatented proprietary technology. Development of substantially equivalent technology by the Company's competitors could negatively impact its business.

*The Company depends on a small team of senior management, and it may have difficulty attracting and retaining additional personnel.*

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

*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 competing businesses in our current or other geographic markets, including as a means to acquire spectrum. 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 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 our market value which will vary, and 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 our acquisition program.

*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 as a provider of PLC technology and a provider of digital satellite television and high-speed Internet products and services 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 its business, results of operations, or financial condition.

**ITEM 1B. UNRESOLVED STAFF COMMENTS.**

None.

**ITEM 2. PROPERTIES.**

The Company presently leases 11,600 square feet of commercial office space in Germantown, Maryland for its corporate headquarters. The Germantown lease expires in November 2010. The Company is currently planning to increase the office space of its Germantown headquarters by approximately 6,000 square feet in April 2007 in conjunction with a corporate initiative to consolidate office space.

The Company also leases 1,800 square feet of office space in White Marsh, Maryland, where it operates a portion of its sales and marketing activities. The White Marsh lease expires in May 2007.

In March 2005, the Company entered into a lease agreement for 6,742 square feet of commercial office space in Crystal City, Virginia. The Crystal City lease expires in March 2008. In February 2007, the Company executed a sublease for this space commencing in April 2007 through the expiration of the lease in March 2008.

In conjunction with the January 2006 acquisition of MST, the Company presently leases 12,600 square feet of commercial office space in Hawthorne, New Jersey for its office and warehouse spaces. This lease expires in April 2010 with an option to extend the lease an additional five years.

Following the acquisitions of SSI and Ethostream the Company assumed leases on 9,000 square feet of office space in Las Vegas, NV for the SSI office and warehouse space on a month to month basis and 4,100 square feet of office space in Milwaukee, WI for Ethostream and this lease expires in May 2011.

**ITEM 3. LEGAL PROCEEDINGS.**

None.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.**

On December 8, 2006, the Company held its annual meeting of stockholders at which the Company's stockholders elected seven (7) directors to serve on the Company's Board of Directors and ratified the appointment of the Company's independent accountants for 2006. The following directors were elected at the annual meeting based on the number of votes indicated below. Each director was elected to serve until the next annual meeting of stockholders or until his successor is elected and qualified.

| Director Name | For | Against | Abstain | Broker Non-votes |
|---|---|---|---|---|
| Warren V. Musser | 45,352,150 | 0 | 1,520,291 | 0 |
| Ronald W. Pickett | 45,343,879 | 0 | 1,526,562 | 0 |
| Stephen L. Sadle | 45,399,903 | 0 | 1,472,538 | 0 |
| Thomas C. Lynch | 46,385,473 | 0 | 486,968 | 0 |
| James L. Peeler | 46,376,673 | 0 | 495,768 | 0 |
| Thomas M. Hall | 46,423,873 | 0 | 448,568 | 0 |
| Seth D. Blumenfeld | 45,392,739 | 0 | 1,479,702 | 0 |

The other matters presented at the meeting were approved by the Company's stockholders as follows:

| Matter Voted Upon | For | Against | Abstain | Broker Non-votes |
|---|---|---|---|---|
| Ratification of Telkonet's Amended and Restated Stock Incentive Plan | 12,119,456 | 2,641,084 | 222,197 | 31,889,704 |
| Ratification of Independent Accountants | 46,555,175 | 142,308 | 174,958 | 0 |

**PART II**

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

On January 24, 2004, the Company's common stock was listed for trading on the American Stock Exchange (AMEX) under the ticker symbol "TKO." Prior to January 24, 2004, the Company's common stock was quoted on the OTC Bulletin Board under the symbol "TLKO.OB." As of March 1, 2007, the Company had 216 stockholders of record and 57,002,301 shares of its common stock issued and outstanding.

The following table documents the high and low sales prices for the Company's common stock on the AMEX for the period beginning January 1, 2005 through December 31, 2006. The information provided for the periods listed below was obtained from the Yahoo! Finance web site.

| | High | Low |
|---|---|---|
| **Year Ended December 31, 2006** | | |
| First Quarter | $ 4.51 | $ 3.35 |
| Second Quarter | $ 4.49 | $ 2.46 |
| Third Quarter | $ 3.50 | $ 1.65 |
| Fourth Quarter | $ 3.27 | $ 2.32 |
| **Year Ended December 31, 2005** | | |
| First Quarter | $ 6.85 | $ 3.66 |
| Second Quarter | $ 5.34 | $ 2.61 |
| Third Quarter | $ 5.60 | $ 3.11 |
| Fourth Quarter | $ 5.23 | $ 3.51 |

The Company has never paid dividends on its common stock and does not anticipate paying dividends in the foreseeable future.

**Performance Graph**

Set forth below is a line graph comparing the cumulative total return on Telkonet's common stock against the cumulative total return of the Market Index for the American Stock Exchange (U.S.) ("AMEX") and for the peer group "Communications Services, within the Standard Industrial Classification Code category, (SIC) Code 4899", for the period beginning August 15, 2002 and each fiscal year ending December 31 thereafter through the fiscal year ended December 31, 2006. Because Telkonet's common stock was not widely traded prior to August 15, 2002, the graph does not show the total return on Telkonet's common stock prior to August 15, 2002. The total returns assume $100 invested on August 15, 2002 with reinvestment of dividends.

**ITEM 6. SELECTED FINANCIAL DATA**

The following table sets forth selected financial data for the last 5 years. This selected financial data should be read in conjunction with the consolidated financial statements and related notes included in Item 15 of this Form 10-K.

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| **(in thousands, except per share amounts)** | **2006** | 2005 | **2004** | **2003** | **2002** |
| Total revenues | $ 5,181 | $ 2,488 | $ 698 | $ 94 | $ — |
| Operating loss | (17,563) | (15,307) | (13,112) | (6,564) | (3,155) |
| Net loss | (27,437) | (15,778) | (13,093) | (7,657) | (3,778) |
| Loss per share - basic | (0.54) | (0.35) | (0.32) | (0.37) | (.22) |
| Loss per share - diluted | (0.54) | (0.35) | (0.32) | (0.37) | (.22) |
| Basic weighted average common shares outstanding | 50,824 | 44,743 | 41,384 | 20,702 | 17,120 |
| Diluted weighted average common shares outstanding | 50,824 | 44,743 | 41,384 | 20,702 | 17,120 |
| Working capital | (531) | 12,061 | 12,672 | 5,296 | (894) |
| Total assets | 12,517 | 23,291 | 15,493 | 6,176 | 295 |
| Short-term borrowings and current portion of long-term debt | — | 6,350 | — | 15 | 310 |
| Long-term debt, net of current portion | — | 9,617 | 588 | 3,132 | 863 |
| Stockholders' equity (deficiency) | 8,135 | 5,315 | 13,646 | 2,388 | (1,527) |

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

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

The Company reports financial results for the following operating business segments:

**Telkonet**

Through the revolutionary Telkonet iWire System™ , Telkonet utilizes proven PLC technology to deliver commercial high-speed Broadband access from an IP "platform" that is easy to deploy, reliable and cost-effective by leveraging a building's existing electrical infrastructure. The building's existing electrical wiring becomes the backbone of the local

area network, which converts virtually every electrical outlet into a high-speed data port, without the costly installation of additional wiring or major disruption of business activity. The segment's net sales in 2006 were $3,425,525, representing 66% of the Company's consolidated net sales.

**MST**

MST is a communications service provider offering Quad-Play services to MTU and MDU residential, hospitality and commercial properties. These Quad-Play services include video, voice, high-speed internet and wireless fidelity ("Wi-Fi") access. In addition, MST currently offers or plans to offer a variety of next-generation telecommunications solutions and services, including satellite installation, video conferencing, surveillance/security and energy management, and other complementary professional services. The segments' net sales upon acquisition for the period February 1 through December 31, 2006 were $1,755,803, representing 34% of the Company's consolidated net sales.

**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 financial statements, including those related to revenue recognition, guarantees and product warranties and stock based compensation. 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, the Company recognizes revenue in accordance with Staff Accounting Bulletin No. 104, *Revenue Recognition* ("SAB104"), which superceded Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements* ("SAB101"). SAB 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the selling prices of the products delivered and the collectibility of those amounts. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. The Company defers any revenue for which the product has not been delivered or is subject to refund until such time that the Company and the customer jointly determine that the product has been delivered or no refund will be required. SAB 104 incorporates Emerging Issues Task Force 00-21 ("EITF 00-21"), *Multiple-Deliverable Revenue Arrangements.* EITF 00-21 addresses accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

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

MST accounts for the revenue, costs and expense related to residential cable services as the related services are performed in accordance with SFAS No. 51, Financial Reporting by Cable Television Companies. Installation revenue for residential cable services is recognized to the extent of direct selling costs incurred. Direct selling costs have exceeded installation revenue in all reported periods. Generally, credit risk is managed by disconnecting services to customers who are delinquent.

**Guarantees and Product Warranties**

FASB Interpretation No. 45, “Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others” (“FIN 45”), requires that upon issuance of a guarantee, the guarantor must disclose and recognize a liability for the fair value of the obligation it assumes under that guarantee.

The Company's guarantees issued subject to the recognition and disclosure requirements of FIN 45 as of December 31, 2006 and 2005 were not material. 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 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. During the year ended December 31, 2006, the Company experienced approximately 3% percent of units returned. Using this experience factor a reserve of $23,300 was accrued. Prior to the fiscal year of 2005, the Company had not established historical ratio of claims, and the cost of replacing defective products and product returns were immaterial and within management's expectations, accordingly there were no warranties provided with the purchase of the Company's products during the year ended December 31, 2004.

**Stock Based Compensation**

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options based on estimated fair values. SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company's fiscal year 2006. The Company's Consolidated Financial Statements as of and for the year ended December 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company's Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the year ended December 31, 2006 was $1,080,895, net of tax effect.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company's Consolidated Statement of Operations. Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation" ("SFAS 123"). Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company's Consolidated Statement of Operations because the exercise price of the Company's stock options granted to employees and directors approximated or exceeded the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company's Consolidated Statement of Operations for the year ended December 31, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company's pro forma information required under SFAS 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred.

Upon adoption of SFAS 123(R), the Company is using the Black-Scholes option-pricing model as its method of valuation for share-based awards granted beginning in fiscal 2006, which was also previously used for the Company's pro forma information required under SFAS 123. The Company's determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the Company's expected stock price volatility over the term of the awards, and certain other market variables such as the risk free interest rate.

***Year Ended December 31, 2006 Compared to Year Ended December 31, 2005***

**Revenues**

The Company's revenue consists of direct product sales and a recurring (lease) model in the commercial, government and international markets of the Telkonet Segment. Additionally, the MST Segment consists of eleven months of revenue from date of acquisition through December 31, 2006 providing certain Quad-Play services. The table below outlines product versus recurring (lease) revenues for comparable periods:

| | Year ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| Revenue: | 2006 | | 2005 | | Variance | |
| Product | $ 3,092,967 | 60% | $ 1,769,727 | 71% | $ 1,323,240 | 75% |
| Rental (lease) | 2,088,361 | 40% | 718,596 | 29% | 1,369,765 | 191% |
| Total | 5,181,328 | 100% | $ 2,488,323 | 100% | 2,693,005 | 108% |

*Product Revenue*

Product revenue in the Telkonet Segment increased approximately $800,000, excluding the sale of certain rental contract agreements to HLC, for the year ended December 31, 2006, and the MST Segment revenue amounted to approximately $280,000 in installation and ancillary services provided to customers for the eleven months ended December 31, 2006. The Telkonet Segment revenue principally arises from the sale of iBridges and other Telkonet iWire System™ components directly to customers. Revenues to date have been principally derived from the Commercial (Hospitality and Multi-Dwelling) and International business units. The Telkonet Segment anticipates continued growth in Commercial and International product revenue in the Value Added Reseller (VAR) purchase programs. The Telkonet Segment expanded its international sales and marketing efforts upon receiving its European certification (CE). The Company has received the FIPS 140-2 certification and continues to pursue opportunities within the government sector. The Company has extended its iWire System™ to included energy information, management and control solutions for residential and commercial buildings.

In the year ended December 31, 2006 and 2005, Telkonet consummated a non-recourse sale of certain rental contract agreements and the related capitalized equipment which were accounted for as operating leases with Hospitality Leasing Corporation. The remaining rental income payments of the contracts were valued at approximately $1,209,000 and $732,000 including the customer support component of approximately $370,000 and $205,000 which Telkonet will retain and continue to receive monthly customer support payments over the remaining average unexpired lease term of 36 and 26 months, respectively. In the years ending December 31, 2006 and 2005, the Company recognized revenue of approximately $683,000 and $439,000, respectively, for the sale, calculated based on the present value of total unpaid rental payments, and expensed the associated capitalized equipment cost, net of depreciation, of approximately $340,000 and $267,000, respectively, and expensed associated taxes of approximately $64,000 and $40,000, respectively.

*Rental (lease)Revenue*

A significant increase in the overall recurring revenue was attributable to the addition of the MST segment subscriber base in February 2006 and amounted to approximately $1,476,000 for the eleven months ended December 31, 2006. The MST Segment subscriber portfolio in includes approximately 20 MDU properties with service bulk service agreements and/or access licenses to service the individual subscribers in metropolitan New York. The Telkonet Segment rental (lease) revenue decreased by $95,000 in the year ended December 31, 2006 compared to the prior year primarily due to the sale of rental contracts to Hospitality Leasing Corporation (HLC) and the VAR purchase program sales effort.

**Cost of Sales**

| Cost of Sales: | Year ended December 31, 2006 | | 2005 | | Variance | |
|---|---|---|---|---|---|---|
| Product | $ 2,062,399 | 67% | $ 1,183,574 | 67% | $ 878,825 | 74% |
| Rental (lease) | 2,418,260 | 116% | 533,605 | 74% | 1,884,655 | 353% |
| Total | 4,480,659 | 86% | $ 1,717,179 | 69% | 2,763,480 | 161% |

*Product Costs*

The Telkonet Segment product cost for the Telkonet iWire System™ product suite primarily includes equipment costs and installation labor. The related product cost in connection with the non-recourse sale of approximately $1,209,000 of rental contract agreements amounted to approximately $347,000 of previously capitalized equipment cost and other related cost.

The MST product costs primarily consist of equipment and installation labor for installation and ancillary services provided to customers.

*Rental (lease) Costs*

MST segment recurring costs primarily represent customer support, programming and amortization of the capitalized costs to support the subscriber revenue. Although MST's programming fees are a significant portion of the cost, MST continues to pursue competitve agreements and volume discounts in conjunction with the growth of the subscriber base. The customer support costs for the year ended December 31, 2006 include build-out of the support services necessary for the anticipated increase in subscribers in metropolitan New York. The capitalized costs are amortized over the lease term and include equipment and installation labor. The Telkonet Segment recurring costs increased for the year ended December 31, 2006 compared to the prior year due to an increase in the number of iBridges supported and through the utilization of an out-sourced Tier I call center which was initiated in July 2005.

**Gross Profit**

| | Year ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| Gross Profit: | 2006 | | 2005 | | Variance | |
| Product | $ 1,030,568 | 33% | $ 586,153 | 33% | $ 444,415 | 76% |
| Rental (lease) | (329,899) | -16% | 184,991 | 26% | (514,890) | -278% |
| Total | 700,669 | 14% | 771,144 | 31% | (70,475) | -9% |

*Product Gross Profit*

The increase of Telkonet gross profit for the year 2006 associated with product revenues over the prior year offsets by ancillary services provided by MST.

*Rental (lease) Gross Profit*

Telkonet gross profit associated with recurring (lease) revenue decreased as a result of the sale of rental contracts to Hospitality Leasing Corporation (HLC) resulting in a decrease in recurring (lease) revenue which was more than offset by increased customer support services related to the increased number of iBridges supported. As MST develops the infrastructure and continues to build-out the subscriber base, the gross margins were $417,664 or -28% for the 11 months end December 31, 2006, primarily due to programming costs and the support infrastructure. MST anticipates increased margins in 2007 as the projected new subscriber base absorbs the current infrastructure.

**Operating Expenses**

| | Year ended December 31, | | |
|---|---|---|---|
| | 2006 | 2005 | Variance |
| Total | 18,263,255 | $ 16,077,912 | 2,185,343 14% |

Overall expenses increased for the year ended December 31, 2006 over the comparable period in 2005 by $2,185,343 or 14%. Of this increase, operating expenses related to the acquisition of MST represented $2,632,449 and were principally due to salary and other operating costs related to the build-out of the "Quad Play" subscriber infrastructure, including managerial and back-office support personnel, professional fees and the amortization of MST's intangible assets. Additionally, the Telkonet operating expenses decreased for the year ended December 31, 2006 due to a reduction in research and development costs as well as a cost incurred in 2005 for the impairment of Telkonet's investment in Amperion.

**Product Research and Development**

| | Year ended December 31, | | |
|---|---|---|---|
| | 2006 | 2005 | Variance |
| Total | $ 1,925,746 | $ 2,096,104 | $ (170,358) -8% |

Telkonet's research and development costs related to both present and future products are expensed in the period incurred. Total expenses for the year ended December 31, 2006 decreased over the comparable prior year by $170,358 or -8%. This decrease was primarily related to costs associated to CE, FIPS 140-2 and other required certifications of the Company's product that were incurred in 2005.

**Selling, General and Administrative**

| | Year ended December 31, | | |
|---|---|---|---|
| | 2006 | 2005 | Variance |
| Total | $ 14,346,364 | $ 12,041,661 | $ 2,304,703 19% |

Selling, general and administrative expenses increased for the year ended December 31, 2006 over the comparable prior year by $2,304,703 or 19%. This increase is attributed to the administrative expenses associated with the acquisition of MST such as payroll costs, advertising, trade shows, facility costs and professional fees. Also, the selling, general and administrative expenses for Telkonet have remained approximately the same as the prior year.

***Year Ended December 31, 2005 Compared to Year Ended December 31, 2004***

**Revenues**

Telkonet's revenue consists of direct product sales and a rental (lease) model in the commercial, government and international markets. The table below outlines product versus rental (lease) revenues for comparable periods:

| | Year ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| Revenue: | 2005 | | 2004 | | Variance | |
| Product | $ 1,769,727 | 71% | $ 477,555 | 68% | $ 1,292,172 | 271% |

| | | | | | | |
|---|---|---|---|---|---|---|
| Rental (lease) | 718,596 | 29% | 221,097 | 32% | 497,499 | 225% |
| Total | $ 2,488,323 | 100% | $ 698,652 | 100% | $ 1,789,671 | 256% |

*Product revenue*

Product revenue principally arises from the sale of iBridges and other Telkonet iWire System™ components directly to customers. Revenues to date have been principally derived from the Commercial (Hospitality and Multi-Dwelling) and International business units. The Company anticipates continued growth in Commercial and International product revenue in the Value Added Reseller purchase programs. The Company expanded its international sales and marketing efforts upon receiving its European certification (CE) in March 2005. The Company expanded its sales and marketing efforts in the government sector in connection with the receipt of the FIPS 140-2 certification received in July 2005.

In December 2005, the Company consummated a non-recourse sale of certain rental contract agreements and the related capitalized equipment which were accounted for as operating leases with Hospitality Leasing Corporation. The remaining rental income payments of the contracts were valued at approximately $732,000, including the customer support component of approximately $205,000 which the Company will retain and continue to receive monthly customer support payments over the remaining average unexpired lease term of 26 months. In December 2005, the Company recognized revenue of approximately $439,000 for the sale, calculated based on the present value of total unpaid rental payments, and expensed the associated capitalized equipment cost, net of depreciation, of approximately $267,000 and expensed associated taxes of approximately $40,000.

*Rental (lease) revenue*

The increase in rental (lease) revenue was primarily due to the increase in non-cancelable leases. Accordingly, revenues associated with these leases are recognized ratably over a three to five year lease term. Revenues to be recognized under these non-cancelable leases (backlog) was approximately $2,411,000 including a non-recourse sale of $918,000 certain rental contract agreements in January 2006. The weighted average remaining lease term was approximately 31 months as of December 31, 2005. The associated unamortized capitalized costs in connection with these leases was approximately $664,000 or 26% of revenue backlog.

**Cost of Sales**

| | Year ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| Cost of Sales: | 2005 | | 2004 | | Variance | |
| Product | $ 1,183,574 | 67% | $ 459,225 | 96% | $ 724,349 | 158% |
| Rental (lease) | 533,605 | 74% | 83,634 | 38% | 449,971 | 538% |
| Total | $ 1,717,179 | 695 | $ 542,859 | 78% | $ 1,174,320 | 216% |

*Product Costs*

Product cost primarily includes Telkonet iWire System™ product suite equipment cost and installation labor. The related product cost in connection with the non-recourse sale of approximately $766,000 of rental contract agreements amounted to approximately $267,000 of previously capitalized equipment cost and other related cost.

*Rental (lease) Costs*

Lease Cost primarily represents the amortization of the capitalized costs which are amortized over the lease term and include Telkonet equipment, installation labor and customer support. This increase compared to the prior year quarter is commensurate with the increase in leases.

**Gross Profit**

| Gross Profit: | Year ended December 31, 2005 | | 2004 | | Variance | |
|---|---|---|---|---|---|---|
| Product | $ 586,153 | 33% | $ 18,330 | 4% | $ 567,823 | 3,098% |
| Rental (lease) | 184,991 | 26% | 137,463 | 62% | 47,528 | -35% |
| Total | $ 771,144 | 31% | $ 155,793 | 22% | $ 615,351 | 395% |

*Product Costs*

Gross profit associated with the product revenues for the year ended December 31, 2005 improved over the prior year primarily as a result of reduction of equipment costs and of improved installation processes, including upfront site surveys and standardized training.

*Rental (lease) Costs*

Gross profit associated with the rental (lease) revenue decreased as a result of the build-out of the customer support services.

**Operating Expenses**

| | Year ended December 31, | | | |
|---|---|---|---|---|
| | 2005 | 2004 | Variance | |
| Total | $ 16,077,912 | $ 13,268,067 | $ 2,809,845 | 21% |

Overall expenses increased for the year ended December 31, 2005 over the comparable period in 2004 by $2,809,845 or 21%. Excluding the fee paid pursuant to certain agreements with consultants of $2,500,000 expensed in the year end December 31, 2004, the increase for the year ended December 31, 2005 over the prior year amounted to $5,309,845 or 49%. This increase was principally due to salary and travel costs related to increased sales and marketing functions and office rent related to the Germantown, MD and Crystal City, VA leases. The number of employees increased from 48 at December 31, 2004 to 66 at December 31, 2005. In addition, the Company wrote-off $400,000 of the carrying value of its investment in Amperion through a charge to operations during the year end December 31, 2005.

**Product Research and Development**

| | Year ended December 31, | | | |
|---|---|---|---|---|
| | 2005 | 2004 | Variance | |
| Total | $ 2,096,104 | $ 1,852,309 | $ 243,795 | 13% |

Research and development costs related to both present and future products are expensed in the period incurred. Total expenses for the year ended December 31, 2005 increased over the comparable prior year by $243,795 or 13%. This increase was primarily related to an increase in salaries and related costs associated with the addition of employees and costs related to CE, FIPS 140-2 and other required certifications of the Company’s product.

**Selling, General and Administrative**

| | Year ended December 31, | | | |
|---|---|---|---|---|
| | 2005 | 2004 | Variance | |
| Total | $ 12,041,661 | $ 7,663,369 | $ 4,378,292 | 57% |

Selling, general and administrative expenses increased for the year ended December 31, 2005 over the comparable prior year by $4,378,292 or 57%. This increase is related to an increase in payroll and associated costs for sales and marketing resources, advertising, trade shows, and office rent and related facility costs.

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**Liquidity and Capital Resources**

*Working Capital*

Our working capital surplus decreased by $12,591,438 during the twelve months ended December 31, 2006 from a working capital surplus of $12,060,807 at December 31, 2005 to a working capital deficit of $(530,631) at December 31, 2006. The decrease in working capital for the twelve months ended December 31, 2006, is due to a combination of factors, of which the significant factors are set out below:

- Cash had a net decrease from working capital by $6,778,042 for the period ended December 31, 2006. The most significant uses of cash are as follows:
  - Approximately $13,972,000 of cash consumed directly in operating activities, including interest paid of $991,000
  - Principal repayments, in cash, of Senior Convertible Debentures and Senior notes amounted to $7,750,000 and $100,000, respectively
  - The cash payments in the acquisition of MST amounted to approximately $958,000, net of acquired cash, and as part of the acquisition the MST debt payoff amounted to approximately $410,000—see discussion of MST acquisition below;
  - An offsetting amount of approximately $2,740,000 related to the impact of proceeds from stock options and warrant exercises
  - An additional offsetting amount from the sale of 2,400,000 shares of common stock at $2.50 per share for an aggregate purchase price of $6,000,000
  - Approximately $2,324,000 was expended on net purchases of capitalized cost and fixed assets.

- The acquisition of MST included a second installment of $900,000 payable in January 2007 and at acquisition $400,000 of potential income tax exposure was accrued in accounts payable and accrued liabilities.

Of the total $3,766,079 in current assets as of December 31, 2006, cash represented $1,644,037. Of the total $20,377,956 in current assets as of December 31, 2005, cash represented $8,422,079, and Restricted Certificate of Deposit represented $10,000,000.

*Senior Notes*

In 2003, the Company issued Senior Notes to Company officers, shareholders, and sophisticated investors in exchange for $5,000,000, exclusive of placement costs and fees. The remaining outstanding senior note of $100,000 matured and was repaid in June 2006.

*Convertible Senior Notes*

In October 2005, the Company completed an offering of convertible senior notes (the “Notes”) in the aggregate principal amount of $20 million. The capital raised in the Note offering was used for general working capital purposes. The Notes bore interest at a rate of 7.25%, payable in cash, and called for monthly principal installments beginning March 1, 2006. The maturity date was 3 years from the date of issuance of the Notes. The Noteholders were entitled, at any time, to convert any portion of the outstanding and unpaid Conversion Amount into shares of Company common stock. At the option of the Company, the principal payments could be paid either in cash or in common stock. Upon conversion into common stock, the value of the stock was determined by the lower of $5 or 92.5% of the average recent market price. The Company also issued one million warrants to the Noteholders exercisable for five years at $5 per share. At any time after six months, should the stock trade at or above $8.75 for 20 of 30 consecutive trading days, the Company could cause a mandatory redemption and conversion to shares at $5 per share. At any time, the Company was entitled to pre-pay the notes with cash or common stock. If the Company elected

to use common stock to pre-pay the Notes, the price of the common stock would be deemed to be the lower of $5 or 92.5% of the average recent market price. If the Company prepaid the Notes other than by mandatory conversion, the Company was obligated to issue additional warrants to the Noteholders covering 65% of the amount pre-paid at a strike price of $5 per share. In addition to standard financial covenants, the Company agreed to maintain a letter of credit in favor of the Noteholders equal to $10 million. Once the principal amount outstanding on the notes declined below $15 million, the balance on the letter of credit was reduced by $.50 for every $1 amortized.

These notes were repaid on August 14, 2006 as discussed in greater detail below under “Early Extinguishment of Debt.”

*Principal Payments of Debt*

For the period of January 1, 2006 through August 14, 2006, the Company paid down principal of $1,250,000 in cash and issued an aggregate of 4,226,246 shares of common stock in connection with the conversion of $10,821,686 aggregate principal amount of the Senior Convertible Notes. Pursuant to the note agreement, the Company issued an additional 1,081,820 warrants to the Noteholders covering 65% of the $8,321,686 accelerated principal at a strike price of $5 per share.

For the period of January 1, 2006 through August 14, 2006, the Company amortized the debt discount to the beneficial conversion feature and value of the attached warrants, and recorded non-cash interest expense in the amount of $251,759 and $500,353, respectively. The Company also wrote-off the unamortized debt discount attributed to the beneficial conversion feature and the value of the attached warrants in the amount of $708,338 and $1,397,857, respectively, in connection with paydown and conversion of the note.

*Early Extinguishment of Debt*

On August 14, 2006, the Company executed separate settlement agreements with the lenders of its Convertible Senior Notes. Pursuant to the settlement agreements the Company paid to the lenders in the aggregate $9,910,392 plus accrued but unpaid interest of $23,951 and certain premiums specified in the Notes in satisfaction of the amounts then outstanding under the Notes. Of the amount to be paid to the lenders under the Notes, $6,500,000 was paid in cash through a drawdown on a letter of credit previously pledged as collateral for the Company's obligations under the Notes. The remaining note balance of $1,428,314 and a Redemption Premium of $1,982,078, calculated as 25% of remaining principal, was paid to the lenders in shares of Company's common stock valued at the lower of $5.00 per share and 92.5% of the arithmetic average of the weighted average price of the Company's common stock on the American Stock Exchange for the twenty trading days beginning on August 16, 2006. The Company also issued 862,452 warrants to purchase shares of the Company's common stock at the exercise price of the lower of $2.58 per share and 92.5% of the average trading price as described above. The Company has accounted for the Redemption Premium and the additional warrants issued as non-cash early extinguishment of debt expense during the year ended December 31, 2006.

As a result of the execution of the settlement agreements and the payments required thereby, the Company fully repaid and believes it satisfied all of its obligations under the Notes. The Company also agreed to pay the expenses of the lenders incurred in connection with the negotiation and execution of the settlement agreements. The settlement agreements were negotiated following the allegation by one of the lenders that the Company's failure to meet the minimum revenue test for the period ending June 30, 2006 as specified on the Notes may have constituted an event of default under the Notes, which allegation the Company disputed.

In conjunction with the settlement agreement, the Company recorded $4,626,679 of loss from early extinguishment of debt, which consists of $1,982,078 redemption premium paid with the Company's common stock, $1,014,934 of additional warrants issued to the lenders, write-off of the remaining unamortized debt discount attributed to the beneficial conversion feature and the value of the attached warrants in the amount of $430,040 and $845,143, respectively, and write-off the remaining unamortized financing costs of $354,484.

The settlement agreements provide that the number of shares issued to the noteholders shall be adjusted based upon the arithmetic average of the weighted average price of the Company's common stock on the American Stock Exchange for the twenty trading days immediately following the settlement date. The Company has concluded that, based upon the weighted average of the Company's common stock between August 16, 2006 and September 13, 2006, the Company is entitled to a refund from the two noteholders. One of the noteholders has informed the Company that it does not believe such a refund is required. As a result, the Company has declined to deliver to the noteholders certain stock purchase warrants issued to them pursuant to the settlement agreements pending resolution of this

disagreement. One of the noteholders has alleged that the Company has failed to satisfy its obligations under the settlement agreement by failing to deliver the warrants. In addition, the noteholder maintains that the Company has breached certain provisions of the registration rights agreement and, as a result of such breach, such noteholder claims that it is entitled to receive liquidated damages from the Company. As of March 15, 2007, no legal claim has been filed by the noteholder.

*Acquisition of Microwave Satellite Technologies, Inc.*

On January 31, 2006, the Company acquired a 90% interest in MST from Frank Matarazzo, the sole stockholder of MST in exchange for $1.8 million in cash and 1.6 million unregistered shares of the Company's common stock for an aggregate purchase price of $9,000,000. The cash portion of the purchase price was paid in two installments, $900,000 at closing and $900,000 in February 2007. The stock portion is payable from shares which will be held in escrow, 400,000 shares of which were paid at closing and the remaining 1,200,000 shares of which shall be issued based on the achievement of 3,300 "Triple Play" subscribers over a three year period. In the period ended December 31, 2006, the Company issued 200,000 shares of the purchase price contingency valued at $900,000 as an adjustment to goodwill. In the event the Company's common stock price is below $4.50 per share upon issuance of the shares from escrow, a pro rata adjustment in the number of shares will be required to support the aggregate consideration of $5.4 million. As of December 31, 2006, the Company's common stock price was below $4.50. To the extent that the market price of Company's common stock is below $4.50 per share upon issuance of the shares from escrow, the number of shares issuable on conversion is ratably increased, which could result in further dilution of the Company's stockholders.

*Acquisition of Smart Systems International (SSI)*

On March 9, 2007, the Company acquired substantially all of the assets of Smart Systems International (SSI), a leading provider of energy management products and solutions to customers in the United States and Canada for cash and Company common stock having an aggregate value of $7,000,000. The purchase price was comprised of $875,000 in cash and 2,227,273 shares of the Company's common stock. The Company is obligated to register the stock portion of the purchase price on or before May 15, 2007 and 1,090,000 shares are being held in an escrow account for a period of one year following the closing from which certain potential indemnification obligations under the purchase agreement may be satisfied. The aggregate number of shares held in escrow is subject to adjustment upward or downward depending upon the trading price of the Company's common stock during the one year period following the closing date.

*Acquisition of Ethostream, LLC*

On March 15, 2007, the Company acquired 100% of the outstanding membership units of Ethostream, LLC, a network solutions integration company that offers installation, sales and service to the hospitality industry. The Ethostream acquisition will enable Telkonet to provide installation and support for PLC products and third party applications to customers across North America. The purchase price of $11,756,097 was comprised of $2.0 million in cash and 3,459,609 shares of the Company's common stock. The entire stock portion of the purchase price is being held in escrow to satisfy certain potential indemnification obligations of the sellers under the purchase agreement. The shares held in escrow are distributable over the three years following the closing. The aggregate number of shares issuable to the sellers is subject to downward adjustment in the event the Company's common stock trades at or above a price of $4.50 per share for twenty consecutive trading days during the one year period following the closing.

*Proceeds from the issuance of common stock*

During the twelve months ended December 31, 2006, the Company received $2,684,663 from the exercise of employee and non-employee stock options and $55,138 from the exercise of warrants.

During the twelve months ended December 31, 2006, the Company issued 2,400,000 shares of common stock valued at $2.50 per share for an aggregate purchase price of $6,000,000. The Company also issued to this investor warrants to purchase 1.56 million shares of its common stock at an exercise price of $4.17 per share.

In February 2007, the Company issued 4,000,000 shares of common stock valued at $2.50 per share for an aggregate purchase price of $10,000,000. The Company also issued to this investor warrants to purchase 2.6 million shares of its

common stock at an exercise price of $4.17 per share.

*Cash flow analysis*

Cash utilized in operating activities was $13,971,529 during the year ended December 31, 2006 compared to $12,086,032 and $9,583,560 during the years ended December 31, 2005 and 2004, respectively. The primary use of cash during the twelve months ended December 31, 2006 was net operating expenses of the Company of $12,980,683 and interest expense payments of $990,846.

The Company was provided and utilized cash for investing activities $6,717,442 and $10,925,719 during the twelve months ended December 31, 2006 and 2005, respectively. During the period ended December 31, 2006, the proceeds from the release of funds from the Restricted Certificate of Deposit provided $10,000,000 in conjunction with the conversion and settlement agreement with the lenders under the Company's Convertible Senior Notes. The expenditures were primarily the result of the acquisition of MST in January 2006 of $958,438, net of acquired cash. Additionally, cost of equipment under operating leases amounted to $1,589,188, net of proceeds from sale of certain equipment under operating lease of $350,571, and $458,271 for the December 31, 2006 and 2005, respectively. Furthermore, purchases of property and equipment amounted to $734,888 and $336,448 for the year ended December 31, 2006 and 2005, respectively.

The Company was provided cash in financing activities of $476,045 and $19,595,128 during the year ended December 31, 2006 and 2005, respectively. The financing activities represent proceeds from the sale of 2,400,000 shares of common stock at $2.50 per share for an aggregate purchase price of $6,000,000 during the twelve months ended December 31, 2006. Additionally, the financing activities represent proceeds from the exercise of stock options and warrants of $2,739,801 and $1,174,538 during the years ended December 31, 2006 and 2005, respectively. The proceeds of the financing activities were offset by repayment of debt principal of $8,263,756 in 2006, including $7,750,000 of principal payments in conjunction with the conversion and settlement agreement with the lenders under the Company's Convertible Senior Notes and approximately $410,000 in conjunction with the acquisition of MST.

The Company believes it has sufficient access to capital to meet its working capital requirements through the remainder of 2007 in available cash and in cash generated from operations. Additional financing may be required in order to meet growth opportunities in financing and/or investing activities. If additional capital is required and the Company is not successful in generating sufficient liquidity from operations or in raising sufficient capital resources on terms acceptable to the Company, this could have a material adverse effect on the Company's business, results of operations, liquidity and financial condition.

**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.

**Acquisition or Disposition of Plant and Equipment**

During the year ended December 31, 2006, fixed assets increased $1,169,899 or 112% primarily from the addition of the MST Segment assets acquired on January 31, 2006 of approximately $435,000 and approximately $674,000 of equipment purchase for the MST build-out. The remainder related to computer equipment and peripherals used in day-to-day operations. The Company anticipates significant expenditures in the MST Segment to continue the build-out the head-end equipment, IPTV and other related projects. The Telkonet segment does not anticipate the sale or purchase of any significant property, plant or equipment during the next twelve months, other than computer equipment and peripherals to be used in the Company's day-to-day operations.

In April 2005, the Company entered into a three-year lease agreement for 6,742 square feet of commercial office space in Crystal City, Virginia. Pursuant to this lease, the Company agreed to assume a portion of the build-out cost for this facility

MST presently leases 12,600 square feet of commercial office space in Hawthorne, New Jersey for its office and warehouse spaces. This lease will expire in April 2010.

Following the acquisitions of SSI and Ethostream, the Company assumed leases on 9,000 square feet of office space in Las Vegas, NV for the SSI office and warehouse space on a month to month basis and 4,100 square feet of office space in Milwaukee, WI for Ethostream and this lease expires in May 2011.

**New Accounting Pronouncements**

On February 16, 2006 the Financial Accounting Standards Board (FASB) issued SFAS 155, “Accounting for Certain Hybrid Instruments,” which amends SFAS 133, “Accounting for Derivative Instruments and Hedging Activities,” and SFAS 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.” SFAS 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 also clarifies and amends certain other provisions of SFAS 133 and SFAS 140. This statement is effective for all financial instruments acquired or issued in fiscal years beginning after September 15, 2006. The Company does not expect its adoption of this new standard to have a material impact on its financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (“GAAP”), and expands disclosures about fair value measurements. The Company will be required to adopt SFAS 157 effective for the fiscal year beginning January 1, 2008. The requirements of SFAS 157 will be applied prospectively except for certain derivative instruments that would be adjusted through the opening balance of retained earnings in the period of adoption. The Company is currently evaluating the impact of the adoption of SFAS 157 on the Company’s consolidated financial statements and management believes that the adoption of SFAS 157 will not have a significant impact on its consolidated results of operations or financial position.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans - an amendment of FASB Statements No. 87, 88, 106, and 132R (‘SFAS 158’). SFAS 158 changes current practice by requiring employers to recognize the overfunded or underfunded positions of defined benefit postretirement plans, including pension plans, on the balance sheet. The funded status is defined as the difference between the projected benefit obligation and the fair value of plan assets. SFAS 158 also requires employers to recognize the change in funded status in other comprehensive income (a component of shareholders’ equity). SFAS 158 does not change the requirements for the measurement and recognition of pension expense in the statement of income. SFAS 158 is effective for fiscal years ending after December 15, 2006. The Company does not anticipate any material impact to its financial condition or results of operations as a result of the adoption of SFAS 158.

In September 2006, the SEC issued Staff Accounting Bulletin 108, *Considering the Effects of Prior Year Misstatements When Quantifying Misstatements in Current Year Financial Statements* (‘SAB 108’). SAB 108 provides interpretive guidance on how the effects of the carryover or reversal of prior year financial statement misstatements should be considered in quantifying a current year misstatement. SAB 108 is effective for financial statements covering the first fiscal year ending after November 15, 2006. The Company does not anticipate any material impact to its financial condition or results of operations as a result of the adoption of SAB 108.

In December 2006, the FASB issued FSP EITF 00-19-2, Accounting for Registration Payment Arrangements ("FSP 00-19-2") which addresses accounting for registration payment arrangements. FSP 00-19-2 specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, Accounting for Contingencies. FSP 00-19-2 further clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other applicable generally accepted accounting principles without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. For registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to the issuance of EITF 00-19-2, this guidance is effective for financial statements issued for fiscal years beginning after December 15, 2006 and interim periods within those fiscal years. The Company has not yet determined the impact that the adoption of FSP 00-19-2 will have on its financial statements.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities.” SFAS 159 permits entities to choose to measure many financial instruments, and certain other items, at fair value. SFAS 159 applies to reporting periods beginning after November 15, 2007. The adoption of SFAS 159 is not expected to have a material impact on the Company’s financial condition or results of operations.

**Disclosure of Contractual Obligations**

| | | Payment Due by Period | | | |
|---|---|---|---|---|---|
| Contractual obligations | Total | Less than 1 year | 1-3 years | 3-5 years | More than 5 |

| | | | | | years |
|---|---|---|---|---|---|
| Long-Term Debt Obligations | $ 900,000 | $ 900,000 | - | - | - |
| Capital Lease Obligations | - | - | - | - | - |
| Operating Lease Obligations | $ 1,117,663 | $ 421,804 | $ 518,909 | $ 176,950 | - |
| Purchase Obligations | - | - | - | - | - |
| Other Long-Term Liabilities Reflected on the Registrant's Balance Sheet Under GAAP | - | - | - | - | - |
| Total | $ 2,017,663 | $ 1,321,804 | $ 518,909 | $ 176,950 | - |

(1) Operating lease obligations includes approximately $266,872 of future lease obligations, primarily related to office and warehouse space, in conjunction with the January 2006 acquisition of Microwave Satellite Technologies, Inc.

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

**Short Term Investments**

We held no marketable securities as of December 31, 2006. Our excess cash is held in money market accounts in a bank and brokerage firms both of which are nationally ranked top tier firms with an average return of approximately 400 basis points. Due to the conservative nature of our investment portfolio, an increase or decrease of 100 basis points in interest rates would not have a material effect on our results of operations or the fair value of our portfolio.

**Investments in Privately Held Companies**

We have invested in privately held companies, which are in the startup or development stages. These investments are inherently risky because the markets for the technologies or products these companies are developing are typically in the early stages and may never materialize. As a result, we could lose our entire initial investment in these companies. In addition, we could also be required to hold our investment indefinitely, since there is presently no public market in the securities of these companies and none is expected to develop. These investments are carried at cost, which as of March 1, 2007 was $131,044 and $8,000 in BPL Global and Amperion, respectively, and at December 31, 2006, are recorded in other assets in the Consolidated Balance Sheets. The Company determined that its investment in Amperion was impaired based upon forecasted discounted cash flow. Accordingly, the Company wrote-off 80%, or $400,000 and 92%, or $92,000, of the carrying value of its investment through a charge to operations during the years ended December 31, 2005 and 2006, respectively. The fair value of the Company's investment in BPL Global, remained at $131,044 as of December 31, 2006.

## ITEM 8. FINANCIAL STATEMENTS.

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

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

None.

## ITEM 9A. CONTROLS AND PROCEDURES.

***Evaluation of Disclosure Controls and Procedures*.** Under the supervision and with the participation of our management, including our Chief Executive Officer and Vice President of Finance (principal accounting officer), the Company evaluated the effectiveness of the design and operation of its disclosure controls and procedures (as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the "Exchange Act")). Disclosure controls and procedures are the controls and other procedures that the Company designed to ensure that it records, processes, summarizes and reports in a timely manner the information it must disclose in reports that it files with or submits to the Securities and Exchange Commission under the Exchange Act. Based on this evaluation, the Chief Executive Officer and the Vice President of Finance concluded that the Company's disclosure controls and procedures were effective as of the end of the period covered by this report.

***Changes in Internal Control over Financial Reporting*.** During the fourth quarter of 2006, there was no change in the Company's internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act) that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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***Management Report On Internal Control over Financial Reporting.*** The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is defined in Rule 13a-15(f) under the Exchange Act as a process designed by, or under the supervision of, the Company's principal executive and principal financial officers and effected by the Company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America and includes those policies and procedures that:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the Company's assets;

- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that the Company's receipts and expenditures are being made only in accordance with authorization of management and directors; and

- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

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 of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of the Company's management, including its principal executive and principal financial officers, the Company assessed, as of December 31, 2006, the effectiveness of its internal control over financial reporting. This assessment was based on criteria established in the framework in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on the Company's assessment, management concluded that the Company's internal control over financial reporting was effective as of December 31, 2006.

The Company's assessment of the effectiveness of its internal control over financial reporting as of December 31, 2006 has been audited by Russell Bedford Stefanou Mirchandani LLP, an independent registered public accounting firm, as stated in their report which is included in this Annual Report on Form 10-K.

RUSSELL BEDFORD STEFANOU MIRCHANDANI LLP
CERTIFIED PUBLIC ACCOUNTANTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors
Telkonet, Inc.
Germantown, MD

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Telkonet, Inc. and its subsidiaries (the Company) maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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 of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Telkonet, Inc. and its wholly-owned subsidiaries maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, Telkonet, Inc. and its subsidiaries, maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established *in Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedules as of and for the year ended December 31, 2006, of the Company and our report dated March 15, 2007 expressed an unqualified opinion on those financial statements and financial statement schedules and included an explanatory paragraph regarding the Company's adoption of the provisions of Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment", effective January 1, 2006.

/s/ RUSSELL BEDFORD STEFANOU MIRCHANDANI LLP

Russell Bedford Stefanou Mirchandani LLP
Certified Public Accountants

McLean, Virginia
March 15, 2007

**ITEM 9B. OTHER INFORMATION.**

None.

**PART III**

**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.**

The following table furnishes the information concerning the Company's directors and officers during the fiscal year ended December 31, 2006. The directors of the Company are elected every year and serve until their successors are duly elected and qualified.

| Name | Age | Title |
|---|---|---|
| Ronald W. Pickett | 59 | President, Director & Chief Executive Officer |
| Frank T. Matarazzo | 45 | President & Chief Executive Officer, Microwave Satellite Technologies, Inc. |
| Robert P. Crabb | 59 | Chief Marketing Officer |
| Stephen Sadle | 61 | Senior Vice President & Director |
| James Landry | 51 | Chief Technology Officer |
| Richard J. Leimbach | 38 | Vice President of Finance |
| Warren V. Musser | 80 | Chairman of the Board |
| Thomas C. Lynch | 64 | Director (1), (2) |
| Dr. Thomas M. Hall | 55 | Director (1), (2) |
| James L. "Lou" Peeler | 73 | Director (1), (2) |
| Seth Blumenfeld | 66 | Director |

(1) Member of the Audit Committee
(2) Member of the Compensation Committee

**Ronald W. Pickett—President, Chief Executive Officer & Director**

Mr. Pickett has served as the Company's Chief Executive Officer since January 2003. In addition, he has fostered the development of Telkonet since 1999 as the Company's principal investor and co-Founder. He was the Founder, and for twenty years served as the Chairman of the Board and President of Medical Advisory Systems, Inc. (a company providing international medical services and pharmaceutical distribution) until its merger with Digital Angel Corporation (AMEX: DOC) in March 2002. A graduate of Gordon College, Mr. Pickett has engaged in various entrepreneurial activities for 35 years. Mr. Pickett has been a director of the Company since January 2003.

**Frank T. Matarazzo—President & Chief Executive Officer, Microwave Satellite Technologies, Inc. (MST)**

Mr. Matarazzo has been the President and Chief Executive Officer of Microwave Satellite Technologies, Inc. since its inception in 1982. Mr. Matarazzo has directed the growth and development of the Microwave Satellite Technologies, Inc. (MST) and designed and constructed the first private cable television systems operated by MST and continues to be involved in all technology deployed at MST. Mr. Matarazzo's experience includes employment for Conrac Avionics, as a prototype design engineer, working on the development of the guidance/navigation systems for military fighter planes as well as the development and construction of the FM communication systems and engine interface units for the Space Shuttle Columbia. He is known in the private cable television industry, having both written articles for trade publications and served as a technical consultant to municipalities on the subject of satellite delivered information systems.

**Robert P. Crabb—Chief Marketing Officer**

Mr. Crabb has over 35 years of sales, marketing and corporate management experience, including 15 years in the insurance industry in property and casualty brokerage and sales and sales management with the Metropolitan Life Insurance Company. His entrepreneurial expertise also includes public company administration, financial consulting, corporate management and commercial/residential real estate development. Mr. Crabb is a former director of Telkonet and has been involved with the Company since 1999.

**Stephen L. Sadle—Senior Vice President, Co-Founder & Director**

From 1999 until he joined Telkonet in 2000, Mr. Sadle served as Senior Vice President and General Sales Manager of Internos (a provider of web-based vertical extranet applications). From 1986 until 1999, Mr. Sadle was Vice President of Business Development and Sales for the Driggs Corporation, a major heavy and infrastructure contracting firm interfacing with government and the private sectors. From 1970 until 1986, Mr. Sadle was President of a successful infrastructure construction and development company in the Washington, D.C. metropolitan area. Mr. Sadle has been a director of the Company since November 1999.

**James F. Landry—Chief Technology Officer**

Mr. Landry has served as the Company's Chief Technology Officer since December 2004 and Vice President of Engineering from September 2001 to May 2004. Before joining Telkonet, Mr. Landry was a Senior Member of 3Com Technical Staff since 1994. Mr. Landry has over 20 years experience in developing communications hardware for the enterprise/carrier market with 3Com, US Robotics, Penril Datacomm and Data General. While at 3Com/US Robotics, he was responsible for the development of the entire xDSL product line as well as a number of modems and interface cards. At Penril, he served as the product development leader for the Series 1544 multiplexer/channel bank and at Data General he was technical leader of system integration for ISDN, WAN. Mr. Landry brings a wealth of practical design leadership and a solid history of delivering products to the marketplace. Mr. Landry holds four US patents.

**Richard J. Leimbach—Vice President of Finance**

Mr. Leimbach has served as the Vice President of Finance since June 2006, also served as Controller from January 2004 until June 2006. Mr. Leimbach is a certified public accountant with over thirteen years of public accounting and private industry experience. Prior to joining Telkonet, Mr. Leimbach was the Controller with Ultrabridge, Inc., an applications solution provider. Mr. Leimbach also served as Corporate Accounting Manager for Snyder Communications, Inc., a global provider of integrated marketing solutions.

**Warren V. Musser—Chairman of the Board of Directors**

Mr. Musser, has taken over 50 companies public during his distinguished and successful career as an entrepreneur, and is the founder and Chairman Emeritus of Safeguard Scientifics, Inc. (a high-tech venture capital company, formerly Safeguard Industries, Inc.). Mr. Musser is currently the Managing Director, The Musser Group (a business consulting firm) and Founder & President, Musser and Company, Inc. (an investment banking firm). In addition, Mr. Musser is a Director of Internet Capital Group, Inc. (a business-to-business venture capital company), and Mr. Musser is a Director and Vice Chairman of Nutri/System, Inc (Nasdaq:NRTI). (a weight management company) and Co-Chairman of Eastern Technology Council (a business advisory firm). Mr. Musser serves on a variety of civic, educational and charitable boards of directors, and serves as vice president of development, Cradle of Liberty Council, Boy Scouts of America; vice chairman of The Eastern Technology Council; and chairman of the Pennsylvania Partnership on Economic Education. Mr. Musser has been a director of the Company since January 2003.

**Thomas C. Lynch—Director**

Mr. Lynch is Senior Vice President and Director of The Staubach Company's Federal Sector (a real estate management and advisory services firm) in the Washington, D.C. area. Mr. Lynch joined The Staubach Company in November 2002 after 6 years as Senior Vice President at Safeguard Scientifics, Inc. (NYSE: SFE) (a high-tech venture capital company). While at Safeguard, he served nearly two years as President and Chief Operating Officer at CompuCom Systems, a Safeguard subsidiary. After a 31-year career of naval service, Mr. Lynch retired in the rank of Rear Admiral. Mr. Lynch's Naval service included chief, Navy Legislative Affairs, command of the Eisenhower Battle Group during Operation Desert Shield, Superintendent of the United States Naval Academy from 1991 to 1994 and Director of the Navy Staff in the Pentagon from 1994 to 1995. Mr. Lynch presently serves as a Director of Pennsylvania Eastern Technology Council, Armed Forces Benefit Association, Catholic Leadership Institute, National Center for the American Revolution at Valley Forge and Mikros Systems. Mr. Lynch has been a director of the Company since October 2003.

**Dr. Thomas M. Hall—Director**

Dr. Hall is the Managing Member of Marrell Enterprises, LLC (a company that specializes in international business development).Dr. Hall also serves on the board of directors of Coris International SA (a Paris-based insurance services company with subsidiaries in 36 countries). For 12 years (until 2002), Dr. Hall was the chief executive officer of Medical Advisory Systems, Inc. (a company providing international medical services and pharmaceutical distribution). Dr. Hall holds a bachelor of science and a medical degree from the George Washington University and a master of international management degree from the University of Maryland. Dr. Hall has been a director of the Company since April 2004.

**James L. “Lou” Peeler—Director**

Mr. Peeler was a founder and member of the board of Digital Communications Corporation (DCC), which evolved into Hughes Network Systems (HNS), a provider of global broadband, satellite, and wireless communications products for home and business, such as DirecTV and DIRECWAY. Mr. Peeler retired as executive vice president of operations in 1999 after 27 years of service and is presently a member of the Advisory Council to Hughes Network Systems. Mr. Peeler also served on the Board of Directors of Hughes Software Systems (HSS). Prior to the founding of DCC, he was vice president of Engineering for Washington Technological Associates (WTA) (a satellite communications development company), where he was instrumental in the development of rocket and satellite communications and instrumentation equipment. Mr. Peeler received a bachelor of science degree in electrical engineering from Auburn University. Mr. Peeler has been a director of the Company since April 2004.

**Seth D. Blumenfeld—Director**

Mr. Blumenfeld served as President of International Services for MCI International (a provider of telecommunication services) from 1998 until his retirement in January of 2005. Mr. Blumenfeld was President and Chief Operating Officer of several of MCI's international subsidiaries from 1984 to 1998. Mr. Blumenfeld earned his Doctorate Jurisprudence from Fordham University Law School in 1965. He practiced law on Wall Street prior to serving as infantry captain for the U.S. Army in Vietnam. From 1976 through 1978, Mr. Blumenfeld lived in Japan. Mr. Blumenfeld's involvement on professional boards and community associations have included Executive Committee member of the United States Council for International Business, Member of the Board of Directors of the United States Telecommunications Training Institute, Member of the State Department Advisory Council on International Communications and Information Policy, Member of the University of Colorado Institute for International Business Board of Advisors, Member of the American Graduate School of International Management (Thunderbird) Board of Advisors, Member of the Advisory Board of Visitors to Fordham University School of Law, and honorary Chairman of the Connecticut Association of Children with Learning Disabilities.

*Audit Committee*

The Company maintains an Audit Committee of the Board of Directors. For the year ended December 31, 2006, Messrs. Hall, Lynch and Peeler served on the Audit Committee. The Company’s Board of Directors has determined that each of Messrs. Hall, Lynch and Peeler is a “financial expert” as defined by Item 401 of Regulation S-K promulgated under the Securities Act of 1933 and the Securities Exchange Act of 1934. The Company’s Board of Directors also has determined that each of Messrs. Hall, Lynch and Peeler are “independent” as such term is defined in Section 121(A) of the AMEX Rules and Rule 10A-3 promulgated under the Securities Exchange Act of 1934. The Board of Directors has adopted an audit committee charter, which was ratified by the Company’s stockholders at the 2004 Annual Meeting of Stockholders.

*Compensation Committee*

The Company maintains a Compensation Committee of the Board of Directors. For the year ended December 31, 2006, Dr. Hall ad Messrs. Lynch and Peeler served on the Compensation Committee. The committee held 1 meeting during 2006.

*Code of Ethics*

The Board has approved, and Telkonet has adopted, a Code of Ethics that applies to all directors, officers and employees of Telkonet. 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.

**Beneficial Ownership SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE**

Section 16(a) of the Securities Exchange Act of 1934 requires our directors and certain of our officers to file reports of holdings and transactions in shares of Telkonet common stock with the Securities and Exchange Commission. Based on our records and other information, we believe that in 2006 our directors and our officers who are subject to Section 16 met all applicable filing requirements.

## ITEM 11. EXECUTIVE COMPENSATION.

### COMPENSATION COMMITTEE REPORT

The Compensation Committee of the Board of Directors has reviewed and discussed the section of this Form 10-K entitled "Compensation Discussion and Analysis" with management. Based on this review and discussion, the Committee has recommended to the Board that the section entitled "Compensation Discussion and Analysis," be included in this Form 10-K for the fiscal year ended December 31, 2006.

Thomas M. Hall
Thomas C. Lynch
James L. Peeler

### COMPENSATION DISCUSSION AND ANALYSIS

**Oversight of Executive Compensation Program**

The Compensation Committee of the Board of Directors oversees the Company's compensation programs, which are designed specifically for the Company's most senior executives officers, including the Chief Executive Officer, Chief Financial Officer and the other executive officers named in the Summary Compensation Table (collectively, the "named executive officers"). Additionally, the Compensation Committee is charged with the review and approval of all annual compensation decisions relating to named executive officers.

The Compensation Committee is composed of 3 independent, non-management members of the Board of Directors. Each year the Company reviews any and all relationships that each director has with the Company and the Board of Directors subsequently reviews these findings.

The responsibilities of the Compensation Committee, as stated in its charter, include the following:

- annually review and approve for the CEO and the executive officers of the Company the annual base salary, the annual incentive bonus, including the specific goals and amount, equity compensation, employment agreements, severance arrangements, and change in control agreements/provisions, and any other benefits, compensation or arrangements.

- make recommendations to the Board with respect to incentive compensation plans, including reservation of shares for issuance under employee benefit plans.

- annually review and recommend to the Board of Directors for its approval the compensation, including cash, equity or other compensation, for members of the Board of Directors for their service as a member of the Board of Directors, a member of any committee of the Board of Directors, a Chair of any committee of the Board of Directors, and the Chairman of the Board of Directors.

- annually review the performance of the Company's Chief Executive Officer.

· make recommendations to the Board of Directors on the Company's executive compensation practices and policies, including the evaluation of performance by the Company's executive officers and issues of management succession.

- review the Company's compliance with employee benefit plans.

- make regular reports to the Board.

- annually review and reassess the adequacy of the Compensation Committee charter and recommend any proposed changes to the Board for approval.

The Compensation Committee is also responsible for completing an annual report on executive compensation for inclusion in the Company's proxy statement. In addition to such annual report, the Compensation Committee maintains written minutes of its meetings, which minutes are filed with the minutes of the meetings of the Board.

**Overview of Compensation Program**

In order to recruit and retain the most qualified and competent individuals as senior executives, the Company strives to maintain a compensation program that is competitive in the global labor market. The purpose of the Company's compensation program is to reward exceptional organizational and individual performance.

The following compensation objectives are considered in setting the compensation programs for our named executive officers:

- drive and reward performance which supports the Company's core values;

- provide a percentage of total compensation that is "at-risk," or variable, based on predetermined performance criteria;

- design competitive total compensation and rewards programs to enhance the Company's ability to attract and retain knowledgeable and experienced senior executives; and

- set compensation and incentive levels that reflect competitive market practices.

**Compensation Elements and Rationale**

*Compensation for Named Executive Officers Other than the CEO*

Compensation for the named executive officers, other than the CEO, are made in the CEO's sole and exclusive discretion. While the Compensation Committee provides its recommendations with respect to compensation for the named executive officers (other than the CEO) as described in greater detail below, the CEO is only required to consider the Compensation Committee's recommendations, but is not bound by its findings.

*Compensation for the Company's CEO*

To reward both short and long-term performance in the compensation program and in furtherance of the Company's compensation objectives noted above, the Company's compensation program for the CEO is based on the following objectives:

(i) **Performance Goals**

The Compensation Committee believes that a significant portion of the CEO's compensation should be tied not only to individual performance, but also to the Company's performance as a whole measured against both financial and non-financial goals and objectives. During periods when performance meets or exceeds these established objectives,

the CEO should be paid at or more than expected levels. When the Company's performance does not meet key objectives, incentive award payments, if any, should be less than such levels.

**(ii) Incentive Compensation**

A large portion of compensation should be paid in the form of short-term and long-term incentives, which are calculated and paid based primarily on financial measures of profitability and stockholder value creation. The CEO has the incentive of increasing Company profitability and stockholder return in order to earn a major portion of his compensation package.

**(iii) Competitive Compensation Program**

The Compensation Committee reviews the compensation of chief executive officers at peer companies to ensure that the compensation program for the CEO is competitive. The Company believes that a competitive compensation program will enhance its ability to retain a capable CEO.

**Financial Metrics Used in Compensation Programs**

Several financial metrics are commonly referenced in defining Company performance for the CEO's executive compensation. These metrics include quarterly metrics to target cash flow break even and specific revenue goals to define Company performance for purposes of setting the CEO's compensation.

**Compensation Benchmarking Relative to Market**

The Company sets the CEO's compensation by evaluating peer group companies. Peer group companies are chosen based on size, industry, annual revenue and whether they are publicly or privately held. Based on these criteria, the Compensation Committee has identified 29 companies in the Company's peer group. These peer group companies include Catapult Communications Corp., Endwave Corp., Carrier Access Corp., Crystal Technology, Echelon Corp. and FiberTower Corp. The Compensation Committee has concluded that the CEO's compensation falls within the 50$^{th}$ percentile of compensation for chief executive officers within the peer group companies.

**Review of Senior Executive Performance**

The Compensation Committee reviews, on an annual basis, each compensation package for the named executive officers. In each case, the Compensation Committee takes into account the scope of responsibilities and experience and balances these against competitive salary levels. The Compensation Committee has the opportunity to meet with the named executive officers at least once per year, which allows the Compensation Committee to form its own assessment of each individual's performance. As indicated above, with the exception of the CEO, recommendations with respect to compensation packages for the named executive officers must be considered by the CEO in connection with establishing compensation for those named executive officers. However, the recommendations of the Compensation Committee with respect to the compensation paid to the named executive officers (other than the CEO) will not be binding on the CEO.

**Components of the Executive Compensation Program**

The Compensation Committee believes the total compensation and benefits program for named executive officers should consist of the following:

- base salary;
- stock incentive plan;
- retirement, health and welfare benefits;
- perquisites and perquisite allowance payments; and
- termination benefits.

**Base Salaries**

With the exception of the CEO, whose compensation is set by the Compensation Committee and approved by the Board of Directors, base salaries and merit increases for the named executive officers are determined by the CEO in his discretion after consideration of a competitive analysis recommendation provided by the Compensation

Committee. The Compensation Committee's recommendation is formulated through the evaluation of the compensation of similar executives employed by companies in the Company's peer group.

**Stock Incentive Plan**

Under the Company's Stock Incentive Plan (the "Plan") incentive stock options and non-qualified options to purchase shares of the Company's common stock may be granted to key employees. An important objective of the long-term incentive program is to strengthen the relationship between the long-term value of the Company's stock price and the potential financial gain for employees as well as the retention of senior management and key personnel. Stock options provide named executive officers with the opportunity to purchase the Company's common stock at a price fixed on the grant date regardless of future market price. Stock options generally ratably vest on a quarterly basis and become exercisable over a five-year vesting period. A stock option becomes valuable only if the Company's common stock price increases above the option exercise price (at which point the option will be deemed "in-the-money") and the holder of the option remains employed during the period required for the option to "vest" thus, providing an incentive for an option holder to remain employed by the Company. In addition, stock options link a portion of an employee's compensation to stockholders' interests by providing an incentive to increase the market price of the Company stock.

The Company practice is that the exercise price for each stock option is equal to the fair market value on the date of grant. Under the terms of the Plan, the option price will not be less than the fair market value of the shares on the date of grant. Or in the case of a beneficial owner of more than 5.0% of the Company's outstanding common stock on the date of grant, the option price will not be less than 110% of the fair market value of the shares on the date of grant.

There is a limited term in which Plan participants can exercise stock options, known as the "option term." The option term is generally ten years from the date of grant. At the end of the option term, the right to purchase any unexercised options expires. Option holders generally forfeit any unvested options if their employment with the Company terminates.

Certain key executives may be a party to option agreements containing clauses that cause their options to become immediately and fully vested and exercisable upon a Change of Control, as defined in the Plan. Additionally, death or disability of the executive during his or her employment period may cause certain stock options to immediately vest and become exercisable per the terms outlined in the stock option award agreement.

The Compensation Committee awards options to named executive officers upon commencement of their employment with the Company, and for successfully acheiving or exceeding predetermined individual and Company performance goals. In determining whether to award stock options and the number of stock options granted to a named executive officer, the Compensation Committee reviews the compensation of executives at peer group companies to ensure that the compensation program is competitive.

**Retirement, Health and Welfare Benefits**

The Company offers a variety of health and welfare and retirement programs to all eligible employees. The named executive officers generally are eligible for the same benefit programs on the same basis as the rest of the broad-based employees. The Company's health and welfare programs include medical, dental, vision, life, accidental death and disability, and short and long-term disability insurance. In addition to the foregoing, the named executive officers are eligible to participate in the Company's 401(k) Profit Sharing Plan.

*401(k) Profit Sharing Plan*

Telkonet maintains a defined contribution profit sharing plan for employees (the "Telkonet 401(k)") that is administered by a committee of trustees appointed by the Company. All Company employees are eligible to participate upon the completion of six months of employment, subject to minimum age requirements. Contributions by employees under the Telkonet 401(k) are immediately vested and each employee is eligible for distributions upon retirement, death or

disability or termination of employment. Depending upon the circumstances, these payments may be made in installments or in a single lump sum.

MST maintains a defined contribution profit sharing plan for employees (the “MST 401(k)”) that is administered by a committee of trustees appointed by the Company. All Company employees are eligible to participate upon the completion of three months of employment, subject to minimum age requirements. Each year the Company makes a contribution to the MST 401(k) without regard to current or accumulated net profits of the Company. These contributions are allocated to participants in amounts of 100% of the participants’ contributions up to 1% of each participant’s gross pay, then 10% of the next 5% of each participant’s gross pay (a higher contribution percentage may be determined at the Company’s discretion). In addition, the Company makes a one-time, annual contribution of 3% of each participant’s gross pay to each participant’s contribution account in the MST 401(k) plan. Participants become vested in equal portions of their Company contribution account for each year of service until full vesting occurs upon the completion of six years of service. Distributions are made upon retirement, death or disability in a lump sum or in installments.

**Perquisites**

The Company leases a vehicle for the use of Telkonet's CEO. The operating lease will expire in September 2008. Additionally, in the first quarter of 2007 the Company began providing monthly car allowance stipends to certain executives of MST and Ethostream.

## EXECUTIVE COMPENSATION

The following table sets forth certain information with respect to compensation for services in all capacities for the years ended December 31, 2006, 2005 and 2004 paid to our Chief Executive Officer, Vice President of Finance (principal financial officer) and the three other most highly compensated executive officers who were serving as such as of December 31, 2006.

### Summary Compensation Table

| Name and Principal Position | Year | Salary ($) | Bonus ($) | Stock Awards ($) | Option Awards ($) (3)(4)(5) | Non-Equity Incentive Plan Compensation ($) | Change in Pension Value and Nonqualified Deferred Compensation Earnings ($) | All Other Compen-sation ($) | Total ($) |
|---|---|---|---|---|---|---|---|---|---|
| Ronald W. Pickett | 2006 | $245,423 | $0 | $0 | $0 | $0 | $0 | $4,593 (3) | $250,016 |
| President and Chief | 2005 | $102,340 | $200,000 | $163,319 (1) | $0 | $0 | $0 | $0 | $465,659 |
| Executive Officer | 2004 | $100,089 | $0 | $107,779 (1) | $0 | $0 | $0 | $0 | $207,868 |
| Frank T. Matarazzo | 2006 | $244,539 | $9,615 | $0 | $0 | $0 | $0 | $0 | $254,154 |
| President and Chief | 2005 | $0 (2) | $0 | $0 | $0 | $0 | $0 | $0 | $0 (2) |
| Executive Officer, MST | 2004 | $0 (2) | $0 | $0 | $0 | $0 | $0 | $0 | $0 (2) |
| Stephen L. Sadle | 2006 | $168,154 | $6,610 | $0 | $0 | $0 | $0 | $0 | $174,764 |
| Senior Vice President | 2005 | $171,872 | $10,000 | $0 | $124,770 | $0 | $0 | $0 | $306,642 |
| | 2004 | $171,983 | $6,538 | $0 | $124,770 | $0 | $0 | $0 | $303,291 |
| Richard J. Leimbach | 2006 | $111,231 | $5,000 | $0 | $36,312 | $0 | $0 | $0 | $152,543 |
| Vice President, Finance | 2005 | $102,340 | $3,936 | $0 | $36,312 | $0 | $0 | $0 | $142,588 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2004 | $76,147 | $3,269 | $0 | $5,825 | $0 | $0 | $0 | $85,241 |
| James F. Landry | 2006 | $174,886 | $6,789 | $0 | $104,500 | $0 | $0 | $0 | $286,176 |
| Chief Technology Officer | 2005 | $176,508 | $15,000 | $0 | $38,124 | $0 | $0 | $0 | $229,632 |
| | 2004 | $172,514 | $15,000 | $0 | $44,958 | $0 | $0 | $0 | $232,499 |

(1) In each year ending December 31, 2005 and 2004, Mr. Pickett earned 36,000 shares issued under the Company's Employee Stock Incentive Plan as additional compensation pursuant to his employment agreement. The fair market value of these shares upon issuance was $163,319, and $107,779, respectively.

(2) In January 2006, the Company acquired a 90% interest in MST, a corporation wholly owned by Frank T. Matarazzo, prior to the acquisition. No compensation was paid by Telkonet to Mr. Matarazzo for the years ended December 31, 2005, and 2004.

(3) In 2004 the following assumptions were used to determine the fair value of stock option awards granted: historical volatility of 76% expected option life of 5.0 years and a risk-free interest rate of 1.35%.

(4) In 2005 the following assumptions were used to determine the fair value of stock option awards granted: historical volatility of 71% expected option life of 5.0 years and a risk-free interest rate of 4.50%.

(5) In 2006 the following assumptions were used to determine the fair value of stock option awards granted: historical volatility of 65% expected option life of 5.0 years and a risk-free interest rate of 5.0%.

**Employment Agreements**

Ronald W. Pickett, President and Chief Executive Officer, is employed pursuant to an employment agreement for an unspecified term that commenced January 30, 2003 and provides for an annual salary $100,000, 3,000 shares of the Company's common stock per month for each month of his employment and bonuses and benefits based upon Telkonet's internal policies. Mr. Pickett's annual salary was increased to $102,340 on August 1, 2004 and he received a bonus of $200,000 for the year ended December 31, 2005. In January 2006, Mr. Pickett's salary was increased to $250,000 with an incentive bonus up to $150,000. The incentive portion of the salary would be awarded based on the successful achievement of certain performance metrics aligned with the Company's 2006 operating plan.

Frank T. Matarazzo, President and Chief Executive Officer, MST, is employed pursuant to an employment agreement for a three-year term that commenced February 1, 2006 and provides for an annual salary of $250,000 and bonuses and benefits based upon MST's internal policies.

Robert P. Crabb, Chief Marketing Officer, is employed pursuant to an employment agreement for a three year term that commenced January 18, 2003 and provides for an annual salary of $120,000 and bonuses and benefits based upon Telkonet's internal policies. Mr. Crabb's annual salary was increased to $172,340 in 2004.

Stephen L. Sadle, Senior Vice President, is employed pursuant to an employment agreement for a three-year term that commenced January 18, 2003 and renewed for a one-year term through January 17, 2007 and provides for an annual salary of $130,000 and bonuses and benefits based upon Telkonet's internal policies. Mr. Sadle's annual salary was increased to $171,872 in 2004.

Richard J. Leimbach, Vice President of Finance, has been employed since January 26, 2004 with an annual salary of $102,340 and bonuses and benefits based upon Telkonet's internal policies. Mr. Leimbach's annual salary was increased to $130,000 in 2006.

James F. Landry, Chief Technology Officer, has been employed since September 24, 2001 with an annual salary of $160,000 with bonuses and benefits based upon Telkonet's internal policies. Mr. Landry's annual salary was increased to $176,508 in 2004.

Bill Dukes, President and CEO of Smart Systems International (an operating division of Telkonet), is employed pursuant to an employment agreement, dated March 9, 2007. Mr. Dukes' employment agreement has a term of [one year] and provides for a base salary of [$250,000] per year and bonuses and benefits based upon Telkonet's internal policies.

Robert Zirpoli, [Senior Engineer] of Smart Systems International (an operating division of Telkonet), is employed pursuant to an employment agreement, dated March 9, 2007. Mr. Zirpoli's employment agreement has a term of [one year] and provides for a base salary of [$100,000] per year and bonuses and benefits based upon Telkonet's internal policies.

Jason Tienor, Chief Executive Officer of Ethostream, LLC, is employed pursuant to an employment agreement, dated March 15, 2007. Mr. Tienor's employment agreement has a term of three years, which may be extended by mutual agreement of the parties thereto, and provides for a base salary of $148,000.00 per year and bonuses and benefits based upon Telkonet's internal policies.

Jeff Sobieski, Chief Financial Officer of Ethostream, LLC, is employed pursuant to an employment agreement, dated March 15, 2007. Mr. Sobieski's employment agreement has a term of three years, which may be extended by mutual agreement of the parties thereto, and provides for a base salary of $148,000.00 per year and bonuses and benefits based upon Telkonet's internal policies.

**GRANT OF PLAN BASED AWARDS**

There were no stock options or restricted stock awards granted in 2006.

**OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END TABLE**

The following table shows outstanding stock option awards classified as exercisable and unexercisable as of December 29, 2006 for the named executive officers. The table also shows unvested and unearned stock awards (both time-based awards and performance-contingent) assuming a market value of $2.67 a share (the closing market price of the Company’s stock on December 29, 2006).

**OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END**

| Name | Option Awards | | | | | Stock Awards | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Number of Securities Underlying Unexercised Options (#) Exerciseable | Number of Securities Underlying Unexercised Options (#) Unexerciseable | Equity Incentive Plan Awards: Number of Securities Underlying Unexercised Unearned Options (#) | Option Exercise Price ($) | Option Expiration Date | Number of Shares or Units of Stock That Have Not Vested (#) | Market Value of Shares or Units of Stock That Have Not Vested ($) | Equity Incentive Plan Awards: Number of Unearned Shares, Units or Other Rights That Have Not Vested (#) | Equity Incentive Plan Awards: Market or Payout Value of Unearned Shares, Units or Other Rights That Have Not Vested ($) |
| Ronald W. Pickett | - | - | - | N/A | N/A | - | - | - | - |
| Frank T. Matarazzo | - | - | - | N/A | N/A | - | - | - | - |
| Stephen L. Sadle | 900,000 | - | - | $1.00 | 1/1/2003 | - | - | - | - |
| Richard J. Leimbach | 32,500 | 55,000 | - | (1) | (1) | - | - | - | - |
| James F. Landry | 350,000 | 150,000 | - | (2) | (2) | - | - | - | - |

_____

(1) Includes 12,500 and 25,000 vested and unvested options, respectively, exerciseable at $2.59 per share with an expiration of 1/26/2014 and 20,000 and 30,000 vested and unvested options, respectively, exerciseable at $5.08 per share with an expiration of 1/1/2015.

(2) Includes 250,000 fully vested options, exerciseable at $1.00 per share with expirations ranging from 12/3/2011 to 7/1/2013 and 100,000 and 150,000 vested and unvested options, respectively, exerciseable at $3.45 per share with an expiration of 5/1/2014.

**OPTION EXERCISES AND STOCK VESTED**

There were no options exercised by, or stock awards vested for the account of, the named executive officers during 2006.

**POTENTIAL PAYMENTS UPON TERMINATION OR CHANGE IN CONTROL**

In January 2003, the Company entered into an Employment Agreement with Mr. Sadle pursuant to which, in the event of a change in control, Mr. Sadle will continue to receive salary and benefits for a period of thirty-six months following such change in control. All of Mr. Sadle's options to purchase common stock will also immediately vest upon a change of control.

For purposes of Mr. Sadle's Employment Agreement, the term "change in control" means the first to occur of the following events (a) any person or group of commonly controlled persons acquires, directly or indirectly, thirty percent (30%) or more of the voting control or value of the equity interests in the Company; or (b) the shareholders of the Company approve an agreement to merge or consolidate with another corporation or other entity resulting (whether separately or in connection with a series of transactions) in a change in ownership of twenty percent (20%) or more of the voting control or value of the equity interests in the Company, or an agreement to sell or otherwise dispose of all or substantially all of the Company's assets (including, without limitation, a plan of liquidation or dissolution), or otherwise approve of a fundamental alteration in the nature of the Company's business.

Rights under the Mr. Sadle's Employment Agreement will be triggered in the event that, following a change in control, the executive's employment with the Company is terminated for any reason or no reason.

If a change of control had occurred on January 1, 2007, Mr. Sadle would be entitled to the following as of such date:

$515,616 in salary as well as benefits paid on the employees behalf based upon Telkonet's internal policies for a period of 36 months.

Each of Mr. Tienor and Mr. Sobieski's Employment Agreement obligate the Company to continue to pay each executive's base salary and provide continued participation in employee benefit plans for the duration of the term of their employment agreements in the event such executive is terminated without "cause" by the Company or if the executive terminates his employment for "good reason." "Cause" is defined as the occurrence of any of the following: (i) theft, fraud, embezzlement, or any other act of dishonesty by the executive; (ii) any material breach by the executive of any provision of the employment agreement which breach is not cured within a reasonable time (but not to exceed thirty (30) days after written notification thereof to the executive by Telkonet; (iii) any habitual neglect of duty or misconduct of the executive in discharging any of his duties and responsibilities under the employment agreement after a written demand for performance was delivered to the executive that specifically identified the manner in which the board believed the executive had failed to discharge his duties and responsibilities, and the executive failed to resume substantial performance of such duties and responsibilities on a continuous basis immediately following such demand; (iv) commission by the executive of a felony or any offense involving moral turpitude; or (v) any default of the executive's obligations under the employment agreement, or any failure or refusal of the executive to comply with the policies, rules and regulations of Telkonet generally applicable to Telkonet employees, which default, failure or refusal is not cured within a reasonable time (but not to exceed thirty (30) days) after written notification thereof to the executive by Telkonet. If cause exists for termination, the executive shall be entitled to no further compensation, except for accrued leave and vacation and except as may be required by applicable law. "Good reason" is defined as the occurrence of any of the following: (i) any material adverse reduction in the scope of the executive's authority or responsibilities; (ii) any reduction in the amount of the executive's compensation or participation in any employee benefits; or (ii) the executive's principal place of employment is actually or constructively moved to any office or other location 50 miles or more outside of Milwaukee, Wisconsin.

In the event Telkonet fails to renew the employment agreements upon expiration of the term, then Telkonet shall continue to pay the executive's base salary and provide the executive with continued participation in each employee benefit plan in which the executive participated immediately prior to expiration of the term for a period of three months following expiration of the term. Each of Messrs. Tienor and Sobieski have agreed to not to compete with the Company or solicit any Company employees for a period of one year following expiration or earlier termination of the

employment agreements.

Each of Mr. Dukes' and Mr. Zirpoli's employment agreements obligate the Company to continue to pay the executive's base salary and provide continued participation in each Company benefit plan for a period of three months following the termination of the executive's employment without cause. In the event the executive is terminated "for cause," or for engaging in any unethical, immoral or unprofessional conduct or violation of a Company policy, he shall not be entitled to any payment beyond such termination date, except for accrued leave and vacation and except as may be required by applicable law. For purposes of the employment agreements, "cause" includes, but is not be limited to, the following: (i) theft, fraud, embezzlement, dishonesty or other similar behavior by the executive; (ii) any material breach by the executive of any provision of the employment agreement; (iii) any habitual neglect of duty or misconduct of the executive in discharging any of his duties and responsibilities under the employment agreement; (iv) any conduct of the executive which is detrimental to or embarrassing to the Company, including, but not limited to, the executive being indicated or convicted of a felony or any offense involving moral turpitude; or (v) any default of the executive's obligations under the employment agreement, which default, failure or refusal is not cured within a reasonable time (but not to exceed thirty (30) days) after written notification thereof to the executive by the Company.

**Director Compensation**

In 2004, each non-employee Director elected or appointed to the Board of Directors was granted an option to purchase forty thousand (40,000) shares of the Company's common stock and each Non-Employee Director will be granted an option to purchase forty thousand (40,000) shares upon his or her re-election at an annual meeting of the Company's stockholders. These options vest on a quarterly basis over a period of one-year.

Compensation for 2006 to the non-employee directors was earned at the rate of $4,000 per month plus $1,000 per meeting attended. The Chairman of the Audit Committee earns compensation at the rate of $4,000 per month, and each non-employee director earns $1,000 for each meeting of the Audit Committee attended.

The following table summarizes all compensation paid to the Company's directors in the year ended December 31, 2006.

| Name | Fees Earned or Paid in Cash ($) | Stock Awards ($) | Option Awards ($) | Non-Equity Incentive Plan Compensation ($) | Change in Pension Value and Nonqualified Deferred Compensation Earnings | All Other Compensation ($) | Total ($) |
|---|---|---|---|---|---|---|---|
| Warren V. Musser | $ 48,000 | $ - | $ - | $ - | $ - | $ 52,000 (1) | $ 100,000 |
| Thomas M. Hall | 52,000 | - | 34,500 (2) | - | - | - | 86,500 |
| Thomas C. Lynch | 52,000 | - | 34,500 (2) | - | - | - | 86,500 |
| James L. Peeler | 52,000 | - | 34,500 (2) | - | - | - | 86,500 |
| Seth D. Blumenfeld | - | 77,595(3) | - | - | - | - | 77,595 |
| Ronald W. Pickett | - | - | - | - | - | - | - |
| Stephen L. Sadle | - | - | - | - | - | - | - |

(1) fees from annual consulting agreement dated September 2003 for non-director services.
(2) stock options granted in January 2006 pursuant to the non-employee director compensation
(3) 20,000 shares issued for services performed through June 2006 pursuant to the professional services agreement dated July 1, 2005.

**COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION**

During the year ended December 31, 2006, Messrs, Hall, Lynch and Peeler served as members of the Company's Compensation Committee. None of the members of the Compensation Committee was an employee of the Company during the year ended December 31, 2006 nor has any of them been an officer of the Company. No executive officer of the Company served during the year ended December 31, 2006 as a member of a compensation committee or as a director of any entity of which any of the Company's directors served as an executive officer.

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

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, 2006.

| | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted -average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) |
|---|---|---|---|
| | (a) | (b) | (c) |
| **Equity compensation plans approved by security holders** | 10,336,866 | $1.87 | 1,645,423 |
| **Equity compensation plans not approved by security holders** | - | - | - |
| **Total** | 10,336,866 | $1.87 | 1,645,423 |

The following table sets forth, as of March 1, 2007, the number of shares of the Company's common stock beneficially owned by each director and executive officer of the Company, by all directors and executive officers as a group, and by each person known by the Company to own beneficially more than 5.0% of the Company's outstanding common stock. As of March 1, 2007, there were no issued and outstanding shares of any other class of the Company's equity securities.

| **Name and Address of Beneficial Owner** | **Amount and Nature of Beneficial Ownership** | **Percentage of Class** |
|---|---|---|
| **Officers and Directors** | | |
| Ronald W. Pickett, President and CEO<br>20374 Seneca Meadows Parkway<br>Germantown, MD 20876 | 2,574,699 | 4.5% |
| Frank T. Matarazzo, President and CEO, MST<br>259-263 Goffle Road<br>Hawthorne, NJ 07506 | 520,000(1) | 0.9% |
| Stephen L. Sadle, Senior Vice President<br>20374 Seneca Meadows Parkway<br>Germantown, MD 20876 | 4,284,514(2) | 7.4% |
| James Landry, Chief Technology Officer<br>20374 Seneca Meadows Parkway<br>Germantown, MD 20876 | 484,200(3) | 0.8% |
| Richard Leimbach, Vice President of Finance<br>20374 Seneca Meadows Parkway<br>Germantown, MD 20876 | 41,000(4) | 0.1% |
| Warren V. Musser, Chairman<br>20374 Seneca Meadows Parkway<br>Germantown, MD 20876 | 2,000,000(5) | 3.4% |
| Thomas C. Lynch, Director<br>20374 Seneca Meadows Parkway<br>Germantown, MD 20876 | 100,000(6) | 0.2% |
| Dr. Thomas M. Hall, Director<br>20374 Seneca Meadows Parkway<br>Germantown, MD 20876 | 647,790(7) | 1.1% |
| James "Lou" L. Peeler, Director<br>20374 Seneca Meadows Parkway<br>Germantown, MD 20876 | 84,400(8)<br>65,000(9) | 0.1%<br>0.1% |

| | | |
|---|---|---|
| Seth D. Blumenfeld, Director<br>20374 Seneca Meadows Parkway<br>Germantown, MD 20876 | | |
| All Directors and Executive Officers as a Group | 10,801,603 | 17.8% |

(1) Includes 600,000 shares of the Company's common stock issued to Mr. Matarazzo in conjunction with the Company's January 2006 acquisition of a 90% interest in Microwave Satellite Technologies, Inc. As part of the purchase price, an additional 1,000,000 shares of the Company's common stock are held in escrow, issuable upon the achievement of certain performance targets and excluded from this table.

(2) Includes options exercisable within 60 days to purchase 900,000 shares of the Company's common stock at $1.00 per share.
(3) Includes options exercisable within 60 days to purchase 250,000 and 150,000 shares of the Company's common stock at $1.00 and $3.45 per share, respectively.
(4) Includes options exercisable within 60 days to purchase 17,500 and 22,500 shares of the Company's common stock at $2.59 and $5.08 per share, respectively.
(5) Includes options exercisable within 60 days to purchase 2,000,000 shares of the Company's common stock at $1.00 per share.
(6) Includes options exercisable within 60 days to purchase 20,000 and 80,000 shares of the Company's common stock at $2.00 and $3.45 per share, respectively.
(7) Includes options exercisable within 60 days to purchase 80,000 shares of the Company's common stock at $3.45 per share.
(8) Includes options exercisable within 60 days to purchase 80,000 shares of the Company's common stock at $3.45 per share.
(9) Includes 15,000 shares of the Company's common stock to be issued within 60 days pursuant to a Professional Services Agreement.

## ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE

***Description of Related Party Transactions***

In September 2003, the Company entered into a consulting agreement (renewable annually) with The Musser Group to compensate Mr. Musser in the amount of $100,000 per year for his services to the Company as a director. Mr. Musser, Chairman of the Board of Directors, is the sole principal and owner of The Musser Group. For the years ended December 31, 2006, 2005 and 2004, the Company paid and expensed $100,000, $100,000 and $100,000, respectively.

On July 1, 2005, Mr. Blumenfeld was retained as a consultant to Telkonet pursuant to a Professional Services Agreement between the Company and Mr. Blumenfeld. Pursuant to the terms of the agreement, Mr. Blumenfeld received 10,000 shares of Company stock upon execution of the agreement, 10,000 shares of Company stock per quarter for the first year (for a total 50,000 shares in the first year) and 5,000 shares of Company stock per quarter thereafter plus a five percent (5%) commission (payable in cash or Company stock) on international sales generated by him with gross margins of 50% or greater. The stock awarded to Mr. Blumenfeld pursuant to the agreement is restricted stock. The agreement has a one year term, which is renewable annually upon both parties' agreement. This agreement expired in June 2006.

In December 2005, the Company issued an aggregate of 363,636 shares of common stock to Ronald W. Pickett, President and Chief Executive Officer of the Company, in exchange for $200,000 of Series B Debentures held by him. The Company also issued an aggregate of 48,858 shares of common stock in exchange for accrued interest of $26,872 for Series B Debentures held by Mr. Pickett. In addition, the Company issued an aggregate of 200,000 shares of common stock upon the exercise by Mr. Pickett of warrants to purchase shares of the Company's common stock at $1.00 per share.

In February 2007, the Company entered into a one-year professional services agreement with Global Transport Logistics, Inc. ("GTI"), for the provision of consulting services for which GTI is paid a fee of $10,000 per month. GTI is 50% owned by Anthony Matarazzo, the brother of MST's Chief Executive Officer.

The Chief Administrative Officer at MST, Laura Matarazzo, is the sister of the President of MST and receives an annual base salary of approximately $134,000 with bonuses and benefits based upon the Company's internal policies.

The Company's Vice President of Government Sales, John Vasilj, is the son-in-law of the President and CEO of the Company and receives an annual base salary of approximately $150,000 with bonuses and benefits based upon the Company's internal policies.

***Company's Policies on Related Party Transactions***

Under the Company's policies and procedures, related-party transactions that must be publicly disclosed under the federal securities laws require prior approval of the Company's independent directors without the participation of any director who may have a direct or indirect interest in the transaction in question. Related parties include directors, nominees for director, principal shareholders, executive officers and members of their immediate families. For these purposes, a "transaction" includes all financial transactions, arrangements or relationships, ranging from extending credit to the provision of goods and services for value and includes any transaction with a company in which a director, executive officer immediate family member of a director or executive officer, or principal shareholder (that is, any person who beneficially owns five percent or more of any class of the Company's voting securities) has an interest by virtue of a 10-percent-or-greater equity interest. The Company's policies and procedures regarding related-party transactions are not a part of a formal written policy, but rather, represent the Company's historical course of practice with respect to approval of related-party transactions.

***Director Independence***

The Board of Directors has determined that the following Directors are "independent" under the listing standards of the American Stock Exchange (AMEX): Dr. Hall, Mr. Lynch and Mr. Peeler. Each of Dr. Hall, Mr. Peeler and Mr. Lynch serve on, and are the only members of, the Company's Audit and Compensation Committees. Although Telkonet does not maintain a standing Nominating Committee, nominees for election as directors are considered and nominated by a majority of Telkonet's independent directors in accordance with the AMEX listing standards. "Independence" for these purposes is determined in accordance with Section 121(A) of the AMEX Rules and Rule 10A-3 under the Securities Exchange Act of 1934.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.**

The following table sets forth fees billed to the Company by our auditors during the fiscal years ended December 31, 2006 and 2005. Additionally, the Company incurred approximately $320,289, of consulting and internal resources associated with its Sarbanes-Oxley compliance review.

| | December 31, 2006 | December 31, 2005 |
|---|---|---|
| 1. Audit Fees | $ 229,552 | $ 119,090 |
| 2. Audit Related Fees | 52,600 | 62,825 |
| 3. Tax Fees | -- | 1,175 |
| 4. All Other Fees | -- | -- |
| Total Fees | $ 282,152 | $ 183,090 |

Audit fees consist of fees billed for professional services rendered for the audit of the Company's consolidated financial statements and review of the interim consolidated financial statements included in quarterly reports and services that are normally provided by Russell Bedford Stefanou Mirchandani LLP in connection with statutory and regulatory filings or engagements.

Audit-related fees consists of fees billed for assurance and related services that are reasonably related to the performance of the audit or review of the Company's consolidated financial statements, which are not reported under "Audit Fees."

Tax fees consists of fees billed for professional services for tax compliance, tax advice and tax planning. The tax fees relate to federal and state income tax reporting requirements.

All other fees consist of fees for products and services other than the services reported above.

Prior to the Company's engagement of its independent auditor, such engagement is approved by the Company's audit committee. The services provided under this engagement may include audit services, audit-related services, tax services and other services. Pre-approval is generally provided for up to one year and any pre-approval is detailed as to the particular service or category of services and is generally subject to a specific budget. Pursuant to the Company's Audit Committee Charter, the independent auditors and management are required to report to the Company's audit committee at least quarterly regarding the extent of services provided by the independent auditors in accordance with this pre-approval, and the fees for the services performed to date. The audit committee may also pre-approve particular services on a case-by-case basis. All audit fees, audit-related fees, tax fees and other fees incurred by the Company for the year ended December 31, 2006, were approved by the Company's audit committee.

## PART IV

## ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES.

The following table sets forth selected unaudited quarterly information for the Company's year-ended December 31, 2006 and 2005.

**QUARTERLY FINANCIAL DATA**
**(unaudited)**

| | March 31, 2006 | June 30, 2006 | September 30, 2006 | December 31, 2006 |
|---|---|---|---|---|
| Net Revenue | $ 1,943,912 | $ 1,152,470 | $ 1,143,097 | $ 941,848 |
| Gross Profit | $ 648,342 | $ 139,628 | $ 83,049 | $ (170,433) |
| Provision for income taxes | $ - | $ - | $ - | $ - |
| Net loss per share -- basic | $ (0.09) | $ (0.16) | $ (0.20) | $ (0.08) |
| Net loss per share -- diluted | $ (0.09) | $ (0.16) | $ (0.20) | $ (0.08) |

| | March 31, 2005 | June 30, 2005 | September 30, 2005 | December 31, 2005 |
|---|---|---|---|---|
| Net Revenue | $ 246,188 | $ 472,947 | $ 621,923 | $ 1,147,265 |
| Gross Profit | $ 88,798 | $ 120,791 | $ 212,749 | $ 348,806 |
| Provision for income taxes | $ - | $ - | $ - | $ - |
| Net loss per share -- basic | $ (0.07) | $ (0.08) | $ (0.08) | $ (0.12) |
| Net loss per share -- diluted | $ (0.07) | $ (0.08) | $ (0.08) | $ (0.12) |

The following table sets forth selected unaudited valuation and qualifying account information for the Company's year-ended December 31, 2006, 2005 and 2004.

**SCHEDULE II- VALUATION AND QUALIFYING ACCOUNTS**
**(unaudited)**

| DESCRIPTION | BALANCE BEGINNING OF YEAR | CHARGED TO COSTS AND EXPENSES | DEDUCTIONS | BALANCE, END OF YEAR |
|---|---|---|---|---|
| **Allowance for doubtful accounts:** | | | | |
| Year ended December 31, | | | | |
| 2006 | $ 30,000 | $ 36,659 | $ 6,659 | $ 60,000 |
| 2005 | 13,000 | 39,710 | (22,710) | 30,000 |
| 2004 | 7,000 | 30,637 | (24,637) | 13,000 |
| | | | | |
| **Reserve for product returns:** | | | | |
| Year ended December 31, | | | | |
| 2006 | $ 24,000 | $ 23,300 | $ — | $ 47,300 |
| 2005 | — | 24,000 | — | 24,000 |
| 2004 | — | — | — | — |

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The following exhibits are included herein or incorporated by reference:

| Exhibit Number | Description Of Document |
|---|---|
| 2.1 | MST Stock Purchase Agreement and Amendment (incorporated by reference to our 8-K filed on February 2, 2006) |
| 2.2 | 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) |
| 2.3 | 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) |
| 3.1 | Articles of Incorporation of the Registrant (incorporated by reference to our Form 8-K (No. 000-27305), filed on August 30, 2000 and our Form S-8 (No. 333-47986), filed on October 16, 2000) |
| 3.2 | Bylaws of the Registrant (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003) |
| 4.1 | Form of Series A Convertible Debenture (incorporated by reference to our Form 10-KSB (No. 000-27305), filed on March 31, 2003) |
| 4.2 | Form of Series A Non-Detachable Warrant (incorporated by reference to our Form 10- KSB (No. 000-27305), filed on March 31, 2003) |
| 4.3 | Form of Series B Convertible Debenture (incorporated by reference to our Form 10-KSB (No. 000-27305), filed on March 31, 2003) |
| 4.4 | Form of Series B Non-Detachable Warrant (incorporated by reference to our Form 10-KSB (No. 000-27305), filed on March 31, 2003) |
| 4.5 | Form of Senior Note (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003) |
| 4.6 | Form of Non-Detachable Senior Note Warrant (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003) |
| 4.7 | 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) |
| 4.8 | Senior Convertible Note 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) |
| 4.11 | Warrant to Purchase Common Stock 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) |
| 4.12 | 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) |
| 4.13 | 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) |
| 4.14 | 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. |
| 4.15 | Form of Warrant to Purchase Common Stock (incorporated by reference to our Current Report on Form 8-K filed on February 5, 2007) |
| 10.1 | |

| | |
|---|---|
| | Amended and Restated Telkonet, Inc. Incentive Stock Option Plan (incorporated by reference to our Registration Statement on Form S-8 (No. 333-412), filed on April 17, 2002) |
| 10.2 | Employment Agreement by and between Telkonet, Inc. and Stephen L. Sadle, dated as of January 18, 2003 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003 |

| | |
|---|---|
| 10.3 | Employment Agreement by and between Telkonet, Inc. and Robert P. Crabb, dated as of January 18, 2003 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003) |
| 10.4 | Employment Agreement by and between Telkonet, Inc. and Ronald W. Pickett, dated as of January 30, 2003 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003) |
| 10.5 | Registration Rights Agreement by and among Telkonet, Inc., Kings Road Investments Ltd. and Portside Growth & Opportunity Fund, dated October 27, 2005 (incorporated by reference to our Form 8-K (No. 001-31972), filed on October 31, 2005) |
| 10.6 | Professional Services Agreement by and between Telkonet, Inc. and Seth D. Blumenfeld, dated July 1, 2005 (incorporated by reference to our Form 10-Q (No. 000-27305), filed on November 9, 2005. |
| 10.7 | Employment Agreement by and between Telkonet, Inc. and Frank T. Matarazzo, dated as of February 1, 2006 (incorporated by reference to our Form 10-K (No. 001-31972), filed March 16, 2006) |
| 10.9 | Settlement Agreement by and among Telkonet, Inc. and Kings Road Investments Ltd., dated as of August 14, 2006 (incorporated by reference to our Form 8-K (No. 001-31972), filed on August 16, 2006) |
| 10.10 | Settlement Agreement by and among Telkonet, Inc. and Portside Growth & Opportunity Fund, dated as of August 14, 2006 (incorporated by reference to our Form 8-K (No. 001-31972), filed on August 16, 2006) |
| 10.11 | Securities Purchase Agreement, dated August 31, 2006, by and among Telkonet, Inc., Enable Growth Partners LP, Enable Opportunity Partners LP and Pierce Diversified Strategy Master Fund LLC, Ena (incorporated by reference to our Form 8-K (No. 001-31972), filed on September 6, 2006) |
| 10.12 | Registration Rights Agreement, dated August 31, 2006, by and among Telkonet, Inc., Enable Growth Partners LP, Enable Opportunity Partners LP and Pierce Diversified Strategy Master Fund LLC, Ena (incorporated by reference to our Form 8-K (No. 001-31972), filed on September 6, 2006) |
| 10.13 | Securities Purchase Agreement, dated February 1, 2007, by and among Telkonet, Inc., Enable Growth Partners LP, Enable Opportunity Partners LP, Pierce Diversified Strategy Master Fund LLC, Ena, Hudson Bay Fund LP and Hudson Bay Overseas Fund, Ltd. (incorporated by reference to our Current Report on Form 8-K filed on February 5, 2007) |
| 10.14 | Registration Rights Agreement, dated February 1, 2007, by and among Telkonet, Inc., Enable Growth Partners LP, Enable Opportunity Partners LP and Pierce Diversified Strategy Master Fund LLC, Ena, Hudson Bay Fund LP and Hudson Bay Overseas Fund, Ltd. (incorporated by reference to our Current Report on Form 8-K filed on February 5, 2007) |
| 10.15 | Employment Agreement by and between Telkonet, Inc. and William Dukes, dated as of March 9, 2007 |
| 10.16 | Employment Agreement by and between Telkonet, Inc. and Robert Zirpoli, dated as of March 9, 2007 |
| 10.17 | Employment Agreement by and between Telkonet, Inc. and Jason Tienor, dated as of March 15, 2007 |
| 10.18 | Employment Agreement by and between Telkonet, Inc. and Jeff Sobieski, dated as of March 15, 2007 |
| 14 | Code of Ethics (incorporated by reference to our Form 10-KSB (No. 001-31972), filed on March 30, 2004). |

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| | |
|---|---|
| 21 | Telkonet, Inc. Subsidiaries |
| 23 | Consent of Russell Bedford Stefanou Mirchandani LLP , Independent Registered Certified Public Accounting Firm, filed herewith |
| 24 | Power of Attorney (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003) |
| 31.1 | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Ronald W. Pickett |
| 31.2 | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Richard J. Leimbach |
| 32.1 | Certification of Ronald W. Pickett pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Richard J. Leimbach pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

**SIGNATURES**

Pursuant to he 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.

/s/ Ronald W. Pickett

Ronald W. Pickett
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/ Warren V. Musser<br>Warren V. Musser | Chairman of the Board | March 16, 2007 |
| /s/ Ronald W. Pickett<br>Ronald W. Pickett | Chief Executive Officer & Director | March 16, 2007 |
| /s/ Richard J. Leimbach<br>Richard J. Leimbach | Vice President of Finance (principal financial officer) (principal accounting officer) | March 16, 2007 |
| /s/ Stephen L. Sadle<br>Stephen L. Sadle | Senior Vice President & Director | March 16, 2007 |
| /s/ Dr. Thomas M. Hall<br>Dr. Thomas M. Hall | Director | March 16, 2007 |
| /s/ James L. Peeler<br>James L. Peeler | Director | March 16, 2007 |
| /s/ Seth D. Blumenfeld<br>Seth D. Blumenfeld | Director | March 16, 2007 |
| /s/ Thomas C. Lynch<br>Thomas C. Lynch | Director | March 16, 2007 |

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**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FINANCIAL STATEMENTS AND SCHEDULES**

**DECEMBER 31, 2006 AND 2005**

**FORMING A PART OF ANNUAL REPORT**
**PURSUANT TO THE SECURITIES EXCHANGE ACT OF 1934**

**TELKONET, INC.**

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**TELKONET, INC.**

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**RUSSELL BEDFORD STEFANOU MIRCHANDANI LLP**
**CERTIFIED PUBLIC ACCOUNTANTS**

**REPORT OF INDEPENDENT REGISTERED CERTIFIED PUBLIC ACCOUNTING FIRM**

Board of Directors
Telkonet, Inc.
Germantown, MD

We have audited the accompanying consolidated balance sheets of Telkonet, Inc. and its subsidiaries (the "Company") as of December 31, 2006 and 2005 and the related consolidated statements of losses, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based upon our audit.

We conducted our audits in accordance with standards of the Public Company Accounting Oversight Board (United States of America). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe 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. and its subsidiaries as of December 31, 2006 and 2005, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123(R), "Share-Based Payment", effective January 1, 2006.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company’s internal control over financial reporting as of December 31, 2006, based on the criteria established in ***Internal Control—Integrated Framework*** issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 15, 2007 expressed an unqualified opinion on management’s assessment of the effectiveness of the Company’s internal control over financial reporting and an unqualified opinion on the effectiveness of the Company’s internal control over financial reporting.

/s/RUSSELL BEDFORD STEFANOU MIRCHANDANI LLP
Russell Bedford Stefanou Mirchandani LLP

McLean, Virginia
March 15, 2007

**TELKONET, INC.**
**CONSOLIDATED BALANCE SHEETS**
**DECEMBER 31, 2006 AND 2005**

| **ASSETS** | 2006 | 2005 |
|---|---|---|
| **Current Assets:** | | |
| Cash and cash equivalents | $ 1,644,037 | $ 8,422,079 |
| Restricted Certificate of Deposit | - | 10,000,000 |
| Accounts receivable, net of allowance for doubtful accounts of $60,000 and $30,000 at December 31, 2006 and 2005, respectively | 295,116 | 119,191 |
| Income tax receivable (Note L) | 291,000 | - |
| Inventories (Note D) | 1,306,593 | 1,475,806 |
| Prepaid expenses and deposits | 229,333 | 360,880 |
| Total current assets | 3,766,079 | 20,377,956 |
| **Property and equipment, at cost** (Note E): | | |
| Furniture and equipment | 2,211,036 | 1,041,137 |
| Less: accumulated depreciation | 582,248 | 323,667 |
| Total property and equipment, net | 1,628,788 | 717,470 |
| **Equipment under operating leases, at cost** (Note F): | | |
| Telecommunications and related equipment, at cost | 3,186,000 | 789,099 |
| Less: accumulated depreciation | 564,233 | 124,669 |
| Total equipment under operating leases, net | 2,621,767 | 664,430 |
| **Other assets:** | | |
| Long-term investments (Note G) | 193,847 | 231,000 |
| Intangible assets, net of accumulated amortization of $282,325 and $0 at December 31, 2006 and December 31, 2005, respectively (Note B and C) | 2,181,602 | - |
| Financing Costs, net of accumulated amortization and write-off of $1,219,410 and $73,499 at December 31, 2006 and 2005, respectively (Note H) | - | 1,145,911 |
| Goodwill (Note B and C) | 1,977,768 | - |
| Deposits | 146,665 | 154,216 |
| Total other assets | 4,499,882 | 1,531,127 |
| **Total Assets** | $ 12,516,516 | $ 23,290,983 |
| **LIABILITIES AND STOCKHOLDERS' EQUITY** | | |
| **Current liabilities:** | | |
| Accounts payable and accrued liabilities (Note P) | $ 2,865,144 | $ 1,821,872 |
| Customer deposits held | - | 86,257 |

| | | | | |
|---|---|---|---|---|
| Senior notes payable, current portion (Note I) | | - | | 100,000 |
| Note Payable - officer (Note L) | | 80,444 | | - |
| Income tax refund due to officer (Note L) | | 291,000 | | - |
| Convertible debentures, current portion (Note H) | | - | | 6,250,000 |
| Note payable in connection with subsidiary acquisition (Note B) | | 900,000 | | - |
| Deferred revenue | | 160,125 | | 59,020 |
| Total current liabilities | | 4,296,713 | | 8,317,149 |
| | | | | |
| **Long-term liabilities:** | | | | |
| Convertible debentures, net of debt discounts (Note H) | | - | | 9,616,521 |
| Deferred revenue | | 42,019 | | - |
| Deferred lease liability | | 42,561 | | 42,317 |
| Total long-term liabilities | | 84,580 | | 9,658,838 |
| | | | | |
| **Commitments and contingencies** (Note Q) | | - | | - |
| **Minority interest** | | **-** | | **-** |
| | | | | |
| **Stockholders' equity** (Note J) | | | | |
| Preferred stock, par value $.001 per share; 15,000,000 shares authorized; none issued and outstanding at December 31, 2006 and 2005 | | - | | - |
| Common stock, par value $.001 per share; 100,000,000 shares authorized; 56,992,301 and 45,765,171 shares issued and outstanding at December 31, 2006 and 2005, respectively | | 56,992 | | 45,765 |
| Additional paid-in-capital | | 78,502,900 | | 48,256,784 |
| Accumulated deficit | | (70,424,669) | | (42,987,553) |
| Stockholders' equity | | 8,135,223 | | 5,314,996 |
| **Total Liabilities and Stockholders' Equity** | $ | 12,516,516 | $ | 23,290,983 |

See accompanying notes to consolidated financial statements

**TELKONET, INC.**
**CONSOLIDATED STATEMENTS OF LOSSES**
**FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004**

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Product Revenues, net | $ 3,092,967 | $ 1,769,727 | $ 477,555 |
| Rental Revenue, net | 2,088,361 | 718,596 | 221,097 |
| Total Revenue | 5,181,328 | 2,488,323 | 698,652 |
| | | | |
| Product | 2,062,399 | 1,183,574 | 459,225 |
| Rental | 2,418,260 | 533,605 | 83,634 |
| Total Cost of Sales | 4,480,659 | 1,717,179 | 542,859 |
| | | | |
| Gross Profit | 700,669 | 771,144 | 155,793 |
| | | | |
| Operating Expenses: | | | |
| Research and Development (Note A) | 1,925,746 | 2,096,104 | 1,852,309 |
| Selling, General and Administrative | 14,346,364 | 12,041,661 | 7,663,369 |
| Consulting Fees (Note J) | - | - | 2,500,000 |
| Impairment write-down in investment in affiliate (Note G) | 92,000 | 400,000 | - |
| Non-Employee Stock Options and Warrants (Note K) | 277,344 | 1,354,219 | 1,180,875 |
| Employee Stock based compensation (Note K) | 1,080,895 | - | - |
| Depreciation and Amortization | 540,906 | 185,928 | 71,514 |
| Total Operating Expense | 18,263,255 | 16,077,912 | 13,268,067 |
| | | | |
| Loss from Operations | (17,562,586) | (15,306,768) | (13,112,274) |
| | | | |
| Other Income (Expense): | | | |
| Other Income (Note H) | - | 8,600 | - |
| Loss on early extinguishment of debt (Note H) | (4,626,679) | | |
| Interest Income | 327,184 | 166,070 | 128,938 |
| Interest Expense | (5,594,604) | ( 646,183) | (109,324) |
| Total Other Income (Expenses) | (9,894,099) | (471,513) | 19,614 |
| | | | |
| Loss Before Provision for Income Taxes | (27,456,685) | (15,778,281) | (13,092,660) |
| | | | |
| Minority interest (Note B) | 19,569 | | |
| Provision for Income Tax (Note N) | - | - | - |
| | | | |
| Net (Loss) | $ (27,437,116) | $ (15,778,281) | $ (13,092,660) |
| | | | |
| Loss per common share (basic and assuming dilution) (Note O) | $ (0.54) | $ (0.35) | $ (0.32) |
| | | | |
| Weighted average common shares outstanding | 50,823,652 | 44,743,223 | 41,384,074 |

See accompanying notes to consolidated financial statements

**TELKONET, INC.**
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**
**FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004**

| | Preferred Shares | Preferred Stock Amount | Common Shares | Common Stock Amount | Additional Paid in Capital | Accumulated Deficit | Total |
|---|---|---|---|---|---|---|---|
| Balance at January 1, 2004 | - | $ - | 30,689,522 | $ 30,690 | $ 16,474,251 | $ (14,116,612) | $ 2,388,329 |
| Shares issued for employee stock options exercised at approximately $1.08 per share | - | - | 540,399 | 540 | 582,358 | - | 582,898 |
| Shares issued in exchange for non-employee options exercised at $1.00 per share | - | - | 328,333 | 328 | 328,005 | - | 328,333 |
| Shares issued to consultants in exchange for services rendered at approximately $3.07 per share | - | - | 63,566 | 63 | 196,252 | - | 196,315 |
| Shares issued for senior note conversion at $2.10 per share (Note I) | - | - | 1,209,038 | 1,209 | 2,537,791 | - | 2,539,000 |
| Shares issued in connection with private placement at $2.00 per share, net of costs | - | - | 6,387,600 | 6,388 | 12,720,455 | - | 12,726,843 |
| Shares issued to consultants for warrants exercised at $2.54 per share | - | - | 50,000 | 50 | 126,950 | - | 127,000 |
| Shares issued to noteholders for warrants exercised at $1.00 per share | - | - | 4,000,950 | 4,001 | 3,996,949 | - | 4,000,950 |
| Shares issued to noteholders for cashless warrants exercised | - | - | 203,751 | 204 | (204) | - | - |
| Shares issued for cashless exercise of underwriter warrants | - | - | 165,116 | 165 | (165) | - | - |
| Shares issued in exchange for convertible debentures at $0.50 per share | - | - | 124,000 | 124 | 61,876 | - | 62,000 |
| Shares issued in exchange for convertible debentures at $0.55 per share | - | - | 200,000 | 200 | 109,800 | - | 110,000 |
| Shares issued in exchange for accrued interest on convertible debentures | - | - | 42,999 | 43 | 23,233 | - | 23,276 |
| Shares issued to an employee in exchange for services at approximately $2.99 per share | - | - | 36,000 | 36 | 107,743 | - | 107,779 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Shares issued to consultants in exchange for consulting fees at $2.50 per share | - | - | 1,000,000 | 1,000 | 2,499,000 | - | 2,500,000 |
| Founders shares returned and canceled in connection with January 2002 capital restructure | - | - | (705,285) | (705) | 705 | - | - |
| Write-off of beneficial conversion features and warrants attached to convertible debentures in connection with conversion of Debenture-1 and Series B debentures | - | - | - | - | (134,666) | - | (134,666) |
| Stock options and warrants granted to consultants in exchange for services rendered | - | - | - | - | 1,180,875 | - | 1,180,875 |
| Net loss | - | - | - | - | - | (13,092,660) | (13,092,660) |
| Balance at December 31, 2004 | - $ | - | 44,335,989 $ | 44,336 $ | 40,811,208 $ | (27,209,272) $ | 13,646,272 |

See accompanying footnotes to consolidated financial statements

**TELKONET, INC.**
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (Continued)**
**FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004**

| | Preferred Shares | Preferred Stock Amount | Common Shares | Common Stock Amount | Additional Paid in Capital | Accumulated Deficit | Total |
|---|---|---|---|---|---|---|---|
| Balance at January 1, 2005 | - | $ - | 44,335,989 | $ 44,336 | $ 40,811,208 | $ (27,209,272) | $ 13,646,272 |
| Shares issued for employee stock options exercised at approximately $1.19 per share | - | - | 415,989 | 416 | 496,077 | - | 496,493 |
| Shares issued in exchange for non-employee options exercised at approximately $2.07 per share | - | - | 172,395 | 172 | 355,973 | - | 356,145 |
| Shares issued to noteholders for warrants exercised at $1.00 per share | - | - | 321,900 | 322 | 321,578 | - | 321,900 |
| Shares issued to noteholders for cashless warrants exercised | - | - | 36,150 | 36 | (36) | - | - |
| Shares issued to an employee in exchange for services at approximately $4.65 per share | - | - | 36,000 | 36 | 163,283 | - | 163,319 |
| Shares issued to director in exchange for services rendered at approximately $4.26 per share | - | - | 30,000 | 30 | 127,766 | - | 127,796 |
| Shares issued to consultants in exchange for services rendered at approximately $4.28 per share | - | - | 1,968 | 2 | 9,000 | - | 9,002 |
| Shares issued in exchange for convertible debentures at $0.55 per share | - | - | 363,636 | 364 | 199,636 | - | 200,000 |
| Shares issued in exchange for interest expense on convertible debentures | - | - | 51,144 | 51 | 28,080 | - | 28,131 |
| Beneficial conversion feature of convertible debentures (Note H) | - | - | - | - | 1,479,300 | - | 1,479,300 |
| Value of warrants attached to convertible debentures (Note H) | - | - | - | - | 2,910,700 | - | 2,910,700 |
| Stock options and warrants granted to consultants in exchange for services | - | - | - | - | 1,354,219 | - | 1,354,219 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| rendered | | | | | | | |
| Net loss | - | - | - | - | - | (15,778,281) | (15,778,281) |
| Balance at December 31, 2005 | - | $ - | 45,765,171 | $ 45,765 | $ 48,256,784 | $ (42,987,553) | $ 5,314,996 |

See accompanying footnotes to consolidated financial statements

**TELKONET, INC.**
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (Continued)**
**FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004**

| | Preferred Shares | Preferred Stock Amount | Common Shares | Common Stock Amount | Additional Paid in Capital | Accumulated Deficit | Total |
|---|---|---|---|---|---|---|---|
| **Balance at January 1, 2006** | **-** | - | 45,765,171 | 45,765 | 48,256,784 | (42,987,553) | 5,314,996 |
| Shares issued for employee stock options exercised at approximately $1.36 per share | - | - | 2,051,399 | 2,051 | 2,656,774 | - | 2,658,826 |
| Shares issued in exchange for non-employee options exercised at $1.00 per share | - | - | 25,837 | 26 | 25,811 | - | 25,837 |
| Shares issued in exchange for warrants exercised at $1.15 per share | - | - | 47,750 | 48 | 55,090 | - | 55,138 |
| Issuance of shares for purchase of subsidiary (Note B) | - | - | 600,000 | 600 | 2,699,400 | - | 2,700,000 |
| Shares issued in exchange for services rendered at approximately $3.87 per share | - | - | 52,420 | 52 | 202,974 | - | 203,026 |
| Shares issued in exchange for convertible debentures, interest expense and penalty at approximately $2.36 per share (Note H) | - | - | 6,049,724 | 6,050 | 14,249,979 | - | 14,256,029 |
| Shares issued for cash in connection with a private placement, shares issued at $2.50 per share | - | - | 2,400,000 | 2,400 | 5,997,600 | - | 6,000,000 |
| Value of additional warrants issued in conjunction with exchange of convertible debentures (Note H) | - | - | - | - | 3,000,249 | - | 3,000,249 |
| Stock-based compensation expense related to employee stock options (Note K) | - | - | - | - | 1,080,895 | - | 1,080,895 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Stock options and warrants granted to consultants in exchange for services rendered (Note K) | - | - | - | - | 277,344 | - | 277,344 |
| Net Loss | - | - | - | - | - | (27,437,116) | (27,437,116) |
| **Balance at December 31, 2006** | **-** | **-** | 56,992,301 | $ 56,992 | $ 78,502,900 | $ (70,424,669) | $ 8,135,223 |

See accompanying footnotes to consolidated financial statements

**TELKONET, INC.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004**

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| **Increase (Decrease) In Cash and Equivalents** | | | |
| **Cash Flows from Operating Activities:** | | | |
| Net loss from operating activities | $ (27,437,116) | $ (15,778,281) | $ (13,092,660) |
| Adjustments to reconcile net loss from operations to cash used in operating activities: | | | |
| Minority interest | (19,569) | - | - |
| Amortization and write-off of debt discount - beneficial conversion feature of convertible debentures (Note H) | 1,390,137 | 138,406 | 21,888 |
| Amortization and write-off of debt discount - value of warrants attached to convertible debentures (Note H) | 2,743,342 | 198,805 | 10,152 |
| Amortization and write-off of financing costs | 1,145,911 | 73,499 | - |
| Other income in connection with derivative warrant liabilities (Note H) | - | (8,600) | - |
| Warrants issued prepayment of debt | 3,000,249 | - | - |
| Common stock issued in exchange for and penalty in connection with early extinguishment of debt (Note H) | 2,006,029 | - | - |
| Stock options and warrants issued in exchange for services (Note K) | 1,358,239 | 1,354,219 | 1,180,875 |
| Common stock issued in exchange for services rendered (Note J) | 203,026 | 300,117 | 304,094 |
| Common stock issued in exchange for conversion of interest | - | 28,131 | 23,276 |
| Common stock issued in exchange for consulting fees (Note J) | - | - | 2,500,000 |
| Depreciation, including equipment under operating leases | 980,470 | 430,104 | 143,358 |
| Impairment write-down in investment in Amperion (Note G) | 92,000 | 400,000 | - |
| Increase / decrease in: | | | |
| Accounts receivable, trade and other | (143,013) | (56,044) | (4,950) |
| Inventory | 169,213 | 397,912 | (1,265,202) |
| Prepaid expenses and deposits | 405,952 | (313,956) | (23,150) |
| Deferred lease liability | 245 | 11,406 | 30,911 |
| Deferred revenue | 68,801 | 59,020 | - |
| Accounts payable, accrued expenses, net | 64,555 | 679,230 | 587,848 |
| **Net Cash Used In Operating Activities** | (13,971,529) | (12,086,032) | (9,583,560) |
| | | | |
| **Cash Flows From Investing Activities:** | | | |
| Costs of equipment under operating leases | (1,939,759) | (458,271) | (491,776) |
| Sale of equipment under operating lease, net | 350,571 | - | - |
| Purchase of property and equipment, net | (734,888) | (336,448) | (514,903) |
| Proceeds (Investment) in Restricted Certificate of Deposit (Note A) | 10,000,000 | (10,000,000) | - |
| Investment in MST (Note B) | (900,000) | | |

| | | | |
|---|---|---|---|
| Net cash acquired from MST (Note B) | 59,384 | | |
| Acquisition costs (Note B) | (117,822) | | |
| Investment in Amperion and BPL Global (Note G) | (44) | (131,000) | (500,000) |
| **Net Cash Used In Investing Activities** | 6,717,442 | (10,925,719) | (1,506,679) |
| | | | |
| **Cash Flows From Financing Activities:** | | | |
| Proceeds from sale of common stock, net of costs and fees (Note J) | 6,000,000 | - | 12,726,843 |
| Proceeds from issuance of convertible debentures, net of costs and fees (Note H) | - | 18,780,590 | - |
| Repayment of convertible debenture (Note H) | (7,750,000) | (10,000) | - |
| Repayment of senior notes (Note I) | (100,000) | (350,000) | - |
| Proceeds from exercise of warrants (Note K) | 55,138 | 321,900 | 4,127,950 |
| Proceeds from exercise of employee and non-employee stock options and warrants (Note K) | 2,684,663 | 852,638 | 911,230 |
| Repayments of loans | (413,756) | - | - |
| Repayments of capital leases | - | - | (15,000) |
| **Net Cash Provided By Financing Activities** | 476,045 | 19,595,128 | 17,751,023 |
| **Net Increase (Decrease) In Cash and Equivalents** | (6,778,042) | (3,416,623) | 6,660,784 |
| Cash and cash equivalents at the beginning of the year | 8,422,079 | 11,838,702 | 5,177,918 |
| Cash and cash equivalents at the end of the year | $ 1,644,037 | $ 8,422,079 | $ 11,838,702 |

See accompanying notes to consolidated financial statements

**TELKONET, INC.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**
**FOR THE YEARS ENDED DECEMBER 31, 2006, 2005 AND 2004**

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Supplemental Disclosures of Cash Flow Information: | | | |
| Cash transactions: | | | |
| Cash paid during the period for interest | $ 990,846 | $ 40,645 | $ 100,608 |
| Income taxes paid | - | - | - |
| Non-cash transactions: | | | |
| Issuance of stock options and warrants in exchange for services rendered (Note K) | 1,358,239 | 1,354,219 | 1,180,875 |
| Common stock issued for services rendered (Note J) | 203,026 | 300,117 | 304,094 |
| Common stock issued in exchange for interest (Note J) | - | 28,131 | 23,276 |
| Common stock issued in exchange for consulting services (Note J) | - | - | 2,500,000 |
| Note payable under subsidiary acquisition (Note B) | 900,000 | - | - |
| Common stock issued in exchange for interest expense and penalty in connection with early extinguishment of debt (Note H) | 2,006,030 | - | - |
| Issuance of shares for purchase of subsidiary | 2,700,000 | - | - |
| Common stock issued in exchange for Senior Note (Note I and K) | - | - | 2,539,000 |
| Common stock issued in exchange for conversion of convertible debenture (Note H and K) | 12,250,000 | 200,000 | 172,000 |
| Write-off of beneficial conversion feature for conversion of debenture | - | - | 134,135 |
| Write-off of value of warrants attached to debenture in connection with conversion | - | - | 531 |
| Impairment write-down in investment in affiliate (Note G) | 92,000 | 400,000 | - |
| Beneficial conversion feature on convertible debentures (Note H) | - | 1,479,300 | - |
| Value of warrants attached to convertible debentures (Note H) | - | 2,910,700 | - |
| Acquisition of MST (Note B): | | | |
| Assets acquired | 4,120,600 | - | - |
| Goodwill (including purchase price contingency) | 6,477,767 | - | - |
| Minority Interest | (19,569) | - | - |
| Liabilities assumed | (1,460,976) | - | - |
| Common stock issued | (2,700,000) | - | - |
| Notes payable issued | (900,000) | - | - |
| Purchase price contingency | (4,500,000) | - | - |
| Direct acquisition costs | (117,822) | - | - |
| Cash paid for acquisition | 900,000 | - | - |

See accompanying notes to consolidated financial statements

**TELKONET, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**DECEMBER 31, 2006, 2005 AND 2004**

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

In January 2006, following the acquisition of Microwave Satellite Technologies (MST) (Note B), the Company began offering complete sales, installation, and service of VSAT and business television networks, and became a full-service national Internet Service Provider (ISP). The MST solution offers a complete “Quad-play” solution to subscribers of HDTV, VoIP telephony, NuVision Broadband Internet access and wireless fidelity (“Wi-Fi”) access, to commercial multi-dwelling units and hotels.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Telkonet Communications, Inc. and 90% owned subsidiary Microwave Satellite Technologies (MST). Significant intercompany transactions have been eliminated in consolidation.

Investments in entities over which the Company has significant influence, typically those entities that are 20 to 50 percent owned by the Company, are accounted for using the equity method of accounting, whereby the investment is carried at cost of acquisition, plus the Company’s equity in undistributed earnings or losses since acquisition.

Concentrations of Credit Risk

Financial instruments and related items, which potentially subject the Company to concentrations of credit risk, consist primarily of cash and cash equivalents. The Company places its cash and temporary cash investments with credit quality institutions. At times, such investments may be in excess of the FDIC insurance limit. The allowance for doubtful accounts was $60,000 and $30,000 at December 31, 2006 and December 31, 2005, respectively.

Cash and Cash Equivalents

For purposes of the Statements of Cash Flows, the Company considers all highly liquid debt instruments purchased with a maturity date of three months or less to be cash equivalents.

Restricted Certificate of Deposit

In the year ended December 31, 2006, restricted cash was drawn down to zero upon in conjunction with the settlement agreements with the lenders of its Convertible Senior Notes (Note H ). The restricted cash at December 31, 2005 consisted of a $10,000,000 certificate of deposit pledged as collateral for an irrevocable letter of credit agreement. The letter of credit agreement automatically renewed annually as required in the Convertible Senior Notes loan covenant. The certificate of deposit provided for approximately 4% interest payable at maturity.

Liquidity

As shown in the accompanying consolidated financial statements, the Company incurred net loss of $27,437,116, $15,778,281 and $13,092,660 for the years ended December 31, 2006, 2005 and 2004, respectively. Net loss included $5,658,986, $338,620 and $0 of non-cash interest and financing expense in connection with the convertible debentures, $4,626,769, $0 and $0 of non-cash expense in connection with the early extinguishment of debt, and $1,358,239, $1,354,219 and $1,180,875 of non-cash compensation to employees and non-employees in connection with stock options granted and vested and $0, $0 and $2,500,000 of common stock issued in exchange for consulting services for the years ended December 31, 2006, 2005 and 2004, respectively. The Company's current liabilities, on a consolidated basis, exceeded its current assets by $530,634 as of December 31, 2006.

**TELKONET, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**DECEMBER 31, 2006, 2005 AND 2004**

**NOTE A-SUMMARY OF ACCOUNTING POLICIES (Continued)**

Property and Equipment

Property and equipment is stated at cost. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets. The estimated useful life ranges from 3 to 10 years.

Long-Lived Assets

The Company has adopted Statement of Financial Accounting Standards No. 144 (SFAS 144). The Statement requires that long-lived assets and certain identifiable intangibles held and used by the Company be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Events relating to recoverability may include significant unfavorable changes in business conditions, recurring losses, or a forecasted inability to achieve break-even operating results over an extended period. The Company evaluates the recoverability of long-lived assets based upon forecasted discounted cash flows. Should an impairment in value be indicated, the carrying value of intangible assets will be adjusted, based on estimates of future discounted cash flows resulting from the use and ultimate disposition of the asset. SFAS No. 144 also requires assets to be disposed of be reported at the lower of the carrying amount or the fair value less costs to sell. The company has determined that its investment in Amperion Inc. has been impaired based upon forecasted discounted cash flow and has written off $92,000 and $400,000, of its investment based on management assessment during the year ended December 31, 2006 and 2005, respectively. (Note G).

Inventories

Inventories consist primarily of Gateways, Extenders, iBridges and Couplers which are the significant components of the Telkonet solution. Cost is determined by the first-in, first-out method. (Note D).

Income Taxes

The Company has implemented the provisions on Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes" (SFAS 109). SFAS 109 requires that income tax accounts be computed using the liability method. Deferred taxes are determined based upon the estimated future tax effects of differences between the financial reporting and tax reporting bases of assets and liabilities given the provisions of currently enacted tax laws.

Net Loss Per Common Share

The Company computes earnings per share under Financial Accounting Standard No. 128, "Earnings Per Share" (SFAS 128). Net loss per common share is computed by dividing net loss by the weighted average number of shares of common stock and dilutive common stock equivalents outstanding during the year. Dilutive common stock equivalents consist of shares issuable upon conversion of convertible notes and the exercise of the Company's stock options and warrants (calculated using the treasury stock method). During 2006, 2005 and 2004, common stock equivalents are not considered in the calculation of the weighted average number of common shares outstanding because they would be anti-dilutive, thereby decreasing the net loss per common share.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

**TELKONET, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**DECEMBER 31, 2006, 2005 AND 2004**

**NOTE A-SUMMARY OF ACCOUNTING POLICIES (Continued)**

Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with Staff Accounting Bulletin No. 104, *Revenue Recognition* ("SAB104"), which superceded Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements* ("SAB101"). SAB 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the selling prices of the products delivered and the collectibility of those amounts. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. The Company defers any revenue for which the product has not been delivered or is subject to refund until such time that the Company and the customer jointly determine that the product has been delivered or no refund will be required. SAB 104 incorporates Emerging Issues Task Force 00-21 ("EITF 00-21"), *Multiple-Deliverable Revenue Arrangements.* EITF 00-21 addresses accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

For equipment under lease, revenue is recognized over the lease term for operating lease and rental contracts. All of the Company's leases are accounted for as operating leases. At the inception of the lease, no lease revenue is recognized and the leased equipment and installation costs are capitalized and appear on the balance sheet as "Equipment Under Operating Leases." The capitalized cost of this equipment is depreciated from two to three years, on a straight-line basis down to the Company's original estimate of the projected value of the equipment at the end of the scheduled lease term. Monthly lease payments are recognized as rental income. The Company has sold a portion of its lease portfolio in December 2005 and substantially all the remaining portfolio during 2006. The related equipment was charged to cost of sales commensurate with the associated revenue recognition (Note F).

MST accounts for the revenue, costs and expense related to residential cable services as the related services are performed in accordance with SFAS No. 51, *Financial Reporting by Cable Television Companies*. Installation revenue for residential cable services is recognized to the extent of direct selling costs incurred. Direct selling costs have exceeded installation revenue in all reported periods. Generally, credit risk is managed by disconnecting services to customers who are delinquent.

Guarantees and Product Warranties

FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"), requires that upon issuance of a guarantee, the guarantor must disclose and recognize a liability for the fair value of the obligation it assumes under that guarantee.

The Company's guarantees were issued subject to the recognition and disclosure requirements of FIN 45 as of December 31, 2006 and 2005. 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 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. During the year ended December 31, 2006 and 2005, the Company experienced

approximately three percent of units returned. As of December 31, 2006 and 2005, the Company recorded warranty liabilities in the amount of $47,300 and $24,000, respectively, using this experience factor. Prior to the fiscal year of 2005, the Company had not established historical ratio of claims, and the cost of replacing defective products and product returns were immaterial and within management's expectations, accordingly there were no warranties provided with the purchase of the Company's products during the year ended December 31, 2004.

Advertising

The Company follows the policy of charging the costs of advertising to expenses incurred. The Company incurred $663,323, $657,794, and $499,874 in advertising costs during the years ended December 31, 2006, 2005 and 2004, respectively.

Research and Development

The Company accounts for research and development costs in accordance with the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 2 ("SFAS 2"), "Accounting for Research and Development Costs." Under SFAS 2, 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 developments 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 2006, 2005 and 2004 were $1,925,746, $2,096,104, and $1,852,309, respectively.

**TELKONET, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
**DECEMBER 31, 2006, 2005 AND 2004**

**NOTE A-SUMMARY OF ACCOUNTING POLICIES (Continued)**

Comprehensive Income

Statement of Financial Accounting Standards No. 130 ("SFAS 130"), "Reporting Comprehensive Income," establishes standards for reporting and displaying of comprehensive income, its components and accumulated balances. Comprehensive income is defined to include all changes in equity except those resulting from investments by owners and distributions to owners. Among other disclosures, SFAS 130 requires that all items that are required to be recognized under current accounting standards as components of comprehensive income be reported in a financial statement that is displayed with the same prominence as other financial statements. The Company does not have any items of comprehensive income in any of the periods presented.

Reclassifications

Certain reclassifications have been made in prior year's financial statements to conform to classifications used in the current year.

Stock Based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), “Share-Based Payment,” (“SFAS 123(R)”) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options based on estimated fair values. SFAS 123(R) supersedes the Company’s previous accounting under Accounting Principles Board Opinion No. 25, “Accounting for Stock Issued to Employees” (“APB 25”) for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (“SAB 107”) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company’s fiscal year 2006. The Company’s Consolidated Financial Statements as of and for the year ended December 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company’s Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the year ended December 31, 2006 was $1,080,895, net of tax effect.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service periods in the Company’s Consolidated Statement of Operations. Prior to the adoption of SFAS 123(R), the Company accounted for stock-based awards to employees and directors using the intrinsic value method in accordance with APB 25 as allowed under Statement of Financial Accounting Standards No. 123, “Accounting for Stock-Based Compensation” (“SFAS 123”). Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company’s Consolidated Statement of Operations because the exercise price of the Company’s stock options granted to employees and directors approximated or exceeded the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company's Consolidated Statement of Operations for the year ended December 31, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company's pro forma information required under SFAS 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred.

Upon adoption of SFAS 123(R), the Company is using the Black-Scholes option-pricing model as its method of valuation for share-based awards granted beginning in fiscal 2006, which was also previously used for the Company's pro forma information required under SFAS 123. The Company's determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company's stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to the Company's expected stock price volatility over the term of the awards, and certain other market variables such as the risk free interest rate.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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**NOTE A-SUMMARY OF ACCOUNTING POLICIES (Continued)**

The following table shows the effect on net earnings and earnings per share had compensation cost been recognized based upon the estimated fair value on the grant date of stock options for the years ended December 31, 2005 and 2004, in accordance with SFAS 123, as amended by SFAS No. 148 “Accounting for Stock-Based Compensation - Transition and Disclosure."

| | 2005 | 2004 |
|---|---|---|
| Net loss - as reported | $ (15,778,281) | $ (13,092,660) |
| Deduct: stock-based compensation expense, net of tax | (2,440,097) | (7,830,385) |
| Net loss - pro forma | $ (18,218,378) | $ (20,923,045) |
| Net loss per common share — basic (and assuming dilution): | | |
| As reported | $ (0.35) | $ (0.32) |
| Deduct: stock-based compensation expense, net of tax | (0.06) | (0.19) |
| Pro forma | $ (0.41) | $ (0.51) |

Disclosure for the year ended December 31, 2006 is not presented because the amounts are recognized in the consolidated financial statements. The fair value for stock awards was estimated at the date of grant using the Black-Scholes option valuation model with the following weighted average assumptions for the year ended December 31, 2005 and 2004:

| | 2005 | 2004 |
|---|---|---|
| Significant assumptions (weighted-average): | | |
| Risk-free interest rate at grant date | 4.5% | 1.35% |
| Expected stock price volatility | 71% | 76% |
| Expected dividend payout | - | - |
| Expected option life (in years) | 5.0 | 5.0 |

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 2006 and prior years, expected stock price volatility is based on the historical volatility of the Company’s stock for the related vesting periods. Prior to the adoption of SFAS 123R, expected stock price volatility was estimated using only historical volatility. The risk-free interest rate is based on the implied yield available on U.S. Treasury constant maturity securities with an equivalent remaining term. The Company has not paid dividends in the past and does not plan to pay any dividends in the near future.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, particularly for the expected term and expected stock price volatility. The Company’s employee stock options have characteristics significantly different from those of traded options, and changes in the subjective input assumptions can materially affect the fair value estimate. Because Company stock options do not trade on a secondary exchange, employees do not derive a benefit from holding stock options unless there is an increase, above the grant price, in the market price of the Company’s stock. Such an increase in stock price would benefit all shareholders commensurately.

**TELKONET, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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**NOTE A-SUMMARY OF ACCOUNTING POLICIES (Continued)**

Segment Information

Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information" ("SFAS 131") establishes standards for reporting information regarding operating segments in annual financial statements and requires selected information for those segments to be presented in interim financial reports issued to stockholders. SFAS 131 also establishes standards for related disclosures about products and services and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision maker, or decision-making group, in making decisions how to allocate resources and assess performance. The information disclosed herein materially represents all of the financial information related to the Company's principal operating segment.

New Accounting Pronouncements

On February 16, 2006 the FASB issued SFAS 155, “Accounting for Certain Hybrid Instruments,” which amends SFAS 133, “Accounting for Derivative Instruments and Hedging Activities,” and SFAS 140, “Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities.” SFAS 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 also clarifies and amends certain other provisions of SFAS 133 and SFAS 140. This statement is effective for all financial instruments acquired or issued in fiscal years beginning after September 15, 2006. The Company does not expect its adoption of this new standard to have a material impact on its financial position, results of operations or cash flows.

The FASB issued SFAS No. 156, “Accounting for Servicing of Financial Assets an amendment of FASB Statement No. 140” (“SFAS No. 156”) in March 2006. SFAS No. 156 requires a company to recognize a servicing asset or servicing liability each time it undertakes an obligation to service a financial asset. A company would recognize a servicing asset or servicing liability initially at fair value. A company will then be permitted to choose to subsequently recognize servicing assets and liabilities using the amortization method or fair value measurement method. SFAS No. 156 is effective for fiscal years beginning after September 15, 2006. The Company does not expect its adoption of this new standard to have a material impact on its financial position, results of operations or cash flows.

On July 13, 2006, the FASB issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes-an Interpretation of FASB Statement No. 109” (“FIN No. 48”). FIN No. 48 clarifies what criteria must be met prior to recognition of the financial statement benefit of a position taken in a tax return. FIN No. 48 will require companies to include additional qualitative and quantitative disclosures within their financial statements. The disclosures will include potential tax benefits from positions taken for tax return purposes that have not been recognized for financial reporting purposes and a tabular presentation of significant changes during each period. The disclosures will also include a discussion of the nature of uncertainties, factors which could cause a change, and an estimated range of reasonably possible changes in tax uncertainties. FIN No. 48 will also require a company to recognize a financial statement benefit for a position taken for tax return purposes when it will be more-likely-than-not that the position will be sustained. FIN No. 48 will be effective for fiscal years beginning after December 15, 2006**.**

On September 15, 2006, the FASB issued SFAS No. 157, “Fair Value Measurements” (“SFAS No. 157”). SFAS No. 157 addresses how companies should measure fair value when they are required to use a fair value measure for recognition and disclosure purposes under generally accepted accounting principles. SFAS No. 157 will require the fair value of

an asset or liability to be based on a market based measure which will reflect the credit risk of the company. SFAS No. 157 will also require expanded disclosure requirements which will include the methods and assumptions used to measure fair value and the effect of fair value measures on earnings. SFAS No. 157 will be applied prospectively and will be effective for fiscal years beginning after November 15, 2007 and to interim periods within those fiscal years.

In September 2006, the Financial Accounting Standards Board issued FASB Statement No. 158, “Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans” (“SFAS 158”). SFAS 158 requires the Company to record the funded status of its defined benefit pension and other postretirement plans in its financial statements. The Company is required to record an asset in its financial statements if a plan is overfunded or record a liability in its financial statements if a plan is underfunded with a corresponding offset to shareholders’ equity. Previously unrecognized assets and liabilities are recorded as a component of shareholders’ equity in accumulated other comprehensive income, net of applicable income taxes. SFAS 158 also requires the Company to measure the value of its assets and liabilities as of the end of its fiscal year ending after December 15, 2008. The Company has implemented SFAS 158 using the required prospective method. The recognition provisions of SFAS 158 are effective for the fiscal year ending after December 15, 2006. The Company does not expect its adoption of this new standard to have a material impact on its financial position, results of operations or cash flows.

In December 2006, the FASB issued FSP EITF 00-19-2, Accounting for Registration Payment Arrangements ("FSP 00-19-2") which addresses accounting for registration payment arrangements. FSP 00-19-2 specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, Accounting for Contingencies. FSP 00-19-2 further clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other applicable generally accepted accounting principles without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. For registration payment arrangements and financial instruments subject to those arrangements that were entered into prior to the issuance of EITF 00-19-2, this guidance is effective for financial statements issued for fiscal years beginning after December 15, 2006 and interim periods within those fiscal years. The Company has not yet determined the impact that the adoption of FSP 00-19-2 will have on its financial statements.

In February 2007, the FASB issued SFAS No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities.” SFAS 159 permits entities to choose to measure many financial instruments, and certain other items, at fair value. SFAS 159 applies to reporting periods beginning after November 15, 2007. The adoption of SFAS 159 is not expected to have a material impact on the Company’s financial condition or results of operations.

**TELKONET, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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**NOTE B - ACQUISITION OF SUBSIDIARY**

Acquisition of Microwave Satellite Technologies, Inc.

On January 31, 2006, the Company acquired a 90% interest in Microwave Satellite Technologies, Inc. ("MST") from Frank Matarazzo, the sole stockholder of MST, in exchange for $1.8 million in cash and 1.6 million unregistered shares of the Company's common stock for an aggregate purchase price of $9,000,000. The purchase price of $9,000,000 was increased by $117,822 for direct costs related to the acquisition. These direct costs included legal, accounting and other professional fees. The cash portion of the purchase price was paid in two installments, $900,000 at closing and $900,000 in February 2007. The stock portion is payable from shares held in escrow, 400,000 shares at closing and the remaining 1,200,000 "purchase price contingency" shares issued based on the achievement of 3,300 "Triple Play" subscribers over a three year period. In the year ended December 31, 2006, the Company issued 200,000 shares of the purchase price contingency valued at $900,000 as an adjustment to Goodwill.

The purchase price contingency shares are price protected for the benefit of the former owner of MST. In the event the Company's common stock price is below $4.50 per share upon issuance of the shares from escrow, a pro rata adjustment in the number of shares will be required to support the aggregate consideration of $5.4 million. The price protection provision provides a cash benefit to the former owner of MST if the as-defined market price of the Company's common stock is less than $4.50 per share at the time of issuance from the escrow. The issuance of additional shares or distribution of other consideration upon resolution of the contingency based on the Company's common stock prices will not affect the cost of the acquisition. When the contingency is resolved or settled, and additional consideration is distributable, the Company will record the current fair value of the additional consideration and the amount previously recorded for the common stock issued will be simultaneously reduced to the lower current value of the Company's common stock.

MST is a communications technology company that offers complete sales, installation, and service of Very Small Aperture Terminal (VSAT) and business television networks, and is a full-service national Internet Service Provider (ISP). Management believes that the MST acquisition will enable Telkonet to provide a complete "Quad-play" solution to subscribers of HDTV, VoIP telephony, NuVision Broadband Internet access and wireless fidelity ("Wi-Fi") access, to commercial multi-dwelling units and hotels.

The acquisition of MST was accounted for using the purchase method in accordance with SFAS 141, "Business Combinations." The value of the Company's common stock issued as a part of the acquisition was determined based on the average price of the Company's common stock for several days before and after the acquisition of MST. The results of operations for MST have been included in the Consolidated Statements of Operations since the date of acquisition. The components of the purchase price were as follows:

| | As Reported | Including Purchase Price Contingency (*) |
|---|---|---|
| Common stock | $ 2,700,000 | $ 7,200,000 |
| Cash (including note payable) | 1,800,000 | 1,800,000 |
| Direct acquisition costs | 117,822 | 117,822 |
| Purchase price | 4,617,822 | 9,117,822 |
| Minority interest | 19,569 | 19,569 |

| | | |
|---|---|---|
| Total | $ 4,637,391 | $ 9,137,391 |

In accordance with Financial Accounting Standard (SFAS) No. 141, Business Combinations, the total purchase price was allocated to the estimated fair value of assets acquired and liabilities assumed. The fair value of the assets acquired was based on management's best estimates. The purchase price was allocated to the fair value of assets acquired and liabilities assumed as follows:

**TELKONET, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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**NOTE B - ACQUISITION OF SUBSIDIARY (continued)**

| | As Reported | Including Purchase Price Contingency (*) |
|---|---|---|
| Cash and other current assets | $ 346,548 | $ 346,548 |
| Equipment and other assets | 1,310,125 | 1,310,125 |
| Subscriber lists | 2,463,927 | 2,463,927 |
| Goodwill and other intangible assets | 1,977,767 | 6,477,767 |
| Subtotal | 6,098,367 | 10,598,367 |
| Current liabilities | 1,460,976 | 1,460,976 |
| Total | $ 4,637,391 | $ 9,137,391 |

(*) At the date of the acquisition, the effect of the “purchase price contingency” shares valued at approximately $5.4 million had not been recorded in accordance with FAS 141. In the second quarter of 2006, the Company issued 200,000 shares of the purchase price contingency valued at $900,000 as an adjustment to Goodwill. The remaining shares, when issued, will reflect an adjustment to Goodwill and Other Intangibles.

Goodwill and other intangible assets represent the excess of the purchase price over the fair value of the net tangible assets acquired. The Company engaged an independent firm to assist in allocating the excess purchase price to the intangible assets and goodwill as appropriate. In accordance with SFAS 142, goodwill is not amortized and will be tested for impairment at least annually. The subscriber list was independently valued at $2,463,927 with an estimated useful life of eight years.

The following unaudited condensed combined pro forma results of operations reflect the pro forma combination of the Telkonet and MST businesses as if the combination had occurred at the beginning of the periods presented compared with the actual results of operations of Telkonet for the same period. The unaudited pro forma condensed combined results of operations do not purport to represent what the companies’ combined results of operations would have been if such transaction had occurred at the beginning of the periods presented, and are not necessarily indicative of Telkonet’s future results.

| | Year Ended December 31, | |
|---|---|---|
| | **Proforma 2006** | **Proforma 2005** |
| Product revenue | $ 3,128,120 | $ 2,393,010 |
| Recurring revenue | 2,188,329 | 1,918,200 |
| | 5,316,449 | 4,311,210 |
| Net (loss) | $ (27,578,779) | $ (11,685,089) |
| Basic (loss) per share | $ (0.54) | $ (0.26) |
| Diluted (loss) per share | $ (0.54) | $ (0.26) |

The acquisition of MST resulted in the valuation by an independent appraiser of MST’s subscriber lists as intangible assets. The MST subscriber list was determined to have an eight-year life. This intangible was amortized using that

life, and amortization from the date of the acquisition through December 31, 2006, was taken as a charge against income in the consolidated statement of operations. In accordance with SFAS 144, Accounting for the Impairment or Disposal of Long-Lived Assets, the intangible asset subject to amortization was reviewed for impairment at December 31, 2006. Goodwill of $1,977,768, excluding the remaining purchase price contingency, represented the excess of the purchase price over the fair value of the net tangible and intangible assets acquired.

At December 31, 2006, the Company performed an impairment test on the goodwill and intangibles acquired, it was determined that there were no changes in the carrying value of goodwill and intangibles acquired.

**TELKONET, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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**NOTE C - INTANGIBLE ASSETS ACQUIRED**

Total identifiable intangible assets acquired and their carrying value at December 31, 2006 are:

| | Gross Carrying Amount | Accumulated Amortization | Net | Residual Value | Weighted Average Amortization Period (Years) |
|---|---|---|---|---|---|
| Amortized Identifiable tangible Assets: | | | | | |
| Subscriber lists | $ 2,463,927 | (282,325) | 2,181,602 | $ - | 8.0 |
| Total Amortized Identifiable Intangible Assets | $ 2,463,927 | (282,325) | 2,181,602 | $ - | |
| Unamortized Identifiable Intangible Assets: | None | | | | |
| Total | $ 2,463,927 | (282,325) | 2,181,602 | $ - | |

Total amortization expense charged to operations for the year ended December 31, 2006 was $282,325. Estimated amortization expense as of December 31, 2006 is as follows:

| Fiscal | |
|---|---|
| 2007 | 307,991 |
| 2008 | 307,991 |
| 2009 | 307,991 |
| 2010 | 307,991 |
| 2011 | 307,991 |
| 2012 and after | 641,647 |
| Total | 2,181,602 |

**NOTE D - INVENTORIES**

Inventories are stated at the lower of cost or market determined by the first-in, first-out (FIFO) method. Inventories primarily consist of Gateways, Extenders, iBridges and Couplers which are the significant components of the Telkonet solution. Components of inventories as of December 31, 2006 and 2005 are as follows:

| | 2006 | 2005 |
|---|---|---|
| Raw Materials | $ 516,604 | $ 598,335 |
| Finished Goods | 789,989 | 877,471 |
| | $ 1,306,593 | $ 1,475,806 |

**TELKONET, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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**NOTE E - PROPERTY, PLANT AND EQUIPMENT**

The Company's property and equipment at December 31, 2006 and 2005 consists of the following:

| | 2006 | 2005 |
|---|---|---|
| Development Test Equipment | $ 184,575 | $ 96,967 |
| Computer Software | 151,986 | 142,894 |
| Leasehold Improvements | 394,871 | 209,911 |
| Office Equipment | 1,137,942 | 360,527 |
| Office Fixtures and Furniture | 341,662 | 230,838 |
| Total | 2,211,036 | 1,041,137 |
| Accumulated Depreciation | (582,248) | (323,667) |
| | $ 1,628,788 | $ 717,470 |

Depreciation expense included as a charge to income was $258,581, $185,928, and $71,514 for the years ended December 31, 2006, 2005 and 2004, respectively.

**NOTE F - EQUIPMENT UNDER OPERATING LEASES**

Equipment leased to customers under operating leases is recorded at cost and is depreciated on the straight line basis to its estimated residual value. Estimated useful lives are two to ten years. Equipment under operating leases at December 31, 2006 and 2005 consist of the following:

| | 2006 | 2005 |
|---|---|---|
| Telecommunications and related equipment | $ 3,186,000 | $ 789,099 |
| Less: accumulated depreciation | (564,233) | (124,669) |
| Capitalized equipment, net of accumulated depreciation | 2,697,517 | 664,430 |
| Less: estimated reserve for residual values | - | -- |
| Capitalized equipment under operating leases, net | 2,621,767 | 664,430 |

In the year end December 31, 2006 and 2005, the Company consummated a non-recourse sale of certain rental contract agreements and the related capitalized equipment which were accounted for as operating leases with Hospitality Leasing Corporation. The remaining rental income payments of the contracts were valued at approximately $1,209,000 and $732,000 including the customer support component of approximately $370,000 and $205,000 which the Company will retain and continue to receive monthly customer support payments over the remaining average unexpired lease term of 36 and 26 months, respectively. In the year ending December 31, 2006 and 2005, the Company recognized revenue of approximately $683,000 and $439,000 for the sale, calculated based on the present value of total unpaid rental payments, and expensed the associated capitalized equipment cost, net of depreciation, of approximately $340,000 and $267,000, and expensed associated taxes of approximately $64,000 and $40,000, respectively.

The following is a schedule by years of minimum future rentals on non-cancellable operating leases as of December 31, 2006:

| | |
|---|---|
| 2007 | 615,395 |
| 2008 | 488,400 |
| 2009 | 402,291 |
| 2010 | 328,975 |
| 2011 | 289,224 |
| | $ 2,124,285 |

**TELKONET, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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**NOTE G - LONG-TERM INVESTMENTS**

Amperion, Inc.

On November 30, 2004, the Company entered into a Stock Purchase Agreement (“Agreement”) with Amperion, Inc. ("Amperion"), a privately held company. Amperion is engaged in the business of developing networking hardware and software that enables the delivery of high-speed broadband data over medium-voltage power lines. Pursuant to the Agreement, the Company invested $500,000 in Amperion in exchange for 11,013,215 shares of Series A Preferred Stock for an equity interest of approximately 0.8%. The Company has the right to appoint one person to Amperion’s seven-person board of directors. The Company accounted for this investment under the cost method, as the Company does not have the ability to exercise significant influence over operating and financial policies of the investee.

It is the policy of the Company to regularly review the assumptions underlying the operating performance and cash flow forecasts in assessing the carrying values of the investment. The Company identifies and records impairment losses on investments when events and circumstances indicate that such decline in fair value is other than temporary. Such indicators include, but are not limited to, limited capital resources, limited prospects of receiving additional financing, and limited prospects for liquidity of the related securities. The Company determined that its investment in Amperion was impaired based upon forecasted discounted cash flow. Accordingly, the Company wrote-off $92,000 and $400,000 of the carrying value of its investment through a charge to operations during the year ended December 31, 2006 and 2005, respectively. The remaining value of the Company’s investment in Amperion is $8,000 and $100,000 at December 31, 2006 and 2005, respectively, and this amount represents the current fair value.

BPL Global, Ltd.

On February 4, 2005, the Company’s Board of Directors approved an investment in BPL Global, Ltd. (“BPL Global”), a privately held company. The Company funded an aggregate of $131,000 as of December 31, 2005 and additional $44 during the year of 2006. This investment represents an equity interest of approximately 4.67% at December 31, 2006. BPL Global is engaged in the business of developing broadband services via power lines through joint ventures in the United States, Asia, Eastern Europe and the Middle East. The Company accounted for this investment under the cost method, as the Company does not have the ability to exercise significant influence over operating and financial policies of the investee. The Company reviewed the assumptions underlying the operating performance and cash flow forecasts in assessing the carrying values of the investment. The fair value of the Company's investment in BPL Global, Ltd. amounted $131,044 and $131,000 as of December 31, 2006 and 2005, respectively.

Interactivewifi.com, LLC

MST maintains an investment in Interactivewifi.com, LLC a privately held company. This investment represents an equity interest of approximately 50% at December 31, 2006. Interactivewifi.com is engaged in providing internet and related services to customers throughout metropolitan New York, including the Nuvisions internet services. MST accounted for this investment under the cost method, as MST does not have the ability to exercise significant influence over operating and financial policies of the investee. Telkonet reviewed the assumptions underlying the operating performance and cash flow forecasts in assessing the carrying values of the investment. The fair value of MST’s investment in Interactivewifi.com amounted to approximately $53,000 as of December 31, 2006.

**NOTE H - CONVERTIBLE PROMISSORY NOTES PAYABLE**

A summary of convertible promissory notes payable at December 31, 2006 and 2005 is as follows:

| | 2006 | 2005 |
|---|---|---|
| Convertible Senior Notes payable ("Convertible Senior Notes"), accrue interest at 7.25% per annum and provide for equal monthly principal installments beginning March 1, 2006. Maturity date is in October 2008. Noteholder has the option to convert unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of $5.00 per share at any time. During the year ended December 31, 2006, the Company paid down $7,750,000 of principal in cash and a total of $12,250,000 of principal was converted to common stock of the Company. | - | $ 20,000,000 |
| Debt Discount - beneficial conversion feature, net of accumulated amortization and write-off of $1,479,300 and $89,163 at December 31, 2006 and 2005, respectively. | - | (1,390,137) |
| Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization and write-off of $ 2,919,300 and $175,958 at December 31, 2006 and 2005, respectively. | - | (2,743,342) |
| Total | - | $ 15,866,521 |
| Less: current portion | - | (6,250,000) |
| | - | $ 9,616,521 |

**TELKONET, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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**NOTE H - CONVERTIBLE PROMISSORY NOTES PAYABLE (Continued)**

During the year ended December 31, 2005, the Company issued convertible senior notes (the "Convertible Senior Notes") having an aggregate principal value of $20 million to sophisticated investors in exchange for $20,000,000, exclusive of $1,219,410 in placement costs and fees. The Convertible Senior Notes accrue interest at 7.25% per annum and call for monthly principal installments beginning March 1, 2006. The maturity date is 3 years from the date of issuance of the notes. At any time or times, the Noteholders shall be entitled to convert any portion of the outstanding and unpaid note amount into fully paid and nonassessable shares of the Company’s common Shares at $5 per share. At any time at the option of the Company, the principal payments may be paid either in cash or in common stock at the lower of $5 or 92.5% of the average recent market price. At any time after six months should the stock trade at or above $8.75 for 20 of 30 consecutive trading days, the Company can cause a mandatory redemption and conversion to shares at $5 per share. At any time, the Company can pre-pay the notes with cash or common stock. Should the Company pre-pay the Notes other than by mandatory conversion, the Company must issue additional warrants to the Noteholders covering 65% of the amount pre-paid at a strike price of $5 per share. In addition to standard financial covenants, the Company has agreed to maintain a letter of credit in favor of the Noteholders equal to $10 million (Note A). Once the principal amount of the note declines below $15 million, the balance is reduced by $.50 for every $1 amortized. In accordance with Emerging Issues Task Force Issue 98-5, Accounting for Convertible Securities with a Beneficial Conversion Features or Contingently Adjustable Conversion Ratios ("EITF 98-5"), the Company recognized an imbedded beneficial conversion feature present in the notes. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid in capital. The Company recognized and measured an aggregate of $1,479,300 of the proceeds, which is equal to the intrinsic value of the imbedded beneficial conversion feature, to additional paid in capital and a discount against the Notes issued during the year ended December 31, 2005. The debt discount attributed to the beneficial conversion feature is amortized over the Notes maturity period (three years) as interest expense.

In connection with the placement of the Notes in October 2005, the Company has also agreed to issue to the Noteholders one million warrants to purchase company common stock exercisable for five years at $5 per share. The Company recognized the value attributable to the warrants in the amount of $2,919,300 to a derivative liability due to the possibility of the Company having to make a cash settlement, including penalties, in the event the Company failed to register the shares underlying the warrants under the Securities Act of 1933, as amended, within 90 days after the closing of the transaction. The Company accounted for this warrant derivative in accordance with EITF 00-19 Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock. The warrants were included as a liability and valued at fair market value until the Company met the criteria under EITF 00-19 for permanent equity. A registration statement covering shares issuable to the Noteholders upon conversion, amortization and/or redemption of the Convertible Senior Notes and upon exercise of the warrants was filed with the Securities and Exchange Commission on Form S-3 on November 23, 2005 and was declared effective on December 13, 2005. The warrant derivative liability was valued at the issuance date of the Notes in the amount of $2,919,300 and then revalued at $2,910,700 on December 13, 2005 upon effectiveness of the Form S-3. The Company charged $8,600 to Other Income and the derivative warrant liability was reclassified to additional paid in capital at December 13, 2005. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 4.00%, a dividend yield of 0%, and volatility of 76%. The $2,919,300 of debt discount attributed to the value of the warrants issued is amortized over the Notes maturity period (three years) as interest expense.

***Principal Payments of Debt***

For the period of January 1, 2006 through August 14, 2006, the Company paid down principal of $1,250,000 in cash and issued an aggregate of 4,226,246 shares of common stock in connection with the conversion of $10,821,686 aggregate principal amount of the Senior Convertible Notes. Pursuant to the note agreement, the Company issued warrants to purchase 1,081,820 shares of common stock to the Noteholders, at a strike price of $5.00 per share, which represented 65% of the $8,321,686 accelerated principal at a strike price of $5 per share. The Company valued the warrants at $1,906,089 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 5.00%, a dividend yield of 0%, and volatility of 65%. The warrants issues are subject to an anti-dilution protection in conjunction with the issuance of certain equity securities. The Company has warrants due the Noteholders as a result of the anti-dilution impact from a $6,000,000 private placement in September 2006 (Note J). The Company has accounted for the additional 53,578 warrants issued, valued at $79,226, as interest expense during the year ended December 31, 2006.

For the period of January 1, 2006 through August 14, 2006, the Company amortized the debt discount to the beneficial conversion feature and value of the attached warrants, and recorded non-cash interest expense in the amount of $251,759 and $500,353, respectively. The Company also wrote-off the unamortized debt discount attributed to the beneficial conversion feature and the value of the attached warrants in the amount of $708,338 and $1,397,857, respectively, in connection with paydown and conversion of the note.

**TELKONET, INC.**
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**NOTE H - CONVERTIBLE PROMISSORY NOTES PAYABLE (Comtinued)**

***Early Extinguishment of Debt***

On August 14, 2006, the Company executed separate settlement agreements with the lenders of its Convertible Senior Notes. Pursuant to the settlement agreements the Company paid to the lenders on August 15, 2006 in the aggregate $9,910,392 plus accrued but unpaid interest of $23,951 and certain premiums specified in the Notes in satisfaction of the amounts then outstanding under the Notes. Of the amount to be paid to the lenders under the Notes, $6,500,000 was paid in cash through a drawdown on a letter of credit previously pledged as collateral for the Company's obligations under the Notes. The remaining note balance of $1,428,314 and a Redemption Premium of $1,982,078, calculated as 25% of remaining principal, was paid to the lenders in shares of Company's common stock valued at the lower of $5.00 per share and 92.5% of the arithmetic average of the weighted average price of the Company's common stock on the American stock exchange for the twenty trading days beginning on August 16, 2006. The Company also issued 862,452 warrants to purchase shares of the Company's common stock at the exercise price of $2.58 per share (92.5% of the average trading price as described above). The Company valued the warrants at $1,014,934 using the Black-Scholes pricing model and the following assumptions: contractual terms of 5 years, an average risk free interest rate of 5.00%, a dividend yield of 0%, and volatility of 65%. The Company has accounted for the Redemption Premium and the additional warrants issued as non-cash early extinguishment of debt expense during the year ended December 31, 2006. Registration statements covering the shares underlying the warrants, were filed with the Securities and Exchange Commission on Form S-3 on September 29, 2006 and October 13, 2006 and were declared effective on October 16, 2006 and October 24, 2006, respectively. As of December 31, 2006, the Company included the warrant derivatives as equity since the criteria under EITF 00-19 for permanent equity was achieved in a nominal period of time subsequent to year end.

As a result of the execution of the settlement agreements and the payments required thereby, the Company fully believes it repaid and satisfied all of its obligations under the Notes. The Company also agreed to pay the expenses of the lenders incurred in connection with the negotiation and execution of the settlement agreements. The settlement agreements were negotiated following the allegation by one of the lenders that the Company's failure to meet the minimum revenue test for the period ending June 30, 2006 as specified on the Notes constituted an event of default under the Notes, which allegation the Company disputed.

The Settlement Agreement provides that the number of shares issued to the Noteholders shall be adjusted based upon the arithmetic average of the weighted average price of the Company's common stock on the American Stock Exchange for the twenty trading days immediately following the settlement date. The Company has concluded that, based upon the weighted average of the Company's common stock between August 16, 2006 and September 13, 2006, the Company is entitled to a refund from the two Noteholders. One of the Noteholders has informed the Company that it does not believe such a refund is required. As a result, the Company has declined to deliver to the Noteholders certain stock purchase warrants issued to them pursuant to the Settlement Agreement pending resolution of this disagreement. The Noteholder has alleged that the Company has failed to satisfy its obligations under the Settlement Agreement by failing to deliver the warrants. In addition, the Noteholder maintains that the Company has breached certain provisions of the Registration Rights Agreement and, as a result of such breach, such Noteholder claims that it is entitled to receive liquidated damages from the Company.

In conjunction with the settlement agreement, the Company recorded $4,626,679 of loss from early extinguishment of debt, which consists of $1,982,078 redemption premium paid with the Company's common stock, $1,014,934 of additional warrants issued to the lenders, write-off of the remaining unamortized debt discount attributed to the

beneficial conversion feature and the value of the attached warrants in the amount of $430,040 and $845,143, respectively, and write-off the remaining unamortized financing costs of $354,484.

**TELKONET, INC.**
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**NOTE I - SENIOR NOTES PAYABLE**

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

In September 2003, certain Senior noteholders elected to surrender their Senior Notes as consideration for the exercise of warrants to purchase shares of common stock of the Company. The Company issued an aggregate of 2,011,000 restricted shares of common stock for warrants exercised at $1.00 per share, in exchange for $2,011,000 of Senior Notes.

In January 2004, certain noteholders requested conversion of their senior notes into Company restricted shares of common stock. The Company's Board of Directors approved this request by amending the terms of the Senior Note for a limited time. The Company immediately notified all of the outstanding Senior Noteholders of this temporary conversion option, and indicated that it would accept the surrender of the Senior Notes as consideration for the purchase of the Company's common shares at a price of $2.10 per share. The conversion price represented the current market price of the Company's common stock. An aggregate of $2,539,000 of senior notes were converted into 1,209,038 shares of common stock of the Company in January 2004. On November 3, 2005, the Company paid $350,000 of these senior notes and obtained a subordination agreement from the remaining $100,000 noteholder. The remaining outstanding senior note matured and was repaid in June 2006. The Company issued 20,000 warrants to purchase common stock of the Company at $5.00 in consideration for the subordination agreement. These warrants expired on June 15, 2006.

**NOTE J - CAPITAL STOCK**

The Company has authorized 15,000,000 shares of preferred stock, with a par value of $.001 per share. As of December 31, 2006, 2005 and 2004, the Company has no preferred stock issued and outstanding. The company has authorized 100,000,000 shares of common stock, with a par value of $.001 per share. As of December 31, 2006, 2005 and 2004, the Company has 56,992,301, 45,765,171 and 44,335,989 shares, respectively, of common stock issued and outstanding.

During the year ended December 31, 2004, the Company issued 540,399 shares of common stock for an aggregate purchase price of $582,898 to certain employees upon exercise of employee stock options at approximately $1.08 per share. Additionally, the Company issued 328,333 shares of common stock for an aggregate purchase price of $328,333 to consultants upon exercise of non-employee stock options at approximately $1.00 per share.

During the year ended December 31, 2004, the Company issued an aggregate of 63,566 shares of common stock, having an aggregate fair market value of $196,315, to consultants in exchange for services rendered, which approximated the fair value of the shares issued during the period services were completed and rendered.

During the year ended December 31, 2004, the Company issued an aggregate of 1,209,038 of restricted shares of common stock upon the election of certain senior note holders to convert their senior notes into equity at a conversion price of $2.10 per share.

During the year ended December 31, 2004, the Company issued 6,387,600 shares of its common stock for an aggregate purchase price of $12,726,843, net of costs and fees.

During the year ended December 31, 2004, the Company issued an aggregate of 4,000,950 shares of common stock upon the exercise of warrants at approximately $1.00 per share and an aggregate of 368,867 shares of common stock in exchange for 448,407 outstanding warrants.

During the year ended December 31, 2004, the Company issued an aggregate of 50,000 shares of common stock to consultants pursuant to warrants exercised at $2.54 per share.

During the year ended December 31, 2004, the Company issued an aggregate of 324,000 shares of common stock in connection with the conversion of $62,000 aggregate principal amount of the Debenture-1 and $110,000 aggregate principal amount of the Series B Debentures. The Company also issued an aggregate of 42,999 shares of common stock in exchange for accrued interest of $23,276 for Debenture 1 and Series B Debentures.

During the year ended December 31, 2004, the Company issued an aggregate of 36,000 shares of common stock to an employee in exchange for $107,779 of services rendered, which approximated the fair value of the shares issued during the period services were completed and rendered. Compensation costs of $107,779 were charged to operations.

**TELKONET, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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**NOTE J - CAPITAL STOCK (Continued)**

In March 2004, the Company entered into consulting agreements (the "Agreements") with Aware Capital Consultants, Inc. and Scarborough, Ltd. ("Consultants"). Pursuant to the Agreements, the Company issued an aggregate of 1,000,000 shares of its restricted common stock to Consultants in exchange for professional services rendered and to be rendered. In accordance with Emerging Issues Task Force Issue 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services ("EITF 96-18"), the measurement date to determine fair value was the date at which a commitment for performance by the counter party to earn the equity instrument was reached. The Company valued the shares issued for consulting services at the rate which represents the fair value of the services received which did not differ materially from the value of the stock issued. Compensation cost of $2,500,000 was charged to operations during the year ended December 31, 2004.

The Company reorganized its capital structure in January 2002 whereby the Company agreed to repurchase common stock held by the founders of the Company. All founders shares were returned and canceled in March 2002, except for 705,285 shares which remained outstanding, but were subject to repurchase by the Company pending receipt of the share certificate evidencing those shares. During the year ended December 31, 2004, the remaining 705,285 shares of founder's stock were returned to and canceled by the Company.

During the year ended December 31, 2005, the Company issued an aggregate of 415,989 shares of common stock for an aggregate purchase price of $496,493 to certain employees upon exercise of employee stock options at approximately $1.19 per share. Additionally, the Company issued an aggregate of 172,395 shares of common stock for an aggregate purchase price of $356,145 to consultants upon exercise of non-employee stock options at $2.07 per share (Note I).

During the year ended December 31, 2005, the Company issued an aggregate of 1,968 shares of common stock, having an aggregate fair market value of $9,002, to consultants in exchange for services rendered, which approximated the fair value of the shares issued during the period services were completed and rendered. Compensation costs of $9,002 were charged to operations during the year ended December 31, 2005.

The Company issued an aggregate of 321,900 shares of common stock to its convertible noteholders upon the exercise of warrants at $1.00 per share. The Company also issued 36,150 shares of common stock in exchange for 50,000 cashless warrants exercised .

The Company issued an aggregate of 36,000 shares of common stock to an employee in exchange for $163,319 of services rendered, which approximated the fair value of the shares issued during the period services were completed and rendered. Compensation costs of $163,319 were charged to operations during the year ended December 31, 2005.

The Company issued an aggregate of 30,000 shares of common stock to a member of the board of directors in exchange for $127,796 of consulting services rendered, which approximated the fair value of shares issued during the period services were completed and rendered. Compensation costs of $127,796 were charged to operations during the year ended December 31, 2005.

During the year ended December 31, 2005, the Company issued an aggregate of 363,636 shares of common stock to its convertible debenture holders in exchange for $200,000 of Series B Debentures. The Company also issued an aggregate of 51,114 shares of common stock in exchange for accrued interest of $28,131 for Series B Debentures.

During the year ended December 31, 2006, the Company issued an aggregate of 2,051,399 shares of common stock for an aggregate purchase price of $2,658,826 to certain employees upon exercise of employee stock options at approximately $1.36 per share. Additionally, the Company issued an aggregate of 25,837 shares of common stock for an aggregate purchase price of $25,837 to consultants upon exercise of non-employee stock options at $1.00 per share (Note K).

During the year ended December 31, 2006, the Company issued an aggregate of 52,420 shares of common stock, valued at $203,026, to consultants in exchange for services rendered, which approximated the fair value of the shares issued during the year services were completed and rendered (Note K).

During the year ended December 31, 2006, the Company issued an aggregate of 6,049,724 shares of common stock at approximately $2.36 per share to its senior convertible debenture holders in exchange for $12,250,000 of debt, $23,951 of interest expenses, and $1,982,078 of redemption premium (Note H).

**TELKONET, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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**NOTE J - CAPITAL STOCK (Continued)**

The Company issued an aggregate of 47,750 shares of common stock to debenture holders upon the exercise of warrants at approximately $55,138 per share (Note K).

On January 31, 2006, the Company entered into a Stock Purchase Agreement ("Agreement") with MST, a privately held company. Pursuant to the Agreement, the Company issued 600,000 shares of Common Stock valued at $4.50 per share (Note B).

During the year ended December 31, 2006, the Company issued 2,400,000 shares of Common Stock valued at $2.50 per share for an aggregate purchase price of $6,000,000. The Company also has issued to this investor warrants to purchase 1.56 million shares of its common stock at an exercise price of $4.17 per share. A registration statement covering the shares underlying the warrants was filed with the Securities and Exchange Commission on Form S-3 on September 29, 2006 and was declared effective on October 16, 2006. As of December 31, 2006, the Company included the warrant derivatives as equity since the criteria under EITF 00-19 for permanent equity was achieved (Note K).

**NOTE K - STOCK OPTIONS AND WARRANTS**

Employee Stock Options

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

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Exercise Prices | Number Outstanding | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| $1.00 - $1.99 | 4,197,929 | 5.87 | $1.00 | 4,196,262 | $1.00 |
| $2.00 - $2.99 | 1,446,000 | 7.18 | $2.49 | 905,800 | $2.43 |
| $3.00 - $3.99 | 2,554,000 | 8.37 | $3.21 | 889,167 | $3.34 |
| $4.00 - $4.99 | 161,000 | 8.14 | $4.44 | 49,000 | $4.44 |
| $5.00 - $5.99 | 162,000 | 8.02 | $5.28 | 62,250 | $5.25 |
| | 8,520,929 | 6.92 | $2.06 | 6,102,479 | $1.62 |

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

| | Number of Shares | Weighted Average Price Per Share |
|---|---|---|
| Outstanding at January 1, 2004 | 8,293,000 | $ 1.19 |
| Granted | 2,108,000 | 3.06 |
| Exercised (Note J) | (540,399) | 1.08 |
| Cancelled or expired | (245,834) | 1.74 |

| | | |
|---|---|---|
| Outstanding at December 31, 2004 | 9,614,767 | $ 1.61 |
| Granted | 1,325,000 | 3.97 |
| Exercised (Note J) | (415,989) | 1.18 |
| Cancelled or expired | (372,200) | 3.74 |
| Outstanding at December 31, 2005 | 10,151,078 | $ 1.85 |
| Granted | 1,125,000 | 3.01 |
| Exercised (Note J) | (2,051,399) | 1.30 |
| Cancelled or expired | (703,750) | 2.67 |
| Outstanding at December 31, 2006 | 8,520,929 | $ 2.06 |

The weighted-average fair value of stock options granted to employees during the years ended December 31, 2006, 2005 and 2004 and the weighted-average significant assumptions used to determine those fair values, using a Black-Scholes option pricing model are as follows:

**TELKONET, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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**NOTE K - STOCK OPTIONS AND WARRANTS (Continued)**

Employee Stock Options (Continued)

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Significant assumptions (weighted-average): | | | |
| Risk-free interest rate at grant date | 5.0% | 4.5% | 1.35% |
| Expected stock price volatility | 65% | 71% | 76% |
| Expected dividend payout | - | - | - |
| Expected option life (in years) | 5.0 | 5.0 | 5.0 |

Total stock-based compensation expense recognized in the consolidated statement of earnings for the year ended December 31, 2006 was $1,080,895, net of tax effect.

The financial statements for the year ended December 31, 2005 and 2004 have not been restated. Had compensation expense for employee stock options granted under the plan been determined based on the fair value at the grant date consistent with SFAS 123R, the Company's pro forma net loss and net loss per share would have been $(18,218,378) and $(0.41), respectively, for the year ended December 31, 2005; and $(20,923,045) and $(0.51), respectively, for the year ended December 31, 2004.

Non-Employee Stock Options

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

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Exercise Prices | Number Outstanding | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| $1.00 | 1,815,937 | 5.34 | $1.00 | 1,815,937 | $1.00 |

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

| | Number of Shares | Weighted Average Price Per Share |
|---|---|---|
| Outstanding at January 1, 2004 | 3,267,500 | $ 1.00 |
| Granted | 60,000 | 3.45 |
| Exercised (Note J) | (328,331) | 1.00 |
| Canceled or expired | (1,000,000) | 1.00 |
| Outstanding at December 31, 2004 | 1,999,169 | $ 1.07 |
| Granted | 15,000 | 3.45 |
| Exercised (Note J) | (172,395) | 2.07 |

| | | | |
|---|---|---|---|
| Canceled or expired | - | | - |
| Outstanding at December 31, 2005 | 1,841,774 | $ | 1.00 |
| Granted | - | | - |
| Exercised (Note J) | (25,837) | | 1.00 |
| Canceled or expired | - | | - |
| Outstanding at December 31, 2006 | 1,815,937 | $ | 1.00 |

The estimated value of the non-employee stock options vested during the year ended December 31, 2006 was determined using the Black-Scholes option pricing model and the amount of the expense charged to operations in connection with granting the options was $273,499, $1,191,767 and $1,130,780 during the year ended December 31, 2006, 2005 and 2004, respectively.

**TELKONET, INC.**
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**NOTE K - STOCK OPTIONS AND WARRANTS (Continued)**

Warrants

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

| Warrants Outstanding | | | | Warrants Exercisable | |
|---|---|---|---|---|---|
| Exercise Prices | Number Outstanding | Weighted Average Remaining Contractual Life (Years) | Weighed Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| $2.59 | 862,452 | 4.62 | $2.59 | 862,452 | $2.59 |
| $4.17 | 1,560,000 | 4.67 | $4.17 | 1,560,000 | $4.17 |
| $4.87 | 2,135,398 | 4.17 | $4.87 | 2,135,398 | $4.87 |
| | 4,557,850 | 4.19 | $4.20 | 4,557,850 | $4.20 |

Transactions involving warrants are summarized as follows:

| | Number of Shares | Weighted Average Price Per Share |
|---|---|---|
| Outstanding at January 1, 2004 | 5,159,490 | $ 1.01 |
| Granted | - | - |
| Exercised (Note J) | (4,468,590) | 0.99 |
| Canceled or expired | (115,000) | 1.00 |
| Outstanding at December 31, 2004 | 575,900 | $ 1.12 |
| Granted | 1,040,000 | 4.85 |
| Exercised (Note J) | (371,900) | 1.00 |
| Canceled or expired | (14,000) | 1.00 |
| Outstanding at December 31, 2005 | 1,230,000 | $ 4.31 |
| Granted | 3,657,850 | 4.03 |
| Exercised (Note J) | (47,750) | 1.15 |
| Canceled or expired | (282,250) | 2.64 |
| Outstanding at December 31, 2006 | 4,557,850 | $ 4.20 |

The Company granted 2,097,850 and 1,000,000 warrants to Convertible Senior Notes holders (Note H), 1,560,000 and 0 warrants to private placement investors (Note J), and 0 and 40,000 compensatory warrants to non-employees during the year ended December 31, 2006 and 2005, respectively. The Company did not granted any warrants during the year ended December 31, 2004. The estimated value of compensatory warrants granted during the period ended December 31, 2006 was determined using the Black-Scholes option pricing model and the following assumptions: contractual term of 3 years, a risk free interest rate of approximately 4.50%, a dividend yield of 0% and volatility of 71%. Compensation expense of $3,845, $162,453, and $50,096 was charged to operations for the year ended December 31,

2006, 2005 and 2004, respectively. The purchase price of the warrants issued to Convertible Senior Notes holders was adjusted from $5.00 to $4.87 per share and approximately 54,000 additional warrants were issued during the year ended December 31, 2006 in accordance with the anti-dilution protection provision of the Convertible Senior Notes Payable Agreement dated October 27, 2005 (Note H), upon the issuance of the 2,400,000 shares of common stock and 1,560,000 warrants to private placement investors (Note J) for a price per share lower than $5.00.

**NOTE L - RELATED PARTY TRANSACTIONS**

In January 2003, the Company entered into an employment agreement with Ronald W. Pickett, President and Chief Executive Officer of the Company, to provide for an annual compensation of $100,000 and 3,000 shares of restricted stock from the Employee Stock Option Plan for each month that he serves as President. As of December 31, 2006, 2005 and 2004, the Company has provided for the issuance of 36,000 shares of its common stock to Mr. Pickett each year.

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**NOTE L - RELATED PARTY TRANSACTIONS (Continued)**

In September 2003, the Company entered into a consulting agreement that provides for annual compensation of $100,000, payable monthly, with The Musser Group, an entity controlled by the Company's Chairman of the Board of Directors, for certain services. As of December 31, 2006, 2005 and 2004, an aggregate of $100,000 of consulting fees was charged to income each year pursuant to the agreement.

In July 2005, the Company entered into a Professional Services Agreement for international consulting with Seth Blumenfeld, a member of the board of directors. Pursuant to the terms of the agreement, Mr. Blumenfeld received 10,000 shares of Company stock upon execution of the agreement, 10,000 shares of Company stock per quarter for the first year and 5,000 shares of Company stock per quarter thereafter plus a five percent (5%) commission. The stock awarded to Mr. Blumenfeld pursuant to the agreement is restricted stock. The agreement has a one year term, which is renewable annually upon both parties' agreement. During the year ended December 31, 2006 and 2005, the Company charged to operations stock-based compensation in aggregate amount of $105,195 and $127,766, respectively, in connection with this agreement.

In December 2005, the Company issued an aggregate of 363,636 shares of common stock to Ronald W. Pickett, President and Chief Executive Officer of the Company, a convertible debenture holder in exchange for $200,000 of Series B Debentures. The Company also issued an aggregate of 48,858 shares of common stock in exchange for accrued interest of $26,872 for Series B Debentures. In addition, the Company issued an aggregate of 200,000 shares of common stock upon the exercise of warrants at $1.00 per share upon conversion of the notes.

In conjunction with the acquisition of MST (Note B) on January 31, 2006, the Company assumed a non-interest bearing demand promissory note in the amount of $80,444 due to Frank Matarazzo, MST President. Additionally, an estimated $291,000 income tax receivable due to the Company for certain carryback tax losses of MST for the period prior to the Company’s acquisition is payable to Frank Matarazzo.

In February 2006, the Company entered into a one-year professional services agreement with Global Transport Logistics, Inc. (“GTI”), for consulting services for which GTI is paid a fee of $10,000 per month. GTI is 50% owned by Anthony Matarazzo, the President of MST’s brother.

**TELKONET, INC.**
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**NOTE M - BUSINESS SEGMENTS AND GEOGRAPHIC INFORMATION**

The Company's reportable operating segments are strategic businesses differentiated by the nature of their products, activities and customers and are described as follows:

Telkonet (TKO) is engaged in the business of developing products for use in the powerline communications (PLC) industry. PLC products use existing electrical wiring in commercial buildings and residences to carry high speed data communications signals, including the internet.

Microwave Satellite Technologies (MST) (Note B), offers complete sales, installation, and service of VSAT and business television networks, and became a full-service national Internet Service Provider (ISP). The MST solution offers a complete “Quad-play” solution to subscribers of HDTV, VoIP telephony, NuVision Broadband Internet access and wireless fidelity (“Wi-Fi”) access, to commercial multi-dwelling units and hotels.

The measurement of losses and assets of the reportable segments is based on the same accounting principles applied in the consolidated financial statements.

Financial data relating to reportable operating segments is as follows:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2006 | 2005 | 2004 |
| | (In thousands of U.S. $) | | |
| **Revenues:** | | | |
| Telkonet | 3,426 | 2,488 | 699 |
| MST | 1,756 | - | - |
| Total revenue | $ 5,182 | $ 2,488 | $ 699 |

| | Year ended December 31, | | |
|---|---|---|---|
| | 2006 | 2005 | 2004 |
| | (In thousands of U.S. $) | | |
| **Gross Profit** | | | |
| Telkonet | 1,155 | 771 | 156 |
| MST | (455) | - | - |
| Total revenue | $ 700 | $ 771 | $ 156 |
| | | | |
| **Operating (loss):** | | | |
| Telkonet | (14,477) | (15,307) | (13,112) |
| MST | (3,087) | - | - |
| Total operatiing (loss) | $ (17,564) | $ (15,307) | $ (13,112) |
| | | | |
| **Interest Income** | | | |
| Telkoent | 327 | 166 | 129 |
| MST | - | - | - |
| Total interest income | $ 327 | $ 166 | $ 129 |
| | | | |
| **Interest Expenses** | | | |

| | | | |
|---|---|---|---|
| Telkonet | 5,594 | 646 | 109 |
| MST | 1 | - | - |
| Total interest expense | $ 5,595 | $ 646 | $ 109 |

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| | Year ended December 31, | | |
|---|---|---|---|
| | 2006 | 2005 | 2004 |
| | (In thousands of U.S. $) | | |
| **Assets** | | | |
| Telkonet | 4,137 | 23,291 | 15,494 |
| MST | 8,379 | - | - |
| Total asset | $ 12,516 | $ 23,291 | $ 15,494 |
| | | | |
| **Capital Expenditures** | | | |
| Telkonet | 94 | 794 | 1,007 |
| MST | 2,581 | - | - |
| Total capital expenditures | $ 2,675 | $ 794 | $ 1,007 |
| | | | |
| **Operating Expenses** | | | |
| Telkonet | 15,632 | 16,078 | 13,268 |
| MST | 2,633 | - | - |
| Total operating expenses | $ 18,265 | $ 16,078 | $ 13,268 |
| | | | |
| **Depreciation and Amortization** | | | |
| Telkonet | 221 | 186 | 72 |
| MST | 320 | - | - |
| Total depreciation and amortization | $ 541 | $ 186 | $ 72 |

All of the Company’s assets as of December 31, 2006, 2005, and 2004 were attributable to U.S. operations.

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The following is a summary of operations within geographic areas, classified by the Company's country of domicile and by foreign countries:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2006 | 2005 | 2004 |
| | (In thousands of U.S. $) | | |
| Revenues from sales to unaffiliated customers from continuing operations in Telkonet and MST segments: | | | |
| United States | 4,509 | 1,871 | 631 |
| Worldwide | 673 | 617 | 68 |
| | $ 5,182 | $ 2,488 | $ 699 |

Sales to major customers in the Telkonet and MST segments out of total revenues are as follows:

| | Year ended December 31, | | |
|---|---|---|---|
| | 2006 | 2005 | 2004 |
| Hospitality Leasing Corporation | 18% | 18% | 19% |

**NOTE N - INCOME TAXES**

The Company has adopted Financial Accounting Standard No. 109 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 loss from operations before income taxes to the actual income tax expense is as follows:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Tax provision computed at the statutory rate | $ (9,564,000) | $ (5,522,000) | $ (4,583,000) |
| Deferred state income taxes, net of federal income tax benefit | - | (525,000) | - |
| Book expenses not deductible for tax purposes | 526,000 | 19,000 | 15,000 |
| U.S. NOL created from stock option exercise | - | (463,000) | (404,000) |
| U.S. deferred tax liability for beneficial conversion feature | - | 518,000 | - |
| Change in valuation allowance for deferred tax assets | 9,038,000 | 5,973,000 | 4,972,000 |
| Income tax expense | $ -- | $ -- | $ -- |

Deferred income taxes include the net tax effects of net operating loss (NOL) carryforwards 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:

| | 2006 | 2005 |
|---|---|---|
| **Deferred Tax Assets:** | | |
| Net operating loss carryforwards | $ 24,273,000 | $ 15,015,000 |
| Warrants and non-employee stock options | 774,000 | 684,000 |
| Investment in Amperion | 189,000 | 152,000 |
| Other | 403,000 | 487,000 |
| Total deferred tax assets | 25,639,000 | 16,338,000 |
| | | |
| **Deferred Tax Liabilities:** | | |
| Beneficial Conversion Feature of Convertible Debentures | - | (527,000) |
| Property and equipment, principally due to differences in depreciation | (13,000) | (66,000) |
| Acquired Intangibles | (1,050,000) | - |
| Other | (19,000) | - |
| Total deferred tax liabilities | (1,082,000) | (593,000) |
| Valuation allowance | (24,557,000) | (15,745,000) |
| Net deferred tax assets | $ -- | $ -- |

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The Company has provided a valuation reserve against the full amount of the net deferred tax assets, because in the opinion of management, it is more likely than not that these tax assets will not be realized.

At December 31, 2006, the Company has net operating loss carryforwards of approximately $66 million for federal income tax purposes which will expire at various dates from 2020 through 2026.

With the implementation of FAS123R, the amount of the NOL carryforward related to stock based compensation expense is not recognized until the stock-based compensation tax deductions reduce taxes payable. Accordingly, the NOL's reported in the deferred tax asset that were generated in the current year do not include the component of the NOL related to excess tax deductions over book compensation cost related to stock based compensation.. The NOL deferred tax asset does include pre-implementation excess tax deductions over book compensation cost related to stock based compensation. The NOL related to excess tax deductions will be recorded directly into Additional Paid-in-Capital at the time they produce a future current tax benefit. Approximately, $2.5 million and $5.5 million of the NOLs at December 31, 2005 and December 31, 2006, respectively, relate to stock option expense for which subsequently recognized tax benefits will be allocated to capital in excess of par value. No tax deduction benefit from the exercise of stock options was recorded to capital in excess of par value for the years ended December 31, 2006, 2005 and 2004, respectively.

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.

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.

**NOTE O - LOSSES PER COMMON SHARE**

The following table presents the computations of basic and dilutive loss per share:

| | 2006 | 2005 | 2004 |
|---|---|---|---|
| Net loss available to common shareholders | $ (27,437,116) | $ (15,778,281) | $ (13,092,660) |
| Basic and fully diluted loss per share | $ (0.54) | $ (0.35) | $ (0.32) |
| Weighted average common shares outstanding | 50,823,652 | 44,743,223 | 41,384,074 |

For the years ended December 31, 2006, 2005 and 2004, 4,604,414, 7,577,208, and 9,198,646 potential shares, respectively were excluded from shares used to calculate diluted losses per share as their inclusion would reduce net losses per share.

**NOTE P - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES**

Accounts payable and accrued liabilities at December 31, 2006 and 2005 are as follows**:**

| | 2006 | 2005 |
|---|---|---|

| | | | | |
|---|---|---|---|---|
| Accounts payable | $ | 1,625,357 | $ | 880,802 |
| Accrued interest | | - | | 263,806 |
| Accrued payroll and payroll taxes | | 559,411 | | 594,401 |
| Accrued purchase price contingency | | 400,000 | | - |
| Warranty | | 47,300 | | 24,000 |
| Other | | 233,076 | | 58,863 |
| Total | $ | 2,865,144 | $ | 1,821,872 |

**TELKONET, INC.**
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**
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## NOTE Q - COMMITMENTS AND CONTINGENCIES

Office Leases Obligations

The Company leases office space under a sub-lease agreement through November 2010 for office space which occupies approximately 11,600 square feet in Germantown, MD. In April 2005, the Company entered into a three-year lease agreement for 6,742 square feet of commercial office space in Crystal City, Virginia. Pursuant to this lease, the Company agreed to assume a portion of the build-out cost for this facility. The Company also leases office space of approximately 1,800 square feet in White Marsh, MD. Additionally, the Company leases two corporate apartments through May 2006 in Germantown, MD and Crystal City, VA.

MST, which was acquired by the Company in January 2006, presently leases 12,600 square feet of commercial office space in Hawthorne, New Jersey for its office and warehouse spaces. This lease will expire in April 2010.

In the year ended September 2006, the Company leased a vehicle for the chief executive officer. The operating lease will expire in September 2008.

Commitments for minimum rentals under non cancelable leases at December 31, 2006 are as follows:

| | |
|---|---|
| 2007 | $ 421,804 |
| 2008 | 279,618 |
| 2009 | 239,291 |
| 2010 | 176,950 |
| 2011 and thereafter | - |
| Total | $ 1,117,663 |

Rental expenses charged to operations for the year ended December 31, 2006, 2005 and 2004 are $578,022, $389,935, and $165,249, respectively.

## NOTE R - COMMITMENTS AND CONTINGENCIES

Capital Lease Obligations

Development test equipment (Note E) includes the following amounts for capitalized leases at December 31, 2006 and 2005:

| | 2006 | 2005 |
|---|---|---|
| Computer equipment and software | $ 52,000 | $ 52,000 |
| Less: accumulated depreciation and amortization | (36,400) | (26,000) |
| | $ 15,600 | $ 26,000 |

The Company has computer equipment and software purchased under non-cancelable leases with an original cost of $52,000. As of December 31, 2006, the Company has paid in full the lease obligation. Depreciation expense of $10,400, $10,400, and $10,400 in connection with the capital leased equipment was charged to operations during the year ended December 31, 2006, 2005 and 2004, 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.

The Company has consulting agreements with outside contractors to provide marketing and financial advisory services. The Agreements are generally for a term of 12 months from inception and renewable automatically from year to year unless either the Company or Consultant terminates such engagement by written notice.

The Company entered into an exclusive financial advisor and consulting agreement in January 2007. The agreement provides a minimum consideration fee, not less than $250,000, in the event of an equity or financing transaction where the advisor is engaged. The agreement may be terminated with sixty days notification by either party.

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.

Senior Convertible Noteholder Claim

The August 14, 2006 Settlement Agreement with the Senior Convertible Debenture Noteholders provided that the number of shares issued to the Noteholders shall be adjusted based upon the arithmetic average of the weighted average price of the Company's common stock on the American Stock Exchange for the twenty trading days immediately following the settlement date (Note H). The Company has concluded that, based upon the weighted average of the Company's common stock between August 16, 2006 and September 13, 2006, the Company is entitled to a refund from the two Noteholders. One of the Noteholders has informed the Company that it does not believe such a refund is required. As a result, the Company has declined to deliver to the Noteholders certain stock purchase warrants issued to them pursuant to the Settlement Agreement pending resolution of this disagreement. The Noteholder has alleged that the Company has failed to satisfy its obligations under the Settlement Agreement by failing to deliver the warrants. In addition, the Noteholder maintains that the Company has breached certain provisions of the Registration Rights Agreement and, as a result of such breach, such Noteholder claims that it is entitled to receive liquidated damages from the Company.

However, in the Company's opinion, the ultimate disposition of these matters will not have a material adverse effect on the Company's results of operations or financial position.

**TELKONET, INC.**
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**NOTE R - COMMITMENTS AND CONTINGENCIES (continued)**

Microwave Satellite Technology, Inc. Purchase Price Contingency

In conjunction with the acquisition of MST on January 31, 2006, the purchase price contingency shares are price protected for the benefit of the former owner of MST (Note B). In the event the Company's common stock price is below $4.50 per share upon issuance of the shares from escrow, a pro rata adjustment in the number of shares will be required to support the aggregate consideration of $5.4 million. The price protection provision provides a cash benefit to the former owner of MST if the as-defined market price of the Company's common stock is less than $4.50 per share at the time of issuance from the escrow. The issuance of additional shares or distribution of other consideration upon resolution of the contingency based on the Company's common stock prices will not affect the cost of the acquisition. When the contingency is resolved or settled, and additional consideration is distributable, the Company will record the current fair value of the additional consideration and the amount previously recorded for the common stock issued will be simultaneously reduced to the lower current value of the Company's common stock.

**NOTE S - BUSINESS CONCENTRATION**

Total sale of rental contract agreements (Note F) and the related capitalized equipment to Hospitality Leasing Corporation approximated $705,000 and $252,000 in the year ending December 31, 2006, and $439,000 and $0 in the year ending 2005, which constituted approximately 18% and approximately 18% of total revenue, respectively, and represented the only major customer for years then ended. Revenue from one major customer represented $136,166 or approximately 19% of 2004 revenues. Total accounts receivable of $8,774, or 2% of total accounts receivable, was due from Hospitality Leasing Corporation as of December 31, 2006. There were no outstanding accounts receivable from these major customers as of December 31, 2005 and 2004.

Purchases from three (3) major suppliers approximated $446,038or 61% of purchase, $598,000 or 48% of purchases, and $885,568 or 40% of purchases for the years ended December 31, 2006, 2005 and 2004, respectively. Total accounts payable of approximately $1,871 or 0.3% of total accounts payable was due to these three suppliers as of December 31, 2006 and approximately $3,000 or .04% of total accounts payable was due to these three suppliers as of December 31, 2005.

**NOTE T - SUBSEQUENT EVENTS**

$10 million Private Placement

On February 2, 2007, we completed a private placement of 4.0 million shares of our common stock to certain accredited investors for gross proceeds of $10 million. The Company incurred $390,000 in private placement fees in connection with this transaction. The proceeds of this offering will be used for general working capital needs and to assist in funding the Company's strategic initiatives. Telkonet also has issued to the purchasers in the private placement warrants to purchase 2.6 million shares of common stock at an exercise price of $4.17 per share. Additionally, the Company agreed to issue to the placement agent warrants to purchase 79,000 shares of its common stock at an exercise price of $4.17 per share. These warrants expire five years from the date of issuance.

Acquisition of Smart Systems International, Inc.

On March 9, 2007, the Company acquired substantially all of the assets of Smart Systems International (SSI), a leading provider of energy management products and solutions to customers in the United States and Canada for cash and Company common stock having an aggregate value of $7,000,000. The purchase price was comprised of $875,000 in cash and 2,227,273 shares of the Company's common stock. The Company is obligated to register the stock portion of the purchase price on or before May 15, 2007 and 1,090,000 shares are being held in an escrow account for a period of one year following the closing from which certain potential indemnification obligations under the purchase agreement may be satisfied. The aggregate number of shares held in escrow is subject to adjustment upward or downward depending upon the trading price of the Company's common stock during the one year period following the closing date.

The acquisition was accounted for using the purchase method of accounting under SFAS No. 141.

The following table presents the purchase price allocation, including estimated professional fees and other related acquisition costs, to the assets acquired and liabilities assumed, based on their fair values as of December 31, 2006 which is the most recent unaudited financial statements:

| | | |
|---|---|---|
| Current assets | $ | 1,477,355 |
| Property, plant and equipment | | 32,052 |
| Other assets | | 378,170 |
| Goodwill and Intangibles | | 5,593,557 |
| Total assets acquired | | 7,481,134 |
| | | |
| Accounts payable and accrued liabilities | | (231,134) |
| Total liabilities assumed | | (231,134) |
| Net assets acquired | $ | 7,250,000 |

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Due to its recent date of acquisition, the purchase price allocation to Intangibles and Goodwill is based upon preliminary data that is subject to adjustment and could change significantly pending the completion of an independent appraisal to accurately evaluate this allocation. The Company recognizes goodwill in connection with this acquisition as a result of SSI's historical development of its subscriber base, high profile customer acquisition, its proprietary suite of energy management products and strategic industry position. The results of the acquisition will be included within the consolidated financial statements from its date of acquisition in 2007.

The following data presents unaudited pro forma revenues, net loss and basic and diluted net loss per share of common stock for the Company as if the acquisition discussed above, had occurred on January 1, 2005. The Company has prepared these pro forma financial results for comparative purposes only. These pro forma financial results may not be indicative of the results that would have occurred if the Company had completed the acquisition at the beginning of the periods shown below or the results that will be attained in the future:

| | Year Ended December 31, 2006 | | |
|---|---|---|---|
| | As Reported | Pro Forma Adjustments | Pro Forma |
| Revenues | $ 5,181,328 | $ 1,599,935 | $ 6,781,263 |
| Net loss | $ (27,437,116) | $ (1,187,836) | $ (28,624,952) |
| Net loss per common share outstanding - basic | $ (0.54) | $ - | $ (0.54) |
| Weighted average common shares outstanding - basic | 50,823,652 | - | 53,050,925 |

| | Year Ended December 31, 2005 | | |
|---|---|---|---|
| | As Reported | Pro Forma Adjustments | Pro Forma |
| Revenues | $ 2,488,323 | $ 661,604 | $ 3,149,927 |
| Net loss | $ (15,778,281) | $ (1,576,771) | $ (17,355,052) |
| Net loss per common share outstanding - basic | $ (0.35) | $ (0.02) | $ (0.37) |
| Weighted average common shares outstanding - basic | 44,743,223 | | 46,970,496 |

Acquisition of Ethostream LLC

On March 15, 2007, the Company acquired 100% of the outstanding membership units of Ethostream, LLC, a network solutions integration company that offers installation, sales and service to the hospitality industry. The Ethostream acquisition will enable Telkonet to provide installation and support for PLC products and third party applications to customers across North America. The purchase price of $11,756,097 was comprised of $2.0 million in cash and 3,459,609 shares of the Company's common stock. The entire stock portion of the purchase price is being held in escrow to satisfy certain potential indemnification obligations of the sellers under the purchase agreement. The shares held in escrow are distributable over the three years following the closing. The aggregate number of shares issuable to the sellers is subject to downward adjustment in the event the Company's common stock trades at or above a price of $4.50 per share for twenty consecutive trading days during the one year period following the closing.

The acquisition was accounted for using the purchase method of accounting under SFAS No. 141.

The following table presents the purchase price allocation, including estimated professional fees and other related acquisition costs, to the assets acquired and liabilities assumed, based on their fair values as of December 31, 2006 which is the most recent unaudited financial statements:

| | |
|---|---|
| Current assets | $ 877,389 |
| Property, plant and equipment | 55,793 |
| Other assets | 303,828 |
| Goodwill & Intangibles | 11,285,895 |
| Total assets acquired | 12,522,905 |
| | |
| Accounts payable and accrued liabilities | (466,808) |
| Total liabilities assumed | (466,808) |
| Net assets acquired | $ 12,056,097 |

**TELKONET, INC.**
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Due to its recent date of acquisition, the purchase price allocation to Intangibles and Goodwill is based upon preliminary data that is subject to adjustment and could change significantly pending the completion of an independent appraisal to accurately evaluate this allocation. The Company recognizes goodwill in connection with this acquisition as a result of Ethostrean's historical development of its subscriber base, high profile customer acquisition, and strategic industry position. The results of the acquisition will be included within the consolidated financial statements from its date of acquisition in 2007.

The following data presents unaudited pro forma revenues, net loss and basic and diluted net loss per share of common stock for the Company as if the acquisition discussed above, had occurred on January 1, 2005. The Company has prepared these pro forma financial results for comparative purposes only. These pro forma financial results may not be indicative of the results that would have occurred if the Company had completed the acquisition at the beginning of the periods shown below or the results that will be attained in the future:

| | Year Ended December 31, 2006 | | |
|---|---|---|---|
| | As Reported | Pro Forma Adjustments | Pro Forma |
| Revenues | $ 5,181,328 | $ 3,511,538 | $ 8,692,866 |
| Net loss | $ (27,437,116) | $ (156,623) | $ (27,593,739) |
| Net loss per common share outstanding - basic | $ (.54) | $ (0.01) | $ (0.51) |
| Weighted average common shares outstanding - basic | 50,823,652 | | 54,283,261 |

| | Year Ended December 31, 2005 | | |
|---|---|---|---|
| | As Reported | Pro Forma Adjustments | Pro Forma |
| Revenues | $ 2,488,323 | $ 2,752,355 | $ 5,240,678 |
| Net loss | $ (15,778,281) | $ (113,996) | $ (15,892,277) |
| Net loss per common share outstanding - basic | $ (.35) | $ 0.02 | $ (0.33) |
| Weighted average common shares outstanding - basic | 44,743,223 | | 48,202,832 |