TELKONET INC
Form 10KSB
March 30, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-KSB

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 small business issuer 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 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.

Yes [X] No [ ]

Check if disclosure of delinquent filers pursuant to Item 405 of Regulation S-B 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-KSB or any amendment to this Form 10-KSB.

[X]

State issuer's revenues for its most recent fiscal year: $698,652

Aggregate market value of the voting stock held by non-affiliates of the registrant as of March 8 2005: $164,590,450

Number of outstanding shares of the registrant's par value $0.001 common stock as of March 8, 2005: 44,496,755

TELKONET, INC.
FORM 10-KSB
INDEX

		Page
	Part I	
Item 1.	Description of Business	3
Item 2.	Description of Property	6
Item 3.	Legal Proceedings	6
Item 4.	Submission of Matters to a Vote of Security Holders	6
	Part II	
Item 5.	Market for Registrant's Common Equity, Related Stockholder Matters and Small Business Issuer Purchases of Securities	7
Item 6.	Management's Discussion and Analysis of Financial Condition and Results of Operations	7
Item 7.	Financial Statements	14
Item 8.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	14
Item 8A.	Controls and Procedures	14
Item 8B.	Other Information	14
	Part III	
Item 9.	Directors and Executive Officers of the Registrant	14
Item 10.	Executive Compensation	17
Item 11.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	20
Item 12.	Certain Relationships and Related Transactions	22
	Part IV	
Item 13.	Exhibits and Reports on Form 8-K	22
Item 14.	Principal Accounting Fees and Services	23

PART I

ITEM 1. DESCRIPTION OF BUSINESS.

GENERAL

Telkonet, Inc. ("Telkonet" or the "Company") was formed in 1999 to

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

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

The PlugPlus(TM)product suite delivers data to the user at speeds in excess of 7 Mega bits per second (Mbps), with burst speeds of 12.6 Mbps. The PlugPlus(TM)product suite is installed by connecting an incoming broadband signal (DSL, T-1/T-3, satellite or cable modem) into the Gateway and connecting the Gateway to a building's electrical panel using one or more Couplers. Once installed, the Gateway distributes the high-speed Internet signal throughout the entire existing network of electrical wires within the building. The user may access a high-speed Internet signal by plugging the iBridge into any electrical outlet and connecting a personal computer to the iBridge using the computer's built-in Ethernet port. Multiple personal computers connected to the iBridge can communicate with one another and can share a single broadband resource via the Gateway.

The Company 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 Company's principal executive offices are located at 20374 Seneca Meadows Parkway, Germantown, MD 20876

BUSINESS HISTORY

In January 2002, the Company announced that it had shifted its management emphasis from research and development to product sales and marketing in order to move its initial proprietary products into the commercial market. In January 2002, the Board of Directors, Founders and executive management of the Company also reassessed the Company's capital structure. In order to attract additional management and marketing expertise, and to raise the necessary capital for manufacturing, sales, and marketing, the Board of Directors approved a plan authorizing the repurchase of certain shares of, and options to purchase, Telkonet common stock held by each of David Grimes, L. Peter Larson and Stephen Sadle who, at the time of the stock repurchase, each owned in excess of five percent of the issued and outstanding capital stock and were directors and executive officers of Telkonet. The net effect of the recapitalization was to reduce the number of shares of issued and outstanding common stock from approximately 22,100,000 shares to 13,900,000 shares.

In May 2002, the Company concluded an offering of Series A convertible debentures pursuant to which the Company raised approximately $1.7 million dollars for working capital purposes. In the fourth quarter of 2002, the Company announced the successful installation of its PlugPlus(TM) product suite at an historic inn in Augusta, Georgia and installation of a product field trial in Wilmington, North Carolina.

In the first quarter of 2003, the Company concluded an offering of Series B convertible debentures pursuant to which the Company raised approximately $2.5 million dollars for working capital purposes. The Company

also executed a strategic alliance agreement with Choice Hotels International (NYSE: CHH), one of the largest hotel franchise companies in the world, pursuant to which Telkonet agreed to become a Choice Hotels-endorsed vendor. In the second quarter of 2003, the Company concluded an offering of Senior Notes pursuant to which the Company raised approximately $5,000,000, exclusive of placement costs and fees. The proceeds of the Note offering were designated for working capital purposes.

In January 2004, the Board of Directors determined to permit the Senior Noteholders, for a limited period of time, to convert their Senior Notes into the Company's common stock at a conversion price of $2.10 per share. In connection with this transaction, Senior Noteholders converted Senior Notes having an aggregate principal value of $2,539,000. As of December 31, 2004, the aggregate outstanding balance on the Senior Notes, including principal and accrued but unpaid interest, was $450,000.

In February 2004, the Company completed a private offering of its common stock resulting in net proceeds of $12.8 million. The Company sold 6,387,600 shares of its common stock in the private offering. The proceeds of the private placement were designated for working capital purposes.

COMPETITION

Several established networking vendors, including the Linksys Division of Cisco Systems (Linksys) and Netgear, have planned and/or announced powerline communications products that are compliant with the HomePlug(TM) Alliance. Both Linksys and Netgear are focused on products for the residential marketplace. While these companies may choose to move into the commercial market at a future date, Linksys and Netgear do not presently represent a direct competitive threat to Telkonet since they only market and sell their products in the residential sector.

Notwithstanding the present absence of direct competitors, there can be no assurance that Linksys Group, Netgear or any other company will not develop PLC products that compete with Telkonet's products in the future. Linksys and Netgear 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, and multi-dwelling units, government facilities, and any other commercial facilities that have a need for Internet access and network connectivity. The Company has also focused on establishing relationships with network administrator and systems administrator partners. Telkonet continues to examine, select and approach entities with existing distribution channels that will be enhanced by the Company's offerings. The Company also intends to focus future sales and marketing efforts in Europe, South America, Asia and the Pacific Rim.

RAW MATERIALS

The Company has not experienced any significant or unusual problems in the purchase of raw materials or commodities. While the Company 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. The Company obtains the majority of its raw materials from the following suppliers: Arrow Electronics, Inc., Avnet Electronics Marketing, Digi-Key Corporation, Intellon Corporation and Superior Manufacturing Services.

CUSTOMERS

The Company is neither limited to, nor reliant upon, a single or narrowly segmented consumer base from which it derives its revenues. Presently, the Company is not dependent on any particular customer under contract. However, the revenues from three major customers approximated 31% of sales for the year ended December 31, 2004. The Company's primary focus is in the Hospitality, Multi-Dwelling Units, Government and International markets.

INTELLECTUAL PROPERTY

The Company has applied for patents that cover its unique technology, and has utilized the recently announced advancements in transmission speeds to build its next generation of products. The Company continues to identify, design and develop enhancements to its core technologies that will provide additional functionality, diversification of application and desirability for current and

future users. It is the intent of the Company to protect this intellectual property by filing additional patent applications. The Company also has multiple registered and common law trademarks that it uses in the conduct of its business. The Company is presently not a party to any intellectual property licensing agreements.

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

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. Differing technical requirements apply to "Class A" devices intended for use in commercial settings and more stringent standards apply to "Class B" devices intended for residential use. An independent, FCC-certified testing lab has verified that our PLC product line 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.

In Europe and other overseas markets, the Company'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, the Company's products that will be 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.

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, 2004 and 2003, the Company spent $1,852,308 and $1,370,785 on research and development activities, respectively. 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. In 2003, research and development activities included (a) improved network reach with the introduction of the Company's secondary gateway, (b) the introduction of an encrypted key-change-over-powerline feature to ease security management, (c) improved ability to remotely monitor network status and the addition of a VLAN support function for enhanced integration with subscriber management and billing systems, and (d) development of the low-cost iBridge/eXtender products.

LONG TERM INVESTMENT

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 4.7%. The Series A Preferred Stock has a preferential right to receive dividends and with respect to liquidation. The Series A Preferred Stock also votes as a single class with the shares of common stock and Class C common stock, except with respect to certain extraordinary matters, including an amendment to Amperion's certificate of incorporation, an increase in the number of authorized shares of Preferred Stock, the issuance of any class of stock having parity with or rights superior to those of the Series A Preferred Stock and certain material transactions, in which case, the Series A Preferred Stock must approve such extraordinary action voting as a separate class. The Company has the right to designate one member of

Amperion's seven-person board of directors. The board of directors has designated Warren "Pete" Musser, the Chairman of the board of directors of Telkonet, to fill this position. Each share of Series A Preferred Stock is entitled to one vote per share. The Company accounted for this investment under the cost method, as the Company does not have the ability to exercise significant influence over Amperion's operating or financial policies.

ENVIRONMENTAL MATTERS

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

EMPLOYEES

As of March 8, 2005, the Company had 57 full time employees. The Company anticipates that it will hire additional key staff throughout 2005 in the areas of business development, sales and marketing, and engineering.

ITEM 2. DESCRIPTION OF PROPERTY.

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 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. The Company also leases a corporate apartment in Germantown, Maryland for an executive officer. This lease expires in May 2005.

In March 2005, the Company entered into a lease agreement for 6,742 square feet of commercial office space in Crystal City, Virginia. Pursuant to this lease, the Company has agreed to assume an allocated portion of the build-out cost for this facility. The Company intends to relocate majority of its sales organization to the Crystal City facility on or about March 24, 2005 when the build-out is complete. The Company anticipates that it will spend approximately $200,000 in connection with this relocation, which expenses include security deposit, office furniture and telephone equipment. The Crystal City lease expires in March 2008

ITEM 3. LEGAL PROCEEDINGS.

None.

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

On October 22, 2004, the Company held its annual meeting of stockholders at which the Company's stockholders were asked to elect seven (7) directors to serve on the Company's Board of Directors, ratify certain stock options granted under the Telkonet, Inc. Amended and Restated Stock Incentive Plan, ratify the Company's Audit Committee Charter and ratify the appointment of the Company's independent accountants for 2004. 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
Warren V. Musser	31,387,735	0	260,762
Ronald W. Pickett	31,291,235	0	357,262
David W. Grimes	31,388,935	0	259,562
Stephen L. Sadle	31,292,835	0	355,662
Thomas C. Lynch	31,568,967	0	79,530
James L. Peeler	31,564,467	0	84,030
Thomas M. Hall	31,568,467	0	80,030

6

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

MATTER VOTED UPON	FOR	AGAINST	ABSTAIN
Ratification of Stock Options	14,572,463	639,826	277,300
Ratification of Audit Committee Charter	31,489,996	84,486	74,015
Ratification of Independent Accountants	31,394,774	70,000	183,723

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND SMALL BUSINESS 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 8, 2005, the Company had 370 stockholders of record and 44,496,755 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 24, 2004 through December 31, 2004. The information provided for the period prior to January 24, 2004 was obtained from the Yahoo! Finance web site.

	HIGH	LOW
YEAR ENDED DECEMBER 31, 2004		
First Quarter............................	$5.48	$2.54
Second Quarter............................	$5.32	$3.00

Third Quarter..............................	$3.50	$2.20
Fourth Quarter.............................	$5.98	$2.61
YEAR ENDED DECEMBER 31, 2003		
First Quarter..............................	$1.90	$0.41
Second Quarter.............................	$4.65	$1.41
Third Quarter..............................	$3.69	$1.55
Fourth Quarter.............................	$2.77	$1.70

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

During the three months ended December 31, 2004, the Company agreed to issue 9,000 shares of common stock to Ronald W. Pickett, the Company's President and Chief Executive Officer, pursuant to his employment agreement dated January 20, 2004. This issuance of shares was made in reliance on the exemption from registration provided by Section 4(2) of the Securities Act of 1933 and/or Rule 506 of Regulation D promulgated thereunder.

ITEM 6. MANAGEMENT'S DISCUSSION AND ANALYSIS OR PLAN OPERATION.

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.

PLAN OF OPERATION

The Company emerged from its development stage as of December 31, 2003 and began generating revenues from operations late in the fourth quarter of 2003. The Company may experience fluctuations in operating results in future periods due to a variety of factors, including, but not limited to, market acceptance of the Internet and powerline communication technologies as a medium for customers requiring high-speed Internet access, the Company's ability to acquire and deliver high quality products at a price lower than those currently available to consumers, the Company's ability to obtain additional financing in a timely manner and on terms favorable to the Company, the Company's ability to

successfully attract customers at a steady rate and maintain customer satisfaction, Company promotions, branding and sales programs, the amount and timing of operating costs and capital expenditures relating to the expansion of the Company's business, operations and infrastructure and the implementation of marketing programs, key agreements and strategic alliances, the number of products offered by the Company, the number returns experienced by the Company, and general economic conditions specific to the Internet, powerline communications and the communications industries generally.

REVENUES

The Company emerged from its development stage as of December 31, 2003. Therefore, there were no comparable revenues in the prior year. During the year, the Company changed its sales model in the Hospitality and Multi-Dwelling markets from principally product sales to a recurring (lease) sales model. Accordingly, revenues are recognized over a three to five year term. The table below outlines product versus recurring (lease) revenues for each quarter in 2004:

Revenue:	2004 1st. Quarter		2nd. Quarter		3rd.Quarter		4th. Qua
Recurring (lease)	20,309	14%	45,880	17%	69,209	87%	85,699
Product	119,790	86%	226,022	83%	10,126	13%	121,617
Total	140,099	100%	271,902	100%	79,335	100%	207,316

RECURRING REVENUE

As of December 31, 2004, revenues to be recognized under non-cancelable contracts (backlog) was approximately $933,000 with a weighted average remaining term of approximately 31 months. The remaining costs to be amortized in connection with these contracts is approximately $451,000.

PRODUCT REVENUE

Product revenue principally arises from the sale of iBridges and other PlugPlus(TM) components directly to customers. Revenues to date have primarily been derived from the Hospitality and Multi-Dwelling business units. The Company has expanded its marketing efforts in the International and Government markets and anticipates full deployment of its product upon successful product certification in each of these respective markets. In March 2005, the Company received European certification of its products and anticipates the initiation of revenue opportunities in the second quarter of 2005.

COST OF SALES

The Company emerged from its development stage as of December 31, 2003. Therefore, there were no comparable costs of sales in the prior year. During the year, the Company changed its sales model in the Hospitality and Multi-Dwelling markets from principally product sales to a recurring (lease) sales model. Total cost of sales amounted to $542,859 and gross margin approximately 22% of total revenue for the year ended December 31, 2004.

OPERATING EXPENSES

Overall expenses increased for the year ended December 31, 2004 over the prior year by $6,714,732 or 102%. Excluding the fee paid pursuant to certain agreements with consultants of $2,500,000 expensed during the second quarter, the increase for the year was $4,214,732 or 64%. This increase is principally due to payroll and related costs for administrative sales and marketing, non-employee compensation for services, advertising and trade show attendance, and rent and related relocation costs for our corporate and sales offices.

LIQUIDITY AND CAPITAL RESOURCES

As of December 31, 2004, the Company's current assets exceeded current liabilities by $12,671,520. Of the total current assets of $13,900,419, cash represented $11,838,702 of this amount as of December 31, 2004.

While the Company believes it has sufficient capital to meet its working capital requirements for the next twelve months, additional financing may be required in order to meet growth opportunities in financing and/or investing activities. If additional capital is required and the Company is not

successful in generating sufficient liquidity from operations or in raising sufficient capital resources on terms acceptable to the Company, this could have a material adverse effect on the Company's business, results of operations, liquidity and financial condition.

In January 2004, the Board of Directors determined to permit the Senior Noteholders, for a limited period of time, to convert their Senior Notes into the Company's common stock at a conversion price of $2.10 per share. In connection with this transaction, Senior Noteholders converted Senior Notes having an aggregate principal value of $2,539,000

In February 2004, Telkonet completed a private placement of its common stock resulting in net proceeds to the Company of approximately $12.8 million. The Company sold 6,387,600 shares of its common stock at a discount of 18% to the average market price of the Company's common stock for the preceding 30 days.

In March 2004, the Company received $3.9 million upon the exercise of 4,235,007 warrants to purchase the Company's common stock. Additionally, $0.2 million of debentures were converted into 324,000 shares of the Company's common stock.

PRODUCT RESEARCH AND DEVELOPMENT

Company-sponsored research and development costs related to both present and future products are expended in the period incurred. Total expenses for the year ended December 31, 2004 increased over the comparable prior year by $481,523, or 35%. This increase was primarily related to an increase in salaries and related costs associated with the addition of 2 full-time employees and costs related to independent lab testing and certification of the Company's product.

SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses increased for the year ended December 31, 2004 over the comparable prior year by $3,574,197 or 87%. The increase is related to an increase in payroll and associated costs for management, sales and marketing resources, advertising and trade show attendance and related relocation costs for corporate and new sales offices.

ACQUISITION OR DISPOSITION OF PLANT AND EQUIPMENT

During the year ended December 31, 2004, fixed assets increased $513,441, which is primarily related to leasehold improvements associated with the Company's relocation of its corporate offices to Germantown, Maryland. The Company does not anticipate the sale or purchase of any significant property, plant or equipment during the next twelve months, other than purchases of leasehold improvements, computer equipment and peripherals to be used in the Company's day-to-day operations.

In March 2005, the Company entered into a lease agreement for 6,742 square feet of commercial office space in Crystal City, Virginia. Pursuant to this lease, the Company has agreed to assume a portion of the build-out cost for this facility. The Company anticipates that it will spend approximately $200,000 in connection with this relocation, which expenses include security deposit, office furniture and telephone equipment.

NUMBER OF EMPLOYEES

As of March 8, 2005, the Company had fifty-seven (57) full time employees. In order for the Company to attract and retain quality personnel, the Company anticipates it will continue to offer competitive salaries to current and future employees. The Company anticipates that it will increase its employment base to meet the needs outlined in its business plan.

As the Company continues to expand, the Company will incur additional costs for personnel. This projected increase in personnel is dependent upon the Company generating revenues and obtaining sources of financing in excess of its existing capital resources. Although the Company believes it has sufficient capital as of March 8, 2005 to support the anticipated growth in operations, there can be no assurance that the Company will be successful in raising the funds required or generating revenues sufficient to fund the projected increase in the number of employees.

NEW ACCOUNTING PRONOUNCEMENTS

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS 151, Inventory Costs--an amendment of ARB No. 43, Chapter 4. This Statement amends the guidance in ARB No. 43, Chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Paragraph 5 of ARB 43, Chapter 4, previously stated that ". . . under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges. . . ." This Statement requires that those items be recognized as current-period charges

regardless of whether they meet the criterion of "so abnormal." In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. This Statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Management does not believe the adoption of this Statement will have any immediate material impact on the Company.

In December 2004, FASB issued SFAS No.152, "Accounting for Real Estate Time-Sharing Transactions--an amendment of FASB Statements No. 66 and 67" (SFAS 152). This Statement amends FASB Statement No. 66, Accounting for Sales of Real Estate, to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in AICPA Statement of Position (SOP) 04-2, Accounting for Real Estate Time-Sharing Transactions. This Statement also amends FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects, to state that the guidance for (a) incidental operations, and (b) costs incurred to sell real estate projects does not apply to real estate time-sharing transactions. The accounting for those operations and costs is subject to the guidance in SOP 04-2. This Statement is effective for financial statements for fiscal years beginning after June 15, 2005, with earlier application encouraged. The Company does not anticipate that the implementation of this standard will have a material impact on its financial position, results of operations or cash flows.

On December 16, 2004, FASB published Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment (SFAS 123R). SFAS 123R

requires that compensation cost related to share-based payment transactions be recognized in the financial statements. Share-based payment transactions within the scope of SFAS 123R include stock options, restricted stock plans, performance-based awards, stock appreciation rights, and employee share purchase plans. The provisions of SFAS 123R are effective as of the first interim period that begins after June 15, 2005. Accordingly, the Company will implement the revised standard in the third quarter of fiscal year 2005. Currently, the Company accounts for its share-based payment transactions under the provisions of APB 25, which does not necessarily require the recognition of compensation cost in the financial statements. Management is assessing the implications of this revised standard, which may materially impact the Company's results of operations in the third quarter of fiscal year 2005 and thereafter.

On December 16, 2004, FASB issued Statement of Financial Accounting Standards No. 153, Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions (SFAS 153). This statement amends APB Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. Under SFAS 153, if a nonmonetary exchange of similar productive assets meets a commercial-substance criterion and fair value is determinable, the transaction must be accounted for at fair value resulting in recognition of any gain or loss. SFAS 153 is effective for nonmonetary transactions in fiscal periods that begin after June 15, 2005. The Company does not anticipate that the implementation of this standard will have a material impact on its financial position, results of operations or cash flows.

FORWARD-LOOKING STATEMENTS AND ASSOCIATED RISKS

This Annual Report on Form 10-KSB contains forward-looking statements. These statements are based on current expectations and assumptions that are subject to risks and uncertainties. Actual results could differ materially because of issues and uncertainties such as those listed below and elsewhere in this report, which, among others, should be considered in evaluating the Company's financial outlook.

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

Telkonet emerged from its development stage as of December 31, 2003. As a result, it has a limited operating history upon which to base an evaluation of its current business and future prospects. The Company has not generated substantial revenues since its inception. Because of the Company's limited operating history, management has limited insight into trends that may emerge and could materially adversely affect the Company's business. Prospective investors should consider the risks and difficulties the Company may encounter in its new and rapidly evolving market, especially given the Company's lack of operating history. These risks include the Company's ability to:

- market the PlugPlus(TM)product suite;
- build a customer base;
- generate revenues;
- compete favorably in a highly competitive market;

- access sufficient capital to support growth;
- recruit and retain qualified employees;
- introduce new products and services; and
- build technology and support systems.

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

Since inception through December 31, 2004, the Company has incurred cumulative losses of $27,209,272 and has never generated enough funds through operations to support its business. The Company expects to continue to incur substantial operating losses through 2005. The Company's losses to date have resulted principally from:

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

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

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

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

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

The Company's quarterly results may also be significantly impacted by

certain accounting treatment of acquisitions, financing transactions or other matters. Such accounting treatment could have a material impact on the Company's results of operations and have a negative impact on the price of the Company's common stock.

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

As of March 8, 2005, the Company's officers and directors owned 22.6% of the Company's issued and outstanding common stock. This means that the Company's officers and directors, as a group, exercise significant control over matters upon which the Company's stockholders may vote, including the selection of the Board of Directors, mergers, acquisitions and other significant corporate transactions.

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

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

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

As of December 31, 2004, the Company had outstanding employee options to purchase a total of 9,614,767 shares of common stock at exercise prices ranging from $1.00 to $4.42 per share, with a weighted average exercise price of $1.61. As of December 31, 2004, the Company had outstanding non-employee options to purchase a total of 1,999,169 shares of common stock at exercise prices of $1.07 per share. As of December 31, 2004, the Company had warrants outstanding to purchase a total of 575,900 shares of common stock at exercise prices ranging from $1.00 to $2.97 per share, with a weighted average exercise price of $1.12. In addition, as of December 31, 2004, the Company had 33,973 additional shares of common stock which may be issued in the future under the Telkonet, Inc. Stock Incentive Plan. The exercise of outstanding options and warrants and the sale in the public market of the shares purchased upon such exercise will be dilutive to existing stockholders and could adversely affect the market price of the Company's common stock.

THE POWERLINE COMMUNICATIONS INDUSTRY IS INTENSELY COMPETITIVE AND RAPIDLY EVOLVING.

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

Delays in product development and introduction could result in:

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

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

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

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

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

could lose market share, any of which could seriously harm the Company's business and results of operations.

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

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

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

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

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

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

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

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

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

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

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

ITEM 7. FINANCIAL STATEMENTS.

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

ITEM 8. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

ITEM 8A. CONTROLS AND PROCEDURES.

As of December 31, 2004, the Company performed an evaluation, under the supervision and with the participation of management, including its Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of its disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information required to be included in the Company's periodic filings with the U.S. Securities and Exchange Commission. There were no significant changes in the Company's internal controls or in other factors that could materially affected or are reasonable likely to materially affect, the Company's internal controls subsequent to the date of the most recent evaluation.

ITEM 8B. OTHER INFORMATION.

None.

PART III

ITEM 9. 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, 2004. 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	57	President, Director & Chief Executive Offic
David Powell	53	Managing Director, International
Robert P. Crabb	57	Corporate Secretary
E. Barry Smith	54	Chief Financial Officer
Stephen Sadle	59	Senior Vice President & Director
James Landry	49	Chief Technology Officer

Name	Age	Title
Warren V. Musser	78	Chairman of the Board
David Grimes	67	Director
Thomas C. Lynch	62	Director
Dr. Thomas M. Hall	53	Director
James L. "Lou" Peeler	71	Director

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 principle 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., 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.

DAVID POWELL--MANAGING DIRECTOR, INTERNATIONAL

Mr. Powell is the Managing Director, International and is responsible for growing Telkonet's business by developing, marketing and selling the Company's high-speed Internet access systems outside the United States. From 1999 until he joined Telkonet in 2003, Mr. Powell served as the Senior Vice

President of the Network Enhancing Technologies Solutions division of Tellabs where he developed leading-edge voice-enhancement and echo cancellation solutions for telecommunications networks worldwide. From 1990 to 1998, Mr. Powell served in various management positions at Coherent Communications Systems Corporation before it was acquired by Tellabs in 1998, including President and Chief Operating Officer, and Vice President and Managing Director of Coherent's European subsidiary, Coherent Communications Systems Limited.

E. BARRY SMITH--CHIEF FINANCIAL OFFICER

Mr. Smith has served as the Company's Chief Financial Officer since February 2003. Mr. Smith is a CPA and senior financial executive with diverse experience in both public and private companies, which includes big-four public accounting experience with the firm of Deloitte & Touche. Mr. Smith also served as Senior Financial Partner and in other executive management positions with Safeguard Scientifics, Inc. and certain of its affiliates, including ThinAirApps, Inc. (wireless application provider-sold to Palm, Inc.), Interactive Marketing Venture (database marketing) and Tangram Enterprise Solutions (software/hardware for PC/LAN mainframe connectivity and enterprise software management). Prior to his employment with Telkonet, Mr. Smith also served as Vice President of Finance & Administration for US Golf Management, a golf course and restaurant management company, Vice President of Finance for International Communications Research, a market research and database services company, and Treasurer for The Chilton Company, a publishing company.

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.

15

JAMES F. LANDRY--CHIEF TECHNOLOGY OFFICER

Mr. Landry has served as the Company's Chief Technology Officer since December 2004 and Vice President of Technology since September 2001. 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. He holds four US patents.

ROBERT P. CRABB--CORPORATE SECRETARY

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.

DAVID W. GRIMES--CO-FOUNDER & DIRECTOR

From 1992 until he joined Telkonet in 1999, Mr. Grimes served as Chief Engineer for Final Analysis, Inc. and led the design and development of the Low Earth Orbit constellation of 38 satellites for use in global store and forward communications. From 1989 to 1992 he was the Engineering Division Director at EER Inc. and supervised over 100 engineers and technicians on electrical mechanical and thermal tasks for Goddard Space Flight Center. From 1982 to 1989 Mr. Grimes served as Chief Executive Officer of Transpace Carriers Inc., a venture to commercialize the Delta launch vehicle. From 1963 to 1982, Mr. Grimes was a Senior Executive with NASA, heading the $200 million per year Delta Program. Mr. Grimes is a recognized expert in space and ground communications systems and brings this expertise to bear on the implementation of the hybrid telephony and high speed Internet technology. Mr. Grimes has been a director of the Company since November 1999.

WARREN V. MUSSER--CHAIRMAN OF THE BOARD OF DIRECTORS

Mr. Musser has had extensive experience with public companies during his distinguished and successful career as an entrepreneur. A partial list of his accomplishments includes: Chairman Emeritus, Safeguard Scientifics, Inc. (formerly Safeguard Industries, Inc.), Chairman of the Board and Chief Executive Officer, Safeguard Scientifics, Inc., Founder, Chairman of the Board and President, Lancaster Corporation (became Safeguard Industries, Inc.), Founder & President, Musser and Company, Inc. (Investment Banking Firm). In addition, Mr. Musser is a Director of CompuCom Systems, Inc. and Internet Capital Group, Inc., Vice Chairman of Nutri/System, Inc. and Eastern Technology Council and Chairman of Economics, PA. He also serves as the Vice President/Development, Cradle of Liberty Council of the Boy Scouts of America. Mr. Musser has been a director of the Company since January 2003.

THOMAS C. LYNCH--DIRECTOR

Mr. Lynch is Senior Vice President, Director of The Staubach Company's Federal Sector 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). 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 Executive Director of Digital Angel Corporation and the Managing Partner of Marrell Enterprises LLC, a company that specializes in international business development. Dr. Hall is a consultant to Coris International SA, a Paris-based insurance services company with subsidiaries in 36 countries. For 12 years, 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), 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.

The Company maintains an Audit Committee of the Board of Directors. For the year ended December 31, 2004, Messrs. Hall, Lynch and Peeler served on the Audit Committee. The Company's Board of Directors has determined that each of Messrs. Hall and Lynch is a "financial expert" as defined by Item 401 of Regulation S-B 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 Item 7(d)(3)(iv) of Schedule 14A 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.

The Company has also adopted a Code of Ethics that applies to the Company's principal executive officer, principal financial officer and those persons performing similar functions, including those employees of the Company with senior financial roles. 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. In addition, the Company will provide a copy of its Code of Ethics free of charge upon request to any person submitting a written request to the Company's Chief Executive Officer.

ITEM 10. EXECUTIVE COMPENSATION.

The following table sets forth all compensation actually paid or accrued by the Company for services rendered to the Company for the years ended December 31, 2004, 2003 and 2002 to the Company's Chief Executive Officer, the Company's four most highly compensated executive officers other than the Chief Executive Officer who were serving as executive officers of the Company as of December 31, 2004, and those persons for whom disclosure would have been required but for the fact that they were not serving as an executive officer of the Company as of December 31, 2004.

SUMMARY COMPENSATION TABLE

	ANNUAL COMPENSATION				LONG TERM	
					AWARDS	
(a)	(b)	(c)	(d)	(e)	(f)	
						SECU

NAME AND PRINCIPAL POSITION	YEAR	SALARY ($)	BONUS ($)	OTHER ANNUAL COMPENSATION	RESTRICTED STOCK ($)	UNDERL
Ronald W. Pickett President & Chief Executive Officer	2003	91,538	-	-	64,460 (1)	
	2004	100,089	-	-	107,779 (1)	
Robert Crabb Corporate Secretary	2002	8,500	-	-	-	
	2003	120,000	-	-	-	
	2004	172,167	6,538	-	-	
Howard Lubert Former Chief Executive Officer	2003	162,083(2)	-	-	-	
	2004	130,000(2)				

17

	ANNUAL COMPENSATION				LONG TERM	
					AWARDS	
(a)	(b)	(c)	(d)	(e)	(f)	
NAME AND PRINCIPAL POSITION	YEAR	SALARY ($)	BONUS ($)	OTHER ANNUAL COMPENSATION	RESTRICTED STOCK ($)	SECU UNDERL
Stephen L. Sadle Sr. Vice President	2002	130,000	-	-	-	
	2003	130,000	-	-		
	2004	171,983	6,538	-		
Jim Landry Chief Technology Officer	2002	116,000	-	-		
	2003	160,000	10,000	-		

	2004	172,514	15,000	-		
E. Barry Smith Chief Financial Officer	2003	115,539	-	-		
	2004	171,983	15,000	-		

(1) In each year ending December 31, 2004 and 2003, 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 $64,460 and $107,779, respectively.

(2) Mr. Lubert's compensation includes $177,083 of the Company's common stock acquired by Mr. Lubert upon the exercise of options exercised in conjunction his resignation in June 2003. The Company paid Mr. Lubert's salary through December 14, 2004 at an annual rate of $130,000. Mr. Lubert's salary of $130,000 was paid in 2004, but accrued in 2003.

OPTION/SAR GRANTS IN LAST FISCAL YEAR
(Individual Grants)

The following table sets forth information concerning stock options granted in the fiscal year ended December 31, 2004, to the persons listed on the Summary Compensation Table.

NAME (a)	NUMBER OF SECURITIES UNDERLYING OPTIONS/SARS GRANTED (#) (b)	PERCENT OF TOTAL OPTIONS/SARS GRANTED TO EMPLOYEES IN FISCAL YEAR (c)	EXERCISE OR BASE PRICE ($/SH) (d)
James Landry	250,000	11.9%	$3.45
Ronald W. Pickett	0	0%	n/a
Robert Crabb	0	0%	n/a
Stephen L. Sadle	0	0%	n/a
E. Barry Smith	0	0%	n/a

18

AGGREGATED OPTION/SAR EXERCISES IN LAST FISCAL YEAR
AND FISCAL YEAR END OPTION/SAR VALUES

The following table summarizes information relating to stock option exercises during the year ended December 31, 2004 by those persons listed on the Summary Compensation Table.

NAME (a)	SHARES ACQUIRED ON EXERCISE (#) (b)	VALUE REALIZED ($) (c)	NUMBER UNEXERC SECURIT UNDERLY OPTIONS/S FY-END EXERCISE UNEXERCIS (d)
Ronald W. Pickett	-	-	-0- -0-
Robert Crabb	-	-	333,333/ 166,667
Stephen L. Sadle	-	-	600,000/ 300,000
James Landry	100,000	350,000	208,333/ 291,667
E. Barry Smith	25,000	89,350	305,333/ 166,667

DIRECTOR COMPENSATION

Telkonet reimburses directors for costs and expenses in connection with their attendance and participation at Board of Directors meetings and for other travel expenses incurred on Telkonet's behalf. Telkonet has the authority to compensate each non-management director up to $48,000 annually and $1,000 for each meeting of the Board of Directors. For the year ended December 31, 2004, each non-management director received an aggregate of $3,000 for his attendance at board of directors meetings. Notwithstanding, upon each director's appointment to the Board of Directors, each director was granted options to purchase 40,000 shares of the Company's common stock that vest ratably over twelve months with an exercise price of $3.45 per share for options issued after April 1, 2004 and $2.00 per share for options issued through March 31, 2004.

EMPLOYMENT AGREEMENTS

Stephen L. Sadle, Senior Vice President, is employed pursuant to an employment agreement for a three-year term that commenced January 18, 2003 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 and he received a bonus of $6,538.

James 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 and he received a bonus of $15,000 for the year ended December 31, 2004.

Robert Crabb, Corporate Secretary, 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 and he received a bonus of $6,538.

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 our 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.

E. Barry Smith, Chief Financial Officer, is employed pursuant to an employment agreement for a one-year term that commenced February 17, 2003 and provides for an annual salary of $130,000 and bonuses and benefits based upon Telkonet's internal policies. Mr. Smith's annual salary was increased to $171,872 in 2004 and he received a bonus of $15,000.

Howard Lubert, former Chief Executive Officer, was employed pursuant to an employment agreement for a two-year term that commenced January 1, 2003 and provided for an annual salary of $130,000 and bonuses and benefits based upon Telkonet's internal policies. Mr. Lubert resigned effective June 16, 2003, however, in connection with Mr. Lubert's separation from the Company, Telkonet agreed to pay Mr. Lubert's salary through December 14, 2004.

In addition, under the Stock Incentive Plan, stock options are periodically granted to employees at the discretion of the Board of Directors. Executives of Telkonet are eligible to receive stock option grants, based upon individual performance and the performance of Telkonet as a whole.

ITEM 11. 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, 2004.

	NUMBER OF SECURITIES TO BE ISSUED UPON EXERCISE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS	WEIGHTED -AVERAGE EXERCISE PRICE OF OUTSTANDING OPTIONS, WARRANTS AND RIGHTS
	(a)	(b)
EQUITY COMPENSATION PLANS APPROVED BY SECURITY HOLDERS	15,000,000	$1.52
EQUITY COMPENSATION PLANS NOT APPROVED BY SECURITY HOLDERS	n/a	n/a
TOTAL	15,000,000	$1.52

The following table sets forth, as of March 8, 2004, 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 8, 2004, there were no issued and outstanding shares of any other class of the Company's equity securities.

NAME AND ADDRESS OF BENEFICIAL OWNER	SHARES BENEFICIALLY OWNED	PE
OFFICERS AND DIRECTORS		
Ronald W. Pickett, President and CEO 20374 Seneca Meadows Parkway Germantown, MD 20876	2,109,205	
E. Barry Smith, Chief Financial Officer 20374 Seneca Meadows Parkway Germantown, MD 20876	408,579 (1)	
Stephen L. Sadle, Senior Vice President 20374 Seneca Meadows Parkway Germantown, MD 20876	3,900,514 (2)	

20

NAME AND ADDRESS OF BENEFICIAL OWNER	SHARES BENEFICIALLY OWNED	PE
OFFICERS AND DIRECTORS		
James Landry, Chief Technology Officer 20374 Seneca Meadows Parkway Germantown, MD 20876	352,950 (3)	
Robert P. Crabb, Corporate Secretary 20374 Seneca Meadows Parkway Germantown, MD 20876	375,000 (4)	
Warren V. Musser, Chairman 20374 Seneca Meadows Parkway Germantown, MD 20876	1,735,027 (5)	
David Grimes, Director 20374 Seneca Meadows Parkway Germantown, MD 20876	1,435,405 (6)	
Thomas C. Lynch, Director 20374 Seneca Meadows Parkway Germantown, MD 20876	60,000 (7)	

Dr. Thomas M. Hall, Director 20374 Seneca Meadows Parkway Germantown, MD 20876	546,640 (8)	
James "Lou" L. Peeler, Director 20374 Seneca Meadows Parkway Germantown, MD 20876	40,000 (9)	
All Directors and Executive Officers as a Group	10,963,320	
5.0% BENEFICIAL OWNERS		
Stephen L. Sadle 20374 Seneca Meadows Parkway Germantown, MD 20876	3,900,514 (2)	

(1) Includes options exerciseable within 60 days to purchase 375,000 shares of the Company's common stock at $1.00 per share.
(2) Includes options exerciseable within 60 days to purchase 675,000 shares of the Company's common stock at $1.00 per share.
(3) Includes options exerciseable within 60 days to purchase 218,750 and 50,000 shares of the Company's common stock at $1.00 and $3.45 per share, respectively.
(4) Includes options exerciseable within 60 days to purchase 375,000 shares of the Company's common stock at $1.00 per share.
(5) Includes options exerciseable within 60 days to purchase 1,500,000 shares of the Company's common stock at $1.00 per share.
(6) Includes options exerciseable within 60 days to purchase 675,000 shares of the Company's common stock at $1.00 per share.
(7) Includes options exerciseable within 60 days to purchase 20,000 and 40,000 shares of the Company's common stock at $2.00 and $3.45 per share, respectively.
(8) Includes options exerciseable within 60 days to purchase 40,000 shares of the Company's common stock at $3.45 per share.
(9) Includes options exerciseable within 60 days to purchase 40,000 shares of the Company's common stock at $3.45 per share.

ITEM 12. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

In September 2003, the Company entered into a consulting agreement, with The Musser Group for certain services. The consulting agreement provides for an annual consulting fee of $100,000, which is payable monthly during the term of the consulting agreement. For the year ended December 31, 2004 and 2003, the Company paid and expensed $100,000 and $33,333, respectively. Warren Musser, Chairman of the Board of Directors, is a principal of the Musser Group.

PART IV

ITEM 13. EXHIBITS.

The following exhibits are included herein or incorporated by reference:

EXHIBIT NUMBER	DESCRIPTION OF DOCUMENT
3.1	Articles of Incorporation of the Registrant (incorporated by reference to our Form 8-K (No. 000-27305), filed on August 30, 2000 and our Form S-8 (No. 333-47986), filed on October 16, 2000)
3.2	Bylaws of the Registrant (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
4.1	Form of Series A Convertible Debenture (incorporated by reference to our Form 10-KSB (No. 000-27305), filed on March 31, 2003)
4.2	Form of Series A Non-Detachable Warrant (incorporated by reference to our Form 10- KSB (No. 000-27305), filed on March 31, 2003)
4.3	Form of Series B Convertible Debenture (incorporated by reference to our Form 10-KSB (No. 000-27305), filed on March 31, 2003)
4.4	Form of Series B Non-Detachable Warrant (incorporated by reference to our Form 10- KSB (No. 000-27305), filed on March 31, 2003)
4.5	Form of Senior Note (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
4.6	Form of Non-Detachable Senior Note Warrant (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
10.1	Amended and Restated Telkonet, Inc. Incentive Stock Option Plan (incorporated by reference to our Registration Statement on Form S-8 (No. 333-412), filed on April 17, 2002)
10.2	Employment Agreement by and between Telkonet, Inc. and 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	Employment Agreement by and between Telkonet, Inc. and E. Barry Smith, dated as of February 17, 2003 (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
14	Code of Ethics (incorporated by reference to our Form 10-KSB (No. 001-31972), filed on March 30, 2004).
21	Telkonet, Inc. Subsidiaries (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003)
23	Consent of Registered Independent Certified Public Accountants
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 E. Barry Smith

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

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

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, 2004 and 2003

	DECEMBER 31, 2004	DECEMBER 31, 2003
1. Audit Fees	$ 63,875	$ 53,925
2. Audit Related Fees	23,900	--
3. Tax Fees	5,000	3,000
4. All Other Fees	--	--
Total Fees	$ 92,775	$ 56,925

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, 2004, were approved by the Company's audit committee.

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant 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

In accordance with the Exchange Act, 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 Warren V. Musser	Chairman of the Board	March 30, 2005
/s/ Ronald W. Pickett Ronald W. Pickett	Chief Executive Officer & Director	March 30, 2005
/s/ E. Barry Smith E. Barry Smith	Chief Financial Officer	March 30, 2005
/s/ James Landry James Landry	Chief Technology Officer	March 30, 2005
/s/ Stephen L. Sadle Stephen L. Sadle	Senior Vice President & Director	March 30, 2005
/s/ Dr. Thomas M. Hall Dr. Thomas M. Hall	Director	March 30, 2005
/s/ James L. Peeler James L. Peeler	Director	March 30, 2005
/s/ David Grimes David Grimes	Director	March 30, 2005

/s/ Thomas C. Lynch	Director	March 30, 2005
Thomas C. Lynch		

24

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FINANCIAL STATEMENTS AND SCHEDULES

DECEMBER 31, 2004 AND 2003

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

TELKONET, INC.

F-1

TELKONET, INC.

INDEX TO FINANCIAL STATEMENTS

Report of Registered Independent Certified Public Accountants

Consolidated Balance Sheets at December 31, 2004 and 2003

Consolidated Statements of Losses for the Years ended December 31, 2004 and 2003

Consolidated Statements of Stockholders' Equity for the Years ended December 31, 2004 and 2003

Consolidated Statements of Cash Flows for the Years ended December 31, 2004 and 2003

Notes to Consolidated Financial Statements

F-2

RUSSELL BEDFORD STEFANOU MIRCHANDANI LLP
CERTIFIED PUBLIC ACCOUNTANTS

REPORT OF REGISTERED INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Directors
Telkonet, Inc.
Germantown, MD

We have audited the accompanying consolidated balance sheets of Telkonet, Inc. and its wholly-owned subsidiary (the "Company") as of December 31, 2004 and 2003 and the related consolidated statements of losses, stockholders' equity, and cash flows for the two years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based 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 wholly-owned subsidiary as of December 31, 2004 and 2003, and the results of its operations and its cash flows for the two years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/RUSSELL BEDFORD STEFANOU MIRCHANDANI LLP

Russell Bedford Stefanou Mirchandani LLP
Certified Public Accountants

McLean, Virginia
January 18, 2005

TELKONET, INC.
CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2004 AND 2003

ASSETS	2004	2
CURRENT ASSETS:		
Cash and cash equivalents	$ 11,838,702	$ 5,1
Accounts receivable, net of allowance for doubtful accounts of		

$13,000 and $7,000 at December 31, 2004 and 2003, respectively	63,147	
Inventories (Note B)	1,873,718	6
Prepaid expenses and deposits	124,852	1
Total current assets	13,900,419	5,9
PROPERTY AND EQUIPMENT, AT COST (Note C):		
Furniture and equipment	704,689	1
Less: accumulated depreciation	137,739	
Total property and equipment, net	566,950	1
EQUIPMENT UNDER OPERATING LEASES, AT COST (Note D):		
Telecommunications and related equipment, at cost	525,664	
Less: accumulated depreciation	75,329	
Total equipment under operating leases, net	450,335	
OTHER ASSETS:		
Long-term investments (Note E)	500,000	
Deposits	76,288	
Total other assets	576,288	
TOTAL ASSETS	$ 15,493,992	$ 6,1
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable and accrued liabilities (Note M)	$ 1,195,924	$ 6
Customer deposits held	32,975	
Capital lease obligation- current (Note N)	--	
Total current liabilities	1,228,899	6
LONG-TERM LIABILITIES:		
Convertible debentures, net of discounts - including related parties (Note F)	137,910	1
Senior notes payable (Note G)	450,000	2,9
Deferred lease liability	30,911	
Total long-term liabilities	618,821	3,1
COMMITMENTS AND CONTINGENCIES (Note N)	--	
STOCKHOLDERS' EQUITY (Note H)		
Preferred stock, par value $.001 per share; 15,000,000 shares authorized; none issued and outstanding at December 31, 2004 and 2003	--	
Common stock, par value $.001 per share; 100,000,000 shares authorized; 44,335,989 and 30,689,522 shares issued and outstanding at December 31, 2004 and 2003, respectively	44,336	
Additional paid-in-capital	40,811,208	16,4
Accumulated deficit	(27,209,272)	(14,1
Stockholders' equity	13,646,272	2,3
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 15,493,992	$ 6,1

See accompanying notes to consolidated financial statements

TELKONET, INC.
CONSOLIDATED STATEMENTS OF LOSSES
FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

	2004	20
Product Revenues, net	$ 477,555	$
Rental Revenue, net	221,097	
Total Revenue	698,652	
Cost of Sales	542,859	1
Gross Profit (Loss)	155,793	(
Operating Expenses:		
Research and Development (Note A)	1,852,308	1,3
Selling, General and Administrative	7,663,369	4,0
Consulting Fees (Note H)	2,500,000	
Non-Employee Stock Options and Warrants (Note I)	1,180,876	9
Depreciation and Amortization	71,514	1
Total Operating Expense	13,268,067	6,5
Loss from Operations	(13,112,274)	(6,5
Other Income (Expense):		
Interest Income	128,938	
Interest (Expense)	(109,324)	(1,1
Total Other Income (Expenses)	19,614	(1,0
(Loss) Before Provision for Income Taxes	(13,092,660)	(7,6
Provision for Income Tax (Note K)	--	
Net (Loss)	$(13,092,660)	$ (7,6
Loss per common share (basic and assuming dilution) (Note L)	$ (0.32)	$
Weighted average common shares outstanding	41,384,074	20,7

See accompanying notes to consolidated financial statements

TELKONET, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

	Preferred Shares	Preferred Stock Amount	Common Shares	Common Stock Amount	Additio Paid in Capi
Balance at January 1, 2003	--	$ --	15,721,131	$ 15,721	$ 4,916
Shares issued for cash at $2.00 per share, net of costs and fees	--	--	333	--	
Shares issued for employee stock options exercised at approximately $1.01 per share	--	--	109,333	109	110
Shares issued to a director for employee stock options exercised at $.50 per share	--	--	315,000	315	157
Shares issued in exchange for non-employee options exercised at $1.00 per share	--	--	187,499	189	187
Shares issued to consultants in exchange for services at approximately $2.13 per share	--	--	149,498	150	318
Shares issued to noteholders for warrants exercised at $1.00 per share	--	--	3,599,250	3,599	3,595
Shares issued to noteholders for warrants exercised at $.50 per share	--	--	500,000	500	249
Shares issued to noteholders for cashless warrants exercised	--	--	317,239	317	
Shares issued in exchange for convertible debentures (Note F)	--	--	7,217,836	7,218	3,799
Shares issued in exchange for accrued interest on convertible debentures (Note F)	--	--	525,403	525	280
Shares issued for warrants exercised at $1.00, in exchange for Senior Notes (Note G)	--	--	2,011,000	2,011	2,008
Write-off of beneficial conversion features and warrants attached to convertible debentures in connection with conversion of Debenture-1 and Series B debentures (Note F)	--	--	--	--	(2,342
Shares issued to an employee in exchange for services at approximately $1.79 per					

share	--	--	36,000	36	64
Stock options and warrants granted to consultants in exchange for services rendered (Note I)	--	--	--	--	1,013
Stock based compensation for the issuance of warrants in exchange for financing costs (Note I)	--	--	--	--	87
Beneficial conversion feature of convertible debentures (Note F)	--	--	--	--	1,761
Value of warrants attached to convertible debentures (Note F)	--	--	--	--	265
Net (loss)	--	--	--	--	
Balance at December 31, 2003	--	--	30,689,522	$ 30,690	$ 16,474

See accompanying footnotes to consolidated financial statement

TELKONET, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (CONTINUED)
FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

	Preferred Shares	Preferred Stock Amount	Common Shares	Common Stock Amount	Additio Paid in Capi
Balance Forward	--	$ --	30,689,522	$ 30,690	$ 16,474
Shares issued for employee stock options exercised at approximately $1.08 per share	--	--	540,399	540	582
Shares issued in exchange for non-employee options exercised at $1.00 per share	--	--	328,333	328	328
Shares issued to consultants in exchange for services rendered at approximately $3.07 per share	--	--	63,566	63	196
Shares issued for senior note conversion at $2.10 per share (Note G)	--	--	1,209,038	1,209	2,537
Shares issued in connection with private placement at $2.00 per share, net					

of costs	--	--	6,387,600	6,388	12,720
Shares issued to consultants for warrants exercised at $2.54 per share	--	--	50,000	50	126
Shares issued to noteholders for warrants exercised at $1.00 per share	--	--	4,000,950	4,001	3,996
Shares issued to noteholders for cashless warrants exercised	--	--	203,751	204	
Shares issued for cashless exercise of underwriter warrants	--	--	165,116	165	
Shares issued in exchange for convertible debentures at $0.50 per share (Note F)	--	--	124,000	124	61
Shares issued in exchange for convertible debentures at $0.55 per share (Note F)	--	--	200,000	200	109
Shares issued in exchange for accrued interest on convertible debentures (Note F)	--	42,999	43	--	23
Shares issued to an employee in exchange for services at approximately $2.99 per share	--	--	36,000	36	107
Shares issued to consultants in exchange for consulting fees at $2.50 per share	--	--	1,000,000	1,000	2,499
Founders shares returned and canceled in connection with January 2002 capital restructure	--	--	(705,285)	(705)	
Write-off of beneficial conversion features and warrants attached to convertible debentures in connection with conversion of Debenture-1 and Series B debentures (Note F)	--	--	--	--	(134
Stock options and warrants granted to consultants in exchange for services rendered (Note I)	--	--	--	--	1,180
Net (loss)	--	--	--	--	
BALANCE AT DECEMBER 31, 2004	--	$ --	44,335,989	$ 44,336	$ 40,811

See accompanying footnotes to consolidated financial statement

TELKONET, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

	2004	2003
INCREASE (DECREASE) IN CASH AND EQUIVALENTS		
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss from development stage operations	$(13,092,660)	$ (7,657,9
Adjustments to reconcile net loss from development stage operations to cash used in operating activities		
Amortization of debt discount - beneficial conversion feature of convertible debentures (Note F)	21,888	655,2
Amortization of debt discount - value of warrants attached to convertible debentures (Note F)	10,152	89,4
Stock options and warrants issued in exchange for services (Note I)	1,180,875	1,013,2
Common stock issued in exchange for services rendered (Note H)	304,094	383,5
Common stock issued in exchange for debenture interest (Note F)	23,276	280,7
Common stock issued in exchange for consulting fees (Note H)	2,500,000	
Write-off of financing costs in connection with conversion of convertible debentures (Note F)	--	204,7
Depreciation and amortization, including equipment under operating leases	143,358	110,9
Increase / decrease in:		
Accounts receivable, trade and other	(4,950)	(56,6
Inventory	(1,265,202)	(568,7
Prepaid expenses and deposits	(23,150)	(173,3
Deferred lease liability	30,911	
Accounts payable, accrued liabilities and customer deposits, net	587,848	122,1
NET CASH (USED IN) OPERATING ACTIVITIES	(9,583,560)	(5,596,4
CASH FLOWS FROM INVESTING ACTIVITIES:		
Costs of equipment under operating leases	(491,776)	(33,8
Purchase of property and equipment, net	(514,903)	(103,0
Investment in Amperion (Note E)	(500,000)	
NET CASH (USED IN) INVESTING ACTIVITIES	(1,506,679)	(136,9
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from sale of common stock, net of costs and fees	12,726,843	6
Repayments of stockholder advances	--	(122,8
Proceeds from issuance of convertible debentures, net of costs and fees (Note F)	--	2,027,1
Proceeds from issuance of senior notes, net of costs and fees (Note G)	--	5,000,0
Proceeds from exercise of warrants (Note H)	4,127,950	3,999,2
Proceeds from exercise of employee and non-employee stock options and warrants (Note H)	911,230	298,3
Repayments of loans	--	(310,0
Repayments of capital leases	(15,000)	
NET CASH PROVIDED BY FINANCING ACTIVITIES	17,751,023	10,892,4
NET INCREASE IN CASH AND EQUIVALENTS	6,660,784	5,159,0
Cash and cash equivalents at the beginning of the year	5,177,918	18,8
Cash and cash equivalents at the end of the year	$ 11,838,702	$ 5,177,9

See accompanying notes to consolidated financial statements

TELKONET, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)
FOR THE YEARS ENDED DECEMBER 31, 2004 AND 2003

	2004	2003
Supplemental Disclosures of Cash Flow Information:		
Cash transactions:		
Cash paid during the period for interest	$ 100,608	$ 135,
Income taxes paid	--	
Non-cash transactions:		
Issuance of stock options and warrants in exchange for services rendered (Note H)	1,180,875	1,013,
Issuance of stock warrants in exchange for financing costs (Note I)	--	87,
Common stock issued for services rendered (Note H)	304,094	383,
Common stock issued in exchange for interest (Note F and H)	23,276	280,
Common stock issued in exchange for consulting services (Note H)	2,500,000	
Common stock issued in exchange for Senior Note (Note G and H)	2,539,000	2,011,
Common stock issued in exchange for conversion of convertible debenture (Note F and H)	172,000	3,807,
Common stock issued in exchange for notes payable (Note H)	--	7,
Write-off of beneficial conversion feature for conversion of debenture (Note F)	134,135	2,046,
Write-off of value of warrants attached to debenture in connection with conversion (Note F)	531	296,
Notes payable issued in connection with capital lease, net of repayments (Note N)	--	15,
Beneficial conversion feature on convertible debentures (Note F)	--	1,761,
Value of warrants attached to convertible debentures (Note F)	--	265,

See accompanying notes to consolidated financial statements

TELKONET, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2004 AND 2003

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.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Telkonet Communications, Inc. Significant

intercompany transactions have been eliminated in consolidation.

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 $13,000 and $7,000 at December 31, 2004 and December 31, 2003, 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.

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.

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 undiscounted 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.

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 B).

NOTE A-SUMMARY OF ACCOUNTING POLICIES (CONTINUED)

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 2004 and 2003, 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.

Revenue Recognition

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

SAB 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the selling prices of the products delivered and the collectibility of those amounts. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. The Company defers any revenue for which the product has not been delivered or is subject to refund until such time that the Company and the customer jointly determine that the product has been delivered or no refund will be required.

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

For equipment under lease, revenue is recognized over the lease term for operating lease and rental contracts. All of the Company's leases are accounted for as operating leases. At the inception of the lease, no lease revenue is recognized and the leased equipment, together with the initial direct costs of installation and support are capitalized, and appear on the balance sheet as

"Equipment Under Operating Leases". The capitalized cost of this equipment is depreciated from two to five 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.

NOTE A-SUMMARY OF ACCOUNTING POLICIES (CONTINUED)

Advertising

The Company follows the policy of charging the costs of advertising to expenses incurred. The Company incurred $499,874 and $136,758 in advertising costs during the years ended December 31, 2004 and 2003, respectively.

Liquidity

As shown in the accompanying consolidated financial statements, the Company has incurred a net loss of $13,092,660 and $7,657,936 for the year ended December 31, 2004 and 2003, respectively. The Company's current assets exceeded its current liabilities by $12,671,520, with cash and cash equivalents representing $11,838,702 of this amount as of December 31, 2004.

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 2004 and 2003 were $1,852,308 and $1,370,785, respectively.

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.

Stock Based Compensation

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure-an amendment of SFAS 123." This statement amends SFAS No. 123, "Accounting for Stock-Based Compensation," to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, this statement amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company has chosen to continue to account for stock-based compensation using the intrinsic value method prescribed in APB Opinion No. 25 and related interpretations. Accordingly, compensation expense for stock options is measured as the excess, if any, of the fair market value of the Company's stock at the date of the grant over the exercise price of the related option. The Company has adopted the annual disclosure provisions of SFAS No. 148 in its financial reports for the years ended December 31, 2004 and 2003 and will adopt the interim disclosure provisions for its financial reports for the subsequent periods.

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

NOTE A-SUMMARY OF ACCOUNTING POLICIES (CONTINUED)

Stock Based Compensation (Continued)

	2004
Net loss - as reported	$(13,092,660)
Add: Total stock based employee compensation expense as reported under intrinsic value method (APB. No. 25)	--
Deduct: Total stock based employee compensation expense as reported under fair value based method (SFAS No. 123)	(7,830,385)
Net loss - Pro Forma	$(20,923,045)
Net loss attributable to common stockholders - Pro forma	$(20,923,045)
Basic (and assuming dilution) loss per share - as reported	$ (0.32)
Basic (and assuming dilution) loss per share - Pro forma	$ (0.51)

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.

Reclassifications

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

New Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board (FASB) issued SFAS 151, Inventory Costs-- an amendment of ARB No. 43, Chapter 4. This Statement amends the guidance in ARB No. 43, Chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). Paragraph 5 of ARB 43, Chapter 4, previously stated that ". . . under some circumstances, items such as idle facility expense, excessive spoilage, double freight, and rehandling costs may be so abnormal as to require treatment as current period charges. . . ." This Statement requires that those items be recognized as current-period charges regardless of whether they meet the criterion of "so abnormal." In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. This Statement is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. Management does not believe the adoption of this Statement will have any immediate material impact on the Company.

In December 2004, the FASB issued SFAS No.152, "Accounting for Real Estate Time-Sharing Transactions--an amendment of FASB Statements No. 66 and 67" ("SFAS 152"). This Statement amends FASB Statement No. 66, Accounting for Sales of Real Estate, to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in AICPA Statement of Position (SOP) 04-2, Accounting for Real Estate Time-Sharing Transactions. This Statement also amends FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects, to state that the guidance for (a) incidental operations and (b) costs incurred to sell real estate projects does not apply to real estate time-sharing transactions. The accounting for those operations and costs is subject to the guidance in SOP 04-2. This Statement is effective for financial statements for fiscal years beginning after June 15, 2005, with earlier application encouraged. The Company does not anticipate that the implementation of this standard will have a material impact on its financial position, results of operations or cash flows.

NOTE A-SUMMARY OF ACCOUNTING POLICIES (CONTINUED)

New Accounting Pronouncements (Continued)

On December 16, 2004, FASB published Statement of Financial Accounting Standards No. 123 (Revised 2004), Share-Based Payment ("SFAS 123R"). SFAS 123R requires that compensation cost related to share-based payment transactions be recognized in the financial statements. Share-based payment transactions within the scope of SFAS 123R include stock options, restricted stock plans, performance-based awards, stock appreciation rights, and employee share purchase plans. The provisions of SFAS 123R are effective as of the first interim period that begins after June 15, 2005. Accordingly, the Company will implement the revised standard in the third quarter of fiscal year 2005. Currently, the Company accounts for its share-based payment transactions under the provisions of APB 25, which does not necessarily require the recognition of compensation cost in the financial statements. Management is assessing the implications of this revised standard, which may materially impact the Company's results of operations in the third quarter of fiscal year 2005 and thereafter.

On December 16, 2004, FASB issued Statement of Financial Accounting Standards No. 153, Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions (" SFAS 153"). This statement amends APB Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. Under SFAS 153, if a nonmonetary exchange of similar productive assets meets a commercial-substance criterion and fair value is determinable, the transaction must be accounted for at fair value resulting in recognition of any gain or loss. SFAS 153 is effective for nonmonetary transactions in fiscal periods that begin after June 15, 2005. The Company does not anticipate that the implementation of this standard will have a material impact on its financial position, results of operations or cash flows.

NOTE B - 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, 2004 and 2003 are as follows:

	2004	2003
Raw Materials	$ 748,110	$ 374,794
Finished Goods	1,125,608	233,722
	$1,873,718	$ 608,516

NOTE C - PROPERTY, PLANT AND EQUIPMENT

The Company's property and equipment at December 31, 2004 and 2003 consists of the following:

	2004	2003
Development Test Equipment	$ 74,920	$ 72,774
Computer Software	62,919	--
Leasehold Improvements	203,948	--
Office Equipment	235,114	103,773

Office Fixtures and Furniture	127,788	14,701
Total	704,689	191,248
Accumulated Depreciation	(137,739)	(67,687)
	$ 566,950	$ 123,561

Depreciation expense included as a charge to income was $71,514 and $35,920 for the years ended December 31, 2004 and 2003, respectively.

TELKONET, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2004 AND 2003

NOTE D - 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 three years. Equipment under operating leases at December 31, 2004 and 2003 consist of the following:

	2004	2003
Telecommunications and related equipment	$ 525,664	$ 33,888
Less: accumulated depreciation	(75,329)	(3,485)
Capitalized equipment, net of accumulated depreciation	450,335	30,403
Less: estimated reserve for residual values	--	--
Capitalized equipment under operating leases, net	450,335	$ 30,403

The following is a schedule by years of minimum future rentals on non-cancellable operating leases as of December 31, 2004:

2005	$ 366,000
2006	337,000
2007	187,000
2008	29,000
2009	14,000
	$ 933,000

NOTE E - LONG-TERM INVESTMENTS

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 4.7%. The Company has one of the

seats on 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 fair value of the Company's investment in Amperion remained at $500,000 as of December 31, 2004.

TELKONET, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2004 AND 2003

NOTE F - CONVERTIBLE PROMISSORY NOTES PAYABLE

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

	2004
Convertible notes payable ("Debenture-1"), in quarterly installments of interest only at 8% per annum, unsecured and due three years from the date of the note with the latest maturity May 2005; Noteholder has the option to convert unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of $.50 per share six months after issuance. During the year ended December 31, 2003, a total of $1,627,100 of Debenture-1 was converted to common stock of the Company. The remaining $62,000 of Debenture-1 was converted to common stock of the Company during the year ended December 31, 2004. As of December 31, 2004, all Debenture-1 has been converted into the Company's common stock (Note H).	$
Debt Discount - beneficial conversion feature, net of accumulated amortization of $0 and $41,411 at December 31, 2004 and 2003, respectively.	
Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of $0 and $3,605 at December 31, 2004 and 2003, respectively.	
Convertible notes payable ("Series B Debenture"), in quarterly installments of interest only at 8% per annum, unsecured and due three years from the date of the note with the latest maturity February 2006; Noteholder has the option to convert unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of $.55 per share six months after issuance. During the year ended December 31, 2003, a total of $2,180,000 of Series B Debenture was converted to common stock of the Company. During the year ended December 31, 2004, additional $110,000 of Series B Debenture was converted to common stock of the Company (Note H).	210,
Debt Discount - beneficial conversion feature, net of accumulated amortization of $49,249 and $75,426 at December 31, 2004 and 2003, respectively.	(49,
Debt Discount - value attributable to warrants attached to notes, net of accumulated amortization of $22,841 and $13,194 at December 31, 2004 and 2003,	

respectively.	(22,
	137,
Total	$ 137,
Less: current portion	
	$ 137,

Convertible Debentures

During the year ended December 31, 2001, the Company issued convertible promissory notes (the "Debenture-1") to Company officers, shareholders, and sophisticated investors in exchange for $940,000, exclusive of placement costs and fees. The Debenture-1 accrues interest at 8% per annum and is payable and due three years from the date of the note with the latest maturity date of November 2004. Noteholder has the option to convert any unpaid note principal together with accrued and unpaid interest to the Company's common stock at a rate of $.50 per share six months after issuance. In accordance with EMERGING ISSUES TASK FORCE ISSUE 98-5, ACCOUNTING FOR CONVERTIBLE SECURITIES WITH A BENEFICIAL CONVERSION FEATURES OR CONTINGENTLY ADJUSTABLE CONVERSION RATIOS ("EITF 98-5"), the Company recognized an imbedded beneficial conversion feature present in the Debenture-1 note.

NOTE F - CONVERTIBLE PROMISSORY NOTES PAYABLE (CONTINUED)

Convertible Debentures (Continued)

The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid in capital. The Company recognized and measured an aggregate of $837,874 of the proceeds, which is equal to the intrinsic value of the imbedded beneficial conversion feature, to additional paid in capital and a discount against the Debenture-1 issued during the year ended December 31, 2001. The debt discount attributed to the beneficial conversion feature is amortized over the Debenture-1's maturity period (three years) as interest expense.

In connection with the placement of the Debenture-1 in 2001, the Company issued non-detachable warrants granting the holders the right to acquire 940,000 shares of the Company's common stock at $1.00 per share. In accordance with EMERGING ISSUES TASK FORCE ISSUE 00-27, APPLICATION OF ISSUE NO. 98-5 TO CERTAIN CONVERTIBLE INSTRUMENTS ("EITF - 0027"), the Company recognized the value attributable to the warrants in the amount of $77,254 to additional paid in capital and a discount against the Debenture-1 issued during the year ended December 31, 2001. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 4.25%, a dividend yield of 0%, and volatility of 21%. The debt discount attributed to the value of the

warrants issued is amortized over the Debenture-1's maturity period (three years) as interest expense.

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

In accordance with EMERGING ISSUES TASK FORCE ISSUE 98-5, ACCOUNTING FOR CONVERTIBLE SECURITIES WITH A BENEFICIAL CONVERSION FEATURES OR CONTINGENTLY ADJUSTABLE CONVERSION RATIOS ("EITF 98-5"), the Company recognized an imbedded beneficial conversion feature present in the Debenture-1 note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid in capital. The Company recognized and measured an aggregate of $693,018 of the proceeds, which is equal to the intrinsic value of the imbedded beneficial conversion feature, to additional paid-in capital and a discount against the Debenture-1 issued during the year ended December 31, 2002. The debt discount attributed to the beneficial conversion feature is amortized over the Debenture-1's maturity period (three years) as interest expense.

In connection with the placement of the Debenture-1 notes in 2002, the Company issued non-detachable warrants granting the holders the right to acquire 749,100 shares of the Company's common stock at $1.00 per share. In accordance with EMERGING ISSUES TASK FORCE ISSUE 00-27, APPLICATION OF ISSUE NO. 98-5 TO CERTAIN CONVERTIBLE INSTRUMENTS ("EITF -0027"), the Company recognized the value attributable to the warrants in the amount of $56,082 to additional paid-in capital and a discount against the Debenture-1 issued during the year ended December 31, 2002. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 1.67%, a dividend yield of 0%, and volatility of 26%. The debt discount attributed to the value of the warrants issued is amortized over the Debenture-1's maturity period (three years) as interest expense.

Series B Debentures

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

NOTE F - CONVERTIBLE PROMISSORY NOTES PAYABLE (CONTINUED)

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 Series B Debenture note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid in capital. The Company recognized and measured an aggregate of $147,859 of the proceeds, which is equal to the intrinsic value of the imbedded beneficial conversion feature, to additional paid-in capital and a discount against the Series B Debenture issued during the year ended December 31, 2002. The debt discount attributed to the beneficial conversion feature is amortized over the Series B Debenture's maturity period (three years) as interest expense.

In connection with the placement of the Series B Debenture notes in 2002, the Company issued non-detachable warrants granting the holders the right to acquire 472,900 shares of the Company's common stock at $1.00 per share. In accordance with EMERGING ISSUES TASK FORCE ISSUE 00-27, APPLICATION OF ISSUE NO. 98-5 TO CERTAIN CONVERTIBLE INSTRUMENTS ("EITF -0027"), the Company recognized the value attributable to the warrants in the amount of $68,595 to additional paid-in capital and a discount against the Series B Debenture issued during the year ended December 31, 2002. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 1.67%, a dividend yield of 0%, and volatility of 26%. The debt discount attributed to the value of the warrants issued is amortized over the Series B Debenture's maturity period (three years) as interest expense.

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

In accordance with EMERGING ISSUES TASK FORCE ISSUE 98-5, ACCOUNTING FOR CONVERTIBLE SECURITIES WITH A BENEFICIAL CONVERSION FEATURES OR CONTINGENTLY ADJUSTABLE CONVERSION RATIOS ("EITF 98-5"), the Company recognized an imbedded beneficial conversion feature present in the Series B Debenture note. The Company allocated a portion of the proceeds equal to the intrinsic value of that feature to additional paid in capital. The Company recognized and measured an aggregate of $1,761,675 of the proceeds, which is equal to the intrinsic value of the imbedded beneficial conversion feature, to additional paid-in capital and a discount against the Series B Debentures issued during the year ended December 31, 2003. The debt discount attributed to the beneficial conversion feature is amortized over the Series B Debentures maturity period (three years) as interest expense.

In connection with the placement of the Series B Debenture notes in January and February 2003, the Company issued non-detachable warrants granting the holders the right to acquire 2,027,100 shares of the Company's common stock at $1.00 per share. In accordance with EMERGING ISSUES TASK FORCE ISSUE 00-27, APPLICATION OF ISSUE NO. 98-5 TO CERTAIN CONVERTIBLE INSTRUMENTS ("EITF -0027"), the Company recognized the value attributable to the warrants in the amount of $265,425 to additional paid-in capital and a discount against the Series B Debentures issued during the year ended December 31, 2003. The Company valued the warrants in accordance with EITF 00-27 using the Black-Scholes pricing model and the following assumptions: contractual terms of 3 years, an average risk free interest rate of 1.25%, a dividend yield of 0%, and volatility of 26%. The debt discount attributed to the value of the warrants issued is amortized over the Series B Debentures maturity period (three years) as interest expense.

TELKONET, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2004 AND 2003

NOTE F - CONVERTIBLE PROMISSORY NOTES PAYABLE (CONTINUED)

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

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

In connection with the conversion of Debenture-1 and Series B Debentures, the Company wrote off the unamortized debt discount attributed to the beneficial conversion feature and the value of the attached warrants in the amount of $2,046,479 and $296,470, respectively, as of December 31, 2003, and an additional $134,135 and $531, respectively, during the year ended December 31, 2004.

The Company amortized the Debenture-1 and the Series B Debenture debt discount attributed to the beneficial conversion feature and the value of the attached warrants, and recorded non-cash interest expense in the amount of $32,040 and $744,695 for the years ended December 31, 2004 and 2003, respectively.

NOTE G - 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. Total outstanding balance of senior notes as of December 31, 2003 was $2,989,000. In January 2004, certain senior note holders

elected to convert $2,539,000 of their senior notes into 1,209,038 shares of common stock of the Company, at a conversion price of $2.10 per share (Note H). The remaining outstanding balance of senior notes as of December 31, 2004 was $450,000.

NOTE H - 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, 2004 and 2003, 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, 2004 and 2003, the Company has 44,335,989 and 30,689,522 shares, respectively, of common stock issued and outstanding.

NOTE H - CAPITAL STOCK (CONTINUED)

During the year ended December 31, 2003, the Company issued 109,333 shares of common stock for an aggregate purchase price of $110,833 to certain employees upon exercise of employee stock options at approximately $1.01 per share. Additionally, the Company issued 187,499 shares of common stock for an aggregate purchase price of $187,500 to consultants upon exercise of non-employee stock options at approximately $1.00 per share. The Company also issued 333 shares of common stock for $666 of cash, net of costs and fees.

During the year ended December 31, 2003, the Company issued 315,000 shares of common stock for an aggregate purchase price of $157,500 to one of the Company's directors upon exercise of employee stock options exercised at $0.50 per share

During the year ended December 31, 2003, the Company issued an aggregate of 149,498 shares of common stock, having an aggregate fair market value of $319,105, 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, 2003, the Company issued an aggregate of 7,217,836 shares of common stock to its convertible debenture holders in exchange for $3,807,100 of debt (Note F) . The Company also issued an aggregate of 525,403 shares of common stock in exchange for accrued interest of $280,734 for Debenture 1 and Series B Debentures (Note F).

During the year ended December 31, 2003, the Company issued an aggregate of 3,599,250 and 500,000 shares of common stock for warrants exercised at $1.00 and $0.50 per share, respectively.

During the year ended December 31, 2003, 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 (see Note G).

During the year ended December 31, 2003, the Company issued an aggregate of 36,000 shares of common stock to an employee in exchange for $64,469 of services rendered, which approximated the fair value of the shares issued during the period services were completed and rendered. Compensation costs of $64,469 were charged to operations.

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 (Note G).

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.

NOTE H - CAPITAL STOCK (CONTINUED)

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 (Note H).

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.

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.

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

NOTE I - 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 E
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable
$1.00 - $1.99	6,183,600	7.93	$ 1.00	4,158,878
$2.00 - $2.99	2,211,167	8.77	$ 2.29	517,350
$3.00 - $3.99	1,200,000	9.38	$ 3.44	142,250
$4.00 - $4.99	20,000	9.99	$ 4.42	--
	9,614,767	8.31	$ 1.61	4,818,478

F-21

TELKONET, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2004 AND 2003

NOTE I - STOCK OPTIONS AND WARRANTS (CONTINUED)

Employee Stock Options (Continued)

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

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2003	1,950,000	$ 1.00
Granted	7,202,333	1.22
Exercised	(109,333)	1.01
Cancelled or expired	(750,000)	1.00
Outstanding at December 31, 2003	8,293,000	$ 1.19
Granted	2,108,000	3.06
Exercised	(540,399)	1.08
Cancelled or expired	(245,834)	1.74
Outstanding at December 31, 2004	9,614,767	$ 1.61

The weighted-average fair value of stock options granted to employees during the years ended December 31, 2004 and 2003 and the weighted-average significant assumptions used to determine those fair values, using a Black-Scholes option pricing model are as follows:

	2004	2003
Significant assumptions (weighted-average):		
Risk-free interest rate at grant date	1.35%	1.13%
Expected stock price volatility	76%	118%
Expected dividend payout	--	--
Expected option life (in years)	5.0	10.0

If the Company recognized compensation cost for the non-qualified employee stock option plan in accordance with SFAS No. 123, the Company's pro forma net loss and net loss per share would have been $(20,923,045) and $(0.51), respectively, for the year ended December 31, 2004; and $(12,869,048) and $(0.62), respectively, for the year ended December 31, 2003.

Non-Employee Stock Options

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

	Options Outstanding			Options E
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable
$ 1.00	1,999,169	7.14	$ 1.07	1,570,002

TELKONET, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2004 AND 2003

NOTE I - STOCK OPTIONS AND WARRANTS (CONTINUED)

Non-Employee Stock Options (Continued)

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

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2003	1,555,000	$ 1.00
Granted	1,900,000	1.00
Exercised	(187,500)	0.96
Canceled or expired		
Outstanding at December 31, 2003	3,267,500	$ 1.00
Granted	60,000	3.45
Exercised	(328,331)	1.00
Canceled or expired	(1,000,000)	1.00
Outstanding at December 31, 2004	1,999,169	$ 1.07

The estimated value of the non-employee stock options vested during the year ended December 31, 2004 was determined using the Black-Scholes option pricing model and the following assumptions: expected option life of 5 years, a risk free interest rate of 1.35%, a dividend yield of 0% and volatility of 76%. The amount of the expense charged to operations in connection with granting the options was $1,130,780 and $982,390 during the year ended December 31, 2004 and 2003, respectively.

Warrants

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

	Options Outstanding			Options E
Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable
$ 1.00	540,900	1.15	$ 1.00	540,900
$ 2.97	35,000	1.38	$ 2.97	35,000
	575,900	1.17	$ 1.12	575,900

Transactions involving warrants are summarized as follows:

	Number of Shares	Weighted Average Price Per Share
Outstanding at January 1, 2003	3,531,460	$ 0.84
Granted	8,591,800	1.01
Exercised	(6,963,770)	0.92
Canceled or expired	--	--
Outstanding at December 31, 2003	5,159,490	$ 1.01
Granted	--	--
Exercised	(4,468,590)	0.99
Canceled or expired	(115,000)	1.00
Outstanding at December 31, 2004	575,900	$ 1.12

NOTE I - STOCK OPTIONS AND WARRANTS (CONTINUED)

Warrants (Continued)

The Company did not grant any compensatory warrants to non-employees during the year ended December 31, 2004. The estimated value of previously granted warrants vested during the period ended December 31, 2004 was determined using the Black-Scholes option pricing model and the following assumptions: contractual term of 3 years, a risk free interest rate of 1.35%, a dividend yield of 0% and volatility of 76%. Compensation expense of $50,096 was charged to operations for the year ended December 31, 2004. The Company capitalized financing costs of $87,217 for compensatory warrants granted in connection with placement of convertible debentures during the year ended December 31, 2003. The financing cost was amortized over the life of the convertible debentures and all unamortized financing cost was expensed upon the conversion of the convertible debentures during the year ended December 31, 2003.

NOTE J - RELATED PARTY TRANSACTIONS

In January 2003, the Company entered into an informal agreement with Warren V. Musser, Chairman of the Board of Directors, pursuant to which the Company agreed to pay Mr. Musser a commission equal to 8.0% of the aggregate value of Series B Debentures purchased by persons referred to Telkonet, Inc. by Mr. Musser. Pursuant to this agreement, Mr. Musser received $8,000 during the year ended December 31, 2003.

In January 2003, the Company entered into an informal agreement with Howard Lubert, Telkonet's formed Chief Executive Officer, pursuant to which the Company agreed to pay Mr. Lubert a commission equal to 8.0% of the aggregate value of the Series B Debentures purchased by persons referred to Telkonet, Inc. by Mr. Lubert. Pursuant to this agreement, Mr. Lubert received $12,000 during the year ended December 31, 2003.

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, 2004 and 2003, the Company has provided for the issuance of 36,000 shares of its common stock to Mr. Pickett each year.

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, 2004 and 2003, an aggregate of $100,000 and $33,333 of consulting fees was charged to income pursuant to the agreement, respectively.

NOTE K - 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. Temporary differences between taxable income reported for financial reporting purposes and income tax purposes are insignificant.

For income tax reporting purposes, the Company's aggregate unused net operating losses approximate $27,200,000 which expire through 2024, subject to limitations of Section 382 of the Internal Revenue Code, as amended. The deferred tax asset related to the carryforward is approximately $9,520,000. The Company has provided a valuation reserve against the full amount of the net operating loss benefit, because in the opinion of management based upon the earning history of the Company, it is more likely than not that the benefits will not be realized.

NOTE K - INCOME TAXES (CONTINUED)

Components of deferred tax assets as of December 31, 2004 are as follows:

Non Current:	
Net operating loss carryforward	$ 9,520,000
Valuation allowance	(9,520,000)
Net deferred tax asset	$ --

NOTE L - LOSSES PER COMMON SHARE

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

	2004	2003
Net loss available to common shareholders	$ (13,092,660)	$ (7,657,936)

	2004	2003
Basic and fully diluted loss per share	$ (0.32)	$ (0.37)
Weighted average common shares outstanding	41,384,074	20,702,482

NOTE M - ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities at December 31, 2004 and 2003 are as follows:

	2004	2003
Accounts payable	$ 812,602	$ 275,987
Accrued interest	21,611	67,350
Accrued payroll and payroll taxes	348,471	283,699
Other	13,240	2,816
Total	$ 1,195,924	$ 629,852

NOTE N - COMMITMENTS AND CONTINGENCIES

Office Leases

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. The Company also leases office space through May 2007 for office space which occupies approximately 1,800 square feet in White Marsh, MD. Additionally, the Company leases a corporate apartment through May 2005 in Germantown, MD. Commitments for minimum rentals under non cancelable leases at December 31, 2004 are as follows:

2005	$ 177,412
2006	183,252
2007	170,203
2008	157,271
2009 and thereafter	312,113
	$1,000,251

Rental expenses charged to operations for the year ended December 31, 2004 and 2003 are $165,249 and $74,777, respectively.

NOTE N - COMMITMENTS AND CONTINGENCIES (CONTINUED)

Capital Lease Obligations

Computer equipment and software includes the following amounts for capitalized leases at December 31, 2004 and 2003:

	2004	2003
Computer equipment and software	$ 52,000	$ 52,000
Less: accumulated depreciation and amortization	(15,600)	(5,200)
	$ 36,400	$ 46,800

The Company has computer equipment and software purchased under non-cancelable leases with an original cost of $52,000. As of December 31, 2004, the Company has paid in full the lease obligation. Depreciation expense of $10,400 and $5,200 in connection with the capital leased equipment was charged to operations during the year ended December 31, 2004 and 2003, 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.

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.

NOTE O - BUSINESS CONCENTRATION

Revenue from three (3) major customers approximated $219,963 or 31% of sales and $41,262 or 44% of sales for the years ended December 31, 2004 and 2003, respectively.