

TELKONET INC
Form 10-K
April 03, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-K

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

For the fiscal year ended December 31, 2016

Commission file number: 001-31972

TELKONET, INC.

(Exact name of registrant as specified in its charter)

Utah 87-0627421
(State or Other Jurisdiction of Incorporation or Organization) (I.R.S. Employer Identification No.)

20800 Swenson Drive Suite 175, Waukesha, WI 53186
(Address of Principal Executive Offices) (Zip Code)

(414) 223-0473
(Registrant's Telephone Number, Including Area Code)

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

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Title of each class Name of each exchange on which registered

None None

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

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

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

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

Aggregate market value of the voting stock held by non-affiliates (based upon the closing sale price of \$0.19 per share on the Over the Counter Bulletin Board) of the registrant as of June 30, 2016: \$23,332,666.

Number of outstanding shares of the registrant's par value \$0.001 common stock as of March 22, 2017: 132,774,475.

Parts I and II incorporate information by reference from the Annual Report to Shareholders for the fiscal year ended December 31, 2016. Part III is incorporated by reference from the Proxy Statement for the Annual Meeting of Shareholders to be held on June 1, 2017.

TELKONET, INC.

FORM 10-K

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PART I

ITEM 1. DESCRIPTION OF BUSINESS.

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

GENERAL

Business

Telkonet, Inc. (the “Company”, “Telkonet”), formed in 1999 and incorporated under the laws of the state of Utah, is the creator of the EcoSmart Platform of intelligent automation solutions designed to optimize energy efficiency, comfort and analytics in support of the emerging Internet of Things (“IoT”). Telkonet’s growth is focused on EcoSmart, its IoT division offering intelligent automation solutions.

In October of 2016, the Company, under the direction and authority of the Board of Directors, committed to a plan to offer for sale Ethostream LLC, High-Speed Internet Access (“HSIA”) subsidiary. While EthoStream is one of the largest public HSIA providers in the world, providing services to more than 12.0 million users monthly across a network of approximately 1,800 locations, the Company will focus on its higher growth potential EcoSmart Platform line. As a result of this decision to sell Ethostream LLC, the operating results of Ethostream for the years ended December 31, 2016 and 2015 have been reclassified as discontinued operations and as assets and liabilities held for sale in the consolidated financial statements. The sale closed on March 29, 2017.

Unless otherwise noted, all financial information in this Form 10-K will reflect results from the Company's continuing operations.

ECOSMART

Telkonet's EcoSmart Platform is comprised of four main pillars.

EcoSmart Suite: The suite of intelligent hardware products designed and developed to provide monitoring, management, command and control over individual and grouped energy consumption throughout building environments.

EcoCentral: The cloud-based dashboard and analytics platform that provides visualization and remote management of Telkonet's monitoring, reporting and analytics through deployed EcoSmart and integrated products.

EcoCare: Telkonet's full offering of professional support and maintenance services including 24/7 monitoring, engineering, analytics, reporting, software and hardware updates, extended warranty, project and relationship management and onsite support.

EcoSmart Mobile: Native iOS and Android applications provided by Telkonet to its partners, customers and end users and guests enabling provisioning, management and access and control over EcoSmart deployments and functionality.

The EcoSmart Platform provides comprehensive energy and operational savings, management monitoring, reporting, analytics and virtual engineering of a customer's portfolio and/or property's room-by-room energy consumption and increased comfort and productivity through a more intelligent and automated environment. Telkonet has deployed more than a half million intelligent devices worldwide in properties and buildings within the hospitality, military, educational, healthcare and other commercial markets. The EcoSmart Platform is rapidly being recognized as a leading solution for reducing energy consumption, operational costs and carbon footprints, and eliminating the need for new energy generation in these markets – all while improving occupant comfort and convenience.

Controlling energy consumption can make a significant impact on a building owner's bottom line, as heating, ventilation and air conditioning ("HVAC") costs represent a substantial portion of a facility's overall utility bill. Hospitality is a key market for Telkonet. According to the EPA EnergySTAR for Hospitality analysis, the median hotel uses approximately 70,000 Btu/ft² from all energy sources.¹ On average, America's approximately 53,000 hotels spend \$2,196 per available room each year on energy.² This represents about 6% of all operating costs. Through a strategic approach to energy efficiency, a 10% reduction in energy consumption would have the same financial effect as increasing the average daily room rate by \$0.60 in limited-service hotels and by \$2.00 in full-service hotels.

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

EcoSmart Suite

EcoTouch: One of the newest additions to Telkonet's suite of hardware, the EcoTouch is an all touch capacitive thermostat interface available in wired and wireless models offering a premium aesthetic. The EcoTouch allows building owners to match the thermostat with the design of their room by changing the color of the metal band or by selecting black or white options.

EcoAir: A wireless thermostat interface mirroring the EcoInsight footprint while enabling the relocation of in room controls without the usual construction expense and downtime.

EcoSource: The remote HVAC control device associated with Telkonet's thermostat interfaces allowing control while removing the need for expensive rewiring and construction. The EcoSource may also be used for third-party integrations, monitoring and control scenarios.

EcoSmart VRF Controller: The newest product in the EcoSmart Suite, the VRF Controller works with most of the new variable refrigerant systems coming to market. The devices replace the EcoSource where discrete relays are not available.

EcoInsight: A programmable and controllable wired thermostat with over 125 configurable settings used to control the efficiency of HVAC through the use of environment variables and triggers.

EcoConnect: An Ethernet to Zigbee bridge that serves as the coordinator for all EcoSmart devices connected to the intelligent automation network, managing approximately 30 - 70 device connections each.

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

EcoSense: A remote occupancy sensor that monitors environments with ultra, high-sensitive sensors designed to detect motion or body heat. All sensors are programmed to ensure accurate occupancy detection. EcoSense may be hardwired or programmed to communicate wirelessly and may be battery operated or utilize external power.

EcoSwitch: The EcoSmart energy management product with the appearance of a traditional 'rocker' light switch. Turning lights off, even for a short time, saves energy and extends lamp life. The EcoSwitch can be used to compose and automate dramatic lighting scenes in a room.

EcoGuard: The EcoSmart control that acts as the replacement for an in-wall outlet and has the ability to monitor and control the flow of power to one or both outlets. Based on occupancy, it can turn off lamps, televisions, appliances, and any other energy-consuming loads that are plugged in, preventing a property from consuming power in an empty room. The EcoGuard completely disconnects devices from the power supply, preventing lights and other in-room electronics from needlessly consuming energy as well as providing monitoring of energy flow and efficiency when a plug is enabled.

EcoContact: A remote, wireless door/window contact with the ability to provide additional occupancy data and control HVAC operability and other consumption measures when doors or windows are open.

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

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

EcoCentral

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

EcoCare

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

EcoSmart Mobile

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

Target Markets

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

Hospitality: hotels, motels, resorts, timeshares, casinos.

Educational: residence halls, dormitories and other campus living options. Also K-12 environments with distributed and portable classrooms.

Military: residence halls, barracks, apartments and other campus living options.

Health care: medical office buildings, assisted and independent living facilities.

Public Housing: apartments and other public living options.

Intelligent Energy Management

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

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

Recovery Time Technology

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

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

How do others do it?

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

EcoSmart Delivers Room-by-Room Savings

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

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

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

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

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

Competitive Advantages

We believe our intelligent automation platform, with our proprietary Recovery Time technology, delivers extensive benefits over competing products, including:

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

Adaptive learning and system programming;

Utility-integrated events capabilities;

Remote HVAC control network;

24/7 EcoCare remote monitoring and diagnostics services;

Plug load, lighting and HVAC controls;

Extensive 3rd-party integrations;

Based on industry standard software and communication protocols (Linux, ZigBee);

Offers rapid return on investment, typical ROI of two to three years; and

Mobile applications facilitating installation, management and end-user accessibility.

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

Based on these platform features and capabilities, we've been awarded, and continue to receive, contracts in the hospitality, military, educational, multiple dwelling unit ("MDU"), healthcare and utility industries. In addition, we believe our relationships with utility-sponsored direct install and rebate-funded programs provide us with a significant advantage over our competitors in the commercial occupancy-based energy management market.

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

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

Industry and Market Overview

According to the U.S. Department of Energy, 18% of all the energy produced in the United States is employed to cool, heat, light, or accomplish other functions within commercial buildings.³ In an effort to remain competitive and manage expenses, governments, building owners, building tenants, and companies in general are looking for ways to become more efficient both fiscally and environmentally. The American Council for an Energy Efficient Economy reported that the cost of saving one unit of energy through energy efficiency is one-fifth (1/5) the cost required to generate that same unit of energy. As a result, we feel that the growth opportunities in the energy management market are in their infancy.

A 2014 report issued by Navigant Research, titled, “Energy Efficient Buildings: Global Outlook”, stated that the global market for energy efficient building products and services is on the rise.⁴ With buildings being one of the largest sources of energy consumption, the opportunity to improve efficiency is significant, ranging from high-efficiency HVAC systems to the utilization of energy-efficient lighting technologies to business models such as energy performance contracting as employed by energy service companies (“ESCOs”) around the world. According to the Navigant report, the total market for energy efficiency in buildings will reach \$623 billion by 2023, an increase of more than 100% from the 2014 market value of \$307 billion.

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

COST OF ENERGY Electricity District Heat Fuel Oil Natural Gas

| | Electricity | District Heat | Fuel Oil | Natural Gas |
|---|-------------|---------------|----------|-------------|
| Educational Buildings (\$8,111 million) | 76% | 7% | 2% | 15% |
| Healthcare Buildings (\$4,882 million) | 80% | N/A | 1% | 19% |
| Office Buildings (\$17,005 million) | 87% | 4% | 1% | 8% |
| Lodging Buildings (\$5,228 million) | 79% | N/A | 3% | 18% |

Source: Energy Information
Administration, 2003
Commercial Buildings
Energy Consumption
Survey

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

⁴ Energy Efficient Buildings: Global Outlook - <https://www.navigantresearch.com/research/energy-efficient-buildings-global-outlook>

Education Industry

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

In July 2008, we entered into an agreement with New York University to implement Telkonet's networked energy management platform to centrally manage energy consumption in its dormitories. Telkonet worked with the University to use its existing building infrastructure to remotely manage and track energy consumption. Approximately 4,600 rooms across 14 dormitories have been completed and have yielded run-time and energy consumption reductions, operational savings from reduced field labor expenses and extension of equipment lifecycle. Since this time, we have grown our educational deployments to include such customers as the University of California Davis, Northern Oklahoma College, the Massachusetts Institute of Technology, Kansas State University, North Carolina State University, University of Akron, University of Notre Dame, Fordham University, Military Academy at West Point, Columbia University, University of Wisconsin-Oshkosh and others.

The opportunities in this market are not limited to higher education institutions. A report by EnergySTAR, a joint program of the U.S. Environmental Protection Agency and the U.S. Department of Energy, showed that our nation's 17,450 K-12 schools spend more than \$6 billion on energy and that as much as 30% of a district's total energy is used inefficiently or unnecessarily.⁵

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

Hospitality Industry

According to EnergySTAR, the cost of energy for America's 47,000 hotels averages \$2,196 per available room each year. As the cost of energy continues to increase, energy efficiency projects can provide an immediate and significant reduction in energy expenses. A 10% reduction in energy costs is equivalent to increasing revenue per available room by \$0.60 for limited service hotels and by more than \$2.00 for full-service hotels.⁶ With EcoSmart, Telkonet can also reduce equipment runtime in unoccupied rooms by 20% to 45% while maintaining guest comfort, making the solution uniquely suited for energy management projects in the hospitality market. The Company has proven that its EcoSmart Platform can deliver a return on investment in less than three years for hospitality customers.

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

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

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

Military Industry

With the Department of Defense (“DOD”) being the single largest energy consumer in the United States, accounting for about 90 percent of the federal government’s energy use and using over 30 million mega-watt hours of electricity per year, we view this market as strategically significant to Telkonet’s interests.⁷

Our energy management platform is already successfully incorporated into the energy initiatives in several military housing sites, military academies and barracks. In October 2009, Executive Order 13514, "Federal Leadership in Environmental, Energy and Economic Performance," was signed and set into action numerous energy requirements in areas such as Sustainable Buildings and Communities, Greenhouse Gas Management and Pollution Prevention and Waste Reduction, among others.⁸ The American Recovery and Reinvestment Act (“ARRA”) jump-started energy management throughout US government and military facilities by providing \$4.26 billion in funding for the Department of Defense Facilities Sustainment, Restoration, and Modernization Program. Telkonet benefited and continues to make use of government funding and other government contracts to provide EcoSmart for use on military bases and other facilities, helping both the DOD and the government as a whole achieve their long-term energy efficiency goals.

Healthcare Industry

Healthcare is an emerging market for energy management as currently healthcare organizations in the United States spend over \$6.5 billion on energy each year and that number continues to rise to meet patients’ needs.⁹ Although hospitals have many specific regulatory mandates, we have been working closely with operators and developers of healthcare support facilities, like medical office buildings, assisted living and other similar facilities, to integrate our EcoSmart energy management initiatives into efficiency opportunities supported by state and federal energy programs. These types of facilities offer a commercial environment similar to the hospitality or educational housing markets, and the increasing growth of the elderly and assisted living markets presents attractive potential for energy efficiency. This market is expected to grow rapidly over the next several years due to its energy savings capabilities. For example, hospital energy managers can use energy efficiency strategies to offset high costs caused by growing plug loads and rising energy prices. A typical 200,000-square-foot, 50-bed hospital in the U.S. annually spends \$680,000—or roughly \$13,611 per bed—on electricity and natural gas. By increasing energy efficiency, hospitals can improve the bottom line and free up funds to invest in new technologies and improve patient care.

Utility Industry

Strategic relationships with regional ESCOs are key to the continued expansion of energy efficiency initiatives. In Pike's 2011 research report, it was estimated that the ESCO market will represent the largest segment of the energy efficient buildings industry in the coming years, with revenues more than doubling from \$30.1 billion in 2011 to \$66.0 billion worldwide by 2017, a projected compound annual growth rate of 14%.

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

Public Housing

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

Competition

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

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

⁸ <https://www.whitehouse.gov/administration/eop/ceq/sustainability>

⁹ <http://www.epa.gov/statelocalclimate/local/topics/commercial-industrial.html>

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

- Recovery Time technology;

- Mesh-networked environment;

- Comprehensive four pillar platform;

- Integration with property and building management systems (PMS & BMS);

- Utility demand-based program integration;

- Existing customer relationships through extensive history in the market; and

- Broad HVAC compatibility.

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

- Reduced cost as compared to BAS/BMS systems;

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

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

Inventory

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

Customers

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

For the years ended December 31, 2016 and 2015, no single customer represented 10% or more of our net revenues from continuing operations.

Intellectual Property

We acquired certain intellectual properties by acquisition, including but not limited to, Patent No. D569, 279, titled “Thermostat.” Patent No. D569279 issued by the USPTO in May 2008 was granted on the ornamental design of a thermostat device and will expire in May of 2022. The expiration of this patent could allow third parties to launch competing products. While we viewed this patent as valuable, we do not view any single patent as material to the Company as a whole.

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

Government Regulation

We are subject to regulation in the United States by the Federal Communications Commission (“FCC”). FCC rules permit the operation of unlicensed digital devices that radiate radio frequency emissions if the manufacturer complies with certain equipment authorization procedures, technical requirements, marketing restrictions and product labeling requirements.

Future products designed by us will require testing for compliance with FCC and European Commission (“EC”) standards. Moreover, if in the future, the FCC or EC changes its technical requirements, further testing and/or modifications may be necessary in order to achieve compliance.

Research & Development

During the years ended December 31, 2016 and 2015, we spent \$1,658,640 and \$1,605,667, respectively, on research and development activities. Telkonet's EcoSmart related development efforts in 2016 and continuing into 2017 are focused on three major areas. The first is around continuous software improvements to maintain compatibility with changing industry equipment and standards as well as moving towards a more mobile platform. The second area is a focus on development with third party device providers for integrated solutions. The growth in connected devices is driving demand for a smart hotel room with many devices working together. This new smart room requires working closely with strategic partners to build a more tightly integrated solution. The final area we continue to focus on is new product development. Telkonet is preparing new product releases and is continuing to innovate with hardware development beyond its current EcoSmart Platform.

Other Information

Employees

As of March 22, 2017, we had 101 full-time employees, of which 52 employees will remain with the Company following the sale of Ethostream LLC on March 28, 2017. We will continue to hire additional personnel as necessary to meet future operating requirements. We anticipate that we may need to hire additional staff in the areas of customer support, field services, engineering, sales and marketing, and administration.

Environmental Matters

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

Discontinued Operations

In October of 2016, the Company decided to offer for sale its Ethostream High-Speed Internet Access ("HSIA") subsidiary. While EthoStream is one of the largest public HSIA providers in the world, providing services to more than 12.0 million users monthly across a network of approximately 1,800 locations, the Company will focus on its higher growth potential EcoSmart Platform line. The operating results of Ethostream for the years ended December 31, 2016 and 2015 have been reclassified as discontinued operations in the consolidated statement of operations and

as of December 31, 2016 and 2015 as assets and liabilities held for sale in the consolidated balance sheets. The Company closed the sale of EthoStream, LLC on March 29, 2017 and the impact on the Company's liquidity as a result of the proceeds from the sale is expected to allow for greater strategic investment in marketing and research and development by the Company.

ITEM 1A. RISK FACTORS.

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

Risks Relating to the Ownership of Our Common Stock

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

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

· fluctuations in our quarterly financial and operating results or the quarterly financial results of companies perceived to be similar to us;

· changes in estimates of our financial results or recommendations by securities analysts;

· potential deterioration of investor confidence resulting from material weaknesses in our internal control over financial reporting;

· our ability to raise and generate working capital to meet our obligations in the ordinary course of business;

· changes in general economic, industry and market conditions;

· failure of any of our products to achieve or maintain market acceptance;

· changes in market valuations of similar companies;

- failure of our products to operate as advertised;
- success of competitive products;
- changes in our capital structure, such as future issuances of securities or the incurrence of additional debt;
- announcements by us or our competitors of significant products, contracts, acquisitions or strategic alliances;
- regulatory developments in the United States, foreign countries or both;
- litigation involving our Company, our general industry or both;
- additions or departures of key personnel; and
- investors' general perception of us.

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

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

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

authorize the issuance of “blank check” preferred stock that could be issued by our board of directors in response to a takeover attempt;

provide that vacancies on our board of directors, including newly created directorships, may be filled only by a majority vote of directors then in office, except a vacancy occurring by reason of the removal of a director without cause shall be filled by vote of the shareholders; and

limit who may call special meetings of shareholders.

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

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

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

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

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

Our common stock is subject to “Penny Stock” restrictions.

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

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

It is possible that we will be required to seek additional capital in the future. This capital funding could involve one or more types of equity securities, including convertible debt, common or convertible preferred stock and warrants to acquire common or preferred stock. Such equity securities could be issued at or below the then-prevailing market price for our common stock. Any issuance of additional shares of our common stock will be dilutive to existing stockholders and could adversely affect the market price of our common stock.

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

As of December 31, 2016, we had outstanding employee options to purchase a total of 2,832,725 shares of common stock at exercise prices ranging from \$0.14 to \$1.00 per share, with a weighted average exercise price of \$0.18. As of December 31, 2016, we had warrants outstanding to purchase a total of 300,000 shares of common stock at exercise prices ranging from \$0.18 to \$0.20 per share, with a weighted average exercise price of \$0.20. The exercise of outstanding options and warrants and the sale in the public market of the shares purchased upon such exercise will be dilutive to existing stockholders and could adversely affect the market price of our common stock.

Risks Related to Our Business

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

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

Delays in product development and introduction could result in:

- loss of or delay in revenue and loss of market share; and
- negative publicity and damage to our reputation and the reputation of our product offerings; and
- decline in the average selling price of our products.

We have identified material weaknesses in our internal controls as of December 31, 2016 that, if not properly remediated, could result in material misstatements in our financial statements.

Based on an evaluation of our disclosure of internal controls and procedures as of December 31, 2016, our management has concluded that, as of such date, there were material weaknesses in our internal control over financial reporting related to a lack of segregation of duties, failure to implement adequate internal control over financial reporting and the need for a stronger internal control environment.. A material weakness is a control deficiency, or a combination of control deficiencies, in internal control over financial reporting, such that there is a more than a remote likelihood that a material misstatement of annual or interim financial statements would not be prevented or detected. We are actively engaged in developing a remediation plan designed to address the material weaknesses. As disclosed in Item 9A of Part II of this report, because of the material weaknesses identified by the Company, our consolidated financial statements may contain material misstatements that would require restatement of the Company's financial results in this report. We have taken, and continue to take, the actions discussed in this report to remediate the identified material weaknesses.

Until these material weaknesses in our internal control over financial reporting are remediated, there is reasonable possibility that material misstatements of our annual or interim consolidated financial statements could occur and not be prevented or detected by our internal controls in a timely manner.

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

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

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

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

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

Our success depends partly on our ability to maintain patent and trade secret protection, to obtain future patents and licenses and to operate without infringing on the proprietary rights of third parties. There can be no assurance that the measures we have taken to protect our intellectual property rights, including intellectual property rights of third parties integrated into our Telkonet iWire System product suite and our EcoSmart Suite of products will prevent misappropriation or circumvention. A patent associated with our Recovery Time technology expired in February 2014. To the extent any competitors are successful in creating competing technologies, this could have an adverse impact on our business and financial results. In addition, there can be no assurance that any patent application, when filed, will result in an issued patent, or that our existing patents, or any patents that may be issued in the future, will provide us with significant protection against competitors. Moreover, there can be no assurance that any patents issued to, or licensed by, us will not be infringed upon or circumvented by others. Infringement by third parties on our proprietary technology could negatively impact our business. Moreover, litigation to establish the validity of patents, to assert infringement claims against others, and to defend against patent infringement claims can be expensive and time-consuming, even if the outcome is in our favor. We also rely on unpatented proprietary technology, and no assurance can be given that others will not independently develop substantially equivalent proprietary information, techniques or processes or that we can meaningfully protect our rights to such unpatented proprietary technology. If our competitors develop substantially equivalent technology and we are unable to enforce any intellectual property rights with respect to such technology in a cost-effective manner or at all, our business and operations would suffer significant harm.

We may incur substantial damages due to litigation.

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

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

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

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

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

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

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

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

Reliance on internally generated cash or debt to finance our operations or complete acquisitions could substantially limit our operational and financial flexibility. The extent to which we will be able or willing to use shares of our common stock to consummate acquisitions will depend on the market value of our common stock which will vary, and our liquidity. Using shares of our common stock for this purpose also may result in significant dilution to our then existing stockholders. To the extent that we are unable to use our common stock to make future acquisitions, our

ability to grow through acquisitions may be limited by the extent to which we are able to raise capital through debt or additional equity financings. No assurance can be given that we will be able to obtain the necessary capital to finance any acquisitions or our other cash needs. If we are unable to obtain additional capital on acceptable terms, we may be required to reduce the scope of any expansion or redirect resources committed to internal purposes. In addition to requiring funding for acquisitions, we may need additional funds to implement our internal growth and operating strategies or to finance other aspects of our operations. Our failure to: (i) obtain additional capital on acceptable terms; (ii) use internally generated cash or debt to complete acquisitions because it significantly limits our operational or financial flexibility; or (iii) use shares of our common stock to make future acquisitions, may hinder our ability to actively pursue any acquisitions.

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

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

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

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

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

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

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

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

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

Involvement in a war or other military action or acts of terrorism may cause significant disruption to commerce throughout the world. To the extent that such disruptions result in (i) delays or cancellations of customer orders, (ii) a general decrease in consumer spending on information technology, (iii) our inability to effectively market and distribute our services or products or (iv) our inability to access capital markets, our business and results of operations

could be materially and adversely affected. We are unable to predict whether the involvement in a war or other military action will result in any long-term commercial disruptions or if such involvement or responses will have any long-term material adverse effect on our business, results of operations, or financial condition.

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

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

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

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

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

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

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

Risks Relating to Our Financial Results and Need for Financing

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

We are currently authorized to issue 190,000,000 shares of common stock under our Amended Restated and Articles of Incorporation. As of March 2017, we have issued 132,774,475 shares of common stock and have approximately 7,680,887 shares of common stock committed for issuance giving effect to the assumed exercise of all outstanding warrants and options and assumed conversion of preferred stock. Due to the limited number of authorized shares available for issuance and because of the significant competition for acquisitions, we may not be able to consummate an acquisition until we increase the number of shares we are authorized to issue. To facilitate the possibility and flexibility of raising additional capital or the completion of potential acquisitions, we would need to seek stockholder approval to increase the number of our authorized shares of common stock. We can provide no assurance that we will succeed in amending our Amended and Restated Articles of Incorporation to increase the number of shares of common stock we are authorized to issue.

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

Since inception through December 31, 2016, we have incurred cumulative losses of \$123,471,034 and have never generated enough funds through operations to support our business. For the year ended December 31, 2016, we had an operating cash flow deficit of \$910,130 from continuing operations. As of December 31, 2016, we have working capital deficit (current liabilities in excess of current assets) from continuing operations of \$916,099 excluding the

Ethostream, LLC assets and liabilities held for sale. Because of the numerous risks and uncertainties associated with our technology, the industry in which we operate, and other factors, we are unable to predict the extent of any future losses or if we will become profitable. If we are unable to generate sufficient revenues from our operations to meet our working capital requirements, we expect to finance our future cash needs through public or debt financings. We cannot be certain that additional funding will be available on acceptable terms, or at all.

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

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

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

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

Our failure to comply with the covenants under our debt instruments could result in an event of default, which, if not cured or waived, could result in us being required to repay these borrowings before their due date or could result in other penalties. If we are forced to refinance these borrowings on less favorable terms, our results of operations and financial condition could be adversely affected by increased costs and rates.

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

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

ITEM 1B. UNRESOLVED STAFF COMMENTS.

None.

ITEM 2. PROPERTIES.

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

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

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

In January 2016, the Company entered into a lease agreement for 2,237 square feet of commercial office space in Germantown, Maryland for its Maryland employee's. The Germantown lease was set to expire at the end of January 2017. In December 2016, the Company entered into a first amendment to the lease agreement extending the lease through the end of January 2018.

ITEM 3. LEGAL PROCEEDINGS.

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.

ITEM 4. MINE SAFETY DISCLOSURES.

None.

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

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

The following table sets forth the quarterly high and low bid prices for our common stock for the years ended December 31, 2016 and 2015.

| | High | Low |
|------------------------------|--------|--------|
| Year Ended December 31, 2016 | | |
| First Quarter | \$0.24 | \$0.13 |
| Second Quarter | 0.23 | 0.18 |
| Third Quarter | 0.25 | 0.18 |
| Fourth Quarter | 0.19 | 0.12 |
| Year Ended December 31, 2015 | | |
| First Quarter | \$0.23 | \$0.13 |
| Second Quarter | 0.25 | 0.16 |
| Third Quarter | 0.28 | 0.18 |
| Fourth Quarter | 0.28 | 0.18 |

Record Holders

As of March 22, 2017, we had 215 record holders of our common stock and 132,774,475 shares of our common stock issued and outstanding.

Securities Authorized for Issuance Under Equity Compensation Plans

The following table provides information concerning securities authorized for issuance pursuant to equity compensation plans approved by the Company's stockholders and equity compensation plans not approved by the Company's stockholders as of December 31, 2016.

| Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding |
|---|--|---|
|---|--|---|

| | (a) | (b) | securities reflected in column (a)) (c) |
|--|-----------|---------|--|
| Equity compensation plans approved by security holders | 3,132,725 | \$ 0.18 | 4,725,053 |
| Equity compensation plans not approved by security holders | – | – | – |
| Total | 3,132,725 | \$ 0.18 | 4,725,053 |

Dividend Policy

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

Unregistered Sales of Equity Securities and Use of Proceeds

None.

ITEM 6. SELECTED FINANCIAL DATA

This item is not applicable.

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

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

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires the Company to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. On an ongoing basis, the Company evaluates significant estimates used in preparing its consolidated financial statements including those related to revenue recognition and allowances for uncollectible accounts receivable, inventory obsolescence, recovery of long-lived asset valuations, income tax provisions and related valuation allowance, stock-based compensation, and contingencies. The Company bases its estimates on historical experience, underlying run rates and various other assumptions that the Company believes to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results could differ from these estimates. The following are critical judgments, assumptions, and estimates used in the preparation of the consolidated financial statements.

Revenue Recognition

For revenue from product sales, the Company recognizes revenue in accordance with ASC 605-10, "Revenue Recognition" and ASC 605-10-S99 guidelines that require that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred; (3) the selling price is fixed and determinable; and (4) collectability is reasonably assured. Determination of criteria (3) and (4) are based on management's judgments regarding the fixed nature of the selling prices of the products delivered and the collectability of those amounts. Assuming all conditions for revenue recognition have been satisfied, product revenue is recognized when products are shipped and installation revenue is recognized when the services are completed. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the

same period the related sales are recorded. The guidelines also address the accounting for arrangements that may involve the delivery or performance of multiple products, services and/or rights to use assets.

Multiple-Element Arrangements (“MEAs”): The Company accounts for contracts that have both product and installation under the MEAs guidance in ASC 605-25. Arrangements under such contracts may include multiple deliverables consisting of a combination of equipment and services. The deliverables included in the MEAs are separated into more than one unit of accounting when (i) the delivered equipment has value to the customer on a stand-alone basis, and (ii) delivery of the undelivered service element(s) is probable and substantially in the Company’s control. Arrangement consideration is then allocated to each unit, delivered or undelivered, based on the relative selling price of each unit of accounting based first on vendor-specific objective evidence (“VSOE”) if it exists, second on third-party evidence (“TPE”) if it exists and on estimated selling price (“ESP”) if neither VSOE or TPE exist.

VSOE – In most instances, products are sold separately in stand-alone arrangements. Services are also sold separately through renewals of contracts with varying periods. The Company determines VSOE based on pricing and discounting practices for the specific product or service when sold separately, considering geographical, customer, and other economic or marketing variables, as well as renewal rates or stand-alone prices for the service element(s).

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

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

Under the estimated selling price method, revenue is recognized in MEAs based on estimated selling prices for all of the elements in the arrangement, assuming all other conditions for revenue recognition have been satisfied. To determine the estimated selling price, the Company establishes the selling price for its products and installation services using the Company's established pricing guidelines, which the proceeds are allocated between the elements and the arrangement.

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

The Company provides call center support services to properties installed by the Company. The Company receives monthly service fees from such properties for its services. The Company recognizes the service fee ratably over the term of the contract. The prices for these services are fixed and determinable prior to delivery of the service. The fair value of these services is known due to objective and reliable evidence from standalone executed contracts. The Company reports such revenues as recurring revenues. Deferred revenue includes deferrals for the monthly support service fees. Long-term deferred revenue represents support service fees to be earned or provided beginning after December 31, 2017. Revenue recognized that has not yet been billed to a customer results in an asset as of the end of the period. As of December 31, 2016 and 2015, there was \$214,821 and \$170,000 recorded within accounts receivable, respectively, related to revenue recognized that has not yet been billed.

Accounts Receivable

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

Inventory Obsolescence

Inventories consist of thermostats, sensors and controllers for Telkonet's EcoSmart product platform. These inventories are purchased for resale and do not include manufacturing labor and overhead. Inventories are stated at the lower of cost or market determined by the first in, first out (FIFO) method. The Company's inventories are subject to technological obsolescence. Management evaluates the net realizable value of its inventories on a quarterly basis and when it is determined that the Company's carrying cost of such excess and obsolete inventories cannot be recovered in full, a charge is taken against income for the difference between the carrying cost and the estimated realizable amount.

Fair Value of Financial Instruments

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

Guarantees and Product Warranties

The Company records a liability for potential warranty claims. The amount of the liability is based on the trend in the historical ratio of claims to sales. The products sold are generally covered by a warranty for a period of one year. In the event the Company determines that its current or future product repair and replacement costs exceed its estimates, an adjustment to these reserves would be charged to earnings in the period such determination is made. During the years ended December 31, 2016 and 2015, the Company experienced approximately between 1% and 3% of returns related to product warranties. As of December 31, 2016 and 2015, the Company recorded warranty liabilities in the amount of \$49,149 and \$28,702, respectively, using this experience factor range.

Income Taxes

The Company accounts for income taxes in accordance with ASC 740-10. Under this method, deferred income taxes (when required) are provided based on the difference between the financial reporting and income tax bases of assets and liabilities and net operating losses at the statutory rates enacted for future periods. The Company has a policy of establishing a valuation allowance when it is more likely than not that the Company will not realize the benefits of its deferred income tax assets in the future.

Stock Based Compensation

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

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

Recovery of Long -Lived Assets

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

Contingent Liabilities - Sales Tax

During 2012, the Company engaged a sales tax consultant to assist in determining the extent of its potential sales tax exposure. Based upon this analysis, management determined the Company had probable exposure for certain unpaid obligations, including interest and penalty, of approximately \$1,100,000 including and prior to the year ended December 31, 2011. The Company had approximately \$227,000 and \$190,000 accrued for this exposure as of December 31, 2016 and 2015, respectively.

The Company continues to manage the liability by establishing voluntary disclosure agreements (VDAs) with the applicable states, which establishes a maximum look-back period and payment arrangements. However, if the aforementioned methods prove unsuccessful and the Company is examined or challenged by taxing authorities, there exists possible exposure of an additional \$30,000, not including any applicable interest and penalties.

Prior to 2016, the Company successfully executed and paid in full VDAs in thirty one states totaling approximately \$695,000 and is current with the subsequent filing requirements.

During the year ended December 31, 2016, the Company executed five VDA's totaling approximately \$70,000.

During the year ended December 31, 2016, the State of Wisconsin performed a sales and use tax audit covering the period from January 1, 2012 through December 31, 2015. The Company estimates the audit could result in approximately \$120,000 in additional use tax and interest and have appropriately accrued and expensed this amount in the consolidated balance sheet and the consolidated statement of operations as of December 31, 2016.

Results of Continuing Operations

Year Ended December 31, 2016 Compared to Year Ended December 31, 2015

Revenues

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

| | Year Ended December 31, | | | | Variance | |
|-----------|-------------------------|------|-------------|------|-----------|-----|
| | 2016 | | 2015 | | | |
| Product | \$7,796,319 | 94% | \$7,242,503 | 96% | \$553,816 | 8% |
| Recurring | 459,695 | 6% | 285,114 | 4% | 174,581 | 61% |
| Total | \$8,256,014 | 100% | \$7,527,617 | 100% | \$728,397 | 10% |

Product Revenue

Product revenue principally arises from the sale and installation of EcoSmart energy management platform. The EcoSmart Suite of products consists of thermostats, sensors, controllers, wireless networking products switches, outlets and a control platform.

For the year ended December 31, 2016, product revenue increased \$0.55 million, or 8% when compared to the prior year. Product revenue from the hospitality market increased \$0.4 million to \$6.30 million for the year ended December 31, 2016 compared to \$5.90 million for the prior year. Product revenue from the residential market increased \$0.2 million to \$0.60 million for the year ended December 31, 2016 compared to \$0.40 million for the prior year period. Product revenue from the education, commercial and government markets remained unchanged at \$0.9 million for the years ended December 31, 2016 and 2015, respectively. The Company's distribution channel through resellers and value added distribution partners while not as robust as in the year ended December 31, 2015, still remains a significant percentage of product revenue. Product revenue attributed to sales from channel partnerships and

value added resellers decreased for the year ended December 31, 2016 to \$4.10 million or 52.6% of total product revenue compared to \$4.80 million or 66.8% in 2015.

Recurring Revenue

Recurring revenue is attributed to our call center support services. The Company recognizes revenue ratably over the service month for monthly support revenues and defers revenue for annual support services over the term of the service period. Recurring revenue consists of Telkonet’s EcoCare service and support program.

For the year end comparison, recurring revenue increased \$0.17 million to \$0.46 million for the year ended December 31, 2016 compared to \$0.29 million for the year ended December 31, 2015.

Cost of Sales

| | Year ended December 31, | | | | Variance | |
|-----------|-------------------------|------|-------------|-----|-----------|------|
| | 2016 | 2015 | | | | |
| Product | \$4,024,675 | 52% | \$3,600,407 | 50% | \$424,268 | 12% |
| Recurring | 124,842 | 27% | 151,958 | 53% | (27,116) | -18% |
| Total | \$4,149,517 | 50% | \$3,752,365 | 50% | \$397,152 | 11% |

Costs of Product Revenue

Costs of product revenue include equipment and installation labor related to EcoSmart technology. For the year ended December 31, 2016, product costs increased by 12% compared to the prior year. The Company’s increased use of outside contractors for installations resulted in a \$0.25 million increase in contractor services. A material cost increase of \$0.19 million was the result of the increase in product revenue. Warranty and freight expenses increased \$0.05 million and \$0.04 million, respectively. The increase use of outside contractors resulted in a decrease of \$0.07 million in salary, wages and travel expense. Inventory adjustments accounted for a \$0.04 decrease.

Costs of Recurring Revenue

Recurring costs are comprised of labor and telecommunication services for our customer service department. For the year ended December 31, 2016, costs of recurring revenue decreased by 18% when compared to the prior year. The decrease of \$0.03 million was for salaries. Customer service department personnel was reduced by one person during the year ended December 31, 2016.

Gross Profit

| | Year ended December 31, | | | | Variance | |
|-----------|-------------------------|------|-------------|-----|-----------|------|
| | 2016 | 2015 | | | | |
| Product | \$3,771,644 | 48% | \$3,642,096 | 50% | \$129,548 | 4% |
| Recurring | 334,853 | 73% | 133,156 | 47% | 201,697 | 151% |
| Total | \$4,106,497 | 50% | \$3,775,252 | 50% | \$331,245 | 9% |

Gross Profit on Product Revenue

Gross profit for the year ended December 31, 2016 increased by 4% when compared to the prior year. The actual gross profit percentages decreased slightly during 2016, 48% for the year ended December 31, 2016 compared to 50% for the year ended December 31, 2015. Contributing to the 2% decrease in gross profit percentage was a 12% increase in product cost of goods sold.

Gross Profit on Recurring Revenue

For the year ended December 31, 2016, our gross profit increased by 151% when compared to the prior year. The variance was mainly attributed to an increase in sales and a decrease in support staff wages and benefits as discussed above.

Operating Expenses

| | Year ended December 31, | | | |
|-------|-------------------------|-------------|-------------|----------|
| | 2016 | 2015 | | Variance |
| Total | \$8,029,808 | \$6,757,917 | \$1,271,891 | 19% |

The Company's operating expenses are comprised of research and development, selling, general and administrative expenses and depreciation and amortization expense. During the year ended December 31, 2016, operating expenses increased by 19% when compared to the prior year as outlined below.

Research and Development

| Year ended December 31, | | | |
|-------------------------|-------------|----------|----|
| 2016 | 2015 | Variance | |
| Total \$1,658,640 | \$1,605,667 | \$52,973 | 3% |

Research and development costs are related to both present and future products and are expensed in the period incurred. Current research and development costs are associated with product development and integration. During the year ended December 31, 2016, research and development costs increased 3% when compared to the prior year. The majority of the variance is due to an approximate \$0.14 million increase in expenditures for salaries and consulting. The additional personnel were needed for product development and engineering. Certification expenses increased \$0.04 million when compared to the prior year. Research and development expense related to retooling and design charges decreased \$0.13 million from the prior year. The majority of the expenses in 2015 were related to the EcoTouch thermostat introduced in fiscal 2015.

Selling, General and Administrative Expenses

| Year ended December 31, | | | |
|-------------------------|-------------|-------------|-----------------|
| 2016 | 2015 | Variance | |
| Total | \$6,336,879 | \$5,123,027 | \$1,213,852 24% |

Selling, general and administrative expenses increased for the year ended December 31, 2016 over the prior year by 24%. For the year end comparison, \$0.29 million of the variance is attributed to the costs associated with the 2016 contested proxy contest. The challenger was successful in obtaining a majority of shareholder votes to seat three new Board of Director members. Stated in the challengers proxy statement was listed that if successfully elected, the challengers would seek to recover from the Company, expenditures that were incurred for the contested proxy. The expenditures were \$0.16 million. Additional proxy related costs the Company incurred included solicitation services of \$0.03 million, stock transfer agent fees of \$0.05 million and legal fees of \$0.05 million. Also contributing to the variance were salary, benefits, consulting and temporary staffing of \$0.28 million, due to the addition of a controller, two channel account managers and an accounting staff position. Sales and use tax increased \$0.25 million from the prior year. During the year ended December 31, 2016, the state of Wisconsin performed a sales and use tax audit covering the period from January 1, 2012 through December 31, 2015. The audit resulted in an additional charge of \$0.12 million for sales and use tax for those periods audited. In addition, sales and use tax for the year ended December 31, 2016 increased \$0.04 million over the prior year period. Also contributing to the variance was a \$0.10 million increase for legal fees, \$0.03 million for bad debt expense, \$0.08 million in public company fees, \$0.03 million for accounting fees and \$0.04 million in stock option expense. These increases were offset by a decrease of \$0.03 million in director fees.

Income from Discontinued Operations, Net of Tax

| Year ended December 31, | | | |
|-------------------------|-------------|-------------|-----------------|
| 2016 | 2015 | Variance | |
| Total | \$2,627,758 | \$2,859,788 | \$(232,030) -8% |

Income from discontinued operations decreased \$0.23 million for the year ended December 31, 2016 over the prior year or 8%. For the year end comparison, \$0.13 million of the variance is attributed to reduced sales revenue from the prior year. Also contributing to the variance were increases in recurring cost of goods sold of \$0.07 million, the majority of which was salary, payroll taxes and benefits. Cost of non-recurring revenues increased \$0.11 million, the majority from salaries, payroll taxes and benefits. Selling, general and administrative costs increased \$0.1 million for the year ended December 31, 2016. The majority of the increase was \$0.06 million for commissions, \$0.06 million for salaries, payroll taxes and benefits offset by a decrease in rent and utilities of \$0.02 million.

EBITDA from Continuing Operations

Management believes that certain non-GAAP financial measures may be useful to investors in certain instances to provide additional meaningful comparisons between current results and results in prior operating periods. Adjusted earnings before interest, taxes, depreciation, amortization and stock-based compensation (“Adjusted EBITDA”) is a metric used by management and frequently used by the financial community. Adjusted EBITDA from continuing operations provides insight into an organization’s operating trends and facilitates comparisons between peer companies, since interest, taxes, depreciation, amortization and stock-based compensation can differ greatly between organizations as a result of differing capital structures and tax strategies. Adjusted EBITDA from continuing operations is one of the measures used for determining our debt covenant compliance. Adjusted EBITDA from continuing operations excludes certain items that are unusual in nature or not comparable from period to period. While management believes that non-GAAP measurements are useful supplemental information, such adjusted results are not intended to replace our GAAP financial results. Adjusted EBITDA from continuing operations is not, and should not be considered, an alternative to net income (loss), income (loss) from operations, or any other measure for determining operating performance or liquidity, as determined under accounting principles generally accepted in the United States (GAAP). In assessing the overall health of its business for the years ended December 31, 2016 and 2015, the Company excluded items in the following general category described below:

Stock-based compensation: The Company believes that because of the variety of equity awards used by companies, varying methodologies for determining stock-based compensation and the assumptions and estimates involved in those determinations, the exclusion of non-cash stock-based compensation enhances the ability of management and investors to understand the impact of non-cash stock-based compensation on our operating results. Further, the Company believes that excluding stock-based compensation expense allows for a more transparent comparison of its financial results to the previous year.

**RECONCILIATION OF NET LOSS FROM
CONTINUING OPERATIONS TO ADJUSTED EBITDA
FOR THE YEARS ENDED DECEMBER 31,**

| | 2016 | 2015 |
|---|---------------|---------------|
| Net loss from continuing operations | \$(4,003,671) | \$(3,048,892) |
| Interest expense, net | 60,246 | 69,441 |
| Provision (benefit) for income taxes | 20,114 | (3,214) |
| Depreciation and amortization | 34,289 | 29,223 |
| EBITDA – continuing operations | (3,889,022) | (2,953,442) |
| Adjustments: | | |
| Stock-based compensation | 55,050 | 14,383 |
| Adjusted EBITDA – continuing operations | \$(3,833,972) | \$(2,939,059) |

Liquidity and Capital Resources

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

The Company reported a net loss from continuing operations of \$4,003,671 for the year ended December 31, 2016, had cash used in operating activities from continuing operations of \$910,130, had an accumulated deficit of \$123,471,034 and total current liabilities in excess of current assets from continuing operations of \$916,099 as of December 31, 2016, excluding the Ethostream, LLC assets and liabilities held for sale. Since inception, the Company's primary sources of ongoing liquidity for operations have come through private and public offerings of equity securities, and the issuance of various debt instruments and asset-based lending.

On March 28, 2017, the Company and the Company's wholly-owned subsidiary, EthoStream LLC, entered into an Asset Purchase Agreement with DCI, whereby DCI would acquire all of the assets and certain liabilities of EthoStream for a cash purchase price of \$12.75 million, subject to an adjustment based on the net working capital of EthoStream on the closing date of the sale transaction. The Company's liquidity plan includes reviewing options for raising additional capital including, but not limited to, asset-based or equity financing, private placements, and the net proceeds received from the Ethostream LLC sale.

Working Capital

Our working capital (current assets in excess of current liabilities) from continuing operations decreased by \$976,495 during the year ended December 31, 2016 from a working capital surplus of \$60,396 at December 31, 2015, to a working capital deficit of \$916,099 at December 31, 2016.

Business Loan

On September 11, 2009, the Company entered into a Loan Agreement in the aggregate principal amount of \$300,000 with the Wisconsin Department of Commerce (the "Department"). The outstanding principal balance bears interest at the annual rate of 2%. Payment of interest and principal was made in the following manner: (a) payment of any and all interest that accrued from the date of disbursement commencing on January 1, 2010 and continuing on the first day of each consecutive month thereafter through and including December 31, 2010; (b) commencing on January 1, 2011 and continuing on the first day of each consecutive month thereafter through and including November 1, 2016, the Company was required to pay equal monthly installments of \$4,426; followed by a final installment on December 1, 2016, which included all remaining principal, accrued interest and other amounts owed by the Company to the Department under the Loan Agreement. The Company could prepay amounts outstanding under the Loan Agreement in whole or in part at any time without penalty. The Loan Agreement was secured by substantially all of the Company's assets. On September 24, 2014, the Department signed a subordination agreement of all the Company's security interests. The proceeds from this loan were used for the working capital requirements of the Company. The Loan Agreement contained covenants which required, among other things, that the Company keep and maintain 75 existing full-time positions and create and fill 35 additional full-time positions in Milwaukee, Wisconsin by December 31, 2012. On June 18, 2012, the Department agreed to permanently waive all penalties associated with the Company's noncompliance with this covenant. The outstanding borrowings under the agreement as of December 31, 2016 and 2015 were zero and \$52,579, respectively.

Promissory Note

On March 4, 2011, the Company sold all its Series 5 PLC product line assets to Wisconsin-based Dynamic Ratings, Inc. (“Purchaser”) under an Asset Purchase Agreement (“APA”). Per the APA, the Company signed an unsecured Promissory Note (the “Note”) due to Purchaser in the aggregate principal amount of \$700,000. The outstanding principal balance bears interest at the annual rate of 6% and was originally due on March 31, 2014. The Note may be prepaid in whole or in part, without penalty at any time. Payments not made when due, by maturity acceleration or otherwise, shall bear interest at the rate of 12% per annum from the date due until fully paid. Effective April 30, 2013, Purchaser approved an amendment to certain terms of the Note. Telkonet commenced a monthly payment of principal and interest of \$20,000 to be applied against the outstanding balance starting May 1, 2013. The interest rate remained unchanged at 6% and the maturity date was extended to January 1, 2016. During the year ended December 31, 2015, the Company made additional payments of \$20,000 in aggregate beyond the required monthly payments of principal and interest. The outstanding principal balance of the Note as of December 31, 2016 and 2015 was zero and \$40,761, respectively.

Kross Promissory Note

On August 4, 2016, the Board of Directors authorized the Company to reimburse Peter T. Kross (“Mr. Kross”), \$161,075 for expenses incurred related to his successful contested proxy. Effective June 27, 2016, Mr. Kross is a director of the Company and considered a related party. On August 30, 2016, Mr. Kross accepted an unsecured promissory note (“Kross Note”) for \$161,075 from the Company. The outstanding principal balance bears interest at the annual rate of 3.00%. Payment of interest and principal began on September 1, 2016 and will continue monthly on the first day of each month thereafter through and including June 1, 2017. The Company is required to pay equal monthly installments of \$16,330 which includes all remaining principal and accrued interest owed by the Company to Mr. Kross under the Kross Note. The Company may prepay in advance any unpaid principal or interest due under the Kross Note without premium or penalty. The principal balance of the Kross Note as of December 31, 2016 was \$97,127.

Revolving Credit Facility

On September 30, 2014, the Company and its wholly-owned subsidiary, EthoStream, as co-borrowers (collectively, the “Borrowers”), entered into a loan and security agreement (the “Heritage Bank Loan Agreement”), with Heritage Bank of Commerce, a California state chartered bank (“Heritage Bank”), governing a new revolving credit facility in a principal amount not to exceed \$2,000,000 (the “Credit Facility”). Availability of borrowings under the Credit Facility from time to time is subject to a borrowing base calculation based on the Company’s eligible accounts receivable and eligible inventory each multiplied by an applicable advance rate, with an overall limitation tied to the Company’s eligible accounts receivable. The Heritage Bank Loan Agreement is available for working capital and other general

business purposes. The outstanding principal balance of the Credit Facility bears interest at the Prime Rate plus 3.00%, which was 6.75% at December 31, 2016 and 6.50% at December 31, 2015. On October 9, 2014, as part of the Heritage Bank Loan Agreement, Heritage Bank was granted a warrant to purchase 250,000 shares of Telkonet common stock. The warrant has an exercise price of \$0.20 and expires October 9, 2021. On February 17, 2016, an amendment to the Credit Facility was executed extending the maturity date to September 30, 2018, unless earlier accelerated under the terms of the Heritage Bank Loan Agreement.

The Heritage Bank Loan Agreement also contains financial covenants that place restrictions on, among other things, the incurrence of debt, granting of liens and sale of assets. The Heritage Bank Loan Agreement also contains financial covenants that require the Borrowers to maintain a minimum EBITDA level, measured quarterly, and a minimum asset coverage ratio, measured monthly. A violation of any of these covenants could result in an event of default under the Heritage Bank Loan Agreement. Upon the occurrence of such an event of default or certain other customary events of defaults, payment of any outstanding amounts under the Credit Facility may be accelerated and Heritage Bank's commitment to extend credit under the Heritage Bank Loan Agreement may be terminated. The Heritage Bank Loan Agreement contains other representations and warranties, covenants, and other provisions customary to transactions of this nature. As of June 30, 2016, the Company was in violation of a financial performance covenant. Heritage Bank granted a waiver of that violation on August 11, 2016. By waiving the violation, Heritage Bank is not surrendering any of its other rights set forth in the Heritage Bank Loan Agreement. On October 27, 2016, an amendment to the Credit Facility was executed modifying the required minimum EBITDA level financial covenant as of September 30, 2016 and December 31, 2016. As of December 31, 2016, the Company was in compliance with the modified financial covenants. The outstanding balance on the Credit Facility was \$1,062,129 and \$901,771 at December 31, 2016 and 2015, respectively. The remaining available borrowing capacity was approximately \$107,000 at December 31, 2016.

On March 28, 2017, the Company and the Company's wholly-owned subsidiary, EthoStream LLC, entered into an Asset Purchase Agreement with DCI-Design Communications LLC, whereby DCI would acquire all of the assets and certain liabilities of EthoStream. Heritage Bank has provided the Company with its consent to the sale transaction. Upon closing of the sale transaction on March 29, 2017, the entire balance outstanding on the Credit Facility was repaid. The Company will work with Heritage Bank to execute a new agreement with the remaining operations of the Company as the sole borrower.

Cash Flow from Continuing Operations Analysis

Cash used in operating activities of continuing operations was \$910,130 and \$194,713 during the years ended December 31, 2016 and 2015, respectively. As of December 31, 2016, our primary capital needs included costs incurred to increase energy management sales, inventory procurement, and managing current liabilities. The working capital changes during the year ended December 31, 2016 were primarily related to an approximate \$512,000 decrease in accounts receivable, a \$125,000 increase in inventory, a \$649,000 decrease in accounts payable offset by a \$61,000 increase in deferred revenue, a \$119,000 increase in customer deposits and a \$80,000 increase in accrued liabilities and expenses. The primary working capital change during the year ended December 31, 2015 was related to an approximate increase of \$757,000 in accounts receivable, a \$292,000 decrease in inventory, a \$61,000 increase in prepaid expenses and other current assets, offset by a \$225,000 increase in accounts payable and a \$187,000 increase in deferred revenue and a \$120,000 increase in accrued liabilities and expenses. Accounts receivable fluctuates based on the negotiated billing terms with customers and collections. We purchase inventory based on forecasts and orders, and when those forecasts and orders change, the amount of inventory may also fluctuate. Accounts payable fluctuates with changes in inventory levels, volume of inventory purchases, and negotiated supplier and vendor terms.

Cash used in investing activities was \$5,352 and cash provided by investing activities was \$10,358 during the years ended December 31, 2016 and 2015, respectively. During the year ended December 31, 2016, the Company purchased \$36,629 of computer equipment. These assets will be depreciated over their respective estimated useful life. Restricted cash of \$31,277 related to a bonding requirement was released during the period once the performance bonds were cancelled.

Cash provided by financing activities was \$744,519 and \$235,455 during the years ended December 31, 2016 and 2015, respectively. During the year ended December 31, 2016, 5,211,542 warrants were exercised for an aggregate of 5,211,542 shares of the Company's common stock at \$0.13 per share. These warrants were originally granted to shareholders of the April 8, 2011 Series B preferred stock issuance. Total proceeds received were \$677,501. Net cash used in financing activities to repay indebtedness was \$93,340 and net proceeds from the line of credit were \$160,358 during the year ended December 31, 2016. Cash used in financing activities to repay indebtedness was \$300,612, shareholders exercised 2,019,236 warrants at \$0.13 resulting in proceeds of \$262,500 and cash borrowed on the line of credit was \$273,567 during the year ended December 31, 2015.

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

Management expects that global economic conditions, in particular the decreasing price of energy, along with competition will continue to present a challenging operating environment through 2017; therefore working capital management will continue to be a high priority for 2017. The Company's estimated cash requirements for our operations for the next 12 months is not anticipated to differ significantly from our present cash requirements for our continuing operations.

Inflation

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

Off-Balance Sheet Arrangements

None.

New Accounting Pronouncements

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

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

This item is not applicable.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

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

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

This item is not applicable.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

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

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Rule 13a-15(f) under the Exchange Act. The Company's internal control over financial reporting is designed to provide reasonable assurances regarding the reliability of financial reporting and the preparation of the financial statements of the Company in accordance with U.S. generally accepted accounting principles, or GAAP. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree or compliance with the policies or procedures may deteriorate.

With the participation of our Chief Executive Officer, our management conducted an evaluation of the effectiveness of our internal control over financial reporting as of December 31, 2016 based on the framework in Internal Control—Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on our evaluation and the material weaknesses described below, management concluded that the Company did not maintain effective internal control over financial reporting as of December 31, 2016 based on the COSO framework criteria. Management has identified control deficiencies regarding the lack of segregation of duties due to the limited size of the Company's accounting department, a failure to implement adequate internal control over financial reporting including in our IT general control environment, and the need for a stronger internal control environment particularly in our financial reporting and close process. We lack sufficient personnel resources and technical accounting and reporting expertise to appropriately address certain accounting and financial reporting matters in accordance with generally accepted accounting principles. We did not have an adequate process or appropriate controls in place to support the accurate reporting of our financial results and disclosures on our Form 10-K. Management of the Company believes that these material weaknesses are due to the small size of the Company's accounting staff. The small size of the Company's accounting staff may prevent adequate controls in the future, such as segregation of duties, due to the cost/benefit of such remediation. We do expect to hire additional personnel to remediate these control deficiencies in the future.

These control deficiencies could result in a misstatement of account balances resulting in a more than remote likelihood that a material misstatement to our financial statements may not be prevented or detected on a timely basis.

Accordingly, we have determined that these control deficiencies as described above constitute material weaknesses.

In light of these material weaknesses, we performed additional analyses and procedures in order to conclude that our consolidated financial statements for the year ended December 31, 2016 and 2015 included in this Annual Report on Form 10-K were fairly stated in accordance with GAAP. Accordingly, management believes that despite our material weaknesses, our financial statements for the years ended December 31, 2016 and 2015 are fairly stated, in all material respects, in accordance with GAAP.

We are reviewing actions to take to remediate the identified material weaknesses. As we continue to evaluate and work to improve our internal controls over financial reporting, our senior management may determine to take additional measures to address control deficiencies or modify the remediation efforts. Until remediation efforts that our senior management identifies as necessary, are completed, tested, and determined effective, the material weaknesses described above will continue to exist.

Under applicable Securities Law, the Company is not required to obtain an attestation report from the Company's independent registered public accounting firm regarding internal control over financial reporting, and accordingly, such an attestation has not been obtained or included in this Annual Report.

Changes in Internal Controls

Other than the material weaknesses discussed above, during the year ended December 31, 2016, there have been no changes in our internal control over financial reporting that have materially affected or are reasonably likely to materially affect our internal controls over financial reporting.

ITEM 9B. OTHER INFORMATION.

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE.

Pursuant to General Instruction G(3), information on directors and executive officers of the Registrant and corporate governance matters is incorporated by reference from our definitive proxy statement for the annual shareholder meeting to be held on June 1, 2017.

Code of Ethics

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

ITEM 11. EXECUTIVE COMPENSATION.

Pursuant to General Instruction G(3), information on executive compensation is incorporated by reference from our definitive proxy statement for the annual shareholder meeting to be held on June 1, 2017.

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

Pursuant to General Instructions G(3), information on security ownership of certain beneficial owners and management and related stockholder matters are incorporated by reference from our definitive proxy statement for the annual shareholder meeting to be held on June 1, 2017.

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

Pursuant to General Instruction G(3), information on certain relationships and related transactions and director independence is incorporated by reference from our definitive proxy statement for the annual shareholder meeting to be held on June 1, 2017.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES.

Pursuant to General Instruction G(3), information on principal accounting fees and services is incorporated by reference from our definitive proxy statement for the annual shareholder meeting to be held on June 1, 2017.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES.

(a) Documents filed as part of this report.

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

(1)

Report of BDO USA, LLP on Consolidated Financial Statements as of and for the years ended December 31, 2016 and 2015

Consolidated Balance Sheets as of December 31, 2016 and 2015

Consolidated Statements of Operations for the Years ended December 31, 2016 and 2015

Consolidated Statements of Stockholders' Equity for the Years ended December 31, 2016 and 2015

Consolidated Statements of Cash Flows for Years ended December 31, 2016 and 2015

Notes to Consolidated Financial Statements

(2) Financial Statement Schedules

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

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

See Exhibit Index located immediately following this Item 15

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

EXHIBIT INDEX

The following exhibits are included herein or incorporated by reference:

| Exhibit Number | Description Of Document |
|---------------------------|--|
| 2.1 | Asset Purchase Agreement by and between Telkonet, Inc. and Smart Systems International, dated as of February 23, 2007 (incorporated by reference to our Form 8-K filed on March 2, 2007) |
| 2.2 | Unit Purchase Agreement by and among Telkonet, Inc., EthoStream, LLC and the members of EthoStream, LLC dated as of March 15, 2007 (incorporated by reference to our Form 8-K filed on March 16, 2007) |
| 2.3 | Asset Purchase Agreement by and between Telkonet Inc. and Dynamic Ratings, Inc. dated as of March 4, 2011(incorporated by reference to our Form 8-K filed on March 9, 2011) |
| 3.1 | Articles of Incorporation of the Company (incorporated by reference to our Form 8-K (No. 000-27305), filed on August 31, 2000 and our Form S-8 (No. 333-47986), filed on October 16, 2000) |
| 3.2 | Bylaws of the Company (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003) |
| 3.3 | Amendment to Amended and Restated Articles of Incorporation (incorporated by reference to our Form 8-K (No. 001-31972), filed November 18, 2009) |
| 3.4 | Amendment to Amended and Restated Articles of Incorporation (incorporated by reference to our Form 8-K filed on August 9, 2010) |
| 3.5 | Amendment to Amended and Restated Articles of Incorporation, (incorporated by reference to our Form 8-K filed on April 13, 2011) |
| 3.6 | Bylaws of the Registrant (incorporated by reference to our Registration Statement on Form S-1 (No. 333-108307), filed on August 28, 2003) |
| 3.7 | Amendment to the Articles of Incorporation filed with the Secretary of State of Utah (incorporated by reference to our Form 8-K filed on April 8, 2011) |
| 4.1 | Senior Convertible Note by Telkonet, Inc. in favor of Portside Growth & Opportunity Fund (incorporated by reference to our Form 8-K (No. 001-31972), filed on October 31, 2005) |
| 4.2 | Warrant to Purchase Common Stock by Telkonet, Inc. in favor of Kings Road Investments Ltd. (incorporated by reference to our Form 8-K (No. 001-31972), filed on October 31, 2005) |
| 4.3 | Form of Warrant to Purchase Common Stock (incorporated by reference to our Current Report on Form 8-K (No. 001-31972), filed on September 6, 2006) |
| 4.4 | Form of Accelerated Payment Option Warrant to Purchase Common Stock (incorporated by reference to our Registration Statement on Form S-3 (No. 333-137703), filed on September 29, 2006) |
| 4.5 | Form of Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K (No. 001-31972) filed on May 12, 2008) |
| 4.6 | Promissory Note, dated September 11, 2009, by and between Telkonet Inc. and the Wisconsin Department of Commerce (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 17, 2009) |
| 4.7 | Form of Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K filed on November 18, 2009) |
| 4.8 | Form of Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K filed on August 9, 2010) |

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- 4.9 Promissory Note, dated March 4, 2011, issued by Telkonet Inc. to Dynamic Ratings, Inc. (incorporated by reference to our Form 8-K filed on March 9, 2011)
- 4.10 Form of Warrant to Purchase Common Stock (incorporated by reference to our Form 8-K filed on April 13, 2011)

- 10.1 Amended and Restated Stock Option Plan (incorporated by reference to our Registration Statement on Form S-8 (No. 333-161909), filed on September 14, 2009)
- 10.2 Loan Agreement, dated September 11, 2009, by and between Telkonet, Inc. and the Wisconsin Department of Commerce (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 17, 2009)
- 10.3 General Business Security Agreement, dated September 11, 2009, by and between Telkonet, Inc. and the Wisconsin Department of Commerce (incorporated by reference to our Form 8-K (No. 001-31972) filed on September 17, 2009)
- 10.4 Series A Convertible Redeemable Preferred Stock Securities Purchase Agreement, dated November 16, 2009 (incorporated by reference to our Form 8-K filed on November 18, 2009)
- 10.5 Series A Convertible Redeemable Preferred Stock Registration Rights Agreement, dated November 16, 2009 (incorporated by reference to our Form 8-K filed on November 18, 2009)
- 10.6 Form of Executive Officer Reimbursement Agreement (incorporated by reference to our Form 8-K filed on November 18, 2009)

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- 10.7 Form of Director and Officer Indemnification Agreement (incorporated by reference to our Form 10-K filed on March 31, 2010)
- 10.8 Series B Convertible Redeemable Preferred Stock Securities Purchase Agreement, dated August 4, 2010 (incorporated by reference to our Form 8-K filed on August 9, 2010)
- 10.9 Series B Convertible Redeemable Preferred Stock Registration Rights Agreement, dated August 4, 2010 (incorporated by reference to our Form 8-K filed on August 9, 2010)
- 10.10 Form of Director Reimbursement Agreement (incorporated by reference to our Form 8-K filed on August 9, 2010)
- 10.11 Form of Transition Agreement and Release (incorporated by reference to our Form 8-K filed on August 9, 2010)
- 10.12 2010 Stock Option and Incentive Plan (incorporated by reference to our Definitive Proxy Statement filed on September 29, 2010)
- 10.13 Distribution Agreement by and between, Telkonet Inc. and Dynamic Ratings, Inc., dated as of March 4, 2011(incorporated by reference to our Form 8-K filed on March 9, 2011)
- 10.14 Consulting Agreement by and between Telkonet Inc. and Dynamic Ratings, Inc, dated as of March 4, 2011 (incorporated by reference to our Form 8-K filed on March 9, 2011)
- 10.15 Securities Purchase Agreement, dated April 8, 2011, by and among Telkonet, Inc. and the parties listed therein, (incorporated by reference to our Form 8-K filed on April 13, 2011)
- 10.16 Registration Rights Agreement, dated April 8, 2011, by and among Telkonet, Inc. and the parties listed therein, (incorporated by reference to our Form 8-K filed on April 13, 2011)
- *10.17 Amended and Restated Employment Agreement by and between Telkonet, Inc. and Jason L. Tienor, dated as of January 3, 2016 (incorporated by reference as an exhibit to Form 10-K filed March 31, 2017)
- *10.18 Amended and Restated Employment Agreement by and between Telkonet, Inc. and Jeffrey J. Sobieski, dated as of January 3, 2016 (incorporated by reference as an exhibit to Form 10-K filed March 31, 2017)
- *10.19 Amended and Restated Employment Agreement by and between Telkonet, Inc. and Matthew P. Koch, dated as of January 3, 2016 (incorporated by reference as an exhibit to Form 10-K filed March 31, 2017)
- *10.20 Employment Agreement by and between Telkonet, Inc. and Gerrit J. Reinders, dated as of May 1, 2015 (incorporated by reference to our Form 8-K filed June 6, 2015)
- *10.21 Employment Agreement by and between Telkonet, Inc. and F. John Stark III, dated as of November 14, 2015 (incorporated by reference to our Form 8-K filed November 17, 2015)
- 10.22 Amendment to Consulting Agreement, dated April 30, 2013, by and between Telkonet, Inc. and Dynamic Ratings, Inc. (incorporated by reference to our Form 8-K filed May 6, 2013)
- 10.23 Business Financing Agreement, dated May 31, 2013, by and between Telkonet, Inc. and Bridge Bank N.A.(incorporated by reference to our Form 8-K filed June 6, 2013)
- 10.24 Loan and Security Agreement, dated September 30, 2014, by and between Telkonet, Inc. and Heritage Bank of Commerce(incorporated by reference to our Form 8-K filed October 2, 2014)
- 10.25 First Amendment to Loan and Security Agreement, dated February 17, 2016, by and between Telkonet, Inc. and Heritage Bank of Commerce(incorporated by reference to our Form 8-K filed February 23, 2016)
- 10.26 Second Amendment to Loan and Security Agreement, dated October 27, 2016, by and between Telkonet, Inc. and Heritage Bank of Commerce(incorporated by reference to our Form 8-K filed October 28, 2016)
- 10.27 2010 Amended and Restated Stock Option and Incentive Plan (amended and restated effective as of November 17, 2016, incorporated by reference as an exhibit to Form 10-K filed March 31, 2017)
- 14 Code of Ethics (incorporated by reference to our Form 10-KSB (No. 001-31972), filed on March 30, 2004)
- 21 Telkonet, Inc. Subsidiaries (incorporated by reference to our Form 10-K (No. 001-31972) filed March 16, 2007)
- 23.1 Consent of BDO USA, LLP, Independent Registered Public Accounting Firm
- 31.1 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Jason L. Tienor

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- 31.2 Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Richard E. Mushrush
- 32.1 Certification of Jason L. Tienor pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Richard E. Mushrush pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 101.INS XBRL Instance Document
- 101.SCH XBRL Schema Document
- 101.CAL XBRL Calculation Linkbase Document
- 101.DEF XBRL Definition Linkbase Document
- 101.LAB XBRL Label Linkbase Document
- 101.PRE XBRL Presentation Linkbase Document

* Indicates management contract or compensatory plan or arrangement.

SIGNATURES

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

TELKONET, INC.

Dated: April 3, 2017 /s/ Jason L. Tienor
Jason L. Tienor

Chief Executive Officer

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

| Name | Position | Date |
|---|---|---------------|
| /s/ Jason L. Tienor Jason Tienor | Chief Executive Officer and Director (principal executive officer) | April 3, 2017 |
| /s/ Richard E. Mushrush | Chief Financial Officer (principal financial officer) | April 3, 2017 |
| /s/Arthur E. Byrnes Arthur E. Byrnes | Chairman of the Board | April 3, 2017 |
| /s/ Tim S. Ledwick Tim S. Ledwick | Director | April 3, 2017 |
| /s/ Peter T. Kross Peter T. Kross | Director | April 3, 2017 |
| /s/ Leland D. Blatt Leland D. Blatt | Director | April 3, 2017 |

CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2016 AND 2015

FORMING A PART OF ANNUAL REPORT

PURSUANT TO THE SECURITIES EXCHANGE ACT OF 1934

TELKONET, INC.

TELKONET, INC.

Index to Financial Statements

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders

Telkonet, Inc.

Waukesha, Wisconsin

We have audited the accompanying consolidated balance sheets of Telkonet, Inc., (the “Company”) as of December 31, 2016 and 2015 and the related consolidated statements of operations, stockholders’ equity, and cash flows for each of the two years in the period ended December 31, 2016. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Telkonet, Inc. at December 31, 2016 and 2015, and the results of its operations and its cash flows for each of the two years in the period ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America.

/s/ BDO USA, LLP

Milwaukee, Wisconsin

April 3, 2017

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TELKONET, INC.**CONSOLIDATED BALANCE SHEETS****DECEMBER 31, 2016 AND 2015**

| | December 31, 2016 | December 31, 2015 |
|---|------------------------------|------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$685,115 | \$679,803 |
| Restricted cash on deposit | – | 31,277 |
| Accounts receivable, net | 1,403,772 | 1,948,069 |
| Inventories | 777,202 | 652,493 |
| Prepaid expenses and other current assets | 205,328 | 146,219 |
| Current assets held for sale | 7,256,714 | 757,564 |
| Total current assets | 10,328,131 | 4,215,425 |
| Property and equipment, net | 143,907 | 141,567 |
| Other assets: | | |
| Deposits | – | 23,871 |
| Deferred financing costs, net | – | 14,633 |
| Long-term assets held for sale | – | 6,582,254 |
| Total other assets | – | 6,620,758 |
| Total Assets | \$10,472,038 | \$10,977,750 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$765,617 | \$1,414,648 |
| Accrued liabilities and expenses | 774,645 | 695,027 |
| Notes payable – current | – | 93,340 |
| Related party payable | 97,127 | – |
| Line of credit | 1,062,129 | 901,771 |
| Deferred revenues-current | 184,793 | 243,804 |
| Deferred lease liability – current | 3,942 | 2,420 |
| Customer deposits | 165,830 | 46,455 |
| Deferred income taxes - current | 933,433 | – |
| Current liabilities held for sale | 1,020,540 | 851,273 |
| Total current liabilities | 5,008,056 | 4,248,738 |
| Long-term liabilities: | | |
| Deferred revenue - long term | 120,421 | – |

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| | | |
|--|---------------|---------------|
| Deferred lease liability - long term | 23,761 | 27,707 |
| Deferred income taxes - long-term | – | 734,047 |
| Long-term liabilities held for sale | – | 76,096 |
| Total long-term liabilities | 144,182 | 837,850 |
| Commitments and contingencies | | |
| Stockholders' Equity | | |
| Series A, par value \$.001 per share; 215 shares issued, 185 shares outstanding at December 31, 2016 and 2015, preference in liquidation of \$1,452,114 and \$1,377,886 as of December 31, 2016 and 2015, respectively | 1,340,566 | 1,340,566 |
| Series B, par value \$.001 per share; 538 shares issued, 52 and 55 shares outstanding at December 31, 2016 and 2015, preference in liquidation of \$393,435 and \$394,055 as of December 31, 2016 and 2015, respectively | 362,059 | 382,951 |
| Common stock, par value \$.001 per share; 190,000,000 shares authorized; 132,774,475 and 127,054,848 shares issued and outstanding at December 31, 2016 and 2015, respectively | 132,774 | 127,054 |
| Additional paid-in-capital | 126,955,435 | 126,135,712 |
| Accumulated deficit | (123,471,034) | (122,095,121) |
| Total stockholders' equity | 5,319,800 | 5,891,162 |
| Total Liabilities and Stockholders' Equity | \$10,472,038 | \$10,977,750 |

See accompanying notes to consolidated financial statements

TELKONET, INC.**CONSOLIDATED STATEMENTS OF OPERATIONS****FOR THE YEARS ENDED DECEMBER 31, 2016 AND 2015**

| | 2016 | 2015 |
|---|----------------|--------------|
| Revenues, net: | | |
| Product | \$7,796,319 | \$7,242,503 |
| Recurring | 459,695 | 285,114 |
| Total Net Revenues | 8,256,014 | 7,527,617 |
| Cost of Sales: | | |
| Product | 4,024,675 | 3,600,407 |
| Recurring | 124,842 | 151,958 |
| Total Cost of Sales | 4,149,517 | 3,752,365 |
| Gross Profit | 4,106,497 | 3,775,252 |
| Operating Expenses: | | |
| Research and development | 1,658,640 | 1,605,667 |
| Selling, general and administrative | 6,336,879 | 5,123,027 |
| Depreciation and amortization | 34,289 | 29,223 |
| Total Operating Expenses | 8,029,808 | 6,757,917 |
| Operating Loss | (3,923,311) | (2,982,665) |
| Other (Expenses) Income: | | |
| Interest (expense), net | (60,246) | (69,441) |
| Total Other (Expenses) | (60,246) | (69,441) |
| Loss from Continuing Operations before Provision (Benefit) for Income Taxes | (3,983,557) | (3,052,106) |
| Provision (Benefit) for Income Taxes | 20,114 | (3,214) |
| Net loss from continuing operations | (4,003,671) | (3,048,892) |
| Discontinued Operations: | | |
| Income from Discontinued Operations (net of tax) | 2,627,758 | 2,859,788 |
| Net loss | \$(1,375,913) | \$(189,104) |
| Accretion of preferred dividends and discount | - | (18,253) |
| Net loss attributable to common stockholders | \$(1,375,913) | \$(207,357) |
| Net income (loss) per common share: | | |

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| | | | | |
|---|-------------|---|-------------|---|
| Basic - continuing operations | \$ (0.03 |) | \$ (0.02 |) |
| Basic - discontinued operations | \$ 0.02 | | \$ 0.02 | |
| Basic - net loss attributable to common stockholders | \$ (0.01 |) | \$ (0.00 |) |
| Diluted - continuing operations | \$ (0.03 |) | \$ (0.02 |) |
| Diluted - discontinued operations | \$ 0.02 | | \$ 0.02 | |
| Diluted - net loss attributable to common stockholders | \$ (0.01 |) | \$ (0.00 |) |
| Weighted Average Common Shares Outstanding used in computing basic net loss per share | 132,774,475 | | 125,859,903 | |
| Weighted Average Common Shares Outstanding used in computing diluted net loss per share | 132,774,475 | | 125,859,903 | |

See accompanying notes to consolidated financial statements

TELKONET, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2016 AND 2015

| | Series A Preferred Stock Shares | Series A Preferred Stock Amount | Series B Preferred Stock Share | Series B Preferred Stock Amount | Common Shares | Common Stock Amount | Additional Paid-in Capital | Accumulated Deficit | Total Stockholders' Equity |
|---|---|--|--|--|------------------|---------------------------|----------------------------------|------------------------|----------------------------------|
| Balance at January 1, 2015 | – | \$– | 55 | \$372,030 | 125,035,612 | \$125,035 | \$125,908,476 | \$(121,906,017) | \$4,499,524 |
| Shares issued to preferred stockholders for warrants exercised at \$0.13 per share | – | – | – | – | 2,019,236 | 2,019 | 260,481 | – | 262,500 |
| Stock-based compensation expense related to employee stock options | – | – | – | – | – | – | 14,383 | – | 14,383 |
| Accretion of redeemable preferred stock dividends | – | 18,454 | – | 10,921 | – | – | (47,628) | – | (18,253) |
| Reclassification from temporary equity to permanent equity | 185 | 1,322,112 | – | – | – | – | – | – | 1,322,112 |
| Net loss | – | – | – | – | – | – | – | (189,104) | (189,104) |
| Balance at December 31, 2015 | 185 | \$1,340,566 | 55 | \$382,951 | 127,054,848 | \$127,054 | \$126,135,712 | \$(122,095,121) | \$5,891,162 |

See accompanying notes to the consolidated financial statements

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TELKONET, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (CONTINUED)

FOR THE YEARS ENDED DECEMBER 31, 2016 AND 2015

| | Series A Preferred Stock | Series A Preferred Stock | Series B Preferred Stock | Series B Preferred Stock | Common | Common Stock | Additional Paid-in Capital | Accumulated Deficit | Total Stockholders' Equity |
|--|--------------------------|--------------------------|--------------------------|--------------------------|-------------|--------------|----------------------------|---------------------|----------------------------|
| | Shares | Amount | Shares | Amount | Shares | Amount | Capital | Deficit | Equity |
| Balance at January 1, 2016 | 185 | \$1,340,566 | 55 | \$382,951 | 127,054,848 | \$127,054 | \$126,135,712 | \$(122,095,121) | \$5,891,162 |
| Shares issued to directors at \$0.18 per share | — | — | — | — | 392,700 | 393 | 71,607 | — | 72,000 |
| Stock-based compensation expense related to employee stock options | — | — | — | — | — | — | 55,050 | — | 55,050 |
| Shares issued to preferred stockholders for warrants exercised at \$0.13 per share | — | — | — | — | 5,211,542 | 5,212 | 672,289 | — | 677,501 |
| Shares issued on conversion of preferred stock at \$0.13 per share | — | — | (3) | (15,000) | 115,385 | 115 | 14,885 | — | — |
| Accrued dividends adjustment due to | — | — | — | (5,892) | — | — | 5,892 | — | — |

preferred
stock
conversion

| | | | | | | | | | | |
|------------------------------------|-----|-------------|----|-----------|-------------|-----------|---------------|-----------------|--------------|-------------|
| Net loss | - | - | - | - | - | - | - | - | (1,375,913) | (1,375,913) |
| Balance at December 31, 2016 | 185 | \$1,340,566 | 52 | \$362,059 | 132,774,475 | \$132,774 | \$126,955,435 | \$(123,471,034) | \$5,319,800 | |

See accompanying notes to the consolidated financial statements

TELKONET, INC.**CONSOLIDATED STATEMENTS OF CASH FLOWS****FOR THE YEARS ENDED DECEMBER 31, 2016 AND 2015**

| | 2016 | 2015 |
|--|---------------|---------------|
| Cash Flows from Operating Activities: | | |
| Net loss from continuing operations | \$(4,003,671) | \$(3,048,892) |
| Net income from discontinued operations | 2,627,758 | 2,859,788 |
| Adjustments to reconcile net loss from continuing operations to cash used in operating activities of continuing operations: | | |
| Stock-based compensation expense | 55,050 | 14,383 |
| Stock issued to directors as compensation | 72,000 | - |
| Amortization of deferred financing costs | 14,633 | 18,949 |
| Depreciation | 34,289 | 29,223 |
| Provision for doubtful accounts, net of recoveries | 32,047 | (102,721) |
| Related party payable | 161,075 | - |
| Deferred income taxes | 199,386 | 199,386 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 512,250 | (756,961) |
| Inventories | (124,709) | 292,102 |
| Prepaid expenses and other current assets | (59,109) | (61,549) |
| Deposits and other long term assets | 23,871 | - |
| Accounts payable | (649,031) | 225,283 |
| Accrued liabilities and expenses | 79,618 | 120,130 |
| Deferred revenue | 61,410 | 186,958 |
| Related party payable | (63,948) | - |
| Customer deposits | 119,375 | (157,230) |
| Deferred lease liability | (2,424) | (13,562) |
| Net Cash Used In Operating Activities of Continuing Operations | (910,130) | (194,713) |
| Net Cash Provided By Operating Activities of Discontinued Operations | 176,275 | 54,018 |
| Net Cash Used In Operating Activities | (733,855) | (140,695) |
| Cash Flows From Investing Activities: | | |
| Purchase of property and equipment | (36,629) | (42,081) |
| Change in restricted cash | 31,277 | 31,723 |
| Net Cash Used In Investing Activities of Continuing Operations | (5,352) | (10,358) |
| Cash Flows From Financing Activities: | | |
| Payments on notes payable | (93,340) | (300,612) |
| Proceeds from exercise of warrants | 677,501 | 262,500 |
| Net proceeds from line of credit | 160,358 | 273,567 |

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| | | |
|--|-----------|-----------|
| Net Cash Provided By Financing Activities of Continuing Operations | 744,519 | 235,455 |
| Net increase in cash and cash equivalents | 5,312 | 84,402 |
| Cash and cash equivalents at the beginning of the year | 679,803 | 595,401 |
| Cash and cash equivalents at the end of the year | \$685,115 | \$679,803 |

See accompanying notes to consolidated financial statements

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TELKONET, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

FOR THE YEARS ENDED DECEMBER 31, 2016 AND 2015

| | 2016 | 2015 |
|--|----------|----------|
| Supplemental Disclosures of Cash Flow Information: | | |
| Cash transactions: | | |
| Cash paid during the year for interest | \$57,266 | \$54,428 |
| Cash paid during the year for income taxes, net of refunds | 15,090 | (10,431) |
| Non-cash transactions: | | |
| Accretion of dividends on redeemable preferred stock | – | 47,628 |

See accompanying notes to consolidated financial statements

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2016 AND 2015

NOTE A – SUMMARY OF ACCOUNTING POLICIES

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

Business and Basis of Presentation

Telkonet, Inc. (the “Company”, “Telkonet”), formed in 1999 and incorporated under the laws of the state of Utah, is the creator of the EcoSmart Platform of intelligent automation solutions designed to optimize energy efficiency, comfort and analytics in support of the emerging Internet of Things (“IoT”). Telkonet’s growth is focused on EcoSmart, its IoT division offering intelligent automation solutions.

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

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries, Telkonet Communications, Inc., and EthoStream, LLC. The current year and prior year accounts of Ethostream LLC have been classified as held for sale on the consolidated balance sheet and as discontinued operations on the consolidated statement of operations and the consolidated statement of cash flows. All significant intercompany balances and transactions have been eliminated in consolidation.

The Company operates in one reportable segment based on management's view of its business for purposes of evaluating performance and making operating decisions. The Company utilizes shared services including but not limited to, human resources, payroll, finance, sales, support services, as well as certain shared assets and sales, general and administrative costs. The Company's approach is to make operational decisions and assess performance based on delivering products and services that together provide solutions to its customer base, utilizing a functional management structure and shared services where possible. Based upon this business model, the chief operating decision maker only reviews consolidated financial information.

Unless otherwise noted, all financial information in the consolidated financial statement footnotes reflect the Company's results from continuing operations.

Liquidity and Financial Condition

The Company reported a net loss of \$4,003,671 from continuing operations for the year ended December 31, 2016, had cash used in operating activities from continuing operations of \$910,130, had an accumulated deficit of \$123,471,034 and total current liabilities in excess of current assets from continuing operations of \$916,099 as of December 31, 2016 excluding the Ethostream, LLC assets and liabilities held for sale. Since inception, the Company's primary sources of ongoing liquidity for operations have come through private and public offerings of equity securities, and the issuance of various debt instruments and asset-based lending.

On February 17, 2016, an amendment to the revolving credit facility with Heritage Bank of Commerce was executed extending the maturity date of the revolving credit facility to September 30, 2018, unless earlier accelerated under the terms of the Loan and Security Agreement (the "Loan Agreement"). The Loan Agreement is available for working capital and other lawful general corporate purposes. The outstanding principal balance of the revolving credit facility bears interest at the Prime Rate plus 3.00%. The outstanding balance was \$1,062,129 as of December 31, 2016 and the remaining available borrowing capacity was approximately \$107,000. As of December 31, 2016, the Company was in compliance with all financial covenants.

On March 28, 2017, the Company and the Company's wholly-owned subsidiary, EthoStream LLC, entered into an Asset Purchase Agreement with DCI-Design Communications LLC ("DCI"), whereby DCI would acquire all of the assets and certain liabilities of EthoStream for a cash purchase price of \$12,750,000, subject to an adjustment based on the net working capital of EthoStream on the closing date of the sale transaction. The Company's liquidity plan includes reviewing options for raising additional capital including, but not limited to, asset-based or equity financing, private placements, and the net proceeds received from the Ethostream LLC sale.

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2016 AND 2015

Concentrations of Credit Risk

Financial instruments and related items, which potentially subject the Company to concentrations of credit risk, consist primarily of cash, cash equivalents and trade receivables. The Company places its cash and temporary cash investments with credit quality institutions. At times, such investments may be in excess of the FDIC insurance limit. The Company has never experienced any losses related to these balances. With respect to trade receivables, the Company performs ongoing credit evaluations of its customers' financial conditions and limits the amount of credit extended when deemed necessary. The Company provides credit to its customers primarily in the United States in the normal course of business. The Company routinely assesses the financial strength of its customers and, as a consequence, believes its trade receivables credit risk exposure is limited.

Cash and Cash Equivalents

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

Restricted Cash on Deposit

During 2014, the Company was awarded a contract with a bonding requirement. The Company satisfied this requirement during the year ended December 31, 2014 with cash collateral supported by an irrevocable standby letter of credit in the amount of \$63,000. The Company continues to execute contracts with bonding requirements and maintains this cash collateral on deposit for current and future projects. The amount which was presented as restricted cash on deposit on the consolidated balance sheet as of December 31, 2015 was released in 2016. The outstanding balance as of December 31, 2016 and 2015 was zero and \$31,277, respectively.

Accounts Receivable

Accounts receivable are uncollateralized customer obligations due under normal trade terms. The Company records allowances for doubtful accounts based on customer-specific analysis and general matters such as current assessment of past due balances and economic conditions. The Company writes off accounts receivable when they become uncollectible. The allowance for doubtful accounts was \$34,573 and \$13,299 at December 31, 2016 and 2015, respectively. Management identifies a delinquent customer based upon the delinquent payment status of an outstanding invoice, generally greater than 30 days past due date. The delinquent account designation does not trigger an accounting transaction until such time the account is deemed uncollectible. The allowance for doubtful accounts is determined by examining the reserve history and any outstanding invoices that are over 30 days past due as of the end of the reporting period. Accounts are deemed uncollectible on a case-by-case basis, at management's discretion based upon an examination of the communication with the delinquent customer and payment history. Typically, accounts are only escalated to "uncollectible" status after multiple attempts at collection have proven unsuccessful.

The allowance for doubtful accounts for the years ended December 31 is as follows:

| | 2016 | 2015 |
|------------------------------|----------|----------|
| Beginning balance | \$13,299 | \$25,973 |
| Provision charged to expense | 32,047 | 6,618 |
| Deductions | (10,773) | (19,292) |
| Ending balance | \$34,573 | \$13,299 |

Inventories

Inventories consist of thermostats, sensors and controllers for Telkonet's EcoSmart product platform. These inventories are purchased for resale and do not include manufacturing labor and overhead. Inventories are stated at the lower of cost or market determined by the first in, first out (FIFO) method. The Company's inventories are subject to technological obsolescence. Management evaluates the net realizable value of its inventories on a quarterly basis and when it is determined that the Company's carrying cost of such excess and obsolete inventories cannot be recovered in full, a charge is taken against income for the difference between the carrying cost and the estimated realizable amount. The charge (benefit) taken against income was approximately \$(18,900) and \$(2,000) for the years ended December 31, 2016 and 2015, respectively.

Property and Equipment

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

Fair Value of Financial Instruments

The Company's financial instruments include cash and cash equivalents, restricted cash on deposit, accounts receivable, accounts payable, line of credit, notes payable, and certain accrued liabilities. The carrying amounts of these assets and liabilities approximate fair value due to the short maturity of these instruments (Level 1 instruments), except for the line of credit and notes payable. The carrying amount of the line of credit and notes payable approximates fair value due to the interest rate and terms approximating those available to the Company for similar obligations (Level 2 instruments).

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TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2016 AND 2015

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

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2: Quoted prices in markets that are not active, or inputs which are observable, either directly or indirectly, for substantially the full term of the asset or liability; or

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and are unobservable.

Long-Lived Assets

The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable in accordance with ASC 360-10. Recoverability is measured by comparison of the carrying amount to the future net cash flows which the assets are expected to generate. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds their fair value. Based on the annual assessment for impairment performed during 2016 and 2015, no impairment was recorded.

Income (Loss) per Common Share

The Company computes earnings per share under ASC 260-10, "Earnings Per Share". Basic net income (loss) per common share is computed using the treasury stock method, which assumes that the proceeds to be received on exercise of outstanding stock options and warrants are used to repurchase shares of the Company at the average market price of the common shares for the year. Dilutive common stock equivalents consist of shares issuable upon the exercise of the Company's outstanding stock options and warrants. For the years ended December 31, 2016 and 2015, there were 3,132,725 and 7,463,635 shares of common stock underlying options and warrants excluded due to these instruments being anti-dilutive, respectively.

Use of Estimates

The preparation of financial statements in conformity with United States of America (U.S.) generally accepted accounting principles (GAAP) require management to make certain estimates, judgments and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Estimates are used when accounting for items and matters such as revenue recognition and allowances for uncollectible accounts receivable, inventory obsolescence, depreciation and amortization, long-lived and intangible asset valuations, impairment assessments, taxes and related valuation allowance, income tax provisions, stock-based compensation, and contingencies. The Company believes that the estimates, judgments and assumptions are reasonable, based on information available at the time they are made. Actual results may differ from those estimates.

Income Taxes

The Company accounts for income taxes in accordance with ASC 740-10 "Income Taxes." Under this method, deferred income taxes (when required) are provided based on the difference between the financial reporting and income tax bases of assets and liabilities and net operating losses at the statutory rates enacted for future periods. The Company has a policy of establishing a valuation allowance when it is more likely than not that the Company will not realize the benefits of its deferred income tax assets in the future.

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2016 AND 2015

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

Revenue Recognition

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

Multiple-Element Arrangements (“MEAs”): The Company accounts for contracts that have both product and installation under the MEAs guidance in ASC 605-25. Arrangements under such contracts may include multiple deliverables consisting of a combination of equipment and services. The deliverables included in the MEAs are separated into more than one unit of accounting when (i) the delivered equipment has value to the customer on a stand-alone basis, and (ii) delivery of the undelivered service element(s) is probable and substantially in the Company’s control. Arrangement consideration is then allocated to each unit, delivered or undelivered, based on the relative selling price of each unit of accounting based first on vendor-specific objective evidence (“VSOE”) if it exists, second on third-party evidence (“TPE”) if it exists and on estimated selling price (“ESP”) if neither VSOE or TPE exist.

VSOE – In most instances, products are sold separately in stand-alone arrangements. Services are also sold separately through renewals of contracts with varying periods. The Company determines VSOE based on pricing and discounting practices for the specific product or service when sold separately, considering geographical, customer, and other economic or marketing variables, as well as renewal rates or stand-alone prices for the service element(s).

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

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

Under the estimated selling price method, revenue is recognized in MEAs based on estimated selling prices for all of the elements in the arrangement, assuming all other conditions for revenue recognition have been satisfied. To determine the estimated selling price, the Company establishes the selling price for its products and installation services using the Company's established pricing guidelines, and the proceeds are allocated between the elements and the arrangement.

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

The Company provides call center support services to properties installed by the Company. The Company receives monthly service fees from such properties for its services. The Company recognizes the service fee ratably over the term of the contract. The prices for these services are fixed and determinable prior to delivery of the service. The fair value of these services is known due to objective and reliable evidence from standalone executed contracts. The Company reports such revenues as recurring revenues. Deferred revenue includes deferrals for the monthly support service fees. Long-term deferred revenue represents support service fees to be earned or provided beginning after December 31, 2017. Revenue recognized that has not yet been billed to a customer results in an asset as of the end of the period. As of December 31, 2016 and 2015, there was \$214,821 and \$170,000 recorded within accounts receivable, respectively, related to revenue recognized that has not yet been billed.

TELKONET, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****DECEMBER 31, 2016 AND 2015****Sales Taxes**

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

Guarantees and Product Warranties

The Company records a liability for potential warranty claims in cost of sales at the time of sale. The amount of the liability is based on the trend in the historical ratio of claims to sales, the historical length of time between the sale and resulting warranty claim, new product introductions and other factors. The products sold are generally covered by a warranty for a period of one year. In the event the Company determines that its current or future product repair and replacement costs exceed its estimates, an adjustment to these reserves would be charged to earnings in the period such determination is made. For the years ended December 31, 2016 and 2015, the Company experienced returns of approximately 1% to 3% of material's included in the cost of sales. As of December 31, 2016 and 2015, the Company recorded warranty liabilities in the amount of \$49,149 and \$28,702, respectively, using this experience factor range.

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

| | 2016 | 2015 |
|------------------------------|----------|----------|
| Beginning balance | \$28,702 | \$23,500 |
| Warranty claims incurred | (50,353) | (16,434) |
| Provision charged to expense | 70,800 | 21,636 |
| Ending balance | \$49,149 | \$28,702 |

Advertising

The Company follows the policy of charging the costs of advertising to expenses as incurred. The Company incurred \$31,573 and zero in advertising costs from continuing operations during the years ended December 31, 2016 and 2015, respectively.

Research and Development

The Company accounts for research and development costs in accordance with the ASC 730-10, "Research and Development". Under ASC 730-10, all research and development costs must be charged to expense as incurred. Accordingly, internal research and development costs are expensed as incurred. Third-party research and development costs are expensed when the contracted work has been performed or as milestone results have been achieved. Company-sponsored research and development costs related to both present and future products are expensed in the period incurred. Total expenditures on research and product development for 2016 and 2015 were \$1,658,640 and \$1,605,667, respectively.

Stock-Based Compensation

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

The expected term of the options represents the estimated period of time until exercise and is based on historical experience of similar awards, giving consideration to the contractual terms, vesting schedules and expectations of future employee behavior. For 2015 and prior years, expected stock price volatility is based on the historical volatility of the Company's stock for the related vesting periods.

Stock-based compensation expense in connection with options granted to employees for the year ended December 31, 2016 and 2015 was \$55,050 and \$14,383, respectively.

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TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2016 AND 2015

Deferred Lease Liability

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

NOTE B – NEW ACCOUNTING PRONOUNCEMENTS

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers (ASU 2014-09), which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP. The guidance for this standard was initially effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period, however in August 2015 the FASB delayed the effective date of the standard for one full year. Companies will adopt the standard using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients, or (ii) a retrospective approach with the cumulative effect of initially adopting ASU 2014-09 recognized at the date of adoption (which includes additional footnote disclosures). The Company expects to adopt ASU 2014-09 as of January 1, 2018, and continues to deliberate on the transition method. The Company continues to evaluate if there will be any effect on the timing and pattern of revenue recognition, and additional disclosures may be required. The Company will continue assessing the impact of ASU 2014-09 on its consolidated financial statements through the date of adoption.

In July 2015, the FASB issued ASU No. 2015-11, Inventory - Simplifying the Measurement of Inventory (Topic 330) (“ASU 2015-11”) ASU 2015-11 requires inventory to be subsequently measured using the lower of cost and net realizable value, thereby eliminating the market value approach. Net realizable value is defined as the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. ASU 2015-11 is effective for reporting periods beginning after December 15, 2016 and is applied prospectively. Early adoption is permitted. The Company is currently evaluating the impact of its pending adoption of

ASU 2015-11 on its consolidated financial statements and does not expect that the adoption will have a material impact on the consolidated financial statements.

In November 2015, the FASB issued ASU No. 2015-17, Income Taxes - Balance Sheet Classification of Deferred Taxes (Topic 740) (“ASU 2015-17”), which requires deferred tax liabilities and assets of the same tax jurisdiction or a tax filing group, as well as any related valuation allowance, be offset and presented as a single noncurrent amount in the consolidated balance sheets. ASU No. 2015-17 is effective for interim and annual periods beginning after December 15, 2016, with early adoption permitted. ASU 2015-17 may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. The Company does not believe this guidance will have a material impact on the Company's future statement of operations or financial position.

In February 2016, the FASB issued ASU No. 2016-02, Leases (“ASU 2016-02”). The new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the statement of operations. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is currently evaluating the impact of its pending adoption of ASU 2016-02 on its consolidated financial statements. Upon adoption, the Company expects that the ROU asset and lease liability will be recognized in the balance sheets in amounts that will be material.

TELKONET, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****DECEMBER 31, 2016 AND 2015**

In August 2016, the FASB issued ASU No. 2016-15, Classification of Certain Cash Receipts and Cash Payments (“ASU 2016-15”). The new standard provides guidance on the classification of certain transactions in the statement of cash flows, such as contingent consideration payments made in connection with a business combination and debt prepayment or extinguishment costs. ASU 2016-15 is effective for fiscal years beginning after December 15, 2017, including interim periods within that fiscal year. When adopted, the new guidance will be applied retrospectively. The Company is currently evaluating the impact of its pending adoption of ASU 2016-15 on its consolidated financial statements.

NOTE C – GOODWILL

Total goodwill acquired and its carrying values at December 31, 2016 and 2015 are:

| | Cost | Accumulated Impairment | Carrying Value |
|----------------|-------------|---------------------------|-------------------|
| Asset: | | | |
| Goodwill – SSI | \$5,874,016 | \$(5,874,016) | \$ – |
| Total Goodwill | \$5,874,016 | \$(5,874,016) | \$ – |

The Company did not amortize goodwill. The Company recorded goodwill in the amount of \$5,874,016 as a result of the acquisition of Smart Systems International (“SSI”) during the year ended December 31, 2007. The Company evaluated goodwill for impairment based on the fair value of the reporting unit to which this goodwill related to at least once a year. The Company utilized a discounted cash flow valuation methodology (income approach) to determine the fair value of the reporting unit. At December 31, 2011, the Company determined that a portion of the value for Smart Systems International’s goodwill was impaired based upon management’s assessment of operating results and forecasted discounted cash flow and wrote off \$3,100,000 in connection with the impairment. At December 31, 2013, the Company determined that the remainder of Smart Systems International’s goodwill was impaired based upon management’s assessment of operating results and forecasted discounted cash flow and recorded an additional impairment charge of \$2,774,016. Since acquisition, the Company has written off \$5,874,016 of goodwill for Smart Systems International.

As of December 31, 2016, the goodwill associated with EthoStream of \$5,796,430 was reclassified to current assets held for sale based on the Company's decision to sell EthoStream in the fourth quarter of 2016. The goodwill as of December 31, 2015 for EthoStream of \$5,796,430 was reclassified to long-term assets held for sale based on the Company's decision to sell EthoStream in the fourth quarter of 2016.

NOTE D – ACCOUNTS RECEIVABLE

Components of accounts receivable as of December 31, 2016 and 2015 are as follows:

| | 2016 | 2015 |
|---------------------------------|-------------|-------------|
| Accounts receivable | \$1,438,345 | \$1,961,368 |
| Allowance for doubtful accounts | (34,573) | (13,299) |
| Accounts receivable, net | \$1,403,772 | \$1,948,069 |

NOTE E – PROPERTY AND EQUIPMENT

The Company's property and equipment as of December 31, 2016 and 2015 consists of the following:

| | 2016 | 2015 |
|-------------------------------|-----------|-----------|
| Development test equipment | \$19,110 | \$19,110 |
| Computer software | 76,134 | 55,677 |
| Office equipment | 36,904 | 20,731 |
| Office fixtures and furniture | 151,330 | 151,330 |
| Total | 283,478 | 246,848 |
| Accumulated depreciation | (139,571) | (105,281) |
| Total property and equipment | \$143,907 | \$141,567 |

Depreciation expense included as a charge to income was \$34,289 and \$29,223 for the years ended December 31, 2016 and 2015, respectively.

TELKONET, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****DECEMBER 31, 2016 AND 2015****NOTE F – ACCRUED LIABILITIES AND EXPENSES**

Accrued liabilities and expenses as of December 31, 2016 and 2015 are as follows:

| | 2016 | 2015 |
|--|-----------|-----------|
| Accrued liabilities and expenses | \$218,629 | \$186,762 |
| Accrued payroll and payroll taxes | 279,199 | 289,575 |
| Accrued sales taxes, penalties, and interest | 227,415 | 189,697 |
| Accrued interest | 253 | 291 |
| Product warranties | 49,149 | 28,702 |
| Total accrued liabilities and expenses | \$774,645 | \$695,027 |

NOTE G – DEBT**Business Loan**

On September 11, 2009, the Company entered into a Loan Agreement in the aggregate principal amount of \$300,000 with the Wisconsin Department of Commerce (the “Department”). The outstanding principal balance bears interest at the annual rate of 2%. Payment of interest and principal is to be made in the following manner: (a) payment of any and all interest that accrues from the date of disbursement commenced on January 1, 2010 and continued on the first day of each consecutive month thereafter through and including December 31, 2010; (b) commencing on January 1, 2011 and continuing on the first day of each consecutive month thereafter through and including November 1, 2016, the Company is required to pay equal monthly installments of \$4,426; followed by a final installment on December 1, 2016 which shall include all remaining principal, accrued interest and other amounts owed by the Company to the Department under the Loan Agreement. The Company may prepay amounts outstanding under the Loan Agreement in whole or in part at any time without penalty. The Loan Agreement was secured by substantially all of the Company’s assets. On September 24, 2014, the Department signed a subordination agreement of all the Company’s security interests. The proceeds from this loan were used for the working capital requirements of the Company. The Loan Agreement contains covenants which required, among other things, that the Company keep and maintain 75 existing full-time positions and create and fill 35 additional full-time positions in Milwaukee, Wisconsin by December

31, 2012. On June 18, 2012, the Department agreed to permanently waive all penalties associated with the Company's noncompliance with this covenant. The outstanding borrowings under the agreement as of December 31, 2016 and 2015 were zero and \$52,579, respectively.

Promissory Note

On March 4, 2011, the Company sold all its Series 5 PLC product line assets to Wisconsin-based Dynamic Ratings, Inc. ("Purchaser") under an Asset Purchase Agreement ("APA"). Per the APA, the Company signed an unsecured Promissory Note (the "Note") due to Purchaser in the aggregate principal amount of \$700,000. The outstanding principal balance bears interest at the annual rate of 6% and was originally due on March 31, 2014. The Note may be prepaid in whole or in part, without penalty at any time. Payments not made when due, by maturity acceleration or otherwise, shall bear interest at the rate of 12% per annum from the date due until fully paid. Effective April 30, 2013, Purchaser approved an amendment to certain terms of the Note. Telkonet commenced a monthly payment of principal and interest of \$20,000 to be applied against the outstanding balance starting May 1, 2013. The interest rate remains unchanged at 6% and the maturity date was extended to January 1, 2016. During the year ended December 31, 2015, the Company made additional payments of \$20,000 in aggregate beyond the required monthly payments of principal and interest. The outstanding principal balance of the Note as of December 31, 2016 and 2015 was zero and \$40,761, respectively.

Kross Promissory Note

On August 4, 2016, the Board of Directors authorized the Company to reimburse Peter T. Kross ("Mr. Kross"), \$161,075 for expenses incurred related to his successful contested proxy. Effective June 27, 2016, Mr. Kross is a director of the Company and considered a related party. On August 30, 2016, Mr. Kross accepted an unsecured promissory note ("Kross Note") for \$161,075 from the Company. The outstanding principal balance bears interest at the annual rate of 3.00%. Payment of interest and principal began on September 1, 2016 and will continue monthly on the first day of each month thereafter through and including June 1, 2017; the Company is required to pay equal monthly installments of \$16,330 which includes all remaining principal and accrued interest owed by the Company to Mr. Kross under the Kross Note. The Company may prepay in advance any unpaid principal or interest due under the Kross Note without premium or penalty. The principal balance of the Kross Note as of December 31, 2016 was \$97,127.

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2016 AND 2015

Revolving Credit Facility

On September 30, 2014, the Company and its wholly-owned subsidiary, EthoStream, as co-borrowers (collectively, the “Borrowers”), entered into a loan and security agreement (the “Heritage Bank Loan Agreement”), with Heritage Bank of Commerce, a California state chartered bank (“Heritage Bank”), governing a new revolving credit facility in a principal amount not to exceed \$2,000,000 (the “Credit Facility”). Availability of borrowings under the Credit Facility from time to time is subject to a borrowing base calculation based on the Company’s eligible accounts receivable and eligible inventory each multiplied by an applicable advance rate, with an overall limitation tied to the Company’s eligible accounts receivable. The Heritage Bank Loan Agreement is available for working capital and other general business purposes. The outstanding principal balance of the Credit Facility bears interest at the Prime Rate plus 3.00%, which was 6.75% at December 31, 2016 and 6.50% at December 31, 2015. On October 9, 2014, as part of the Heritage Bank Loan Agreement, Heritage Bank was granted a warrant to purchase 250,000 shares of Telkonet common stock. The warrant has an exercise price of \$0.20 and expires October 9, 2021. On February 17, 2016, an amendment to the Credit Facility was executed extending the maturity date to September 30, 2018, unless earlier accelerated under the terms of the Heritage Bank Loan Agreement.

The Heritage Bank Loan Agreement also contains financial covenants that place restrictions on, among other things, the incurrence of debt, granting of liens and sale of assets. The Heritage Bank Loan Agreement also contains financial covenants that require the Borrowers to maintain a minimum EBITDA level, measured quarterly, and a minimum asset coverage ratio, measured monthly. A violation of any of these covenants could result in an event of default under the Heritage Bank Loan Agreement. Upon the occurrence of such an event of default or certain other customary events of defaults, payment of any outstanding amounts under the Credit Facility may be accelerated and Heritage Bank’s commitment to extend credit under the Heritage Bank Loan Agreement may be terminated. The Heritage Bank Loan Agreement contains other representations and warranties, covenants, and other provisions customary to transactions of this nature. As of June 30, 2016, the Company was in violation of a financial performance covenant. Heritage Bank granted a waiver of that violation on August 11, 2016. By waiving the violation, Heritage Bank did not surrendering any of its other rights set forth in the Heritage Bank Loan Agreement. On October 27, 2016, an amendment to the Credit Facility was executed modifying the required minimum EBITDA level financial covenant as of September 30, 2016 and December 31, 2016. As of December 31, 2016, the Company was in compliance with the modified financial covenants. The outstanding balance on the Credit Facility was \$1,062,129 and \$901,771 at December 31, 2016 and 2015, respectively. The remaining available borrowing capacity was approximately \$107,000 at December 31, 2016.

On March 28, 2017, the Company and the Company's wholly-owned subsidiary, EthoStream LLC, entered into an Asset Purchase Agreement with DCI-Design Communications LLC, whereby DCI would acquire all of the assets and certain liabilities of EthoStream. Heritage Bank has provided the Company with its consent to the sale transaction. Upon closing of the sale transaction on March 29, 2017, the entire balance outstanding on the Credit Facility was repaid. The Company will work with Heritage Bank to execute a new agreement with the remaining operations of the Company as the sole borrower.

NOTE H – PREFERRED STOCK

Series A

The Company has designated 215 shares of preferred stock as Series A Preferred Stock ("Series A"). Each share of Series A is convertible, at the option of the holder thereof, at any time, into shares of common stock at an initial conversion price of \$0.363 per share. In the event of a change of control (as defined in the purchase agreement with respect to the Series A), or at the holder's option, on November 19, 2014 and for a period of 180 days thereafter, provided that at least 50% of the shares of Series A issued on the Series A Original Issue Date remain outstanding as of November 19, 2014, and the holders of at least a majority of the then outstanding shares of Series A provide written notice requesting redemption of all shares of Series A, the Company was required to redeem the Series A for the purchase price of \$5,000 per share, plus any accrued but unpaid dividends. By way of the redemption option available to holders of the Company's Series A shares having expired on May 18, 2015 with no Series A holders requesting redemption of their shares, the redemption feature at the option of the holders was eliminated, thereby, resulting in the reclassification of \$1,322,112 from temporary equity, which was classified as "redeemable preferred stock" in the Company's consolidated balance sheets, to permanent equity during the year ended December 31, 2015.

On November 16, 2009, the Company sold 215 shares of Series A with attached warrants to purchase an aggregate of 1,628,800 shares of the Company's common stock at \$0.33 per share. The Series A shares were sold at a price per share of \$5,000 and each Series A share is convertible into approximately 13,774 shares of common stock at a conversion price of \$0.363 per share. The Company received \$1,075,000 from the sale of the Series A shares.

For the years ended December 31, 2016 and 2015, the Company recorded accrued dividends for Series A in the amount of zero and \$36,707, respectively. The recorded accrued dividends have been charged to additional paid-in capital (since there is a deficit in retained earnings) and an increase to the net income (loss) attributable to common stockholders and the net unpaid recorded accrued dividends have been added to the carrying value of the preferred stock.

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2016 AND 2015

Series B

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

On August 4, 2010, the Company sold 267 shares of Series B with attached warrants to purchase an aggregate of 5,134,626 shares of the Company's common stock at \$0.13 per share. The Series B shares were sold at a price per share of \$5,000 and each Series B share was convertible into approximately 38,461 shares of common stock at a conversion price of \$0.13 per share. The Company received \$1,335,000 from the sale of the Series B shares. Up and until the quarter ended September 30, 2013, the Series B were redeemable at the option of the holder, the carrying value of the preferred stock, net of discount and including accumulated dividends, had been classified as redeemable preferred stock on the consolidated balance sheets. During the year ended December 31, 2011, shareholders converted 45 redeemable preferred shares issued on August 4, 2010, to, in aggregate 1,730,762 shares of common stock. During the year ended December 31, 2013, shareholders converted 167 redeemable preferred shares issued on August 4, 2010, to, in aggregate, 6,423,072 shares of common stock.

A portion of the proceeds from the August 4, 2010 offering was allocated to the warrants based on their relative fair value, which totaled \$394,350 using the Black-Scholes option pricing model. Further, the Company attributed a beneficial conversion feature of \$394,350 to the Series B preferred shares based upon the difference between the effective conversion price of those shares and the closing price of the Company's common stock on the date of issuance. The assumptions used in the Black-Scholes model were as follows: (1) dividend yield of 0%; (2) expected volatility of 123%, (3) weighted average risk-free interest rate of 1.76%, (4) expected term of approximately 4 years, and (5) estimated fair value of Telkonet common stock of \$0.109 per share. The expected term of the warrants represents the estimated period of time until exercise and was based on historical experience of similar awards and giving consideration to the contractual terms. The amounts attributable to the warrants and beneficial conversion feature, aggregating \$788,700, were recorded as a discount and deducted from the face value of the preferred stock. The discount is being amortized over the period from issuance to November 19, 2014 (the initial redemption date) as a charge to additional paid-in capital (since there is a deficit in retained earnings). During the year ended December 31, 2013, a portion of the discount of approximately \$123,100 was accelerated and recognized immediately as a charge to

additional paid-in capital and accretion of preferred stock discounts and an increase to the net loss attributable to common stockholders for the 167 redeemable preferred shares converted to common stock.

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

As a result of the Series B conversions during the year ended December 31, 2013, fewer than 50% of the Series B shares issued on the Series B Original Issuance Date, August 4, 2010, remain outstanding, and the balance of the outstanding Series B shares will not become redeemable at the option of the holders. The redemption feature at the option of the holders is eliminated, thereby, resulting in the reclassification of \$324,063 from temporary equity, which was classified as "redeemable preferred stock" in the Company's consolidated balance sheets, to permanent equity during the year ended December 31, 2013.

For the years ended December 31, 2016 and 2015, the Company accrued dividends for Series B in the amount of zero and \$10,921, respectively. The recorded accrued dividends had been charged to additional paid-in capital (since there is a deficit in retained earnings) and the net unpaid recorded accrued dividends have been added to the carrying value of the preferred stock.

Preferred stock carries certain preference rights as detailed in the Company's Amended Articles of Incorporation related to both the payment of dividends and as to payments upon liquidation in preference to any other class or series of capital stock of the Company. As of December 31, 2016, the liquidation preference of the preferred stock is based on the following order: first, Series B with a preference value of \$393,435, which includes cumulative accrued unpaid dividends of \$133,435, and second, Series A with a preference value of \$1,452,114, which includes cumulative accrued unpaid dividends of \$527,114. As of December 31, 2015, the liquidation preference of the preferred stock is based on the following order: first, Series B with a preference value of \$394,055, which includes cumulative accrued unpaid dividends of \$119,055, and second, Series A with a preference value of \$1,377,886, which includes cumulative accrued unpaid dividends of \$452,886. Both series of preferred stock are equal in their dividend preference over common stock.

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2016 AND 2015

NOTE I – CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock (designated and undesignated), with a par value of \$.001 per share. The Company has designated 215 shares as Series A preferred stock and 538 shares as Series B preferred stock. At December 31, 2016 and 2015, there were 185 shares of Series A and 52 and 55 shares of Series B outstanding, respectively.

The Company has authorized 190,000,000 shares of common stock with a par value of \$.001 per share. As of December 31, 2016 and 2015, the Company had 132,774,475 and 127,054,848 common shares issued and outstanding, respectively.

During the year ended December 31, 2016, 5,211,542 warrants were exercised for an aggregate of 5,211,542 shares of the Company's common stock at \$0.13 per share. These warrants were originally granted to shareholders of the April 8, 2011 Series B preferred stock issuance. The Company received proceeds of \$677,501 from the exercise of warrants.

During the year ended December 31, 2016, the Company issued 392,700 shares of common stock to directors for services performed during 2016. These shares were valued at \$72,000, which approximated the fair value of the shares when they were issued.

During the year ended December 31, 2016, 3 shares of Series B preferred stock were converted to, in aggregate, 115,385 shares of common stock.

During the year ended December 31, 2015, 2,019,236 warrants were exercised for an aggregate of 2,019,236 shares of the Company's common stock at \$0.13 per share. These warrants were originally granted to shareholders of the August 4, 2010 Series B preferred stock issuance. The Company received proceeds of \$262,500 from the exercise of warrants.

NOTE J – STOCK OPTIONS AND WARRANTS**Stock Options**

The Company maintains an equity incentive plan, (the “Plan”). The Plan was established in 2010 as an incentive plan for officers, employees, non-employee directors, prospective employees and other key persons. The Plan is administered by the Board of Directors or the compensation committee, which is comprised of not less than two Non-Employee Directors who are independent. A total of 10,000,000 shares of stock were reserved and available for issuance under the Plan. The exercise price per share for the Stock covered by a stock option granted shall be determined by the administrator at the time of grant but shall not be less than 100 percent of the fair market value on the date of grant. The term of each stock option shall be fixed by the administrator, but no stock option shall be exercisable more than ten years after the date the stock option is granted. As of December 31, 2016, there were approximately 4,725,053 shares remaining for issuance in the Plan.

It is anticipated that providing such persons with a direct stake in the Company’s welfare will assure a better alignment of their interests with those of the Company and its stockholders.

The following table summarizes the changes in options outstanding and the related prices for the shares of the Company’s common stock issued to employees of the Company under the Plan as of December 31, 2016.

| Options Outstanding | | | Options Exercisable | | |
|---------------------|--------------------|---|---------------------------------|--------------------|---------------------------------|
| Exercise Prices | Number Outstanding | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| \$0.01 - \$0.15 | 175,000 | 0.81 | \$ 0.14 | 175,000 | \$ 0.14 |
| \$0.16 - \$1.00 | 2,657,725 | 4.05 | 0.18 | 2,305,821 | 0.18 |
| | 2,832,725 | 3.85 | \$ 0.18 | 2,505,821 | \$ 0.18 |

TELKONET, INC.**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****DECEMBER 31, 2016 AND 2015**

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

| | Number of Shares | Weighted Average Exercise Price Per Share |
|----------------------------------|---------------------|---|
| Outstanding at January 1, 2015 | 1,930,225 | \$ 0.40 |
| Granted | 50,000 | 0.18 |
| Exercised | — | — |
| Cancelled or expired | (155,000) | 1.81 |
| Outstanding at December 31, 2015 | 1,825,225 | \$ 0.28 |
| Granted | 1,300,000 | 0.17 |
| Exercised | — | — |
| Cancelled or expired | (292,500) | 0.69 |
| Outstanding at December 31, 2016 | 2,832,725 | \$ 0.18 |

The expected life of awards granted represents the period of time that they are expected to be outstanding. The Company determines the expected life based on historical experience with similar awards, giving consideration to the contractual terms, vesting schedules, exercise patterns and pre-vesting and post-vesting forfeitures. The Company estimates the volatility of the Company's common stock based on the calculated historical volatility of the Company's common stock using the trailing 36 months of share price data prior to the date of the award. The Company bases the risk-free interest rate used in the Black-Scholes option valuation model on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term equal to the expected life of the award. The Company has not paid any cash dividends on the Company's common stock and does not anticipate paying any cash dividends in the foreseeable future. Consequently, the Company uses an expected dividend yield of zero in the Black-Scholes option valuation model. The Company uses historical data to estimate pre-vesting option forfeitures and record share-based compensation for those awards that are expected to vest. In accordance with ASC 718-10, the Company calculates share-based compensation for changes to the estimate of expected equity award forfeitures based on actual forfeiture experience.

The following table summarizes the assumptions used to estimate the fair value of options granted during the years ended December 2016 and 2015, using the Black-Scholes option-pricing model:

| | 2016 | 2015 |
|---------------------------------|-------|-------|
| Expected life of option (years) | 3 | 10 |
| Risk-free interest rate | 0.96% | 1.28% |
| Assumed volatility | 83% | 135% |
| Expected dividend rate | 0 | 0 |
| Expected forfeiture rate | 25% | 32% |

The total estimated fair value of the options granted during the years ended December 31, 2016 and 2015 was \$99,742 and \$8,481. The total fair value of underlying shares related to options that vested during the years ended December 31, 2016 and 2015 was \$160,923 and \$14,383. Future compensation expense related to non-vested options at December 31, 2016 was \$34,310 and will be recognized over the next 4.5 years. The aggregate intrinsic value of the vested options was zero as of December 31, 2016 and 2015. Total stock-based compensation expense recognized in the consolidated statements of operations for the years ended December 31, 2016 and 2015 was \$55,050 and \$14,383, respectively.

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2016 AND 2015

Warrants

The following table summarizes the changes in warrants outstanding and the related exercise prices for the warrants issued to non-employees of the Company.

| Exercise Prices | Warrants Outstanding | | | Warrants Exercisable | |
|-----------------|----------------------|------------------|------------------|----------------------|------------------|
| | Number | Weighted Average | | Number | Weighted Average |
| | | Remaining | Weighted Average | | |
| | Outstanding | Contractual Life | Exercise Price | | |
| \$ 0.18 | 50,000 | 0.90 | \$ 0.18 | 50,000 | \$ 0.18 |
| 0.20 | 250,000 | 4.77 | 0.20 | 250,000 | 0.20 |
| | 300,000 | 4.13 | \$ 0.20 | 300,000 | \$ 0.20 |

Transactions involving warrants are summarized as follows:

| | Number of Shares | Weighted Average Exercise Price Per Share |
|----------------------------------|------------------|---|
| Outstanding at January 1, 2015 | 7,915,533 | \$ 0.27 |
| Issued | — | — |
| Exercised | (2,019,236) | 0.13 |
| Cancelled or expired | (257,887) | 3.00 |
| Outstanding at December 31, 2015 | 5,638,410 | 0.20 |
| Issued | — | — |
| Exercised | (5,211,542) | 0.13 |
| Cancelled or expired | (126,868) | 3.00 |

Outstanding at December 31, 2016 300,000 \$ 0.20

There were no warrants granted, 5,211,542 warrants exercised and 126,868 cancelled or forfeited during the year ended December 31, 2016. There were no warrants granted, 2,019,236 warrants exercised and 257,887 cancelled or forfeited during the year ended December 31, 2015.

NOTE K – RELATED PARTY TRANSACTIONS

On May 18 and June 4, 2015, now former director, William Davis and current Chief Executive Officer Jason Tienor each signed a General Indemnity Agreement pledging personal property on behalf of the Company for a customer contract that required bonding. The Company agreed to compensate each in the amount of \$3,000, grossed up to accommodate their 2015 federal income tax liability associated with the payments.

On July 15 and July 17, 2015, Messrs. Davis and Tienor each signed a General Indemnity Agreement pledging personal property on behalf of the Company for another customer contract that required bonding. The Company agreed to compensate each in the amount of \$2,000, grossed up to accommodate their 2015 federal income tax liability associated with the payments. The amounts owed to Messrs. Davis and Tienor as of December 31, 2016 and 2015, were zero and \$11,994, respectively, and were recorded in accrued liabilities and expenses on the accompanying consolidated balance sheets.

On August 4, 2016, the Board of Directors authorized the Company to reimburse Peter T. Kross (“Mr. Kross”), \$161,075 for expenses incurred related to his successful contested proxy. Effective June 27, 2016, Mr. Kross is a director of the Company and considered a related party. On August 30, 2016, Mr. Kross accepted an unsecured promissory note (“Kross Note”) for \$161,075 from the Company. The outstanding principal balance bears interest at the annual rate of 3.0%. Payment of interest and principal began on September 1, 2016 and will continue monthly on the first day of each month thereafter through and including June 1, 2017; the Company is required to pay equal monthly installments of \$16,330 which includes all remaining principal and accrued interest owed by the Company to Mr. Kross under the Kross Note. The Company may prepay in advance any unpaid principal or interest due under the Kross Note without premium or penalty. The principal balance of the Kross Note as of December 31, 2016 was \$97,127. During the year ended December 31, 2016, the Company made principal and interest payments of \$65,319 to Mr. Kross.

TELKONET, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2016 AND 2015

During the year ended December 31, 2016, the Company agreed to issue common stock in the amount of \$72,000 to the Company's non-employee directors as compensation for their attendance and participation in the Company's Board of Director and committee meetings.

On July 1, 2016, each newly elected Board of Director member, Mr. Kross, Mr. Blatt and Mr. Byrnes were each granted 100,000 stock options per the Company's Board of Director compensation plan. These options have an expiration period of ten years, vest quarterly over five years and have an exercise price of \$0.19.

From time to time the Company may receive advances from certain of its officers in the form of salary deferment, cash advances to meet short term working capital needs. These advances may not have formal repayment terms or arrangements. As of December 31, 2016 and 2015, there were no such arrangements.

NOTE L – INCOME TAXES

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

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

| | 2016 | 2015 |
|---|---------------|---------------|
| Tax provision (benefits) computed at the statutory rate | \$(1,304,289) | \$(1,092,230) |
| State taxes | (26,981) | 12,921 |
| Book expenses not deductible for tax purposes | 16,380 | 18,960 |

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| | | |
|---|-------------|------------|
| Expired capital losses | – | 110,291 |
| Other | 2,747 | (14,272) |
| | (1,312,143) | (964,330) |
| Change in valuation allowance for deferred tax assets | 1,332,257 | 961,116 |
| Income tax expense | \$20,114 | \$(3,214) |

During 2016, approximately \$900,000 of state net operating loss carryforwards expired and the Company lowered its effective state tax rate. The aggregate effect of these items resulted in a reduction to the allowance of approximately \$80,000.

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

| | 2016 | 2015 |
|-----------------------------------|--------------|--------------|
| Deferred Tax Assets: | | |
| Net operating loss carry forwards | \$34,458,920 | \$32,979,306 |
| Intangibles | 781,920 | 908,461 |
| Other | 580,125 | 534,646 |
| Total deferred tax assets | 35,820,965 | 34,422,413 |
| Deferred Tax Liabilities: | | |
| Intangibles | (933,433) | (734,047) |
| Total deferred tax liabilities | (933,433) | (734,047) |
| Valuation allowance | (35,820,965) | (34,422,413) |
| Net deferred tax liabilities | \$(933,433) | \$(734,047) |

A valuation allowance is recorded when it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of the deferred tax assets depends on the ability of the Company to generate sufficient taxable income of the appropriate character in the future and in the appropriate taxing jurisdictions. As of December 31, 2016 and December 31, 2015, the Company's valuation allowance, established for the tax benefit that may not be realized, totaled approximately \$35,820,000 and \$34,420,000, respectively. The overall increase in the valuation allowance is related to the federal and state losses generated for the year ended December 31, 2016, less the federal and state loss carryforwards that expired as of December 31, 2016.

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At December 31, 2016 the Company had net operating loss carryforwards of approximately \$97,200,000 and \$51,100,000 for federal and state income tax purposes, respectively, which will expire at various dates from 2017 – 2036.

The Company has indefinite-lived goodwill, which is not amortized for financial reporting purposes. However, this asset is amortized over 15 years for tax purposes. As such, income tax expense and a deferred income tax liability arise as a result of the tax-deductibility of this asset. The resulting deferred income tax liability, which is expected to continue to increase over time, will have an indefinite life, resulting in what is referred to as a “naked tax credit.” This deferred income tax liability could remain on the Company’s balance sheet permanently unless there is an impairment of the related asset (for financial reporting purposes), or the business to which those assets relate were to be disposed. Due to the fact that the aforementioned deferred income tax liability could have an indefinite life, it is not netted against the Company’s deferred tax assets when determining the required valuation allowance. Doing so would result in the understatement of the valuation allowance and related income tax expense.

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

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

The Company files income tax returns in the U.S. federal jurisdiction and various state jurisdictions. The Company is generally no longer subject to U.S. federal income tax examinations by tax authorities for years before 2012 and various states before 2012. Although these years are no longer subject to examination by the Internal Revenue Service (IRS) and various state taxing authorities, net operating loss carryforwards generated in those years may still be adjusted upon examination by the IRS or state taxing authorities if they have been or will be used in a future period.

The Company follows the provisions of uncertain tax positions as addressed in FASB Accounting Standards Codification 740-10-65-1. The Company recognized no change in the liability for unrecognized tax benefits. The Company has no tax positions at December 31, 2016 or 2015 for which the ultimate deductibility is highly certain but for which there is uncertainty about the timing of such deductibility. The Company recognizes interest accrued related to unrecognized tax benefits in interest expense and penalties in operating expense. No such interest or penalties were recognized during the periods presented. The Company had no accruals for interest and penalties at December 31, 2016 or 2015. The Company's utilization of any net operating loss carryforwards may be unlikely due to its continuing losses.

NOTE M – COMMITMENTS AND CONTINGENCIES

Office Leases Obligations

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

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

In January 2016, the Company entered into a lease agreement for 2,237 square feet of commercial office space in Germantown, Maryland for its Maryland employee's. The Germantown lease was set to expire at the end of January 2017. In December 2016, the Company entered into a first amendment to the lease agreement extending the lease through the end of January 2018.

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Commitments for minimum rentals under non-cancelable leases as of December 31, 2016 are as follows:

| | |
|------------------------------------|-----------|
| Years ending December 31, | |
| 2017 | \$ 80,604 |
| 2018 | 79,065 |
| 2019 | 80,646 |
| 2020 | 82,259 |
| 2021 | 34,880 |
| Total | \$357,454 |

Rental expenses charged to operations for the years ended December 31, 2016 and 2015 was \$169,807 and \$206,307, respectively. Sub-rental income received for the year ended December 31, 2016 and 2015 was zero and \$136,666, respectively.

Employment and Consulting Agreements

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

Jason L. Tienor, President and Chief Executive Officer, is employed pursuant to an amended and restated employment agreement with us dated January 3, 2016, which was executed in January, 2017. The agreement amends and restates an employment agreement dated May 1, 2015. Mr. Tienor's amended and restated employment agreement has a term of one (1) year, which may be extended by mutual agreement of the parties thereto, and provides, among other things, for an annual base salary of \$212,200 per year and bonuses and benefits based on the Company's internal policies and participation in our incentive and benefit plans. The agreement also calls for a bonus to be paid upon the sale of the Company's subsidiary resulting in a purchase price (before any closing costs or working capital adjustments) equal to or greater than twelve million five hundred thousand dollars (\$12,500,000). The bonus will be equal to twenty five

thousand dollars (\$25,000) plus one third of five percent of each dollar in excess of a purchase price of twelve million five hundred dollars (\$12,500,000). Upon execution of the employment agreement in 2017, 1,000,000 stock options were granted at their fair market value and vest over a three year period. However, the stock options vest immediately upon the sale of the Company's subsidiary, Ethostream LLC, in March 2017.

Jeffrey J. Sobieski, Chief Technology Officer, is employed pursuant to an amended and restated employment agreement with us dated January 3, 2016, which was executed in January, 2017. The agreement amends and restates an employment agreement dated May 1, 2015. Mr. Sobieski's amended and restated employment agreement has a term of one (1) year, which may be extended by mutual agreement of the parties thereto, and provides for a base salary of \$201,575 per year and bonuses and benefits based upon the Company's internal policies and participation in the Company's incentive and benefit plans. The agreement also calls for a bonus to be paid upon the sale of the Company's subsidiary resulting in a purchase price (before any closing costs or working capital adjustments) equal to or greater than twelve million five hundred thousand dollars (\$12,500,000). The bonus will be equal to twenty five thousand dollars (\$25,000) plus one third of five percent of each dollar in excess of a purchase price of twelve million five hundred dollars (\$12,500,000). Upon execution of the employment agreement in 2017, 1,000,000 stock options were granted at their fair market value and vest over a three year period. However, the stock options vest immediately upon the sale of the Company's subsidiary, Ethostream LLC, in March 2017.

Matthew P. Koch, Chief Operations Officer, is employed pursuant to an amended and restated employment agreement with us dated January 3, 2016, which was executed in January, 2017. Mr. Koch's amended and restated employment agreement has a term of one (1) year, which may be extended by mutual agreement of the parties thereto, and provides for a base salary of \$143,900 per year and bonuses and benefits based upon the Company's internal policies and participation in the Company's incentive and benefit plans. The agreement also calls for a bonus to be paid upon the sale of the Company's subsidiary resulting in a purchase price (before any closing costs or working capital adjustments) equal to or greater than twelve million five hundred thousand dollars (\$12,500,000). The bonus will be equal to twenty five thousand dollars (\$25,000) plus one third of five percent of each dollar in excess of a purchase price of twelve million five hundred dollars (\$12,500,000). Upon execution of the employment agreement in 2017, 1,000,000 stock options were granted at their fair market value and vest over a three year period. However, the stock options vest immediately upon the sale of the Company's subsidiary, Ethostream LLC, in March 2017.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2016 AND 2015

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.

Indemnification Agreements

On March 31, 2010, the Company entered into Indemnification Agreements with director William H. Davis, and executives Jason L. Tienor, President and Chief Executive Officer and Jeffrey J. Sobieski, then Chief Operating Officer. On April 24, 2012, the Company entered into an Indemnification Agreement with director Timothy S. Ledwick. On July 1, 2016, the Company entered into Indemnification Agreements with director's Arthur E. Byrnes, Peter T. Kross and Leland D. Blatt. On January 1, 2017, the Company entered into an Indemnification Agreements with Chief Financial Officer Richard E. Mushrush.

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

Sales Taxes

During 2012, the Company engaged a sales tax consultant to assist in determining the extent of its potential sales tax exposure. Based upon this analysis, management determined the Company had probable exposure for certain unpaid obligations, including interest and penalty, of approximately \$1,100,000 including and prior to the year ended December 31, 2011. The Company had approximately \$227,000 and \$190,000 accrued for this exposure as of December 31, 2016 and 2015, respectively.

The Company continues to manage the liability by establishing voluntary disclosure agreements (VDAs) with the applicable states, which establishes a maximum look-back period and payment arrangements. However, if the aforementioned methods prove unsuccessful and the Company is examined or challenged by taxing authorities, there exists possible exposure of an additional \$30,000, not including any applicable interest and penalties.

Prior to 2016, the Company successfully executed and paid in full VDAs in thirty one states totaling approximately \$695,000 and is current with the subsequent filing requirements.

During the year ended December 31, 2016, the Company executed and paid five VDA's totaling approximately \$70,000.

During the year ended December 31, 2016, the state of Wisconsin perform a sales and use tax audit covering the period from January 1, 2012 through December 31, 2015. The Company estimates the audit could result in approximately \$120,000 in additional use tax and interest and have appropriately accrued and expensed this amount in the consolidated balance sheet and the consolidated statement of operations as of December 31, 2016.

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

| | 2016 | 2015 |
|----------------------------|------------|------------|
| Balance, Beginning of year | \$ 189,697 | \$ 35,951 |
| Sales tax collected | 310,823 | 175,044 |
| Provisions | 151,000 | 164,593 |
| Payments | (424,105) | (185,891) |
| Balance, End of year | \$ 227,415 | \$ 189,697 |

NOTE N – BUSINESS CONCENTRATION

For the years ended December 31, 2016 and 2015, no single customer represented 10% or more of the Company's total net revenues from continuing operations.

As of December 31, 2016, two customers accounted for 24% of the Company's net accounts receivable from continuing operations. As of December 31, 2015, two customers accounted for 20% of the Company's net accounts receivable from continuing operations.

Purchases from one supplier approximated \$2,235,000, or 62%, of total purchases for the year ended December 31, 2016 and approximately \$2,117,000, or 70%, of total purchases for the year ended December 31, 2015 from continuing operations. Total due to this supplier, net of deposits, was \$45,037 and \$437,520 as of December 31, 2016 and 2015, respectively.

NOTE O – EMPLOYEE BENEFIT PLAN

The Company has an employee savings plan covering substantially all employees who are at least 21 years of age and have completed at least 6 months of service. Effective January 1, 2012, the plan provides for matching contributions equal to 100% of each dollar contributed by the employee up to 4% of the employee's salary. The Company's matching contributions vest immediately. The Company may also elect to make discretionary contributions. The Company made contributions to the plan of approximately \$172,000 and \$153,000 for the years ended December 31, 2016 and 2015, respectively.

NOTE P – DISCONTINUED OPERATIONS

In October of 2016, the Company, under the direction and authority of the Board of Directors, committed to a plan to offer for sale Ethostream LLC, High-Speed Internet Access ("HSIA") subsidiary. While EthoStream is one of the largest public HSIA providers in the world, providing services to more than 12.0 million users monthly across a network of approximately 1,800 locations, the Company will focus on its higher growth potential EcoSmart Platform line. As a result of this decision to sell Ethostream LLC, the operating results of Ethostream for the years ended December 31, 2016 and 2015 have been reclassified as discontinued operations and as assets and liabilities held for sale in the consolidated financial statements as detailed in the table below.

| | December 31, | |
|---------------------------------------|--------------|--------------|
| | 2016 | 2015 |
| Cash and cash equivalents | \$ 106,743 | \$ 271,446 |
| Accounts receivable, net | 456,478 | 315,278 |
| Inventories | 350,506 | 159,559 |
| Other current assets | 12,980 | 11,281 |
| Other asset - goodwill | 5,796,430 | – |
| Other asset – intangible asset, net | 533,577 | – |
| Current assets held for sale | 7,256,714 | 757,564 |
| Property and equipment, net | – | 437 |
| Goodwill | – | 5,796,430 |
| Intangible asset, net | – | 775,257 |
| Deposits | – | 10,130 |
| Long-term assets held for sale | – | 6,582,254 |
| Accounts payable | 465,346 | 339,918 |
| Accrued liabilities and expenses | 241,123 | 187,015 |
| Deferred revenues | 37,509 | 48,161 |
| Customer deposits | 200,466 | 263,384 |
| Deferred lease liability | 76,096 | 12,795 |
| Current liabilities held for sale | 1,020,540 | 851,273 |
| Deferred lease liability | – | 76,096 |
| Long-term liabilities held for sale | – | 76,096 |
| Net assets of discontinued operations | \$ 6,236,174 | \$ 6,412,449 |

The following table summarizes the statements of operations information for discontinued operations.

| | Years Ended December | |
|---|----------------------|-------------|
| | 31, 2016 | 2015 |
| Revenues, net: | | |
| Product | \$3,529,012 | \$3,666,201 |
| Recurring | 3,894,998 | 3,890,108 |
| Total Net Revenues | 7,424,010 | 7,556,309 |
| Cost of Sales: | | |
| Product | 2,235,641 | 2,134,547 |
| Recurring | 925,212 | 858,704 |
| Total Cost of Sales | 3,160,853 | 2,993,251 |
| Gross Profit | 4,263,157 | 4,563,058 |
| Operating Expenses: | | |
| Research and development | 2,511 | – |
| Selling, general and administrative | 1,191,385 | 1,258,700 |
| Depreciation and amortization | 242,117 | 244,284 |
| Total Operating Expenses | 1,436,013 | 1,502,984 |
| Income from Discontinued Operations before Provision for Income Taxes | 2,827,144 | 3,060,074 |
| Provision for Income Taxes | 199,386 | 200,286 |
| Income from Discontinued Operations (net of tax) | \$2,627,758 | \$2,859,788 |

The consolidated statements of cash flows do not present the cash flows from discontinued operations for investing activities or financing activities because there were no investing or financing activities associated with the discontinued operations in the years ended December 31, 2016 and 2015.

NOTE Q – SUBSEQUENT EVENT

On March 28, 2017, the Company, and the Company’s wholly-owned subsidiary, EthoStream LLC, a Wisconsin limited liability company (“EthoStream”), entered into an Asset Purchase Agreement (the “Purchase Agreement”) with DCI-Design Communications LLC, a Delaware limited liability company (“DCI”), whereby DCI would acquire all of the assets and certain liabilities of EthoStream for a cash purchase price of \$12,750,000. The Purchase Agreement includes that proceeds of \$900,000 are to be withheld from the \$12,750,000 cash purchase price and placed into an escrow account to support potential indemnification obligations of up to \$800,000 and net working capital

adjustments of up to \$100,000. The escrow amount, net of potential claims, would be fully released after an escrow period not to exceed 12 months after closing. The assets included, among other items, certain inventory, contracts and intellectual property. DCI acquired only the liabilities provided for in the Purchase Agreement. On March 29, 2017, pursuant to the terms and the conditions of the Purchase Agreement, the Company closed on the sale. Further details of the transaction can be referenced in our Form 8-K filed with the Security and Exchange Commission on March 31, 2017.

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