
Disclosure Statement Pursuant to the Pink Basic Disclosure Guidelines

Telkonet, Inc.

**20800 Swenson Dr
Waukesha, WI 53186**

414-302-2299

www.telkonet.com

ir@telkonet.com

17310202

Annual Report

For the period ending December 31, 2023 (the "Reporting Period")

Outstanding Shares

The number of shares outstanding of our Common Stock was:

299,212,282 as of December 31, 2023

Shell Status

Indicate by check mark whether the company is a shell company (as defined in Rule 405 of the Securities Act of 1933, Rule 12b-2 of the Exchange Act of 1934 and Rule 15c2-11 of the Exchange Act of 1934):

Yes: No:

Indicate by check mark whether the company's shell status has changed since the previous reporting period:

Yes: No:

Change in Control

Indicate by check mark whether a Change in Control¹ of the company has occurred over this reporting period:

Yes: No:

1) Name and address(es) of the issuer and its predecessors (if any)

In answering this item, provide the current name of the issuer any names used by predecessor entities, along with the dates of the name changes.

¹ "Change in Control" shall mean any events resulting in:

(i) Any "person" (as such term is used in Sections 13(d) and 14(d) of the Exchange Act) becoming the "beneficial owner" (as defined in Rule 13d-3 of the Exchange Act), directly or indirectly, of securities of the Company representing fifty percent (50%) or more of the total voting power represented by the Company's then outstanding voting securities;

(ii) The consummation of the sale or disposition by the Company of all or substantially all of the Company's assets;

(iii) A change in the composition of the Board occurring within a two (2)-year period, as a result of which fewer than a majority of the directors are directors immediately prior to such change; or

(iv) The consummation of a merger or consolidation of the Company with any other corporation, other than a merger or consolidation which would result in the voting securities of the Company outstanding immediately prior thereto continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity or its parent) at least fifty percent (50%) of the total voting power represented by the voting securities of the Company or such surviving entity or its parent outstanding immediately after such merger or consolidation.

Comstock Coal Company August 2000

The state of incorporation or registration of the issuer and of each of its predecessors (if any) during the past five years; Please also include the issuer's current standing in its state of incorporation (e.g. active, default, inactive):

UT

Describe any trading suspension orders issued by the SEC concerning the issuer or its predecessors since inception:

N/A

List any stock split, stock dividend, recapitalization, merger, acquisition, spin-off, or reorganization either currently anticipated or that occurred within the past 12 months:

N/A

The address(es) of the issuer's principal executive office:

20800 Swenson Dr
Waukesha, WI 53186

The address(es) of the issuer's principal place of business:

Check if principal executive office and principal place of business are the same address:

Has the issuer or any of its predecessors been in bankruptcy, receivership, or any similar proceeding in the past five years?

No: Yes: If Yes, provide additional details below:

2) Security Information

Transfer Agent

Name: **Broadridge Financial Solutions, Inc**

Phone: **720-697-4366**

Email: **stevie.marcus@broadridge.com**

Address: _____

Publicly Quoted or Traded Securities:

The goal of this section is to provide a clear understanding of the share information for its publicly quoted or traded equity securities. Use the fields below to provide the information, as applicable, for all outstanding classes of securities that are publicly traded/quoted.

| | |
|--|---|
| Trading symbol: | TKOI |
| Exact title and class of securities outstanding: | Common |
| CUSIP: | 879604106 |
| Par or stated value: | \$.001 |
| Total shares authorized: | 475,000,000 <u>as of date:12/31/23</u> |
| Total shares outstanding: | <u>299,212,282</u> <u>as of date:12/31/23</u> |
| Total number of shareholders of record: | 264 <u>as of date:12/31/23</u> |

Other classes of authorized or outstanding equity securities:

The goal of this section is to provide a clear understanding of the share information for its other classes of authorized or outstanding equity securities (e.g. preferred shares). Use the fields below to provide the information, as applicable, for all other authorized or outstanding equity securities.

| | |
|--|--------------------------------|
| Trading symbol: | TKOI |
| Exact title and class of securities outstanding: | Preferred Series A |
| CUSIP: | 879604106 |
| Par or stated value: | \$.001 |
| Total shares authorized: | 215 <u>as of date:12/31/23</u> |
| Total shares outstanding: | 177 <u>as of date:12/31/23</u> |
| Total number of shareholders of record: | 10 <u>as of date:12/31/23</u> |

| | |
|--|--------------------------------|
| Trading symbol: | TKOI |
| Exact title and class of securities outstanding: | Preferred Series B |
| CUSIP: | 879604106 |
| Par or stated value: | \$.001 |
| Total shares authorized: | 567 <u>as of date:12/31/23</u> |
| Total shares outstanding: | 52 <u>as of date:12/31/23</u> |
| Total number of shareholders of record: | 8 <u>as of date:12/31/23</u> |

Security Description:

The goal of this section is to provide a clear understanding of the material rights and privileges of the securities issued by the company. Please provide the below information for each class of the company's equity securities, as applicable:

1. For common equity, describe any dividend, voting and preemption rights.

Holders of our Series A Preferred Stock and holders of our Series B Preferred Stock will each vote on an as-converted basis together with holders of our common stock as a single class in connection with each of the proposals in this proxy statement. Each share of common stock is entitled to one vote on all matters to be voted upon at the Meeting; each share of Series A Preferred Stock is entitled to 13,774 votes on all matters to be voted upon at the Meeting; and each share of Series B Preferred Stock is entitled to 38,461 votes on all matters to be voted on at the Meeting. At least a majority of our shares outstanding on the Record Date and entitled to vote (counting our Series A Preferred Stock and Series B Preferred Stock each on an as-converted basis, representing an aggregate of 4,493,066 shares of common stock for such purposes) must be represented at the Meeting, either in person or by proxy, in order to constitute a quorum for the transaction of business. Abstentions and broker non-votes will be counted for purposes of determining the presence or absence of a quorum. Broker non-votes occur when a nominee holding shares for a beneficial owner does not have discretionary voting power on a matter and has not received instructions from the beneficial owner.

VOTING RIGHTS. Except as otherwise expressly provided by law or in this Article III, each outstanding share of Common Stock shall be entitled to one (1) vote on each matter to be voted on by the shareholders of the Corporation.

LIQUIDATION RIGHTS. Subject to any prior or superior rights of liquidation as may be conferred upon any shares of Preferred Stock, and after payment or provision for payment of the debts and other liabilities of the Corporation, upon any voluntary or involuntary liquidation, dissolution or winding up of the affairs of the Corporation, the holders of Common Stock then outstanding shall be entitled to receive all of the assets and funds of the Corporation remaining and available for distribution. Such assets and funds shall be divided among and paid to the holders of Common Stock, on a pro-rata basis according to the number of shares of Common Stock held by them.

DIVIDENDS. Dividends may be paid on the outstanding shares of Common Stock as and when declared by the Board of Directors, out of funds legally available therefor; provided, however, that no dividends shall be made with respect to the Common Stock until any preferential dividends required to be paid or set apart for any shares of Preferred Stock have been paid or set apart.

RESIDUAL RIGHTS. All rights accruing to the outstanding shares of the Corporation not expressly provided for to the contrary herein or in any amendment hereto or thereto shall be vested in the Common Stock.

PREEMPTIVE RIGHTS. No holder of shares of Common Stock shall be entitled to any preemptive or preferential rights of subscription to any shares of any class of capital stock of the Corporation, whether now or hereafter authorized, or to any obligations convertible into capital stock of the Corporation issued or sold. The term "obligations convertible into capital stock" shall include any notes, bonds or other evidences of indebtedness to which are attached or with which are issued warrants or other rights to purchase capital stock of the Corporation.

2. For preferred stock, describe the dividend, voting, conversion, and liquidation rights as well as redemption or sinking fund provisions.

[Series A Convertible Redeemable Preferred Stock Securities Purchase Agreement, dated November 16, 2009 \(incorporated by reference to our Form 8-K \(File No. 001-31972\) filed on November 18, 2009\)](#)

[Series B Convertible Redeemable Preferred Stock Securities Purchase Agreement, dated August 4, 2010 \(incorporated by reference to our Form 8-K \(File No. 001-31972\) filed on August 9, 2010\)](#)

3. Describe any other material rights of common or preferred stockholders.

N/A

4. Describe any material modifications to rights of holders of the company's securities that have occurred over the reporting period covered by this report.

N/A

3) Issuance History

The goal of this section is to provide disclosure with respect to each event that resulted in any changes to the total shares outstanding of any class of the issuer's securities **in the past two completed fiscal years and any subsequent interim period**.

Disclosure under this item shall include, in chronological order, all offerings and issuances of securities, including debt convertible into equity securities, whether private or public, and all shares, or any other securities or options to acquire such securities, issued for services. Using the tabular format below, please describe these events.

A. Changes to the Number of Outstanding Shares

Indicate by check mark whether there were any changes to the number of outstanding shares within the past two completed fiscal years:

No: Yes: (If yes, you must complete the table below)

| Shares Outstanding as of Second Most Recent Fiscal Year End: | | | *Right-click the rows below and select "Insert" to add rows as needed. | | | | | | |
|--|---|--|--|--------------------------------|-----------------------------|--------------------------------|--|---|---------------------------------|
| Opening Balance | | | | | | | | | |
| Date <u>1/1/22</u> | Common: 136,311,335 Preferred: <u>185</u> | | | | | | | | |
| Date of Transaction | Transaction type (e.g., new issuance, cancellation, shares) | Number of Shares Issued (or cancelled) | Class of Securities | Value of shares issued (\$/per | Were the shares issued at a | Individual/ Entity Shares were | Reason for share issuance (e.g. for cash or debt conversion) - | Restricted or Unrestricted as of this filing. | Exemption or Registration Type. |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| — | — | — | — | — | — | — | — |
|---|---|---|---|---|---|---|---|

Use the space below to provide any additional details, including footnotes to the table above:

—

4) Issuer’s Business, Products and Services

The purpose of this section is to provide a clear description of the issuer’s current operations. (Please ensure that these descriptions are updated on the Company’s Profile on www.otcmarkets.com).

A. Summarize the issuer’s business operations (If the issuer does not have current operations, state “no operations”)

Telkonet enables users to intelligently control energy use based on their preferences, reducing energy consumption, and improving facility management capabilities.

B. List any subsidiaries, parent company, or affiliated companies.

Telkonet Communications, Inc

C. Describe the issuers’ principal products or services.

Telkonet, Inc. (the “Company”, “Telkonet”), formed in 1999 and incorporated under the laws of the state of Utah, is the creator of the EcoSmart and the Rhapsody Platforms of intelligent automation solutions designed to optimize energy efficiency, comfort and analytics in support of the emerging Internet of Things (“IoT”).

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. In 2020, the Company launched the Rhapsody Platform, which simplifies the installation and setup of the Company’s newest products and integrations. Both platforms provide 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, educational, governmental and other commercial markets. The platforms are recognized as a 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.

5) Issuer’s Facilities

The goal of this section is to provide a potential investor with a clear understanding of all assets, properties or facilities owned, used or leased by the issuer and the extent in which the facilities are utilized.

In responding to this item, please clearly describe the assets, properties or facilities of the issuer, give the location of the principal plants and other property of the issuer and describe the condition of the properties. If the issuer does not have complete ownership or control of the property (for example, if others also own the property or if there is a mortgage on the property), describe the limitations on the ownership.

If the issuer leases any assets, properties or facilities, clearly describe them as above and the terms of their leases.

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 would have expired in April 2021, but was subsequently amended and extended through April 30, 2026. On April 7, 2017 the Company executed an amendment to its existing lease in Waukesha, Wisconsin to expand another 3,982 square feet, bringing the total leased space to 10,344 square feet. In addition, the lease term was extended from May 1, 2021 to April 30, 2026. The commencement date for this amendment was July 15, 2017.

In May 2017, the Company entered into a lease agreement for 5,838 square feet of floor space in Waukesha, Wisconsin for its inventory warehousing operations. This lease expires on May 31, 2024.

In November 2021, the Company entered into a lease agreement for 425 square feet of commercial office space in Gaithersburg, Maryland. This lease would have expired in April 2021, but was subsequently amended and extended through November 30, 2024.

6) Officers, Directors, and Control Persons

Using the table below, please provide information, as of the period end date of this report, regarding any officers, or directors of the company, individuals or entities controlling more than 5% of any class of the issuers securities, or any person that performs a similar function, regardless of the number of shares they own. **If any insiders listed are corporate shareholders or entities, provide the name and address of the person(s) beneficially owning or controlling such corporate shareholders, or the name and contact information (City, State) of an individual representing the corporation or entity in the note section.**

Include Company Insiders who own any outstanding units or shares of any class of any equity security of the issuer.

The goal of this section is to provide an investor with a clear understanding of the identity of all the persons or entities that are involved in managing, controlling or advising the operations, business development and disclosure of the issuer, as well as the identity of any significant or beneficial shareholders.

| Names of All Officers, Directors and Control Persons | Affiliation with Company (e.g. Officer Title /Director/Owner of more than 5%) | Residential Address (City / State Only) | Number of shares owned | Share type/class | Ownership Percentage of Class Outstanding | Names of control person(s) if a corporate entity |
|---|--|--|-------------------------------|-------------------------|--|---|
| <u>Flavio DePaulis</u> (via foreign entities below) | <u>Director</u> | <u>UAE</u> | <u>162,900,947</u> | <u>Common</u> | <u>54</u> | |
| <u>VDA Group SpA</u> | _____ | <u>Italy</u> | <u>162,900,947</u> | <u>Common</u> | <u>54</u> | |
| <u>VDA Holding S.A.</u> | _____ | <u>Luxembourg</u> | <u>162,900,947</u> | <u>Common</u> | <u>54</u> | |
| <u>Meti Holding Sar</u> | _____ | <u>Luxembourg</u> | <u>162,900,947</u> | <u>Common</u> | <u>54</u> | |
| <u>Piercarlo Gramaglia</u> | <u>Director</u> | <u>Italy</u> | <u>0</u> | _____ | <u>0</u> | |
| <u>Tim S Ledwick</u> | <u>Director</u> | <u>Florida</u> | <u>929,781</u> | <u>Common</u> | <u>.3</u> | |
| <u>Richard E. Mushrush</u> | <u>CFO</u> | <u>Wisconsin</u> | <u>0</u> | | | |
| <u>Steven E. Quick</u> | <u>Director</u> | <u>Illinois</u> | <u>0</u> | | | |
| <u>Jeffrey J. Sobieski</u> | <u>CTO</u> | <u>Wisconsin</u> | <u>1,055,279</u> | <u>Common</u> | <u>.7</u> | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |

7) Legal/Disciplinary History

A. Identify whether any of the persons or entities listed above have, in the past 10 years, been the subject of:

1. A conviction in a criminal proceeding or named as a defendant in a pending criminal proceeding (excluding traffic violations and other minor offenses);

No

2. The entry of an order, judgment, or decree, not subsequently reversed, suspended or vacated, by a court of competent jurisdiction that permanently or temporarily enjoined, barred, suspended or otherwise limited such person's involvement in any type of business, securities, commodities, or banking activities;

No

3. A finding or judgment by a court of competent jurisdiction (in a civil action), the Securities and Exchange Commission, the Commodity Futures Trading Commission, or a state securities regulator of a violation of federal or state securities or commodities law, which finding or judgment has not been reversed, suspended, or vacated; or

No

4. The entry of an order by a self-regulatory organization that permanently or temporarily barred, suspended, or otherwise limited such person's involvement in any type of business or securities activities.

No

B. Describe briefly any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the issuer or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought. Include similar information as to any such proceedings known to be contemplated by governmental authorities.

N/A

8) Third Party Service Providers

Provide the name, address, telephone number and email address of each of the following outside providers. You may add additional space as needed.

Securities Counsel (must include Counsel preparing Attorney Letters).

Firm: **Moses & Singer, LLP**
Address 1: **405 Lexington Avenue**
Address 2: **New York, NY 10174-1299**
Phone: **212-554-7800**
Email: _____

Accountant or Auditor

Firm: **Wipfli, LLP**
Address 1: **150 South 5th St**
Address 2: **Minneapolis, MN 55402**

Phone: 952-548-3400
Email: _____

Investor Relations

Name: _____
Firm: _____
Address 1: _____
Address 2: _____
Phone: _____
Email: _____

All other means of Investor Communication:

Twitter: _____
Discord: _____
LinkedIn: _____
Facebook: _____
[Other]: _____

Other Service Providers

Provide the name of any other service provider(s) that **that assisted, advised, prepared, or provided information with respect to this disclosure statement**. This includes counsel, broker-dealer(s), advisor(s), consultant(s) or any entity/individual that provided assistance or services to the issuer during the reporting period.

Name: _____
Firm: _____
Nature of Services: _____
Address 1: _____
Address 2: _____
Phone: _____
Email: _____

9) Financial Statements

A. The following financial statements were prepared in accordance with:

- IFRS
- U.S. GAAP

B. The following financial statements were prepared by (name of individual)²:

Name: _____
Title: _____
Relationship to Issuer: _____
Describe the qualifications of the person or persons who prepared the financial statements: _____

Provide the following financial statements for the most recent fiscal year or quarter. For the initial disclosure statement (qualifying for Pink Current Information for the first time) please provide reports for the two previous fiscal years and any subsequent interim periods.

- a. Audit letter, if audited;

² The financial statements requested pursuant to this item must be prepared in accordance with US GAAP or IFRS and by persons with sufficient financial skills.

- b. Balance Sheet;
- c. Statement of Income;
- d. Statement of Cash Flows;
- e. Statement of Retained Earnings (Statement of Changes in Stockholders' Equity)
- f. Financial Notes

Important Notes:

- Financial statements must be “machine readable”. Do not publish images/scans of financial statements.
- All financial statements for a fiscal period must be published together with the disclosure statement in one Annual or Quarterly Report.

TELKONET, INC.

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TELKONET, INC.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors
Telkonet, Inc.
Waukesha, Wisconsin

Opinion

We have audited the accompanying consolidated balance sheet of Telkonet, Inc. and subsidiaries (the “Company and subsidiaries”) as of December 31, 2023, and the related consolidated statement of operations, stockholders’ equity, and cash flows for the year then ended and the related notes (collectively referred to as the “financial statements”).

In our opinion, the financial statements present fairly, in all material aspects, the financial position of the Company at December 31, 2023, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Our responsibilities under those standards are further described in the Auditor’s Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of the Company and to meet our other ethical responsibilities in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Substantial Doubt about the Company’s Ability to Continue as a Going Concern

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note A to the financial statements, the Company has experienced several years of net losses and negative cash flows from operations. Management’s evaluation of the events and conditions and management’s plans regarding those matters are also described in Note A. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to that matter.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the Company’s ability to continue as a going concern within one year after the date that the financial statements are available to be issued.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is substantial likelihood that, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users made on the basis of these financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design 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. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about Telkonet, Inc.'s ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

Other Matter

The financial statements as of and for the year ended December 31, 2022 were audited in accordance with the standards of the Public Company Accounting Oversight Board. A separate audit opinion on the 2022 financial statements, dated March 31, 2023, accompanies this opinion.

/s/ Wipfli LLP
Minneapolis, Minnesota

April 29, 2024

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors
Telkonet, Inc.
Waukesha, Wisconsin

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheet of Telkonet, Inc. and subsidiaries (the “Company and subsidiaries”) as of December 31, 2022 and the related consolidated statement of operations, stockholders’ equity, and cash flows for the year then ended and the related notes (collectively referred to as the “financial statements”). In our opinion, the financial statements present fairly, in all material aspects, the financial position of the Company at December 31, 2022, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on the Company’s financial statements based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 2022 financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audit, we are required to obtain an understanding of internal control over financial reporting, 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.

Our audit included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audit also included evaluating the accounting principles used and the significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audit provide a reasonable basis for our opinion.

Critical Audit Matter

The critical audit matter communicated below is a matter arising from the current period audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of this critical audit matter does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matter below, providing a separate opinion on the critical audit matter or on the accounts or disclosures to which it relates.

Critical Audit Matter Description

Revenue recognition on turnkey solution customer contracts ongoing at year-end

As described in Note A to the financial statements, revenue from customer contracts which encompass both product and installation services are referred to as “turnkey solutions” and contain a single performance obligation. Revenue from turnkey solution customer contracts is recognized over time using an output measure based on the number of rooms installed. We identified revenue recognition on turnkey solution customer contracts ongoing at year-end as a critical audit matter because of the estimates used by management to measure progress and the impact these estimates have on revenue recognition.

How the Critical Audit Matter Was Addressed in the Audit

Our audit procedures related to evaluating the estimates used by management in the determination of the accounting for turnkey solution customer contracts ongoing at year-end included the following, among others:

We selected a sample of turnkey solution customer contracts ongoing at year-end and evaluated management’s calculation of revenue recognized over time by performing the following procedures:

- Analyzed the contract to determine if all arrangement terms that may have an impact on revenue recognition were identified and evaluated management's accounting for the contract.
- Obtained and reviewed the contract to evaluate whether the transaction price was appropriately identified.
- Tested the data used in the revenue recognition schedule for completeness and accuracy by agreeing key inputs to supporting documentation.
- Tested management’s revenue recognition calculation schedule for mathematical accuracy

/s/ Wipfli LLP
Minneapolis, Minnesota

March 31, 2023

We have served as the Company’s auditor since 2020.

TELKONET, INC.
CONSOLIDATED BALANCE SHEETS
DECEMBER 31, 2023 AND 2022

| | <u>December 31, 2023</u> | <u>December 31, 2022</u> |
|--|--------------------------|--------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 2,152,088 | \$ 3,243,594 |
| Accounts receivable, net | 2,179,271 | 1,958,103 |
| Inventories, net | 1,903,488 | 1,306,186 |
| Contract assets | 31,496 | 94,840 |
| Prepaid expenses | 271,978 | 702,500 |
| Total current assets | <u>6,538,321</u> | <u>7,305,223</u> |
| Property and equipment, net | <u>143,229</u> | <u>126,096</u> |
| Other assets: | | |
| Deposits | 4,595 | 4,595 |
| Operating lease right of use assets | 382,621 | 442,903 |
| Total other assets | <u>387,216</u> | <u>447,498</u> |
| Total Assets | <u>\$ 7,068,766</u> | <u>\$ 7,878,817</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | 1,308,568 | 1,145,658 |
| Accrued liabilities | 878,851 | 702,583 |
| Contract liabilities - current | 959,228 | 650,340 |
| Lease Liabilities - current | 152,042 | 157,334 |
| Income taxes payable | 4,948 | 6,297 |
| Total current liabilities | <u>3,303,637</u> | <u>2,662,212</u> |
| Long-term liabilities: | | |
| Lease liabilities | 260,647 | 350,694 |
| Contract liabilities - long term | 49,827 | 49,213 |
| Accrued royalties - long-term | 70,000 | 220,000 |
| Total long-term liabilities | <u>380,474</u> | <u>619,907</u> |
| Total liabilities | <u>3,684,111</u> | <u>3,282,119</u> |
| Stockholders' Equity | | |
| Preferred Stock Series A, par value \$.001 per share; 215 shares designated, 177 shares outstanding at December 31, 2023 and 181 outstanding at December 31, 2022, preference in liquidation of \$1,885,254 and \$1,855,454 as of December 31, 2023 and December 31, 2022, respectively. | 1,290,765 | 1,310,765 |
| Preferred Stock Series B, par value \$.001 per share; 567 shares designated, 52 shares outstanding at December 31, 2023 and December 31, 2022, preference in liquidation of \$539,251 and \$518,428 as of December 31, 2023 and December 31, 2022 respectively. | 362,059 | 362,059 |
| Common Stock, par value \$.001 per share; 475,000,000 shares authorized; 299,212,282 shares issued and outstanding at December 31, 2022 and December 31, 2023. | 299,212 | 299,212 |
| Additional paid-in-capital | 132,578,075 | 132,578,075 |
| Accumulated deficit | (131,145,456) | (129,953,413) |
| Total stockholders' equity | <u>3,384,655</u> | <u>4,596,698</u> |
| Total Liabilities and Stockholders' Equity | <u>\$ 7,068,766</u> | <u>\$ 7,878,817</u> |

See accompanying notes to consolidated financial statements

TELKONET, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 2023 AND 2022

| | Year Ended December 31 | |
|---|---------------------------|-----------------------|
| | 2023 | 2022 |
| Revenues, net: | | |
| Product Revenue | \$ 8,224,677 | \$ 7,793,740 |
| Recurring Revenue | 673,047 | 654,279 |
| Total Net Revenues | <u>8,897,724</u> | <u>8,448,019</u> |
| Cost of Sales: | | |
| Product COGS | 4,128,050 | 4,112,166 |
| Recurring COGS | 182,589 | 132,983 |
| Total Cost of Sales | <u>4,310,639</u> | <u>4,245,149</u> |
| Gross Profit | <u>4,587,085</u> | <u>4,202,870</u> |
| Operating Expenses: | | |
| Research and development | 1,063,219 | 1,070,473 |
| Selling, general and administrative | 4,652,262 | 4,334,698 |
| Depreciation and amortization | 58,119 | 43,832 |
| Total Operating Expenses | <u>5,773,600</u> | <u>5,449,003</u> |
| Operating (Loss) | <u>(1,186,515)</u> | <u>(1,246,133)</u> |
| Other Income / (Expenses): | | |
| (Loss) on Fixed Assets Disposal | - | (526) |
| Interest expense, net | (5,199) | (23,542) |
| Total Other Income / (Expenses): | <u>(5,199)</u> | <u>(24,068)</u> |
| (Loss) before Provision for Income Taxes | <u>(1,181,316)</u> | <u>(1,270,201)</u> |
| Income Tax Provision | 10,727 | 15,036 |
| Net (Loss) | <u>\$ (1,192,043)</u> | <u>\$ (1,285,237)</u> |
| Net (Loss) per Common Share: | | |
| Basic – net income (loss) attributable to common stockholders | <u>\$ 0.00</u> | <u>\$ 0.00</u> |
| Diluted – net income (loss) attributable to common stockholders | <u>\$ 0.00</u> | <u>\$ 0.00</u> |
| Weighted Average Common Shares Outstanding – basic | 299,212,282 | 296,497,266 |
| Weighted Average Common Shares Outstanding – diluted | 299,212,282 | 296,497,266 |

See accompanying notes to consolidated financial statements

TELKONET, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
JANUARY 1, 2022 THROUGH DECEMBER 31, 2022

| | Series A Preferred Stock Shares | Series A Preferred Stock Amount | Series B Preferred Stock Shares | Series B Preferred Stock Amount | Common Stock Shares | Common Stock Amount | Additional Paid In Capital | Accumulated Deficit | Total Stockholders' Equity |
|---|--|--|--|--|---------------------------|---------------------------|----------------------------------|------------------------|----------------------------------|
| Balance at January 1, 2022 | 185 | \$1,340,566 | 52 | \$ 362,059 | 136,311,335 | \$ 136,311 | \$127,740,976 | \$(128,668,176) | \$ 911,736 |
| Stock and warrants issued in VDA Transaction | - | - | - | - | 162,900,947 | 162,901 | 4,837,099 | - | 5,000,000 |
| Shares repurchased per severance agreement | (4) | (29,801) | - | - | - | - | - | - | (29,801) |
| Net loss attributable to common stockholders | - | - | - | - | - | - | - | (1,285,237) | (1,285,237) |
| Balance at December 31, 2022 | <u>181</u> | <u>\$1,310,765</u> | <u>52</u> | <u>\$ 362,059</u> | <u>299,212,282</u> | <u>\$ 299,212</u> | <u>\$132,578,075</u> | <u>\$(129,953,413)</u> | <u>\$ 4,596,698</u> |

TELKONET, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
JANUARY 1, 2023 THROUGH DECEMBER 31, 2023

| | Series A Preferred Stock Shares | Series A Preferred Stock Amount | Series B Preferred Stock Shares | Series B Preferred Stock Amount | Common Stock Shares | Common Stock Amount | Additional Paid In Capital | Accumulated Deficit | Total Stockholders' Equity |
|---|--|--|--|--|---------------------------|---------------------------|----------------------------------|------------------------|----------------------------------|
| Balance at January 1, 2023 | 181 | \$1,310,765 | 52 | \$ 362,059 | 299,212,282 | \$ 299,212 | \$132,578,075 | \$(129,953,413) | \$ 4,596,698 |
| Shares repurchased per repurchase agreement | (4) | (20,000) | - | - | - | - | - | - | (20,000) |
| Net loss attributable to common stockholders | - | - | - | - | - | - | - | (1,192,043) | (1,192,043) |
| Balance at December 31, 2023 | <u>177</u> | <u>\$1,290,765</u> | <u>52</u> | <u>\$ 362,059</u> | <u>299,212,282</u> | <u>\$ 299,212</u> | <u>\$132,578,075</u> | <u>\$(131,145,456)</u> | <u>\$ 3,384,655</u> |

See accompanying notes to the consolidated financial statements

TELKONET, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 2023 AND 2022

| | Year Ended | |
|--|---------------------|---------------------|
| | December 31 | |
| | 2023 | 2022 |
| Cash Flows from Operating Activities: | | |
| Net loss | \$ (1,192,043) | \$ (1,285,237) |
| Adjustments to reconcile net loss to cash used in operating activities: | | |
| Depreciation and amortization | 58,119 | 43,832 |
| Loss on fixed asset disposal | - | 526 |
| Noncash operating lease expense (ROU) | 60,282 | 127,609 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | (221,168) | (947,549) |
| Inventories, net | (597,302) | (480,627) |
| Prepaid expenses | 430,522 | 32,592 |
| Deposits | - | 3,000 |
| Accounts payable | 162,910 | (719,877) |
| Accrued royalties - long-term | (150,000) | (140,000) |
| Accrued liabilities | 176,267 | (16,138) |
| Contract liabilities | 309,502 | (241,677) |
| Contract assets | 63,344 | 171,174 |
| Operating lease liabilities | (95,339) | (146,816) |
| Accrued income tax payable | (1,349) | 866 |
| Net Cash Used In Operating Activities | (996,255) | (3,598,322) |
| Cash Flows From Investing Activities: | | |
| Payments for Property & Equipment | (75,251) | (87,553) |
| Proceeds from sale of fixed assets | - | 1,300 |
| Net Cash Used In Investing Activities | (75,251) | (86,253) |
| Cash Flows From Financing Activities: | | |
| Proceeds from stock and warrants issued in VDA Transaction | - | 5,000,000 |
| Repurchase of employee-owned Series A shares | (20,000) | (29,801) |
| Proceeds from line of credit | - | 4,434,152 |
| Payments on line of credit | - | (4,837,241) |
| Net Cash Provided By Financing Activities | (20,000) | 4,567,110 |
| Net (decrease)/increase in cash and cash equivalents | (1,091,506) | 882,535 |
| Cash and cash equivalents at the beginning of the period | 3,243,594 | 2,361,059 |
| Cash and cash equivalents at the end of the period | \$ 2,152,088 | \$ 3,243,594 |

See accompanying notes to consolidated financial statements

TELKONET, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
FOR THE YEARS ENDED DECEMBER 31, 2023 AND 2022

| | Year Ended December 31, | |
|---|------------------------------------|-------------|
| | 2023 | 2022 |
| Supplemental Disclosures of Cash Flow Information: | | |
| Cash transactions: | | |
| Cash paid (received) during the period for interest | \$ 5,199 | \$ 23,542 |

See accompanying notes to consolidated financial statements

TELKONET, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2023 AND 2022

NOTE A – BASIS OF PRESENTATION AND SIGNIFICANT 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 and the Rhapsody Platforms of intelligent automation solutions designed to optimize energy efficiency, comfort and analytics in support of the emerging Internet of Things (“IoT”).

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. In 2020, the Company launched the Rhapsody Platform, which simplifies the installation and setup of the Company’s newest products and integrations. Both platforms provide 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, educational, governmental and other commercial markets. The platforms are recognized as a 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 subsidiary, Telkonet Communications, Inc., operating as a single reportable business segment.

VDA Transaction and Change in Control

On August 6, 2021, the Company entered into a stock purchase agreement (the “Purchase Agreement”) with VDA Group S.p.A., an Italian joint stock company (“VDA”), pursuant to which VDA would, at the Closing (as defined in the Purchase Agreement), contribute \$5 million to Telkonet (the “Financing”) and, in exchange, Telkonet would issue to VDA: (i) 162,900,947 shares of Company Common Stock (the “Issuance”); and (ii) a warrant to purchase 105,380,666 additional shares of Common Stock (the “Warrant”) (the Issuance and the Warrant referred to collectively herein as the “VDA Transaction”). The Closing occurred on January 7, 2022.

Following the issuance of 162,900,947 shares of Common Stock to VDA upon the Closing, VDA owns 53% of the issued and outstanding Common Stock on a fully diluted as exercised/converted basis, resulting in a change of control of the Company. VDA could eventually own as much as 65% of the issued and outstanding Common Stock on a fully diluted as exercised/converted basis if it fully exercises the Warrant.

The Company has elected not to apply pushdown accounting adjustments to the Company’s financial statements related to the change in control as allowed by Accounting Standards Update No. 2017-17.

Going Concern and Management's Plan

The accompanying financial statements have been prepared on a going concern basis which assumes the Company will be able to realize its assets and discharge its liabilities in the normal course of business for the foreseeable future and, thus, do not include any adjustments relating to the recoverability and classification of assets and liabilities that may be necessary if the Company is unable to continue as a going concern.

Since inception through December 31, 2023, we have incurred cumulative losses of \$131,145,456 and have never generated enough funds through operations to support our business. For the year ended December 31, 2023, the Company had negative operating cash flow of \$996,255 from operations. The Company's ability to continue as a going concern is dependent upon generating profitable operations in the future and obtaining the necessary financing to meet its obligations and repay its liabilities arising from normal business operations when they come due. There can be no assurance that the Company will be able to secure such financing at commercially reasonable terms, if at all. If cash resources become insufficient to meet the Company's ongoing obligations, the Company will be required to scale back or discontinue portions of its operations or discontinue operations entirely, whereby, the Company's shareholders may lose some or all of their investment.

Beginning in 2022, the Company began initiating a number of cost elimination and liquidity management actions, including, but not limited to, decreasing spend with third party consultants and providers, strategically reviewing whether or not to fill employee positions in the event of vacancies, deregistering from the Securities and Exchange Commission and shifting the supply chain to lower cost alternatives. Management expects these actions will continue to reduce operating losses. There is no guarantee these actions, nor any other actions identified, will yield profitable operations in the foreseeable future.

At December 31, 2023, the Company had approximately \$2,152,000 of cash and approximately \$872,000 of availability on its credit facility. The Company currently expects to draw on these cash reserves and utilize the credit facility to finance its near term working capital needs. The Credit Facility provides us with needed liquidity to assist in meeting our obligations or pursuing strategic objectives. Continued operating losses will deplete these cash reserves and could result in a violation of the financial covenants. Consequently, repayment of amounts borrowed 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 occurrence of any of these events could have a material adverse effect on our business and results of operations.

Accordingly, and in light of the Company's historic losses, there is substantial doubt about the Company's ability to continue as a going concern.

Deregistration of Common Stock

On March 29, 2023, a Form 8-K was filed announcing the Company's intention to voluntarily deregister its common stock from the requirements of Sections 12(g) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and suspend its reporting obligations under Section 15(d) of the Exchange Act. On March 31, 2023, the Company filed a Form 15 to effect the deregistration and suspension with the U.S. Securities and Exchange Commission.

The Company's board of directors ("Board") determined that the elimination of reporting requirements under the Exchange Act was in the best interests of the Company and its stockholders. The Board's decision was based on eliminating the expense of its public reporting requirements under the Exchange Act, as well as management's time in complying with the public reporting requirements.

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.

Accounts Receivable

Accounts receivable are uncollateralized customer obligations due under normal trade terms. The Company records allowances for credit losses 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 credit losses 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.

In June 2016, the FASB issued guidance (ASC 326) which the Company is required to measure expected credit losses for financial instruments, including trade receivables, based on historical experience, current conditions, and reasonable forecasts. The Company adopted the standard effective January 1, 2023. The impact of the adoption was not considered material to the consolidated financial statements. The estimate for expected credit losses is \$110,792 at December 31, 2023. Prior to January 1, 2023, the Company recorded an allowance for doubtful accounts for estimated losses resulting from the inability of customer to make required payments. The allowance for doubtful accounts was \$32,058 at December 31, 2022.

Changes in the allowance for allowance for credit losses and allowance for doubtful accounts on accounts receivable for the years ended December 31, 2023 and 2022, respectively:

| | <u>December 31, 2023</u> | <u>December 31, 2022</u> |
|-------------------|---------------------------------|---------------------------------|
| Beginning balance | \$ 32,058 | \$ 5,563 |
| Provisions | 116,166 | 50,410 |
| Write-offs, net | (37,432) | (23,915) |
| Ending balance | <u>\$ 110,792</u> | <u>\$ 32,058</u> |

Inventories

Inventories consist of thermostats, sensors and controllers for Telkonet's product platforms. These inventories are purchased for resale and do not include manufacturing labor and overhead. Inventories are stated at the lower of cost or net realizable value 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 reserve for inventory obsolescence was approximately \$176,000 and \$388,000 at December 31, 2023, and 2022, 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 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 expanded disclosure requirements. 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.

The Company's financial instruments include cash and cash equivalents, accounts receivable, accounts payable, line of credit 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. The carrying amount of the line of credit approximates fair value due to the interest rate and terms approximating those available to the Company for similar obligations (Level 2 instruments).

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 assessment for impairment performed during 2023 and 2022, no impairment was recorded.

Use of Estimates

The preparation of financial statements in conformity with United States of America (U.S.) generally accepted accounting principles ("GAAP") requires 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 credit losses, inventory obsolescence, depreciation and amortization, long-lived assets, 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, expected when the differences reverse. The Company has a policy of establishing a valuation allowance when it is more likely than not that the Company will not realize the benefits of its deferred income tax assets in the future.

The Company follows 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 de-recognition, classification, treatment of interest and penalties, and disclosure of such positions.

Revenue from Contracts with Customers

Accounting Standards Codification Topic 606, Revenue from Contracts with Customers (“ASC 606, the Standard”) supersedes nearly all legacy revenue recognition guidance. ASC 606, the Standard outlines a comprehensive five-step revenue recognition model based on the principle that an entity should recognize revenue based on when it satisfies its performance obligations by transferring control of promised goods or services in an amount that reflects the consideration to which the entity expects to be entitled in exchange for said goods or services.

Identify the customer contracts

The Company accounts for a customer contract under ASC 606 when the contract is legally enforceable. A contract is legally enforceable when all of the following criteria are met: (1) the contract has been approved by the Company and the customer and both parties are committed to perform their respective obligations, (2) the Company can identify each party’s rights regarding goods or services transferred, (3) the Company can identify payment terms for goods or services transferred, (4) the contract has commercial substance, and (5) collectability of all the consideration to which the Company is entitled in exchange for the goods or services transferred is probable.

A contract does not exist if either party to the contract has the unilateral right to terminate a wholly unperformed contract without compensating the other party (or parties). Nearly all of the Company’s contracts do not contain such mutual termination rights for convenience. All contracts are in written form.

Identify the performance obligations

The Company will enter into product only contracts that contain a single performance obligation related to the transfer of products to a customer.

The Company will also enter into certain customer contracts that encompass product and installation services, referred to as “turnkey” solutions. These contracts ultimately provide the customer with a solution that enhances the functionality of the customer’s existing equipment. For this reason, the Company has determined that the product and installation services are not separately identifiable performance obligations, but in essence represent one, combined performance obligation (“turnkey”).

The Company also offers technical phone support services to customers. This service is considered a separate performance obligation.

Determine the transaction price

The Company generally enters into contracts containing fixed prices. It is not customary for the Company to include contract terms that would result in variable consideration. In the rare situation that a contract does include this type of provision, it is not expected to result in a material adjustment to the transaction price. The Company regularly extends pricing discounts; however, they are negotiated up front and adjust the fixed transaction price set out in the contract.

Customer contracts will typically contain upfront deposits that will be applied against future invoices, as well as customer retainage. The intent of any required deposit or retainage is to ensure that the obligations of either party are honored and follow customary industry practices. In addition, the Company will typically be paid in advance at the beginning of any support contracts, consistent with industry practices. None of these payment provisions are intended to represent significant implicit financing. The Company’s standard payment terms are thirty days from invoice date. Products are fully refundable when returned in their original packaging without damage or defacing less a restocking fee. Historical returns have shown to be immaterial. The Company offers a standard one-year assurance warranty. However, customers can purchase an extended warranty. Under the revenue recognition standard, extended warranties are accounted for as a service warranty, requiring the revenue to be recognized over the extended service periods. Contracts involving an extended warranty are immaterial and will continue to be combined with technical phone support services revenue and recognized on a straight-line basis over the term of the contract.

Allocate the transaction price to the performance obligations

Revenues from customer contracts are allocated to the separate performance obligations based on their relative stand-alone selling price (“SSP”) at contract inception. The SSP is the price at which the Company would sell a promised good or service separately. The best evidence of an SSP is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers. However, turnkey solutions are sold for a broad range of amounts resulting from, but not limited to, tiered discounting for value-added resellers (“VAR”) based upon committed volumes and other economic factors. Due to the high variability of our pricing, the Company cannot establish a reliable SSP using observable data. Accordingly, the Company uses the residual approach to allocate the transaction price to performance obligations related to its turnkey solutions. When support services are not included within the turnkey solution, the residual method is not utilized and no allocation of the transaction price to the performance obligation is necessary.

All support service agreements, whether single or multi-year terms, automatically renew for one-year terms at a suggested retail price (“SRP”). Support service renewals are consistently priced and therefore would support the use of SRP as the best estimate of an SSP for such performance obligations.

Revenue Recognition

The Company recognizes revenues from product only sales at a point in time when control over the product has transferred to the customer. As the Company’s principal terms of sale are FOB shipping point, the Company primarily transfers control and records revenue for product only sales upon shipment.

A typical turnkey project involves the installation and integration of 200-300 rooms in a customer-controlled facility and takes approximately sixty days to complete. Since control over goods and services transfers to a customer once a room is installed, the Company recognizes revenue for turnkey solutions over time. The Company uses an outputs measure based on the number of rooms installed to recognize revenues from turnkey solutions.

Revenues from support services are recognized over time, in even daily increments over the term of the contract, and are presented as “Recurring Revenue” in the Statement of Operations.

Contracts are billed in accordance with the terms and conditions, either at periodic intervals or upon substantial completion. This can result in billing occurring subsequent to revenue recognition, resulting in contract assets. Contract assets are presented as current assets in the Consolidated Balance Sheet.

Contract liabilities include deferrals for the monthly support service fees. Long-term contract liabilities represent support service fees that will be recognized as revenue after December 31, 2024.

Contract Fulfillment Cost

The Company recognizes related costs of the contract over time in relation to the revenue recognition. Costs included within the projects relate to the cost of material, direct labor and costs of outside services utilized to complete projects. These are presented as “Contract assets” in the Consolidated Balance Sheet.

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, 2023 and 2022, the Company experienced returns of approximately 1% of materials included in cost of sales, respectively. As of December 31, 2023 and 2022, the Company recorded warranty liabilities in the amount of \$11,802 and \$13,663, respectively, using this experience factor range.

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

| | <u>December 31, 2023</u> | <u>December 31, 2022</u> |
|---|---------------------------------|---------------------------------|
| Beginning balance | \$ 13,663 | \$ 46,650 |
| Warranty claims incurred | (53,205) | (14,659) |
| Provision charged (credited) to expense | 51,344 | (18,328) |
| Ending balance | <u>\$ 11,802</u> | <u>\$ 13,663</u> |

Advertising

The Company follows the policy of charging the costs of advertising to expenses as incurred. The Company incurred \$15,122 and \$3,502 in advertising costs during the years ended December 31, 2023 and 2022, respectively.

Research and Development

The Company accounts for research and development costs in accordance with 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 2023 and 2022 were \$1,063,218 and \$1,070,473, respectively.

NOTE B – NEW ACCOUNTING PRONOUNCEMENTS

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. ASU 2016-13 provides guidance for estimating credit losses on certain types of financial instruments, including trade receivables, by introducing an approach based on expected losses. The expected loss approach will require entities to incorporate considerations of historical information, current information and reasonable and supportable forecasts. ASU 2016-13 also amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The guidance requires a modified retrospective transition method and early adoption is permitted. The Company adopted ASU No. 2016-13 on January 1, 2023. The financial assets held by the Company that are subject to guidance in ASC 326 were trade accounts receivable. The net impact to retained earnings was immaterial, thus no adjustment was made. The adoption of ASU No. 2016-13 did not have a material impact on the Company's consolidated financial statements.

Accounting Standards Not Yet Adopted

In December 2023, the FASB issued ASU No. 2023-09, Income Taxes (Topic 740): Improvements to Income Tax Disclosures, which is intended to enhance the transparency and decision usefulness of income tax disclosures. The main provisions of ASU 2023-09 require a public entity to disclose on an annual basis (i) specific prescribed categories in the rate reconciliation, (ii) additional information for reconciling items that meet a quantitative threshold, (iii) the amount of income taxes paid, net of refunds received, disaggregated by federal, state, and foreign taxes, (iv) the amount of income taxes paid, net of refunds received, disaggregated by individual jurisdictions in which income taxes paid is equal to greater than 5 percent of total income taxes paid, (v) income or loss from continuing operations before income tax expense or benefit disaggregated between domestic and foreign, and (vi) income tax expense or benefit from continuing operations disaggregated by federal, state, and foreign. ASU 2023-09 also removes certain disclosure requirements related to unrecognized tax benefits and cumulative unrecognized temporary differences. The new guidance is effective for the fiscal years beginning after December 15, 2025. Early adoption is permitted. The Company is still evaluating the impact ASU 2023-09 will have on the Company's consolidated financial statement disclosures.

Management has evaluated other recently issued accounting pronouncements and does not believe any will have a significant impact on our consolidated financial statements and related disclosures.

NOTE C– REVENUE

The following table presents the Company’s product and recurring revenues disaggregated by industry for the year ended December 31, 2023.

| | <u>Hospitality</u> | <u>Education</u> | <u>Multiple Dwelling Units</u> | <u>Government</u> | <u>Healthcare</u> | <u>Total</u> |
|-------------------|---------------------|-------------------|--------------------------------|---------------------|-------------------|---------------------|
| Product Revenue | \$ 6,741,648 | \$ 153,468 | \$ 105,923 | \$ 1,223,029 | \$ 609 | \$ 8,224,677 |
| Recurring Revenue | 485,522 | 186,536 | 0 | 440 | 549 | 673,047 |
| | <u>\$ 7,227,170</u> | <u>\$ 340,004</u> | <u>\$ 105,923</u> | <u>\$ 1,223,469</u> | <u>\$ 1,158</u> | <u>\$ 8,897,724</u> |
| % of Total | 81% | 4% | 1% | 14% | 0% | 100% |

The following table presents the Company’s product and recurring revenues disaggregated by industry for the year ended December 31, 2022.

| | <u>Hospitality</u> | <u>Education</u> | <u>Multiple Dwelling Units</u> | <u>Government</u> | <u>Healthcare</u> | <u>Total</u> |
|-------------------|---------------------|---------------------|--------------------------------|-------------------|-------------------|---------------------|
| Product Revenue | \$ 5,289,933 | \$ 1,429,292 | \$ 80,700 | \$ 993,452 | \$ 363 | \$ 7,793,740 |
| Recurring Revenue | 539,891 | 112,448 | 1,940 | 0 | 0 | 654,279 |
| | <u>\$ 5,829,824</u> | <u>\$ 1,541,740</u> | <u>\$ 82,640</u> | <u>\$ 993,452</u> | <u>\$ 363</u> | <u>\$ 8,448,019</u> |
| % of Total | 69% | 18% | 1% | 12% | 0% | 100% |

Sales taxes and other usage-based taxes are excluded from revenues.

Remaining performance obligations

As of December 31, 2023, the aggregate amount of the transaction price allocated to remaining performance obligations was approximately \$2.9 million. Except for support services, the Company expects to recognize 100% of the remaining performance obligations over the next six months. As of December 31, 2022, the aggregate amount of the transaction price allocated to remaining performance obligations was approximately \$3.0 million.

Contract assets and liabilities

| | <u>December 31, 2023</u> | <u>December 31, 2022</u> | <u>January 1, 2022</u> |
|--------------------------------|--------------------------|--------------------------|------------------------|
| Contract assets | \$ 31,496 | \$ 94,840 | \$ 139,082 |
| Contract liabilities - current | 959,228 | 650,340 | 800,965 |

Contracts are billed in accordance with the terms and conditions, either at periodic intervals or upon substantial completion. This can result in billing occurring subsequent to revenue recognition, resulting in contract assets. Contract assets are presented as current assets in the Consolidated Balance Sheet.

Often, the Company will require customers to pay a deposit upon contract signing that will be applied against work performed or products shipped. In addition, the Company will often invoice the full term of support at the start of the support period. Billings that occur prior to revenue recognition result in contract liabilities. The change in the contract liability balance during the 12 month period ended December 31, 2023 is the result of cash payments received and billing in advance of satisfying performance obligations.

Contract costs

Costs to complete a turnkey contract primarily relate to the materials cost and direct labor and are recognized proportionately as the performance obligation is satisfied. The Company will defer cost to complete a contract when materials have shipped (and control over the materials has transferred to the customer), but an insignificant amount of rooms have been installed. The Company will recognize any deferred costs in proportion to revenues recognized from the related turnkey contract. The Company does not expect deferred contract costs to be long-lived since a typical turnkey project takes approximately sixty days to complete. Deferred contract costs are generally presented as current assets in the Consolidated Balance Sheet.

The Company incurs incremental costs to obtain a contract in the form of sales commissions. These costs, whether related to performance obligations that extend beyond twelve months or not, are immaterial and will continue to be recognized in the period incurred within selling, general and administrative expenses.

NOTE D – ACCOUNTS RECEIVABLE

Components of accounts receivable as of December 31, 2023 and 2022 are as follows:

| | <u>December 31, 2023</u> | <u>December 31, 2022</u> |
|--------------------------------|--------------------------|--------------------------|
| Accounts receivable | \$ 2,290,063 | \$ 1,990,161 |
| Allowance for credit losses | (110,792) | - |
| Allowance for doubtful account | - | (32,058) |
| Accounts receivable, net | <u>\$ 2,179,271</u> | <u>\$ 1,958,103</u> |

NOTE E – PROPERTY AND EQUIPMENT

The Company's property and equipment as of December 31, 2023 and 2022 consists of the following:

| | <u>December 31, 2023</u> | <u>December 31, 2022</u> |
|------------------------------|--------------------------|--------------------------|
| Computer Hardware | \$ 63,953 | \$ 63,953 |
| Computer Software | 105,6744 | 76,134 |
| Furniture & Fixtures | 458,600 | 412,889 |
| Leasehold Improvements | 18,016 | 18,016 |
| Machinery & Equipment | <u>16,461</u> | <u>16,461</u> |
| Total | 662,704 | 587,453 |
| Accumulated Depreciation | (519,475) | (461,357) |
| Total Property and Equipment | <u>\$ 143,229</u> | <u>\$ 126,096</u> |

Depreciation and amortization expense included as a charge to income was \$58,119 and \$43,832 for the years ended December 31, 2023 and 2022, respectively.

NOTE F – CURRENT ACCRUED LIABILITIES

Current accrued liabilities as of December 31, 2023 and 2022 are as follows:

| | <u>December 31, 2023</u> | <u>December 31, 2022</u> |
|---|--------------------------|--------------------------|
| Accrued payroll and payroll taxes | \$ 333,768 | \$ 252,193 |
| Accrued professional fees | 122,326 | 143,706 |
| Accrued sales taxes, penalties and interest | 75,688 | 778 |
| Product warranties | 11,802 | 13,663 |
| Other accrued liabilities | <u>335,267</u> | <u>292,243</u> |
| Total current accrued liabilities | <u>\$ 878,851</u> | <u>\$ 702,583</u> |

NOTE G – DEBT

Revolving Credit Facility

On September 30, 2014, the Company 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 revolving credit facility in a principal amount not to exceed \$2,000,000 (subsequently reduced to \$1,000,000 on December 13, 2021), (the “Credit Facility”). Availability of borrowings under the Credit Facility 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 Credit Facility is secured by all of the Company’s assets. The Credit Facility 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 11.5% on December 31, 2023 and 10.5% on December 31, 2022.

On March 10, 2022, the Company entered into a fourteenth amendment to the Heritage Bank Loan Agreement to extend the revolving maturity date to June 30, 2023, unless earlier accelerated under the terms of the Heritage Bank Loan Agreement.

On June 26, 2023, the Company entered into a fifteenth amendment (the “Fifteenth Amendment”) to the Heritage Bank Loan Agreement to extend the revolving maturity date to June 30, 2024, unless earlier accelerated under the terms of the Heritage Bank Loan Agreement. In addition, the Fifteenth Amendment revised the financial covenants to a Remaining Months Liquidity (“RML”), measured as of the last day of each month (each, a “Measurement Date”) and not be less than twelve months. The Company’s failure to comply with the RML, as of any particular Measurement Date (the “Noncompliance Date”), shall not be deemed a breach, if the Company maintains at least \$1,000,000 in unrestricted cash at all times on and after such Noncompliance Date (the “Minimum Cash Covenant”), and the Company authorizes Heritage Bank to (i) place a “hold” on any account on amounts up to \$1,000,000 in the aggregate, and (ii) decline to honor presentments (including but not limited to any requests for withdrawals, or checks, wires, and ACH drafts) against any account in order for the Company to maintain compliance with the Minimum Cash Covenant.

In addition to the financial covenants, the Heritage Bank Loan Agreement contains covenants that place restrictions on, among other things, the incurrence of debt, granting of liens and sale of assets. A violation of either 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.

The outstanding balance on the Credit Facility was \$0 at December 31, 2023 and December 31, 2022 respectively, and the remaining available borrowing capacity was approximately \$872,000 and \$1,000,000, respectively. As of December 31, 2023, the Company was in compliance with all financial covenants.

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 the Company’s common stock at a conversion price of \$0.363 per share. On November 16, 2009, the Company sold 215 shares of Series A with attached warrants (since expired) 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. In prior years, 30 of the preferred shares issued on November 16, 2009 were converted to shares of the Company’s common stock. In a prior year, the redemption feature available to the Series A holders expired.

Series B

The Company has designated 567 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. On August 4, 2010, the Company sold 267 shares of Series B with attached warrants (since expired) 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 on August 4, 2010. On April 8, 2011, the Company sold 271 additional shares of Series B with attached warrants (since expired) 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 on April 8, 2011. In prior years, 486 of the preferred shares issued on August 4, 2010 and April 8, 2011 were converted to shares of the Company’s common stock. In a prior year, the redemption feature available to the Series B holders expired.

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, 2023, the liquidation preference of the preferred stock is based on the following order: first, Series B with a preference value of \$539,251, which includes cumulative accrued unpaid dividends of \$279,251, and second, Series A with a preference value of \$1,885,254, which includes cumulative accrued unpaid dividends of \$1,000,254. As of December 31, 2022, the liquidation preference of the preferred stock is based on the following order: first, Series B with a preference value of \$518,428, which includes cumulative accrued unpaid dividends of \$258,428, and second, Series A with a preference value of \$1,855,454, which includes cumulative accrued unpaid dividends of \$950,454.

NOTE I – CAPITAL STOCK

The Company has authorized 15,000,000 shares of preferred stock, with a par value of \$.001 per share. Of those shares, the Company has designated 215 shares as Series A preferred stock and 567 shares as Series B preferred stock. At December 31, 2023, there were 177 shares of Series A and 52 shares of Series B outstanding. At December 31, 2022, there were 181 shares of Series A and 52 shares of Series B outstanding.

As of December 31, 2023 and December 31, 2022, the Company has authorized 475,000,000 shares of common stock with a par value of \$.001 per share. As of December 31, 2023 and 2022, the Company had 299,212,282 shares of common stock issued and outstanding.

During the year ended December 31, 2022, the Company issued to VDA 162,900,947 of Company Common Stock and a warrant to purchase 105,380,666 additional shares of Common Stock.

During the years ended December 31, 2023 and 2022, no warrants were exercised.

During the years ended December 31, 2023 and 2022, no shares of Series A or B preferred stock were converted to shares of common stock.

NOTE J – STOCK OPTIONS AND WARRANTS

Employee Stock Options

The Company maintains an equity incentive plan (the “2020 Plan”). The 2020 Plan was established in 2020 as an incentive plan for officers, employees, non-employee directors, prospective employees and other key persons. The 2020 Plan replaced the 2010 Amended and Restated Stock Option and Incentive Plan, as amended (the “2010 Plan”), which expired on November 17, 2020. The 2020 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 2020 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, 2023, there were approximately 10,000,000 shares remaining for issuance under the 2020 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 2010 Plan as of December 31, 2023. No options have been issued under the 2020 Plan.

| Exercise Prices | Options Outstanding | | | Options Exercisable | |
|-----------------|---------------------|---------------------------------|---------------------------------|---------------------|---------------------------------|
| | Number Outstanding | Weighted Average Remaining Life | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| \$0.01-\$0.15 | 1,000,000 | 3.01 | 0.14 | 1,000,000 | \$ 0.14 |
| \$0.16-\$0.20 | 41,153 | 4.84 | 0.17 | 41,153 | \$ 0.17 |
| | <u>1,041,153</u> | 3.08 | 0.14 | <u>1,041,153</u> | \$ 0.14 |

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

| | Number of Shares | Weighted Average Exercise Price |
|---------------------------|------------------|---------------------------------|
| Balance January 1, 2022 | 3,349,793 | \$ 0.16 |
| Granted | – | – |
| Cancelled, Expired | (822,946) | \$ 0.17 |
| Exercised | – | – |
| Balance December 31, 2022 | 2,526,847 | \$ 0.16 |
| Granted | – | – |
| Cancelled, Expired | (1,485,694) | \$ 0.16 |
| Exercised | – | – |
| Balance December 31, 2023 | <u>1,041,153</u> | \$ 0.14 |

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 share price data for the trailing period equal to the expected term 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 records 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.

There were no options granted in the years ended December 31, 2023 and 2022.

The total fair value of underlying shares related to options that vested during the years ended December 31, 2023 and 2022 was \$0. The aggregate intrinsic value of the vested options was zero as of December 31, 2023 and 2022. During the year ended December 31, 2023, no options were granted, exercised or cancelled, but 1,485,694 expired. During the year ended December 31, 2022, no options were granted, exercised or cancelled, but 822,946 expired. Total stock-based compensation expense in connection with options granted to employees recognized in the consolidated statements of operations for the years ended December 31, 2023 and 2022 was \$0.

Warrants

The following table summarizes the changes in warrants outstanding and the related exercise price for the warrants issued.

Transactions involving warrants are summarized as follows:

| | <u>Number of Shares</u> | <u>Weighted Average Price / Share</u> |
|---|-------------------------|---------------------------------------|
| Outstanding at January 1, 2022 | 105,380,666 | \$ 0.06 |
| Granted | — | — |
| Exercised | — | — |
| Cancelled or Expired | — | — |
| Outstanding at December 31, 2022 | 105,380,666 | \$ 0.06 |
| Granted | — | — |
| Exercised | — | — |
| Cancelled or Expired | — | — |
| Outstanding at December 31, 2023 | 105,380,666 | \$ 0.06 |

The active warrants relate to those owned by VDA as a result of the VDA Transaction, which closed on January 7, 2022.

NOTE K – RELATED PARTY TRANSACTIONS

For the years ended December 31, 2023 and 2022, the Company paid cash consideration of \$110,660 and \$311,960, respectively to the Company's non-employee directors as compensation for their attendance and participation in the Company's Board of Director and committee meetings. The amount payable to directors at December 31, 2023 and 2022 was \$16,196 and \$8,333, respectively.

For the years ended December 31, 2023 and 2022, the Company recognized revenue of \$406,373 and \$98,289, respectively from VDA. Accounts receivable from VDA totaled \$123,581 and \$93,083 at December 31, 2023 and 2022, respectively.

For the years ended December 31, 2023 and 2022, the Company had purchases from VDA of \$620,498 and \$56,963. Accounts payable and accrued expenses to VDA at December 31, 2023 and 2022 totaled \$159,290 and \$44,175, respectively.

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 loss from operations before income taxes to the actual income tax (benefit) / expense is as follows:

| | <u>2023</u> | <u>2022</u> |
|---|-------------------------|-------------------------|
| Tax benefit computed at the statutory rate | \$ (247,970) | \$ (266,742) |
| State Taxes | 287,977 | 39,875 |
| Book expenses not deductible for tax purposes | 2,353 | 944 |
| Rate change | 9,896 | (29,705) |
| Deferred Tax Write Off | 1,073,010 | – |
| Other | (225) | 3,370 |
| | <u>1,125,041</u> | <u>(252,258)</u> |
| Change in valuation allowance for deferred tax assets | (1,114,314) | 267,293 |
| Income tax expense | <u>\$ 10,727</u> | <u>\$ 15,036</u> |

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:

| | <u>2023</u> | <u>2022</u> |
|------------------------------------|--------------------|--------------------|
| Deferred Tax Assets: | | |
| Net operating loss carried forward | \$ 21,371,675 | \$ 22,499,045 |
| Intangibles | – | – |
| Credits | – | – |
| Other | 515,789 | 502,733 |
| Total Deferred Tax Assets | <u>21,887,464</u> | <u>23,001,778</u> |
| Deferred Tax Liability | | |
| Intangibles | – | – |
| Total Deferred Tax Liabilities | <u>–</u> | <u>–</u> |
| Valuation Allowance | (21,887,464) | (23,001,778) |
| Net Deferred Tax Assets | <u>\$ –</u> | <u>\$ –</u> |

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, 2023 and December 31, 2022, the Company's valuation allowance, established for the tax benefit that may not be realized, totaled approximately \$21,890,000 and \$23,000,000, respectively. The overall decrease in the valuation allowance is related to expiration of federal and state net operating losses.

At December 31, 2023 the Company had net operating loss carryforwards of approximately \$96,300,000 and \$22,200,000 for federal and state income tax purposes which will expire at various dates from 2024 – 2043. There are approximately \$14,500,000 of federal net operating losses that do not expire.

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 2022, and in 2005 and 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 2020 and various states before 2019. 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, 2023 or 2022 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, 2023 or 2022. 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 would have expired in April 2021, but was subsequently amended and extended through April 30, 2026. On April 7, 2017 the Company executed an amendment to its existing lease in Waukesha, Wisconsin to expand another 3,982 square feet, bringing the total leased space to 10,344 square feet. In addition, the lease term was extended from May 1, 2021 to April 30, 2026. The commencement date for this amendment was July 15, 2017.

In May 2017, the Company entered into a lease agreement for 5,838 square feet of floor space in Waukesha, Wisconsin for its inventory warehousing operations. The lease would have expired in May 2024, but on July 1, 2023, the Company amended and extended the lease through April 30, 2026.

In November 2021, the Company entered into a lease agreement for 425 square feet of commercial office space in Gaithersburg, Maryland. This lease would have expired in April 2021, but was subsequently amended and extended through November 30, 2024.

The Company determines if an arrangement is a lease at inception. This determination generally depends on whether the arrangement conveys to the Company the right to control the use of an explicitly or implicitly identified fixed asset for a period of time in exchange for consideration. Control of an underlying asset is conveyed to the Company if the Company obtains the rights to direct the use of and to obtain substantially all of the economic benefits from using the underlying asset. The Company does not separate non-lease components from lease components to which they relate and accounts for the combined lease and non-lease components as a single lease component.

Operating leases are included in our Consolidated Balance Sheet as right-of-use assets, operating lease liabilities – current and operating lease liabilities – long-term. We do not recognize a right-of-use asset and lease liability for leases with a term of 12 months or less. Our current operating leases are for facilities. Our leases may contain renewal options; however, we do not recognize right-of-use assets or lease liabilities for renewal periods unless it is determined that we are reasonably certain of renewing the lease at inception or when a triggering event occurs. Some of our lease agreements may contain rent escalation clauses, rent holidays, capital improvement funding, or other lease concessions.

In determining our right-of-use assets and lease liabilities, we apply a discount rate to the minimum lease payments within each lease agreement. ASC 842 requires us to use the rate of interest that a lessee would have to pay to borrow on a collateralized basis over a similar term, an amount equal to the lease payments in a similar economic environment. When we cannot readily determine the discount rate implicit in the lease agreement, we utilize our current borrowing rate on our outstanding line of credit. The Company's line of credit utilizes market rates to assess an interest rate. Refer to Note G for further discussion.

We recognize our minimum rental expense on a straight-line basis based on the fixed components of a lease arrangement. Payments are set on a pre-determined schedule within each lease agreement. We amortize this expense over the term of the lease beginning with the date of the standard adoption for current leases and beginning with the date of initial possession, which is the date we enter the leased space and begin to make improvements in the preparation for its intended use, for future leases. Variable lease components represent amounts that are not fixed in nature and are not tied to an index or rate and are recognized as incurred. Variable lease components consist primarily of the Company's proportionate share of common area maintenance, utilities, taxes and insurance and are presented as operating expenses in the Company's statements of operations in the same line item as expense arising from fixed lease payments.

The components of lease expense for the years ended December 31 are as follows:

| | Year Ended December 31 | |
|------------------------------|-----------------------------------|-------------------|
| | 2023 | 2022 |
| Operating lease cost - fixed | \$ 171,084 | \$ 175,959 |
| Variable lease cost | 139,691 | 135,109 |
| Total operating lease cost | <u>\$ 310,775</u> | <u>\$ 311,068</u> |

Other information related to leases as of December 31 is as follows:

| | December 31, 2023 | December 31, 2022 |
|---|--------------------------|--------------------------|
| Operating lease liability - current | \$ 152,042 | \$ 157,334 |
| Operating lease liability - long term | 260,647 | 350,694 |
| Operating cash flows from operating leases | 310,775 | 311,068 |
| Weighted-average remaining lease term of operating leases | 2.3 years | 3.2 years |
| Weighted-average discount rate of operating leases | 8.5% | 8.5% |

Future annual minimum operating lease payments as of December 31, 2023 were as follows:

| | | |
|------------------------------|-----------|-----------------|
| 2024 | \$ | 183,485 |
| 2025 | | 206,917 |
| 2026 | | 69,725 |
| 2027 | | - |
| 2028 and thereafter | | - |
| Total minimum lease payments | | <u>460,127</u> |
| Less imputed interest | | <u>(47,438)</u> |
| Total | <u>\$</u> | <u>412,689</u> |

Rental expenses charged to operations for the years ended December 31, 2023 and 2022 was \$310,775 and \$311,068, 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.

Under the terms of a Consulting Agreement dated January 7, 2022, Piercarlo Gramaglia will serve as Chief Executive Officer of the Company for a term of eighteen (18) months, unless earlier terminated pursuant to the terms of the Consulting Agreement. In exchange for his service as Chief Executive Officer, the Company will pay Mr. Gramaglia an annual fee of \$30,000 and will pay his reasonable expenses associated with the performance of his duties as Chief Executive Officer. The Agreement was extended on July 1, 2023 and expired on December 31, 2023. The Company is currently in discussions with Mr. Gramaglia to extend the Consulting Agreement to a date yet to be determined.

John M. Srouji, Chief Sales & Operations Officer, is employed pursuant to an employment agreement with us effective February 1, 2023 and expiring on May 31, 2026. The term of the employment agreement will automatically renew for an additional twelve months. Mr. Srouji will receive a base salary of \$300,000 per year and bonuses and benefits based on the Company's internal policies and on participation in the Company's incentive and benefit plans.

Jeffrey J. Sobieski, Chief Technology Officer, is employed pursuant to an employment agreement with us effective February 1, 2023 and expiring May 31, 2026. The term of the employment agreement will automatically renew for a period of an additional twelve (12) months, and provides for a base salary of \$250,000 per year and bonuses and benefits based upon the Company's internal policies and participation in the Company's incentive and benefit plans. Per the agreement, Mr. Sobieski is eligible to receive a bonus, not to exceed 15% of his base salary, should predetermined objectives be met.

Richard E. Mushrush, Chief Financial Officer, is employed pursuant to an employment agreement with us effective February 1, 2023 and expiring May 31, 2026. The term of the employment agreement will automatically renew for a period of an additional twelve (12) months, and provides for a base salary of \$122,000 per year and bonuses and benefits based upon the Company's internal policies and participation in the Company's incentive and benefit plans. Per the agreement, Mr. Mushrush is eligible to receive a bonus, not to exceed 20% of his base salary, should predetermined objectives be met.

In addition to the foregoing, stock options may be periodically granted to employees under the Company's 2020 equity incentive plan at the discretion of the Compensation Committee of the Board of Directors. Executives of the Company are eligible to receive stock option grants, based upon individual performance and the performance of the Company as a whole.

Litigation

The Company is subject to legal proceedings and claims which arise in the ordinary course of its business. Although occasional adverse decisions or settlements may occur, other than the Sipco litigation discussed below, which has been dismissed, 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.

Sipco Litigation and License Agreement

The Company continues to fulfill its obligations under the Wireless Network Patent License Agreement (the "License Agreement") between SIPCO, LLC ("Sipco") and IPCO, LLC dba IntusIQ (collectively, the "Licensors") and the Company, dated November 30, 2020. The parties entered into the License Agreement in connection with the settlement of a lawsuit filed by Sipco as disclosed in more detail in the Company's previously filed reports.

The minimum payments required under the License Agreement have been accrued for on the Company's Condensed Consolidated Balance Sheets in accordance with GAAP, which specifies that when a liability is probable and the amount can be reasonably estimated, said liability should be recorded in the current reporting period. Per the License Agreement, the contractual minimum payments began on January 1, 2022 and continue until December 31, 2024, thus satisfying both criteria of probable and reasonably estimable. Accordingly, a long-term liability was recorded representing the sum of those contractual minimums. As of December 2023, the Company had a current liability of approximately \$226,459, which \$76,459 is included in accounts payable and \$150,000 in other accrued liabilities (See Note F – Current Accrued Liabilities for further breakdown of accrued liabilities), along with a non-current liability of \$70,000 included in accrued royalties – long-term recorded on its Consolidated Balance Sheets.

Indemnification Agreements

On March 31, 2010, the Company entered into an Indemnification Agreement with Jeffrey J. Sobieski, then Chief Operating Officer. On April 24, 2012, the Company entered into an Indemnification Agreement with director Tim S. Ledwick. On January 1, 2017, the Company entered into an Indemnification Agreement 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 Tax

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.

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

| | <u>December 31, 2023</u> | <u>December 31, 2022</u> |
|------------------------|---------------------------------|---------------------------------|
| Beginning balance | \$ 778 | \$ 16,634 |
| Sales tax collected | 196,801 | 162,710 |
| Provisions (reversals) | (780) | (10,610) |
| Payments | (121,111) | (167,956) |
| Ending balance | <u>\$ 75,688</u> | <u>\$ 778</u> |

NOTE N – BUSINESS CONCENTRATION

For the year December 31, 2023, two customers, each representing equal to or greater than 10% of total net revenues, accounted for approximately 35% of total net revenues. For the year December 31, 2022, two customers, each representing over 15% of total net revenues, accounted for approximately 37% of total net revenues.

As of December 31, 2023, there were three customers, each representing over 10% of the Company's net accounts receivable, accounting for 55% of the Company's net accounts receivable. As of December 31, 2022, one customer accounted for approximately 35% of the Company's net accounts receivable.

Purchases from two suppliers accounted for \$3,001,657, or 86%, of total purchases for the year ended December 31, 2023. Purchases from two suppliers accounted for \$3,919,435, or 95%, of total purchases for the year ended December 31, 2022. 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.

As of December 31, 2023, there were three suppliers, each representing over 10% of the Company's net accounts payable, accounting for 82% of the Company's net accounts payable.

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 3 months of service. 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. In response to the impact COVID-19 had on the Company's operations and financial results, in June 2020 management suspended the Company's 401(k) match and reinstated it on January 1, 2023. The Company made contributions to the plan of approximately \$100,000 and \$0 for the years ended December 31, 2023 and 2022, respectively.