

**SIELOX, INC. AND SUBSIDIARY**  
CONSOLIDATED FINANCIAL STATEMENTS  
AND  
INDEPENDENT ACCOUNTANTS' COMPILATION REPORT  
MARCH 31, 2011

## SIELOX, INC. AND SUBSIDIARY

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## **INDEPENDENT ACCOUNTANTS' COMPILATION REPORT**

To the Board of Directors and Stockholders of  
Sielox, Inc. and Subsidiary

We have compiled the accompanying consolidated balance sheet of Sielox, Inc. and Subsidiary (collectively, the "Company") as of March 31, 2011, and the related consolidated statements of operations, changes in stockholders' equity, and comprehensive income (loss), and cash flows for the three month periods ended March 31, 2011 and 2010. We have not audited or reviewed the accompanying consolidated financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.

Management is responsible for the preparation and fair presentation of the consolidated financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the consolidated financial statements.

Our responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

The accompanying consolidated balance sheet of Sielox, Inc. and Subsidiary, as of December 31, 2010, was previously reviewed by us, and we stated that we were not aware of any material modifications that should be made to the consolidated balance sheet in order for it to be in conformity with accounting principles generally accepted in the United States of America in our report dated August 17, 2011, but we have not performed any procedures in connection with that review engagement since that date.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2, the Company has continued to incur negative cash flows from operations and net losses from operations, which raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 2. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Roseland, New Jersey  
October 12, 2011

**SIELOX, INC. AND SUBSIDIARY**  
**CONSOLIDATED BALANCE SHEETS**  
(\$ in thousands)

**ASSETS**

<b>Current assets</b>	<u><b>March 31, 2011</b></u>	<u><b>December 31, 2010</b></u>
Cash	\$ 148	\$ 407
Accounts receivable, less allowance for doubtful accounts of \$141 and \$140 in 2011 and 2010, respectively	1,914	2,023
Inventories, net of reserve for obsolescence of \$311 and \$264 in 2011 and 2010, respectively	5,199	4,694
Prepaid expenses	129	335
Promissory note, current portion	167	167
Current assets of discontinued operations	-	10
<b>Total current assets</b>	<u>7,557</u>	<u>7,636</u>
Property and equipment, net	76	48
Trade Name - Costar	800	800
Distribution agreement, net	1,119	1,137
Customer relationships, net	333	400
Promissory note, net of current portion	333	333
<b>Total assets</b>	<u>\$ 10,218</u>	<u>\$ 10,354</u>
 <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  		
<b>Current liabilities</b>		
Accounts Payable	\$ 1,237	\$ 1,574
Accrued expenses and other	48	285
Contingent purchase price, current portion	225	285
Lines of credit	1,359	626
Current liabilities of discontinued operations	4	75
<b>Total current liabilities</b>	<u>2,873</u>	<u>2,845</u>
Long term liability, contingent purchase price	-	9
<b>Total liabilities</b>	<u>2,873</u>	<u>2,854</u>
<b>Stockholders' equity</b>		
Common stock	42	42
Additional paid in capital	155,837	155,805
Accumulated other comprehensive income	260	260
Accumulated deficit	<u>(144,270)</u>	<u>(144,083)</u>
Less common stock held in treasury	(4,524)	(4,524)
<b>Total stockholders' equity</b>	<u>7,345</u>	<u>7,500</u>
<b>Total liabilities and stockholders' equity</b>	<u>\$ 10,218</u>	<u>\$ 10,354</u>

See independent accountants' compilation report and notes to consolidated financial statements

**SIELOX, INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(\$ in thousands)

	<b>For the Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>Net revenues</b>	\$ 3,462	\$ 2,654
<b>Cost of revenues</b>	2,605	2,007
<b>Gross profit</b>	857	647
<b>Selling, general and administrative expenses</b>	1,035	998
<b>Loss from operations</b>	(178)	(351)
Other income (expenses)		
Interest income	2	-
Interest expense	(25)	(31)
Other income	15	-
Total other expense, net	(8)	(31)
Loss from continuing operations	(186)	(382)
Loss from discontinued operations (see Note 3)	(1)	(31)
<b>Net loss</b>	\$ (187)	\$ (413)
Per share of common stock		
Loss from continuing operations	(0.01)	(0.01)
Loss from discontinued operations	0.00	0.00
Net loss per share	(0.01)	(0.01)
Weighted average shares outstanding	36,213	35,982

See independent accountants' compilation report and notes to consolidated financial statements

**SIELOX, INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF**  
**STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME (LOSS)**  
**FOR THE THREE MONTH PERIODS ENDED MARCH 31, 2011 AND MARCH 31, 2010**  
(\$ in thousands)

	Common Stock		Additional	Treasury Stock		Accumulated	Accumulated	Total
	Shares	Amount	Paid - In	Shares	Amount	Other	Deficit	Stockholders'
			Capital			Comprehensive		Equity
						Income (Loss)		
Balances at December 31, 2009	42,017	\$ 42	\$ 155,805	6,296	\$ (4,524)	\$ 260	\$ (143,725)	\$ 7,858
Net loss	-	-	-	-	-	-	(413)	(413)
Balances at March 31, 2010	<u>42,017</u>	<u>\$ 42</u>	<u>\$ 155,805</u>	<u>6,296</u>	<u>\$ (4,524)</u>	<u>\$ 260</u>	<u>\$ (144,138)</u>	<u>\$ 7,445</u>
Balances at December 31, 2010	42,017	\$ 42	\$ 155,805	6,296	\$ (4,524)	\$ 260	\$ (144,083)	\$ 7,500
Net loss	-	-	-	-	-	-	(187)	(187)
Stock based compensation	-	-	32	-	-	-	-	32
Balances at March 31, 2011	<u>42,017</u>	<u>\$ 42</u>	<u>\$ 155,837</u>	<u>6,296</u>	<u>\$ (4,524)</u>	<u>\$ 260</u>	<u>\$ (144,270)</u>	<u>\$ 7,345</u>

See independent accountants' compilation report and notes to consolidated financial statements

**SIELOX, INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(\$ in thousands)

	<b>For the Three Months Ended March 31,</b>	
	<b>2011</b>	<b>2010</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net loss	\$ (187)	\$ (413)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Stock-based compensation	32	-
Depreciation and amortization	100	108
Provision for doubtful accounts	1	(60)
Changes in operating assets and liabilities:		
Accounts receivable, net	108	(96)
Inventory	(505)	(93)
Prepaid expenses	206	72
Accounts payable	(337)	453
Accrued expenses and other	(237)	7
Net cash provided by (used in) operating activities	(819)	(22)
Net cash used in discontinued operations	(61)	(148)
Net cash provided by (used in) operating activities	(880)	(170)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of fixed assets	(43)	-
Payment of earnout provision related to Southern Imaging	(69)	(62)
Net cash used in investing activities	(112)	(62)
<b>CASH PROVIDED BY FINANCING ACTIVITIES</b>		
Proceeds from debt, net	733	267
<b>NET INCREASE (DECREASE) IN CASH</b>	(259)	35
<b>CASH, BEGINNING OF PERIOD</b>	407	122
<b>CASH, END OF PERIOD</b>	\$ 148	\$ 157
<b>Cash of continuing operations</b>	\$ 148	\$ 157
<b>Cash of discontinued operations</b>	\$ -	\$ 8
<b>SUPPLEMENTAL DISCLOSURE CASH FLOW INFORMATION:</b>		
Cash paid during the period for interest	\$ 25	\$ 74

See independent accountants' compilation report and notes to consolidated financial statements

**SIELOX, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(\$ in thousands)**

**NOTE 1 - NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

Sielox, Inc. (“Sielox”), incorporated in the State of Delaware in February 1997 under the name “Fairmarket, Inc.”, and its wholly owned subsidiary, Costar Video Systems, LLC (“Costar”) (collectively the “Company”), develops, designs and distributes a range of security solution products such as surveillance cameras, lenses, digital video recorders and high speed domes. The Company also develops designs and distributes industrial vision products to observe repetitive production and assembly lines, thereby increasing efficiency by detecting faults in the production process.

The Company operates through one wholly-owned subsidiary, Costar.

**PRINCIPLES OF CONSOLIDATION**

The accompanying consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) and include the accounts of the Company and its wholly owned subsidiary, Costar. All material intercompany transactions have been eliminated in consolidation.

These consolidated financial statements were approved by management and available for issuance on October 12, 2011. Subsequent events have been evaluated through this date.

**USE OF ESTIMATES**

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**CASH**

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

**ACCOUNT RECEIVABLE, AND ALLOWANCE FOR DOUBTFUL ACCOUNTS**

The Company complies with the accounting and reporting requirements of GAAP that lend to or finance the activities of others. Accounts receivable are recorded at net realizable values. The Company maintains an allowance for estimated losses resulting from the failure of customers to make required payments and for anticipated returns. The allowance is based on specific facts and circumstances surrounding individual customers as well as historical experience. Provisions for losses on receivables and returns are charged to income to maintain the allowance at a level considered adequate to cover losses and future returns. Receivables are charged off against the reserve when they are deemed uncollectible and returns are charged off against the reserve when the actual returns are incurred.

**INVENTORIES**

Inventories are recorded on the first in first out basis and are stated at the lower of average cost or market. A provision is made to reduce excess or obsolete inventories to their net realizable value. As of March 31, 2011 and December 31, 2010 the Company had \$5,199 and \$4,694 in finished goods, respectively.

**SIELOX, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(\$ in thousands)**

**NOTE 1 - NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**PROPERTY AND EQUIPMENT**

Property and equipment is stated at cost less accumulated depreciation and amortization. Depreciation and amortization is computed using the straight-line method over estimated useful lives of 3-5 years.

	Estimated Useful Life
Computer hardware and software	3 years
Furniture and Fixtures	5 years
Leasehold improvements	Shorter of lease term or asset useful life

**INTANGIBLE ASSETS**

In accordance with GAAP, intangible assets with indefinite lives are not amortized, but instead tested for impairment. Intangible assets are reviewed for impairment at least annually or whenever events or changes in business combinations indicate the carrying value of the assets may not be recoverable. Impairment losses are recognized if the fair value of the intangible is less than its carrying value.

Intangible assets with finite lives are amortized over their estimated useful lives. These intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amounts of the assets may not be recoverable. A loss is recognized in the statements of operations if it is determined that an impairment exists based on expected future undiscounted cash flows. The amount of the impairment is the excess of the carrying amount of the impaired asset over its fair value.

**LONG-LIVED ASSETS**

In accordance with GAAP, we review property and equipment for impairment whenever events or changes in circumstances indicated that the carrying amounts of the assets may not be recoverable. A loss is recognized on the statements of operations if it is determined that an impairment exists based on expected future undiscounted cash flows. The amount of the impairment is the excess of the carrying amount of the impaired asset over its fair value.

**REVENUE RECOGNITION**

The Company ships and invoices its sales in accordance with signed purchase orders. The Company only recognizes revenue when it is realized and earned. The Company considers its revenue to have been earned when goods are shipped in accordance with signed purchase orders. Any software imbedded in the products sold is considered incidental to the product being sold.

Revenue from separately priced extended warranty and product maintenance contracts is deferred and recognized in income on a straight-line basis over the contract period.

**SIELOX, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(\$ in thousands)**

**NOTE 1 - NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**RESEARCH & DEVELOPMENT**

Expenditures for research, development and engineering of software and hardware products, that are included in selling, general and administrative expenses in the consolidated statements of operations, are expensed as incurred.

**STOCK BASED COMPENSATION**

The Company complies with the accounting and reporting requirements of the Accounting for Stock-Based Compensation guidelines which require companies to record compensation expense for share-based awards issued to employees in exchange for services provided. The amount of the compensation expense is based on the estimated fair value of the awards on their grant dates and is recognized over the applicable vesting period.

The fair value of stock options is determined using an option-pricing model that takes into account the stock price at the grant date, the exercise price, the expected life of the option, the volatility of the underlying stock, expected dividends, and the risk free interest rate over the expected life of the option.

The Company elected to utilize the modified prospective transition method, which requires the application of the accounting standard to all share-based awards issued on or after January 1, 2006 and any outstanding share-based awards that were issued but not vested as of January 1, 2006.

During the three months ended March 31, 2011 and 2010, the Company recognized \$32 and \$0 in stock based compensation expense in its consolidated financial statements, respectively.

**INCOME TAXES**

The Company complies with GAAP which requires an asset and liability approach to financial reporting for income taxes. Deferred income tax assets and liabilities are computed for differences between the financial statement and tax bases of assets and liabilities that will result in future taxable or deductible amounts, based on enacted tax laws and rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established, when necessary, to reduce deferred income tax assets to the amount expected to be realized.

The determination of the Company's provision for income taxes requires significant judgment, the use of estimates, and the interpretation and application of complex tax laws. Significant judgment is required in assessing the timing and amounts of deductible and taxable items and the probability of sustaining uncertain tax positions. The benefits of uncertain tax positions are recorded in the Company's financial statements only after determining a more-likely-than-not probability that the uncertain tax positions will withstand challenge, if any, from tax authorities. When facts and circumstances change, the Company reassesses these probabilities and records any changes in the financial statements as appropriate. Accrued interest and penalties related to income tax matters are classified as a component of income tax expense.

**SIELOX, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(\$ in thousands)**

**NOTE 1 - NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

**INCOME TAXES (continued)**

In accordance with GAAP, the Company is required to determine whether a tax position is more likely than not to be sustained upon examination by the applicable taxing authority, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The Company files an income tax return in the U.S. federal jurisdiction, and may file income tax returns in various U.S. states and foreign jurisdictions. The tax benefit recognized is measured as the largest amount of benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. De-recognition of a tax benefit previously recognized results in the Company recording a tax liability that reduces retained earnings. This policy has been applied to all existing tax positions upon the Company's initial adoption for the period ended March 31, 2011 and December 31, 2010.

The Company files an income tax return in the U.S. federal jurisdiction, and may file income tax returns in various U.S. states and foreign jurisdictions. Generally, the Company is no longer subject to income tax examinations by major taxing authorities for years before 2007.

**COMPREHENSIVE INCOME (LOSS)**

Comprehensive income (loss) consists of net income (loss) and other comprehensive income (loss), which includes foreign currency translation adjustments. In accordance with GAAP, the Company establishes standards for disclosure and financial statement presentation for reporting total comprehensive income (loss) and its individual components. Comprehensive income (loss), as defined, includes all changes in equity during a period from non-owner resources.

**NOTE 2 - LIQUIDITY AND GOING CONCERN CONSIDERATION**

The Company has continued to incur losses and negative cash flows from operations. For the three months ended March 31, 2011, the Company incurred a net loss of approximately \$187. As of March 31, 2011, the Company had an accumulated deficit of approximately \$144,270 and outstanding debt in the amount of \$1,359 from its line of credit which expired on September 20, 2011.

Effective August 21, 2009, Costar entered into a Revolving Credit and Security Agreement (the "Costar Loan Agreement") with BBVA Compass Bank ("Compass"). The Costar Loan Agreement provides Costar with up to \$4,000 in revolving lines of credit. Borrowings under the Costar Loan Agreement accrued interest at a rate equal to the greater of (i) 5% per annum and (ii) the 30-day LIBOR plus 3% per annum. The provisions of the Costar Loan Agreement are more fully described in Note 7.

In addition, effective June 1, 2010, and again on November 21, 2010, Compass Bank ("Compass") amended and restated the Revolving Credit and Security Agreement dated as of August 21, 2009. The restated agreement provides Costar with up to \$2,500 in revolving lines of credit due on January 21, 2011, or such future date to which the Maturity Date of the revolving line may be extended at the bank's sole discretion. Borrowings under the restated agreement accrued interest at a rate equal to the greater of 7% per annum or the 30-day LIBOR plus 4% per annum.

**SIELOX, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(\$ in thousands)**

**NOTE 2 - LIQUIDITY AND GOING CONCERN CONSIDERATION (continued)**

In addition, effective January 21, 2011, April 21, 2011, June 21, 2011, and August 5, 2011, Compass amended and restated the Revolving Credit and Security Agreement dated as of August 21, 2009. The restated agreement provides Costar with up to \$1,500 in revolving lines of credit due on September 20, 2011. The Company did not renew their Revolving Credit and Security Agreement with Compass.

Effective as of September 23, 2011, Costar entered into a Loan and Security Agreement with Briar Capital ("Briar"). The Loan and Security Agreement allows for up to \$3,500 in revolving lines of credit, with a three year maturity. Borrowings under the Loan and Security Agreement accrued interest at the 30-day LIBOR rate plus 8.25% per annum. The provisions of the Loan and Security Agreement with Briar are more fully described in Note 7.

The Company has taken measures to reduce expenses. One of those measures was the decision to suspend its reporting obligations under the Securities Exchange Act of 1934, as amended. On March 30, 2010, the Company filed Form 15. As a result, the Company has ceased filing current and periodic reports with the SEC. There can be no assurances that the Company will successfully reduce expenses.

The Company's existing and future obligations include expenses associated with marketing and growing its customer base and product offerings. The general economic slowdown has negatively impacted demand for the Company's products, thereby limiting the ability of the Company to improve its liquidity through increased sales. No adjustment has been made in the consolidated financial statements of the Company to the amounts and classification of assets and liabilities which could result should the Company be unable to continue as a going concern.

There can be no assurance that the Company will be successful in building its customer base and product lines or that available capital will be sufficient to fund current operations and to meet the Company's financial obligations as they relate to working capital requirements and debt repayment obligations until such time that revenues increase to the extent necessary to cover operating costs. If the Company is unsuccessful in building its customer base or if available capital is insufficient to fund current operations, there could be a material adverse effect on the financial position, results of operations and cash flows of the Company.

**NOTE 3 – DISCONTINUED OPERATIONS**

As required under GAAP, the Company has classified the results of operations of Sielox, LLC within income from discontinued operations. The assets and liabilities of this entity have been classified within current and non-current assets and current and long term liabilities of discontinued operations on the consolidated balance sheet.

During December 2010, the Company entered into an agreement to sell certain of the assets and liabilities of its wholly owned subsidiary, Sielox, LLC. Sielox, LLC develops, designs and distributes a range of access control systems and products. The Company sold net assets of \$2,431 including accounts receivable of \$1,414 and inventory of \$595 among others. These assets were sold for \$2,525 in cash and a \$500 promissory note. The net gain on the sale was \$492 which includes approximately \$100 in legal costs associated with the sale.

**SIELOX, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(\$ in thousands)

**NOTE 3 – DISCONTINUED OPERATIONS (continued)**

One of the agreed conditions of the sale was that Costar would continue to sell its range of security solution products through the Sielox network of approved business partners. The terms and conditions that govern the sale of Costar products are stated in the Master Distribution Agreement (the “Agreement”) entered into between Costar and HGW Acquisition Company (“HGW”). The term of the Agreement commences on January 1, 2011, and ends on December 31, 2013. During the term of the Agreement, HGW has agreed to purchase Costar products in the minimum amount of \$5,000. Actual purchases will be measured against a schedule of semi-annual purchase commitments (the “Purchase Commitment”). In furtherance of the Purchase Commitment, HGW delivered to Costar a secured promissory note with an original principal balance in the amount of \$500 and bearing interest on the unpaid balance at a rate equal to 7% per annum. The promissory note is secured by a first priority security interest in HGW’s accounts receivable. In the event that HGW fails to purchase Costar products in an amount equal to the Purchase Commitment as of the end of an applicable semi-annual period, HGW will have a period of 30 days to remedy the purchase default.

That remedy will be in the form of a payment to Costar, of an amount equal to 25% of the shortfall, plus interest.

The results of operations and the assets and liabilities of discontinued operations included in the consolidated statements of operations and consolidated balance sheets are as follows:

	For the three months ended,	
	<u>March 31, 2011</u>	<u>March 31, 2010</u>
Net revenues	\$-	\$1,438
Cost of revenues	-	859
Gross Profit	-	579
Selling, general & administrative expenses	<u>1</u>	<u>566</u>
Operating income (loss)	(1)	13
Other expenses		
Interest expense	-	(43)
Net loss	<u>\$(1)</u>	<u>\$(30)</u>

**SIELOX, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(\$ in thousands)

**NOTE 3 – DISCONTINUED OPERATIONS (continued)**

	<u>March 31, 2011</u>	<u>December 31, 2010</u>
Cash	\$ -	\$ 10
Accounts receivable, net	-	-
Inventory, net	-	-
Prepaid expenses	<u>-</u>	<u>-</u>
Current assets of discontinued operations	-	10
Property and equipment, net	-	-
Trademark – Sielox, LLC	-	-
Proprietary Technology	-	-
Deposits and other assets	<u>-</u>	<u>-</u>
Long term assets of discontinued operations	<u>-</u>	<u>-</u>
Accounts payable	-	-
Accrued expenses and other	4	75
Line of credit	-	-
Deferred revenue	<u>-</u>	<u>-</u>
Current liabilities of discontinued operations	<u>\$ 4</u>	<u>\$ 75</u>

The assets and liabilities only include those assets and liabilities that were included in the asset based sale of Sielox, LLC.

**NOTE 4 - CONCENTRATIONS**

**CONCENTRATION OF CUSTOMERS**

The Company’s security surveillance product line customers include traditional “large box” national retailers and distributors. The Company’s industrial vision product line customers include manufacturers that assemble products using automated production lines; they use the Company’s video systems to monitor activity on the production line. For the three months ended March 31, 2011 and 2010, the Company’s largest customer accounted for approximately \$1,043 and \$901, or 30.1% and 34.0% of the Company’s total revenue, respectively. The same customer owed \$364 and \$434, or 19.0% and 25.1%, of the outstanding receivable balance, as of March 31, 2011 and 2010, respectively.

**CONCENTRATION OF SUPPLIERS**

For the three months ended March 31, 2011 and 2010, the Company made purchases from one main supplier of approximately 33.2% and two main suppliers of approximately 44.1% of total purchases, respectively. Amounts owed to these suppliers were approximately 43.5% and 59.0%, of the total accounts payable balance, as of March 31, 2011 and 2010, respectively.

**SIELOX, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(\$ in thousands)

**NOTE 5 - PROPERTY AND EQUIPMENT**

Property and equipment from continuing operations at March 31, 2011 and December 31, 2010, were as follows:

	<u>2011</u>	<u>2010</u>
Office Furniture and Equipment	\$ 379	\$ 317
Demonstration and Technical Equipment	<u>41</u>	<u>41</u>
	420	358
Less accumulated depreciation	<u>(344)</u>	<u>(310)</u>
Total	<u>\$ 76</u>	<u>\$ 48</u>

**NOTE 6 – INTANGIBLE ASSETS**

In accordance with GAAP, intangible assets with indefinite lives are not amortized, but instead tested for impairment. Intangible assets are reviewed for impairment at least annually or whenever events or changes in business combinations indicate the carrying value of the assets may not be recoverable. Impairment losses are recognized if the fair value of the intangible is less than its carrying value.

Intangible assets that are subject to amortization are reviewed for potential impairment whenever events or circumstances indicate that carrying amounts may not be recoverable. Assets not subject to amortization are tested for impairment at least annually.

The following is a summary of amortized and unamortized intangibles from continuing operations at March 31, 2011 and December 31, 2010.

	<u>March 31, 2011</u>		<u>December 31, 2010</u>	
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>
Amortized Intangible Assets				
Customer Relationships	1,598	1,265	1,598	1,198
Distribution Agreement	<u>1,468</u>	<u>349</u>	<u>1,468</u>	<u>331</u>
	3,066	1,614	3,066	1,529
Unamortized Intangible Assets				
Trade Name Costar	<u>800</u>		<u>800</u>	
	<u>3,866</u>		<u>3,866</u>	

The weighted average amortization period is 12 years. The estimated useful life for customer relationships distribution agreements are 6 and 20 years, respectively.

**SIELOX, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(\$ in thousands)**

**NOTE 6 – INTANGIBLE ASSETS (continued)**

Amortization expense was \$85 and \$100 for the three month periods ended March 31, 2011 and 2010. Estimated amortization expense for each of the ensuing years is:

Year Ending March 31,

2012	\$207
2013	\$ 73
2014	\$ 73
2015	\$ 73

**NOTE 7 - CREDIT LINES**

Effective as of August 21, 2009, Costar entered into the Costar Loan Agreement with Compass. The Costar Loan Agreement provided Costar with up to \$4,000 in revolving lines of credit. The obligations under the Costar Loan Agreement are evidenced by a Master Revolving Promissory Note made by Costar in favor of Compass. The obligations under the Costar Loan Agreement are secured by a lien on substantially all accounts receivable, inventory, equipment, general intangibles, including intellectual property, chattel paper, instruments and documents of Costar, as set forth in the Costar Loan Agreement. The Company is a guarantor of Costar's obligations under the Costar Loan Agreement pursuant to the unlimited guaranty made by the Company in favor of Compass. Borrowings under the Costar Loan Agreement accrued interest at a rate equal to the greater of (i) 5% per annum and (ii) the 30-day LIBOR plus 3% per annum.

The Costar Loan Agreement contains customary representations and warranties, events of default and covenants, including, among other things, covenants that restrict the ability of Costar to incur certain additional indebtedness or to issue equity interests. The Costar Loan Agreement also contains financial covenants restricting Costar's Debt Service Coverage Ratio, Total Debt to Tangible Net Worth Ratio, and Quick Ratio (as each of such terms is defined in the Loan Agreement), as well as limiting capital expenditures of Costar and requiring Costar and the Company to maintain a specific Tangible Net Worth. As of March 31, 2011 and December 31, 2010, approximately \$1,359 and \$626, respectively, was owed to Compass.

In addition, effective as of June 1, 2010, and again on November 21, 2010, Compass amended and restated the Revolving Credit and Security Agreement dated as of August 21, 2009. The restated agreement provides Costar with up to \$2,500 in revolving lines of credit due on January 21, 2011, or such future date to which the Maturity Date of the revolving line may be extended at the bank's sole discretion. Borrowings under the restated agreement accrue interest at a rate equal to the greater of 7% per annum or the 30-day LIBOR plus 4% per annum.

Effective January 21, 2011, Compass amended and restated the Revolving Credit and Security Agreement dated as of August 21, 2009. The restated agreement provides Costar with up to \$1,500 in revolving lines of credit due on April 21, 2011, or such future date to which the Maturity Date of the revolving line may be extended at the bank's sole discretion.

**SIELOX, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(\$ in thousands)**

**NOTE 7 - CREDIT LINES (continued)**

Effective March 31, 2011, the Company was in default of one of the covenants with Compass, and has requested a waiver from the bank. In addition, effective April 21, 2011, June 21, 2011, and August 5, 2011, Compass amended and restated the Costar Loan Agreement dated as of August 21, 2009. The restated agreement provides Costar with up to \$1,500 in revolving lines of credit due on September 20, 2011. The Company did not renew their Revolving Credit and Security Agreement with Compass.

Effective as of September 23, 2011, Costar entered into a Loan and Security Agreement with Briar Capital ("Briar"). The Loan and Security Agreement allows for up to \$3,500 in revolving lines of credit, with a three year maturity. The obligations under the Costar Loan and Security Agreement with Briar are secured by a lien on substantially all accounts receivable, inventory, equipment, general intangibles, including intellectual property, chattel paper, instruments and documents of Costar, as set forth in the Loan and Security Agreement with Briar. The Company is a guarantor of Costar's obligations under the Costar Loan and Security Agreement with Briar pursuant to the guaranty made by the Company in favor of Briar. Borrowings under the Loan and Security Agreement accrue interest at the 30-day LIBOR rate plus 8.25% per annum.

The Costar Loan and Security Agreement with Briar contains customary representations and warranties, events of default and covenants, including, among other things, covenants that restrict the ability of Costar to incur certain additional indebtedness or to issue equity interests. The Costar Loan and Security Agreement with Briar also contains financial covenants restricting capital expenditures of Costar and requiring Costar and the Company to maintain a specific Tangible Net Worth.

**NOTE 8 - STOCKHOLDERS' EQUITY**

At March 31, 2011 and December 31, 2010, the authorized capital stock of the Company consisted of (i) 90,000,000 shares of voting common stock with a par value of \$0.001 per share and (ii) 10,000,000 shares of preferred stock with a par value of \$0.001 per share. The Company's Board has the authority to determine the voting powers, designations, preferences, privileges and restrictions of the preferred shares.

**NOTE 9 - EARNOUT, CONTINGENT PURCHASE PRICE**

Pursuant to that certain Asset Purchase Agreement, dated as of June 20, 2006, by and between Southern Imaging, Inc., Video Solutions Technology Center, LLC, and certain shareholders of Southern Imaging, Costar and Video Solutions Technology Center, LLC, whereby the Company acquired substantially all of the assets of Southern Imaging and Video Solutions (the "Southern Imaging Agreement," included as Exhibit 2.1 to the Company's 8-K filed on June 26, 2006), the Company was obligated to make an earn-out payment of \$773 on April 1, 2009 (the "2008 earn out payment"). The Company was unable to pay, in full, the 2008 earn-out payment. Since that date, several payments have been made that include principal and interest at 9% per annum. As of March 31, 2011 and December 31, 2010, the unpaid balance was approximately \$225 and \$294, respectively.

**SIELOX, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(\$ in thousands)**

**NOTE 9 - EARNOUT, CONTINGENT PURCHASE PRICE (continued)**

On January 15, 2010, the Company and the previous owners of Southern Imaging agreed on a payment schedule whereby the Company will make a payment, on or about the 15<sup>th</sup> of each month, of \$25, including principal and interest at 9% per annum.

Effective September 20, 2011, the Company entered into a payoff agreement with Thompson, Pritchett & Switzer, L.P., requiring approximately \$84 to be paid as the final earn-out payment. In addition, effective September 23, 2011, the earn-out payment was paid in full, per the payoff agreement.

**NOTE 10- LEASE AGREEMENTS**

The Company leases certain of its facilities under operating leases which expire in 2011. On January 31, 2011 the Company entered into a new lease agreement that will expire in 2018. Future minimum annual rent payments are approximately as follows:

Year Ending March 31,	
2012	\$ 85
2013	99
2014	109
2015	117
<u>Thereafter</u>	<u>363</u>
<u>Total</u>	<u>\$773</u>

**NOTE 11 - LEGAL PROCEEDINGS**

The Company, as well as the Company's subsidiary, L Q Corporation, are defendants in certain purported class action lawsuits entitled "In re Initial Public Offering Securities Litigation, 21 MC 92 (SAS)" filed by individual shareholders in the U.S. District Court for the Southern District of New York against certain of the Company's former officers and directors, and various of the underwriters in the Company's initial public offering ("IPO") and secondary offering. The lawsuits have been filed by individual shareholders who purport to seek class action status on behalf of all other similarly situated persons who purchased our common stock between July 8, 1999 and December 6, 2000. A consolidated amended class action complaint was filed on April 19, 2002. The complaint alleges that certain underwriters of the IPO solicited and received excessive and undisclosed fees and commissions in connection with that offering. The complaint further alleges that the defendants violated the federal securities laws by issuing a registration statement and prospectus in connection with the Company's IPO which failed to accurately disclose the amount and nature of the commissions and fees paid to the underwriter defendants. On or about October 8, 2002, the Court entered an Order dismissing the claims asserted against certain individual defendants in the consolidated actions without any payment from these individuals or the Company. On or about February 19, 2003, the Court entered an Order dismissing with prejudice the claims asserted against the Company under Section 10(b) of the Exchange Act. As a result, the only claims that remain against the Company are those arising under Section 11 of the Securities Act.

**SIELOX, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(\$ in thousands)**

**NOTE 11 - LEGAL PROCEEDINGS (continued)**

On October 5, 2009, the court entered an order granting final approval of the settlement. Ten appeals were filed objecting to the definition of the settlement classes and fairness of the settlement, five of which have been dismissed with prejudice. Appeal briefs have been filed by the remaining objector groups. The plaintiffs were scheduled to file an answering brief on December 17, 2011, but instead moved to dismiss one of the appeals based on alleged violations of the Second Circuit rules, including failure to serve, falsifying proofs of service, and failure to include citations to the record. While this motion to dismiss the appeals is pending, the brief deadlines on the main appeal should be tolled pursuant to Second Circuit Local Rule 31.2.

In May 2011, the Second Circuit dealt with the final two remaining appellants. One was dismissed, the other was brought before Judge Scheindlin to determine whether the appellant is a class member. Judge Scheindlin issued her decision that appellant is not a class member. If there is no appeal against this decision the case will finally be settled.

*Thompson, Pritchett & Switzer, LP v. Sielox, Inc. Et al. C.A. No. 09-13228 (Tex. Dist. Dallas County)*

A Complaint has been filed in the District Court of Dallas County, Texas, 162<sup>nd</sup> Judicial District (Cause No. 0913228), on behalf of Thompson, Pritchett & Switzer, L.P., as Plaintiff, against the Company, its predecessor company and Costar, as Defendants, alleging that the Defendants owe the Plaintiff approximately \$705 plus 9% interest and attorneys fees in connection with certain “earn-out” payments alleged to be due and owing to the Plaintiff by the Defendants in connection with that certain Asset Purchase Agreement pursuant to which the predecessor of the Company acquired certain companies known as Southern Imaging Inc. and Video Solutions Technologies Center Inc. On October 13, 2009, the parties agreed that the Plaintiff would not serve the Defendants with the Complaint until after January 15, 2010 unless the Defendants default on any of the following agreed upon payments: \$125 on October 14, 2009 (payment has been made), \$25 on November 2, 2009 (payment has been made) and an additional \$25 on December 15, 2009 (payment has been made). On January 15, 2010, the Company and the previous owners of Southern Imaging agreed on a payment schedule where by the Company will make a payment on or about the 15<sup>th</sup> of each month, of \$25, including principal and interest at 9% per annum. Effective September 20, 2011, the Company entered into a payoff agreement with Thompson, Pritchett & Switzer, L.P., requiring approximately \$84 to be paid as the final earn-out payment. In addition, effective September 23, 2011, the earn-out payment was paid in full, per the payoff agreement.

**NOTE 12 - SUBSEQUENT EVENT**

Effective April 21, 2011, June 21, 2011, and August 5, 2011, Compass amended and restated the Revolving Credit and Security Agreement dated as of August 21, 2009. The restated agreement provides Costar with up to \$1,500 in revolving lines of credit due on September 20, 2011. Borrowings under the Costar Loan Agreement accrue interest at a rate equal to the greater of (i) 7% per annum and (ii) the 30-day LIBOR plus 4% per annum. The provisions of the Costar Loan Agreement are more fully described in Note 7. The Company did not renew their Revolving Credit and Security Agreement with Compass.

Effective September 23, 2011, the Company entered into a Loan and Security Agreement with Briar Capital (“Briar”). The Loan and Security Agreement allows for up to \$3,500 in revolving lines of credit, with a three year maturity. Borrowings under the Loan and Security Agreement accrue interest at the 30-day LIBOR rate plus 8.25% per annum. The provisions of the Loan and Security Agreement with Briar are more fully described in Note 7.

**SIELOX, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(\$ in thousands)**

**NOTE 12 - SUBSEQUENT EVENT (continued)**

Effective September 20, 2011, the Company entered into a payoff agreement with Thompson, Pritchett & Switzer, L.P., requiring approximately \$84 to be paid as the final earn-out payment. In addition, effective September 23, 2011, the earn-out payment was paid in full, per the payoff agreement.