

**SIELOX, INC. AND SUBSIDIARIES**

CONSOLIDATED FINANCIAL STATEMENTS  
AND  
INDEPENDENT ACCOUNTANTS' REVIEW REPORT

DECEMBER 31, 2010 AND 2009

## SIELOX, INC. AND SUBSIDIARIES

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## Rothstein Kass

### INDEPENDENT ACCOUNTANTS' REVIEW REPORT

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

We have reviewed the accompanying consolidated balance sheets of Sielox, Inc. and Subsidiaries (collectively, the "Company") as of December 31, 2010 and 2009, and the related consolidated statements of operations, changes in stockholders' equity (deficit) and comprehensive income (loss), and cash flows for the years then ended. A review includes primarily applying analytical procedures to management's financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the consolidated financial statements as a whole. Accordingly, we do not express such an opinion.

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 review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the consolidated financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

Based on our reviews, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with accounting principles generally accepted in the United States of America.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 4, 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 4. The accompanying consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

*Rothstein, Kass & Company, P.C.*

Roseland, New Jersey  
June 20, 2011

**SIELOX, INC. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(\$ In thousands)

**ASSETS**

	December 31,	
	2010	2009
<b>Current Assets</b>		
Cash	\$ 407	\$ 122
Accounts receivable, less allowance for doubtful accounts of \$140 and \$254 in 2010 and 2009 respectively	2,023	1,575
Inventories, net of reserve for obsolescence of \$264 and \$183 in 2010 and 2009 respectively	4,694	4,423
Prepaid expenses	335	184
Promissory Note, current portion	167	
Current assets of discontinued operations	10	2,254
<b>Total Current Assets</b>	7,636	8,558
Property and equipment, net	48	124
Promissory Note, net of current portion	333	
Trade Name - Costar	800	800
Distribution agreement, net	1,137	1,211
Customer relationships, net	400	666
Deposits and other assets		22
Non-current assets of discontinued operations		721
<b>Total Assets</b>	\$ 10,354	\$ 12,102

**LIABILITIES AND STOCKHOLDERS' EQUITY**

**Current Liabilities**

Accounts payable	\$ 1,574	\$ 822
Accrued expenses and other	285	89
Contingent purchase price, current portion	285	261
Lines of credit	626	1,262
Current liabilities of discontinued operations	75	1,517
<b>Total Current Liabilities</b>	2,845	3,951

Long term liability, contingent purchase price

**Total Liabilities**

9	293
2,854	4,244

**Stockholders' Equity**

Common stock	42	42
Additional paid in capital	155,805	155,805
Accumulated other comprehensive income	260	260
Accumulated deficit	(144,083)	(143,725)
	12,024	12,382
Less common stock held in treasury	(4,524)	(4,524)
<b>Total Stockholders' Equity</b>	7,500	7,858

**Total Liabilities and Stockholders' Equity**

\$ 10,354	\$ 12,102
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See independent accountants' review report and notes to consolidated financial statements

**SIELOX, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
(\$ In thousands)

	For the Years Ended December 31,	
	<b>2010</b>	<b>2009</b>
<b>Net revenues</b>	\$ 12,656	\$ 13,485
<b>Cost of revenues</b>	9,288	9,880
<b>Gross profit</b>	3,368	3,605
<b>Selling, general and administrative expenses</b>	4,051	4,712
Impairment of intangibles net of unearned contingent price of \$270		(1,745)
<b>Loss from operations</b>	(683)	(2,852)
Other income (expenses)		
Other income	3	
Interest income		1
Interest expense	(128)	(132)
Total other income (expense), net	(125)	(131)
Loss from continuing operations	(808)	(2,983)
Income (loss) from discontinued operations (see Note 3)	450	(924)
<b>Net Loss</b>	\$ (358)	\$ (3,907)

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

**SIELOX, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF**  
**STOCKHOLDERS' EQUITY (DEFICIT) AND COMPREHENSIVE INCOME (LOSS)**  
**FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009**  
(\$ In thousands)

	Common Stock Shares	Common Stock Amount	Additional Paid - In Capital	Treasury Stock Shares	Treasury Stock Amount	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Stockholders' Equity (Deficit)
Balances at January 1, 2009	42,017	\$ 42	\$ 155,788	6,296	\$ (4,524)	\$ 260	\$ (139,818)	\$ 11,748
Net loss							(3,907)	(3,907)
Stock based compensation			17					17
Balances at December 31, 2009	<u>42,017</u>	<u>\$ 42</u>	<u>\$ 155,805</u>	<u>6,296</u>	<u>\$ (4,524)</u>	<u>\$ 260</u>	<u>\$ (143,725)</u>	<u>\$ 7,858</u>
Net loss							(358)	(358)
Balances at December 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>\$ (144,083)</u>	<u>\$ 7,500</u>

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

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

	For the Years Ended December 31,	
	<b>2010</b>	<b>2009</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income (loss) from continuing operations	\$ (808)	\$ (2,983)
Net income (loss) from discontinued operations, net of taxes	450	(924)
Impairment of intangibles, net		1,745
Adjustments to reconcile net loss to net cash used in operating activities:		
Stock-based compensation		17
Depreciation and amortization	416	430
Provision for doubtful accounts	(114)	144
Changes in operating assets and liabilities:		
Accounts receivable, net	(334)	2,264
Inventory	(271)	24
Prepaid expenses	(151)	307
Other assets	22	
Accounts payable	752	(1,001)
Accrued expenses and other	196	(629)
Net cash provided by (used in) operating activities from continuing operations	158	(606)
Net cash used in operating activities from discontinued operations	(759)	(193)
Net cash used in operating activities	(601)	(799)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of fixed assets		(3)
Proceeds from sale of short-term investments, at fair value		305
Payment of earnout provision related to Southern Imaging	(260)	(219)
Net cash provided by (used in) investing activities of continuing operations	(260)	83
Net cash provided by (used in) investing activities of discontinued operations	2,547	(155)
Net cash provided by (used in) used in investing activities	2,287	(72)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Paydown of debt	(636)	(11)
Net cash used in financing activities of continuing operations	(636)	(11)
Net cash provided by (used in) financing activities of discontinued operations	(867)	867
Net cash provided by (used in) financing activities	(1,503)	856
<b>NET INCREASE (DECREASE) IN CASH</b>	183	(15)
<b>CASH, BEGINNING OF PERIOD</b>	234	249
<b>CASH, END OF PERIOD</b>	\$ 417	\$ 234
Cash of continuing operations	\$ 407	\$ 122
Cash of discontinued operations	\$ 10	\$ 112
<b>SUPPLEMENTAL DISCLOSURE CASH FLOW INFORMATION:</b>		
Cash paid during the period for interest	\$ 305	\$ 229
Cash paid during the period for taxes	\$ 52	\$ 56
<b>SCHEDULE OF NON-CASH INVESTING ACTIVITIES:</b>		
Promissory note received in connection with Sielox, LLC Sale	\$ 500	\$ -

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

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

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

Sielox, Inc. (the “Company”) was incorporated in the State of Delaware in February 1997 under the name “Fairmarket, Inc.” The Company 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. Costar 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. Through December 31, 2010, the Company operated with another wholly-owned subsidiary, Sielox, LLC (“Sielox”). Sielox ran the Company’s operations related to its access control systems.

As of December 31, 2010, the Company sold substantially all of its assets in its wholly-owned subsidiary, Sielox. The results of Sielox’s operations have been classified in discontinued operations for the years ended December 31, 2010 and 2009 (See Note 3).

**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 subsidiaries, Costar and Sielox. All material intercompany transactions have been eliminated in consolidation.

These consolidated financial statements were approved by management and available for issuance on June 20, 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.

**ACCOUNTS 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.

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

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

**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 December 31, 2010 and 2009, the Company had \$0 and \$221 in raw materials and \$4,694 and \$4,423 in finished goods, respectively.

**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.

**GOODWILL**

In accordance with GAAP, goodwill is not amortized but is instead tested for impairment. We test goodwill for impairment on an annual basis, relying on a number of factors including operating results, business plans and future cash flows. Recoverability of goodwill is evaluated using a two-step process. The first step involves a comparison of fair value of our Company with its carrying value. If the carrying amount exceeds its fair value, the second step of the process involves a comparison of the fair value and carrying value of the goodwill. If the carrying value exceeds its fair value, an impairment loss is recognized in an amount equal to the excess.

**INVESTMENTS**

Short-term investments totaled \$0 at December 31, 2010, and 2009, respectively. As of May 20, 2009, the Company received \$243 as a complete liquidation of its position in a capital reserve fund held at a financial institution. There were no realized or unrealized losses incurred on these securities for the period ended December 31, 2010 and 2009.

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

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

**LONG-LIVED ASSETS**

In accordance with GAAP, we review property and equipment for impairment whenever events or changes in circumstances indicate 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.

**DEFERRED REVENUE**

Deferred revenue represents the unrecognized portion of the Company's separately priced product maintenance contracts. Revenue from these contracts is recognized in income on a straight line basis over the contract period.

**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 twelve months ended December 31, 2010, and 2009, the Company recognized \$0, and \$17 respectively in stock based compensation expense in its consolidated financial statements.

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

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

**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.

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 December 31, 2009.

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, and unrealized gains and losses on marketable securities classified as available for sale. 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 – IMPAIRMENT LOSS**

The decline in the national economy, among other factors, has contributed to the Company's declining revenues and continued losses. Consequently, the Company engaged the services of a valuation consultant to conduct an independent valuation of goodwill and intangible assets.

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

**NOTE 2 – IMPAIRMENT LOSS (continued)**

Based on the results of this valuation, which used historical information as well as management's projections, forecasts and assumptions, management has determined that the Company's goodwill is impaired as the fair value of the reporting unit is less than the units carrying value. The resulting impairment of the Company's goodwill as of December 31, 2010 and 2009 was \$0 and \$1,229, respectively.

In addition, based on the same independent valuation, management has determined that the fair value of the Company's trademark and trade name are less than their respective carrying values. The resulting impairment of the Costar trade name as of December 31, 2010 and 2009 was \$0 and \$786, respectively, and the resulting impairment, included in discontinued operations, of the Sielox trademark as of December 31, 2010 and 2009 was \$0 and \$130, respectively.

The Company had a long term liability of \$270 for a potential additional purchase price to be paid to the former owners of Southern Imaging, Inc. The payment was contingent upon certain levels of sales income being achieved. Those levels were not met in 2009 and consequently the Company had no obligation to pay the additional amount. The \$270 was recorded as an adjustment to impairment loss in the consolidated statement of operations as of December 31, 2009. A combined net impairment charge of \$0 and \$1,745, as of December 31, 2010 and 2009, respectively, is recognized on the consolidated statement of operations.

**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. The associated gains from this sale, which closed on December 31, 2010, have been included in income (loss) from discontinued operations on the consolidated statement of operations for the year ended December 31, 2010.

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.

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

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

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:

	<u>Years Ended December 31,</u>	
	<u>2010</u>	<u>2009</u>
Net revenues	\$6,963	\$5,982
Cost of revenues	<u>4,480</u>	<u>3,644</u>
Gross Profit	2,483	2,338
Selling, general & administrative expenses	<u>2,350</u>	<u>3,035</u>
Operating income (loss)	133	(697)
Other income (expenses)		
Gain on sale of assets, net of costs of \$100	492	
Interest expense	(175)	(97)
Impairment of intangibles		<u>(130)</u>
Net income (loss)	<u>\$450</u>	<u>\$(924)</u>
	<u>December 31,</u>	
	<u>2010</u>	<u>2009</u>
Cash	\$10	\$112
Accounts receivable, net	-	991
Inventory, net	-	1,102
Other current assets	<u>-</u>	<u>49</u>
Current assets of discontinued operations	<u>10</u>	<u>2,254</u>
Property and equipment, net		158
Trademark – Sielox, LLC		170
Proprietary Technology		349
Other assets	<u>—</u>	<u>44</u>
Long term assets of discontinued operations	<u>-</u>	<u>721</u>
Accounts payable	-	520
Accrued expenses and other	75	130
Line of credit	<u>-</u>	<u>867</u>
Current liabilities of discontinued operations	<u>\$75</u>	<u>\$1,517</u>

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

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

**NOTE 4 – LIQUIDITY AND GOING CONCERN CONSIDERATION**

The Company has continued to incur losses and negative cash flows from operations. For the twelve months ended December 31, 2010 and 2009, the Company incurred a net loss from continuing operations of \$808 and \$2,983, respectively, and cash flows provided by (used in) continuing operations of \$158 and (\$606), respectively. As of December 31, 2010 and 2009, the Company had an accumulated deficit of \$144,083 and \$143,725, respectively, and outstanding debt from continuing operations in the amount of \$626 and \$1,262, respectively, from its lines of credit which expires on June 21, 2011. The outstanding debt amount of \$2,129 as of December 31, 2009 included \$867 owed by Sielox, LLC to Summit Financial Resources, L.P. (“Summit”). That amount is included in current liabilities of discontinued operations on the consolidated balance sheet. Due to the current credit crisis, it is uncertain that the Company’s lines of credit will be renewed when they become due. It is also uncertain if the facilities will be renewed at an acceptable rate. Without the availability of existing credit facilities, there is substantial doubt about the Company’s ability to continue as a going concern.

Effective August 25, 2009, Sielox entered into a Loan and Security Agreement (the “Sielox Loan Agreement”) with Summit Financial Resources, L.P. (“Summit”). The Sielox Loan Agreement provides Sielox with up to \$1,500 in revolving lines of credit. The provisions of the Sielox Loan Agreement are more fully described in Note 8.

Effective August 17, 2010, Summit modified and extended the Sielox Loan Agreement. In accordance with the Loan Agreement, the Company paid a facility renewal fee of \$15. The maturity date is extended to August 17, 2011. All other terms and conditions of the Sielox Loan Agreement remain in full force and effect.

Effective on December 31, 2010, following the asset based sale of Sielox, LLC, the Company’s relationship with Summit was terminated and all indebtedness to the lender was repaid from the proceeds of the sale.

In addition, effective as of August 21, 2009, Costar entered into a Revolving Credit and Security Agreement (the “Costar Loan Agreement”, and together with the Sielox Loan Agreement the “Loan Agreements”) with BBVA Compass Bank (“Compass”). The Costar Loan Agreement provides Costar with up to \$4,000 in revolving lines of credit. The provisions of the Costar Loan Agreement are more fully described in Note 8.

In addition, effective June 1, 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 November 21, 2011, or such future date as to which the maturity date of the revolving line may be extended at the bank’s sole discretion.

Effective 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 as to which the maturity date of the revolving line may be extended at the bank’s sole discretion.

In addition, effective January 21, 2011 and again on April 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 June 21, 2011, or such future date as to which the maturity date of the revolving line may be extended at the bank’s sole discretion. The Company is currently in discussions for a further extension of this credit facility.

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

**NOTE 4 – LIQUIDITY AND GOING CONCERN CONSIDERATION (continued)**

The Company has taken measures to reduce expenses in the second half of 2009 and in 2010. One of those measures was the suspension of its reporting obligations under the Securities Exchange Act of 1934, as amended. On March 30, 2010, the Company filed a Form 15 with the Securities and Exchange Commission (“SEC”). As a result, the Company no longer files current and periodic reports with the SEC. There can be no assurance that the Company will be successful in reducing 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 5 – 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 twelve months ended December 31, 2010 and 2009, the Company’s two largest customers accounted for approximately \$4,200 and \$6,100, or 33.2 % and 45.2% of the Company’s total revenue, respectively. Those same customers owed \$602 and \$496, or 29.8% and 31.5% of the outstanding accounts receivable balance, respectively.

**CONCENTRATION OF SUPPLIERS**

For the twelve months ended December 31, 2010 and 2009, the Company made purchases from one main supplier of approximately 25.4% and 36.9% of total purchases, respectively. Amounts owed to this supplier were approximately 59.3% and 41.6% of the total accounts payable balance, respectively.

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

**NOTE 6 – PROPERTY AND EQUIPMENT**

Property and equipment are recorded at cost less accumulated depreciation. The Company provides for depreciation using the straight-line method over estimated useful lives of 3-7 years.

Property and equipment from continuing operations at December 31, 2010 and 2009 were as follows:

	<u>2010</u>	<u>2009</u>
Office Furniture and Equipment	\$315	\$362
Demonstration and Technical Equipment	<u>41</u>	<u>81</u>
	356	443
Less accumulated depreciation	<u>(310)</u>	<u>(319)</u>
Total	<u>\$48</u>	<u>\$124</u>

**NOTE 7 – 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 December 31, 2010 and 2009:

	<u>December 31, 2010</u>		<u>December 31, 2009</u>	
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>
<b>Amortized Intangible Assets</b>				
Customer Relationships	1,598	1,198	1,598	932
Distribution Agreement	<u>1,468</u>	<u>331</u>	<u>1,468</u>	<u>257</u>
	3,066	1,529	3,066	1,189
<b>Unamortized Intangible Assets</b>				
Trade Name Costar	<u>800</u>		<u>800</u>	
	<u>3,866</u>		<u>3,866</u>	

The weighted average amortization period is 13 years. The estimated useful life for customer relationships and distribution agreements are 6 and 20, respectively.

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

**NOTE 7 – INTANGIBLE ASSETS (continued)**

Amortization expense was \$340 in 2010 and 2009, respectively. Estimated amortization expense for each of the ensuing years through December 31, 2014 is:

December 31,

2011	340
2012	207
2013	73
2014	73
2015	73

**NOTE 8 – CREDIT LINES**

Effective on August 25, 2009, the Company's relationship with the Bank of Texas was terminated and all indebtedness to that lender was repaid from the Company's two new credit facilities.

Effective as of August 25, 2009, Sielox entered into the Sielox Loan Agreement with Summit to provide an asset-based facility of up to \$1.5 million. The obligations under the Sielox Loan Agreement are secured by a lien on all accounts receivable, inventory, equipment, general intangibles, including intellectual property, chattel paper, instruments and documents of Sielox, as set forth in the Sielox Loan Agreement and in the Security Agreement (Intellectual Property) by and between Sielox and Summit.

Borrowings under the Sielox Loan Agreement accrued interest at the Wall Street Journal prime rate, plus 2% per annum and incur a monthly administrative fee of 1.1% of the average monthly loan outstanding. The Sielox Loan Agreement contained customary representations and warranties, events of default and covenants, including among other things, covenants that restrict the ability of the Borrower to incur certain additional indebtedness or to issue equity interests and covenants that impose certain reporting requirements on Sielox. As of December 31, 2009, \$867 was owed to Summit.

Effective on December 31, 2010, following the asset based sale of Sielox, LLC, the Company's relationship with Summit Financial Resources was terminated and all indebtedness to that lender was repaid from the proceeds of the sale.

Effective as of August 21, 2009, Costar entered into the Costar Loan Agreement with Compass Bank. 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 accrue interest at a rate equal to the greater of (i) 5% per annum and (ii) the 30-day LIBOR plus 3% per annum.

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

**NOTE 8 – CREDIT LINES (continued)**

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 each of the Costar and the Company to maintain a specific Tangible Net Worth. As of December 31, 2010 and 2009, approximately \$626 and \$1,262, respectively, was owed to Compass Bank.

In addition, effective June 1, 2010, Compass amended and restated the Revolving Credit and Security Agreement, dated as of August 21, 2009, executed by and between Costar Video Systems LLC and Compass ("the Costar Loan Agreement"). The Costar Loan Agreement provides Costar with up to \$2,500 in revolving lines of credit due on November 21, 2011, or such future date as to which the maturity date of the revolving line may be extended at the banks sole discretion.

Effective November 21, 2010, Compass Bank amended and restated the Revolving Credit and Security Agreement dated as of August 21, 2009. The restated agreement provided Costar with up to \$2,500 in revolving lines of credit due on January 21, 2011, or such future date as to which the maturity date of the revolving line may be extended at the banks 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 (.26% at December 31, 2010) plus 4% per annum.

Effective December 31, 2010, the Company was in default of one of the covenants with Compass, and has requested a waiver from the bank. In addition, effective January 21, 2011 and again on April 21, 2011, Compass Bank 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 June 21, 2011, or such future date as to which the maturity date of the revolving line may be extended at the bank's sole discretion. The Company is currently in discussions for a further extension of this credit facility.

**NOTE 9 – STOCKHOLDERS' EQUITY**

At December 31, 2010 and 2009, the authorized capital stock of the Company consisted of (i) 90,000,000 shares of voting common stock, 42,016,924 shares issued, 35,982,295 outstanding, with a par value of \$0.001 per share and (ii) 10,000,000 shares of preferred stock, 0 shares issued, 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 10 – 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.

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

**NOTE 10 – EARNOUT, CONTINGENT PURCHASE PRICE (continued)**

Since that date, several payments have been made that include principal and interest at 9% per annum. As of December 31, 2010 and 2009, the unpaid balance was approximately \$294 and \$554, respectively.

On October 13, 2009, the Company and the previous owners of Southern Imaging agreed that the Company would make the following payments: \$125 on October 14, 2009, \$25 on November 2, 2009 and \$25 on December 15, 2009. All of the agreed payments were made.

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. Future payments of principal are approximately as follows:

Year Ending December 31,	
2011	\$285
2012	9

**NOTE 11 – 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:

Years Ending December 31,	
2011	\$35
2012	85
2013	99
2014	109
2015	117
<u>Thereafter</u>	<u>363</u>
<u>Total</u>	<u>\$808</u>

**NOTE 12 – DEFERRED INCOME TAX**

Deferred tax liabilities and assets are determined based on the difference between financial statement and tax bases using enacted tax rates in effect for the year in which the differences are expected to reverse. The components of the deferred taxes at December 31, 2010 are as follows (in thousands):

	<u>December 31,</u> <u>2010</u>
Net operating loss carry forwards	\$9,343
Valuation allowance	<u>(9,343)</u>
Net deferred tax assets	<u>\$ -----</u>

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

**NOTE 12 – DEFERRED INCOME TAX (continued)**

In connection with ownership changes, it was determined that certain of the Company's net operating loss carry forwards ("NOL") have been limited. As of December 31, 2010, the Company has approximately \$23,000 of NOLs that can be utilized in future years. These NOLs, if not used, will expire between 2019 and 2030.

A valuation allowance has been established for the full amount of the tax asset since it is more likely than not that the deferred tax asset will not be realized. The valuation allowance for deferred tax assets increased by approximately \$70 in 2010.

**NOTE 13 – CONCENTRATIONS OF CREDIT RISK**

The Company maintains its cash balances in various financial institutions. These balances are insured by the Federal Deposit Insurance Corporation up to \$250,000 per institution.

**NOTE 14 – LEGAL PROCEEDINGS**

The Company, as well as the Company's subsidiary, L Q Corporation, which currently has no operations, 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 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.

The parties have reached a global settlement of the litigation. The Company and other defendants will receive complete dismissal from the case.

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, 2010, but instead moved to dismiss one of the appeals based on alleged violations of the Second Circuits rules, including failure to serve, falsifying proofs of service, and failure to include citations to the record. While this motion to dismiss the appeal is pending, the briefing deadlines on the main appeal should be tolled pursuant to Second Circuit Local Rule 31.2.

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

**NOTE 14 – LEGAL PROCEEDINGS (continued)**

*Berger v. L Q Corp., C.A. No. 3363 (Del. Ch.)*

A Petition for Appraisal of Stock (the “Petition”) under Delaware’s General Corporation Law (the “DGCL”), 8 Del. C. § 262, was filed in the Delaware Court of Chancery on November 19, 2007 against L Q Corporation, our wholly owned subsidiary, by Andrew T. Berger (“Berger”), a purported beneficial owner of 49,014 shares of common stock in L Q Corporation, and by Cede & Co., the purported record owner of the shares beneficially owned by Berger.

The Petition demanded appraisal of Berger’s shares in L Q Corporation, the payment of the fair value of such shares to Berger under Section 262 of the DGCL, and an award of fees and costs in connection with the filing and prosecution of the Petition. L Q Corporation moved to dismiss the Petition on December 19, 2007. In response to L Q Corporation’s motion to dismiss, Berger amended the petition for appraisal (the “Amended Petition”) on January 11, 2008. L Q Corporation filed a motion to dismiss the Amended Petition on January 23, 2008. L Q Corporation subsequently withdrew its motion to dismiss the Amended Petition on April 24, 2008, and answered the Amended Petition on May 1, 2008. On February 11, 2009, the parties agreed to mediate this action pursuant to Court of Chancery Rule 174 in an effort to settle this action, and a mediation conference was held on March 19, 2009. At the mediation conference, the parties reached an agreement in principle to settle the action.

Thereafter, the partner negotiated an agreement of dismissal and release (the “Agreement”) and the Agreement was executed by the parties on or about March 25, 2009. After the Agreement was executed by the parties, the parties executed a stipulation of dismissal of the action on March 31, 2009 (the “Stipulation”), submitted the Stipulation to the Court of Chancery and requested that the Court of Chancery enter the Stipulation as an Order of the Court of Chancery, which would dismiss the action with prejudice. On March 31, 2009, the Court of Chancery entered the stipulation as an Order of the Court of Chancery which dismissed the action with prejudice.

*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. Should the Defendants ultimately be served with the Complaint, the Defendants intend to vigorously defend against the allegations in the Complaint.

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

**NOTE 15 – DEREGISTRATION OF THE COMPANY’S COMMON STOCK**

On February 26, 2010, the Company issued a press release announcing its intention to file a Form 15 with the SEC to terminate the registration of its common stock under Section 12(g) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”).

On March 30, 2010, the Company filed Form 15. As a result, the Company has ceased to file current and periodic reports with the SEC. The Company is eligible to deregister its common stock because it has fewer than 300 stockholders of record.

The decision to deregister was made by the Company’s Board of Directors on the recommendation of a Special Committee of independent directors that thoroughly examined the issue. The decision to deregister is consistent with other cost-cutting measures that the Company has taken in order to more effectively align the Company’s operating cost structure with changing market conditions. Deregistration will also significantly minimize the administrative burden associated with being a SEC reporting company, permitting the Company’s management team to better focus its attention and resources on existing plans to increase revenue including, among other things, the continued development of the Company’s customer base and product lines.

The Board of Directors and management believe that deregistering under the Exchange Act will not have a material negative impact on the Company’s current relationships with employees, customers or suppliers, or its existing financing arrangements.

As of the date of the filing of the Form 15, the Company’s obligation to file reports under the Securities Exchange Act, including forms 10-K, 10-Q and 8-K, was immediately suspended. Other filing requirements terminated upon the effectiveness of the deregistration under Section 12(g) of the Exchange Act, which occurred 90 days after the filing of the Form 15.

The Company will continue to hold an annual stockholders’ meeting and will make quarterly and annual financial information available to stockholders by press release and through its website located at <http://www.sielox.com>.

The Company’s shares are no longer quoted on the OTCBB. Instead, the share are quoted on the OTC Markets Group, LLC an electronic network through which participating broker-dealers can make markets, and enter orders to buy and sell shares of companies.