# COSTAR TECHNOLOGIES, INC. AND SUBSIDIARY

## CONSOLIDATED FINANCIAL STATEMENTS
## AND
## INDEPENDENT ACCOUNTANTS' COMPILATION REPORT

SEPTEMBER 30, 2011

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARY

Certified
Public
Accountants

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# INDEPENDENT ACCOUNTANTS' COMPILATION REPORT

To the Board of Directors and Stockholders of
Costar Technologies, Inc.

We have compiled the accompanying consolidated balance sheet of Costar Technologies, Inc. and Subsidiary (collectively, the "Company") as of September 30, 2011, and the related consolidated statements of operations for the three and nine month periods ended September 30, 2011 and 2010 and the statements of changes in stockholders' equity, and comprehensive income (loss), and cash flows for the nine month periods ended September 30, 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 Costar Technologies, 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.

Rothstein, Kass & Company, P.C.

Roseland, New Jersey
November 15, 2011

**COSTAR TECHNOLOGIES, INC. AND SUBSIDIARY**
**CONSOLIDATED BALANCE SHEETS**
**($ in thousands)**

**ASSETS**

| **Current assets** | **September 30, 2011** | **December 31, 2010** |
|---|---|---|
| Cash | $ 189 | $ 407 |
| Accounts receivable, less allowance for doubtful accounts of $105 and $140 in 2011 and 2010, respectively | 2,389 | 2,023 |
| Inventories, net of reserve for obsolescence of $390 and $264 in 2011 and 2010, respectively | 5,167 | 4,694 |
| Prepaid expenses | 391 | 335 |
| Promissory note, current portion | 167 | 167 |
| Current assets of discontinued operations | - | 10 |
| **Total current assets** | 8,303 | 7,636 |
| Property and equipment, net | 132 | 48 |
| Trade Name - Costar | 800 | 800 |
| Distribution agreement, net | 1,083 | 1,137 |
| Customer relationships, net | 200 | 400 |
| Promissory note, net of current portion | 333 | 333 |
| **Total assets** | $ 10,851 | $ 10,354 |

**LIABILITIES AND STOCKHOLDERS' EQUITY**

| **Current liabilities** | | |
|---|---|---|
| Accounts payable | $ 1,568 | $ 1,574 |
| Accrued expenses and other | 68 | 285 |
| Contingent purchase price, current portion | - | 285 |
| Lines of credit | 1,681 | 626 |
| Current liabilities of discontinued operations | - | 75 |
| **Total current liabilities** | 3,317 | 2,845 |
| Long term liability, contingent purchase price | - | 9 |
| **Total liabilities** | 3,317 | 2,854 |
| **Stockholders' equity** | | |
| Common stock | 42 | 42 |
| Additional paid in capital | 155,837 | 155,805 |
| Accumulated other comprehensive income | 260 | 260 |
| Accumulated deficit | (144,081) | (144,083) |
| Less common stock held in treasury | (4,524) | (4,524) |
| **Total stockholders' equity** | 7,534 | 7,500 |
| **Total liabilities and stockholders' equity** | $ 10,851 | $ 10,354 |

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

**COSTAR TECHNOLOGIES, INC. AND SUBSIDIARY**
**CONSOLIDATED STATEMENTS OF OPERATIONS**
**($ in thousands, except per share amounts)**

| | For the Three Months Ended September 30, | | For the Nine Months Ended September 30, | |
|---|---|---|---|---|
| | **2011** | **2010** | **2011** | **2010** |
| **Net revenues** | $ 4,231 | $ 3,403 | $ 12,052 | $ 9,011 |
| **Cost of revenues** | 3,135 | 2,458 | 9,013 | 6,637 |
| **Gross profit** | 1,096 | 945 | 3,039 | 2,374 |
| **Selling, general and administrative expenses** | 948 | 884 | 2,964 | 2,779 |
| **Profit (loss) from operations** | 148 | 61 | 75 | (405) |
| Other income (expenses) | | | | |
| Interest expense | (31) | (37) | (88) | (98) |
| Other income | 1 | 2 | 16 | 3 |
| Total other expense, net | (30) | (35) | (72) | (95) |
| Net profit (loss) from continuing operations | 118 | 26 | 3 | (500) |
| Net profit (loss) from discontinued operations (see Note 3) | - | 31 | (1) | 64 |
| **Net profit (loss)** | $ 118 | $ 57 | $ 2 | $ (436) |
| Per share of common stock | | | | |
| Profit (loss) from continuing operations | 0.00 | 0.00 | 0.00 | (0.01) |
| Profit (loss) from discontinued operations | 0.00 | 0.00 | (0.00) | 0.00 |
| Net profit (loss) per share | 0.00 | 0.00 | 0.00 | (0.01) |
| Weighted average shares outstanding | 36,444 | 35,982 | 36,213 | 35,982 |

**COSTAR TECHNOLOGIES, INC. AND SUBSIDIARY**
**CONSOLIDATED STATEMENTS OF**
**STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME (LOSS)**
**FOR THE NINE MONTH PERIODS ENDED SEPTEMBER 30, 2011 AND SEPTEMBER 30, 2010**
**($ in thousands)**

| | Common Stock | | Additional Paid - In | Treasury Stock | | Accumulated Other Comprehensive | Accumulated | Total Stockholders' |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Capital | Shares | Amount | Income (Loss) | Deficit | Equity |
| Balances at December 31, 2009 | 42,017 | $ 42 | $ 155,805 | 6,296 | $ (4,524) | $ 260 | $ (143,725) | $ 7,858 |
| Net loss | - | - | - | - | - | - | (436) | (436) |
| Balances at September 30, 2010 | 42,017 | $ 42 | $ 155,805 | 6,296 | $ (4,524) | $ 260 | $ (144,161) | $ 7,422 |
| | | | | | | | | |
| Balances at December 31, 2010 | 42,017 | $ 42 | $ 155,805 | 6,296 | $ (4,524) | $ 260 | $ (144,083) | $ 7,500 |
| Net profit | - | - | - | - | - | - | 2 | 2 |
| Stock based compensation | - | - | 32 | - | - | - | - | 32 |
| Balances at September 30, 2011 | 42,017 | $ 42 | $ 155,837 | 6,296 | $ (4,524) | $ 260 | $ (144,081) | $ 7,534 |

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

| | For the Nine Months Ended September 30, 2011 | 2010 |
|---|---|---|
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Net profit (loss) | $ 2 | $ (436) |
| Adjustments to reconcile net profit (loss) to net cash used in operating activities: | | |
| Stock-based compensation | 32 | - |
| Depreciation and amortization | 288 | 317 |
| Provision for doubtful accounts | (35) | (112) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | (331) | (73) |
| Inventory | (473) | (474) |
| Prepaid expenses | (56) | 26 |
| Accounts payable | (6) | 555 |
| Accrued expenses and other | (217) | 23 |
| Net cash used in operating activities | (796) | (174) |
| Net cash used in discontinued operations | (65) | (339) |
| Net cash used in operating activities | (861) | (513) |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Purchase of fixed assets | (118) | - |
| Payment of earnout provision related to Southern Imaging | (294) | (193) |
| Net cash used in investing activities | (412) | (193) |
| **CASH FLOWS PROVIDED BY FINANCING ACTIVITIES** | | |
| Proceeds from debt, net | 1,055 | 724 |
| **NET INCREASE (DECREASE) IN CASH** | (218) | 18 |
| **CASH, BEGINNING OF PERIOD** | 407 | 122 |
| **CASH, END OF PERIOD** | $ 189 | $ 140 |
| **Cash of continuing operations** | $ 189 | $ 140 |
| **Cash of discontinued operations** | $ - | $ 29 |
| **SUPPLEMENTAL DISCLOSURE CASH FLOW INFORMATION:** | | |
| Cash paid during the period for interest | $ 83 | $ 223 |

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

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

Costar Technologies, Inc. (formerly known as Sielox, Inc.) is 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 Parent 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 November 15, 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.

**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 September 30, 2011 and December 31, 2010 the Company had $5,167 and $4,694 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.

**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.

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

### 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.

### 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 nine months ended September 30, 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.

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

### INCOME TAXES (continued)

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 September 30, 2011 and December 31, 2010. Generally, the Company is no longer subject to income tax examination by major taxing authorities for the years before 2008.

### 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 posted a net profit, but continued to show negative cash flows from operations. For the nine months ended September 30, 2011, the Company incurred a net profit of approximately $2. As of September 30, 2011, the Company had an accumulated deficit of approximately $144,081 and outstanding debt in the amount of $1,681 from its line of credit which expires on September 23, 2014.

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 provided 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.

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

In addition, effective June 1, 2010, and again on November 21, 2010, Compass amended and restated the Costar Loan 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. 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.

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 provided 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.

In addition, 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 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.

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 a 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.

**($ in thousands)**

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

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.

One of the agreed conditions of the sale was that Costar would continue to sell its range of security solution products through the Sielox, LLC 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. The first semi-annual purchase commitment was measured on June 30, 2011, and was achieved. 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 nine months ended, | |
|---|---|---|
| | September 30, 2011 | September 30, 2010 |
| Net revenues | $ - | $5,101 |
| Cost of revenues | - | 3,229 |
| Gross Profit | - | 1,872 |
| Selling, general & administrative expenses | 1 | 1,683 |
| Operating income (loss) | (1) | 189 |
| Other expenses | | |
| Interest expense | - | (125) |
| Net profit (loss) | $(1) | $ 64 |

**($ in thousands)**

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

| | September 30, 2011 | December 31, 2010 |
|---|---|---|
| Cash | $ - | $ 10 |
| Accounts receivable, net | - | - |
| Inventory, net | - | - |
| Other current assets | - | - |
| Current assets of discontinued operations | - | 10 |
| Property and equipment, net | - | - |
| Trademark – Sielox, LLC | - | - |
| Proprietary technology | - | - |
| Other assets | - | - |
| Long term assets of discontinued operations | - | - |
| Accounts payable | - | - |
| Accrued expenses and other | - | 75 |
| Line of credit | - | - |
| Current liabilities of discontinued operations | $ - | $ 75 |

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 nine months ended September 30, 2011 and 2010, the Company's largest customer accounted for approximately $4,921 and $2,981, or 40.8% and 33.1% of the Company's total revenue, respectively. The same customer owed $1,131 and $375, or 47.3% and 27.2%, of the outstanding receivable balance, as of September 30, 2011 and 2010, respectively.

**CONCENTRATION OF SUPPLIERS**

For the nine months ended September 30, 2011 and 2010, the Company made purchases from one main supplier of approximately 29.5% and 35.0% of total purchases, respectively. Amounts owed to this supplier were approximately 61.0 % and 59.6% of the total accounts payable balance, as of September 30, 2011 and 2010, respectively.

**($ in thousands)**

## NOTE 5 - PROPERTY AND EQUIPMENT

Property and equipment from continuing operations at September 30, 2011 and December 31, 2010, were as follows:

| | 2011 | 2010 |
|---|---|---|
| Office Furniture and Equipment | $ 382 | $ 317 |
| Demonstration and Technical Equipment | 41 | 41 |
| | 423 | 358 |
| Less accumulated depreciation | (291) | (310) |
| Total | $ 132 | $ 48 |

## 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 September 30, 2011 and December 31, 2010.

| | September 30, 2011 | | December 31, 2010 | |
|---|---|---|---|---|
| | Gross Carrying Amount | Accumulated Amortization | Gross Carrying Amount | Accumulated Amortization |
| Amortized Intangible Assets | | | | |
| Customer Relationships | 1,598 | 1,398 | 1,598 | 1,198 |
| Distribution Agreement | 1,468 | 385 | 1,468 | 331 |
| | 3,066 | 1,783 | 3,066 | 1,529 |
| Unamortized Intangible Assets | | | | |
| Trade Name Costar | 800 | | 800 | |
| | 3,866 | | 3,866 | |

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

**($ in thousands)**

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

Amortization expense was $255 for both nine month periods ended September 30, 2011 and 2010. Estimated amortization expense for each of the ensuing years is:

| Year Ending September 30, | |
|---|---|
| 2012 | $273 |
| 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 was 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 contained 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 contained 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 September 30, 2011 and December 31, 2010, approximately $0 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 Costar Loan 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. 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.

Effective January 21, 2011, Compass amended and restated the Revolving Credit and Security Agreement dated as of August 21, 2009. The restated agreement provided Costar with up to $1,500 in revolving lines of credit due on April 21, 2011.

On March 31, 2011, the Company was in default of one of the covenants with Compass, and requested a waiver from the bank. 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 provided Costar with up to $1,500 in revolving lines of credit due on September 20, 2011. The Company did not renew the Revolving Credit and Security Agreement with Compass.

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

Effective as of September 23, 2011, Costar entered into a Loan and Security Agreement with 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 a rate equal to 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. As of September 30, 2011 and December 31, 2010, approximately $1,681 and $0, respectively, was owed to Briar.

**NOTE 8 - STOCKHOLDERS' EQUITY**

At September 30, 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 were made that included principal and interest at 9% per annum.

On January 15, 2010, the Company and the previous owners of Southern Imaging agreed on a payment schedule whereby the Company would make a payment, on or about the 15$^{th}$ 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.

**($ in thousands)**

**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 September 30, | |
|---|---|
| 2012 | $ 83 |
| 2013 | 95 |
| 2014 | 107 |
| 2015 | 115 |
| Thereafter | 393 |
| Total | $ 793 |

**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.

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. The appellant filed a notice of appeal of Judge Scheindlin's August 25, 2011 decision that he has no standing to object to the settlement.

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

*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, 162nd 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, $25 on November 2, 2009 and an additional $25 on December 15, 2009. 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 15th 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**

The Company held its annual meeting on October 19, 2011, and the results, certified by Computershare, Inc., confirmed that each of the Company's five director nominees were elected to the Board by a substantial margin. The Company's five directors are Rory J. Cowan, Gregory T. Hradsky, Jared L. Landaw, James D. Pritchett, and Jeffery S. Wald. The certified results also confirmed that stockholders supported the change of the name of the Company from Sielox, Inc. to Costar Technologies, Inc., the authorization of the Board to effect a reverse stock split and the ratification of the selection of Rothstein Kass & Company, P.C. as the Company's independent registered public accountants for the fiscal year ended December 31, 2011.

Effective October 21, 2011, the Company purchased certain assets and liabilities of Industrial Vision Source ("IVS") from Mace Security International, Inc. (OTCQB: MACE). The Company acquired substantially all of IVS' accounts receivable, inventory, accounts payable, and IVS' related intangible assets, including its customer list and trade names. The company paid approximately $517 in cash at closing with an additional $100 due in 90 days if certain revenue targets are achieved. IVS is the oldest industrial camera distributor in the United States. IVS has been distributing machine vision, factory automation, microscopy and video teleconferencing products since 1989.