

SIELOX, INC. AND SUBSIDIARIES
CONSOLIDATED FINANCIAL STATEMENTS
AND
INDEPENDENT ACCOUNTANTS' REVIEW REPORT
DECEMBER 31, 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 sheet of Sielox, Inc. and Subsidiaries (collectively, the "Company") as of December 31, 2009, and the related consolidated statement of operations, changes in stockholders' equity (deficit) and comprehensive income (loss), and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of the management of the Company.

A review consists principally of inquiries of Company personnel and analytical procedures applied to financial data. It is substantially less in scope than an audit in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, 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 3, 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 3. 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 3, 2010

SIELOX, INC AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET
(\$ In thousands)
December 31, 2009

ASSETS

Current Assets

Cash	\$ 234
Accounts receivable, less allowance for doubtful accounts of \$254	2,565
Inventories, net of reserve for obsolescence of \$247	5,525
Prepaid expenses	234

Total Current Assets	<u>8,558</u>
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Fixed assets, net	282
Trade Name - Costar	800
Trade mark - Sielox LLC	170
Distribution agreement, net	1,211
Customer relationships, net	666
Proprietary technology, net	349
Deposits and other assets	66

Total Assets	<u>\$ 12,102</u>
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LIABILITIES AND STOCKHOLDERS' EQUITY

Current Liabilities

Accounts payable	\$ 1,342
Accrued expenses and other	162
Contingent purchase price, current portion	261
Deferred revenue	57
Lines of credit	2,129

Total Current Liabilities	<u>3,951</u>
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Long term liability, contingent purchase price	293
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Total Liabilities	<u>4,244</u>
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Stockholders' equity

Common stock	42
Additional paid in capital	155,805
Accumulated other comprehensive income	260
Accumulated deficit	<u>(143,725)</u>
	12,382
Less common stock held in treasury	(4,524)

Total stockholders equity	<u>7,858</u>
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Total liabilities and stockholders' equity	\$ <u>12,102</u>
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See accompanying notes to consolidated financial statements

SIELOX, INC AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF OPERATIONS
(\$ In thousands)

For the Year Ended
December 31, 2009

Net revenues	\$ 19,466
Cost of revenues	<u>13,524</u>
Gross profit	5,942
Selling, general and administrative expenses	<u>(7,746)</u>
Impairment of intangibles , net of unearned contingent purchase price of \$270	<u>(1,875)</u>
Loss from operations	(3,679)
Other income (expenses)	
Interest income	1
Interest expense	<u>(229)</u>
Total other income (expense), net	<u>(228)</u>
Net Loss	<u><u>\$ (3,907)</u></u>

See accompanying notes to consolidated financial statements

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

	Common Stock		Additional Paid - In Capital	Treasury Stock		Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Stockholders' Equity (Deficit)
	Shares	Amount		Shares	Amount			
Balances at December 31, 2008	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>

See accompanying notes to consolidated financial statements

SIELOX, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS
(\$ In thousands)
YEAR ENDED DECEMBER 31, 2009

CASH FLOWS FROM OPERATING ACTIVITIES

Net loss	\$ (3,907)
Impairment of intangibles, net	1,875
Adjustments to reconcile net loss to net cash used in operating activities:	
Stock-based compensation	17
Depreciation and amortization	596
Provision for doubtful accounts	175
Changes in operating assets and liabilities:	
Accounts receivable, net	2,185
Inventory	154
Prepaid expenses	288
Accounts payable	(1,575)
Accrued expenses and other	(637)
Deferred revenue, current	30
	<u> </u>
Net cash used in operating activities	<u>(799)</u>

CASH FLOWS FROM INVESTING ACTIVITIES

Purchase of fixed assets	(158)
Proceeds from sale of short-term investments, at fair value	305
Payment of earnout provision related to Southern Imaging	<u>(219)</u>
Net cash used in investing activities	<u>(72)</u>

CASH PROVIDED BY FINANCING ACTIVITIES

proceeds from debt, net	<u>856</u>
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NET DECREASE IN CASH

(15)

CASH, BEGINNING OF PERIOD

249

CASH, END OF PERIOD

\$ 234

SUPPLEMENTAL DISCLOSURE CASH FLOW INFORMATION:

Cash paid during the period for interest	\$ <u>229</u>
Cash paid during the period for taxes	\$ <u>56</u>

See accompanying 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 subsidiaries, Costar Video Systems, LLC (“Costar”) and Sielox LLC (“Sielox”), (collectively the “Company”), develops, designs and distributes a range of security solution products such as surveillance cameras, lenses, digital video recorders, high speed domes and access control systems. 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 two wholly-owned subsidiaries: Costar and Sielox. Costar runs the Company’s operations relating to its security surveillance and industrial vision products and Sielox runs the Company’s operations relating to its access control systems.

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 3, 2010. 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.

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, 2009, the Company had \$221 in raw materials and \$5,304 in finished goods.

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, 2009. 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, 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, 2009, the Company recognized \$17 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.

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. 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.

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

NOTE 2 - IMPAIRMENT LOSS (continued)

The resulting impairment of the Company's goodwill, on a gross basis, was \$1,229. The gross impairment loss was the aggregate for the year and the accumulated impairment loss to date. There was no accumulated impairment loss at the beginning of the year. 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 was \$786 and the resulting impairment of the Sielox trademark was \$130.

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 have not been met in 2009 and consequently the Company has 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 \$1,875 is recognized on the consolidated statement of operations.

NOTE 3 - 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, 2009, the Company incurred a net loss of approximately \$3,907 and negative cash flows from operations of approximately \$799. As of December 31, 2009, the Company had an accumulated deficit of approximately \$143,725 and outstanding debt in the amount of \$2,129 from its lines of credit which expire on August 25, 2010. 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, due on August 25, 2010. The provisions of the Sielox Loan Agreement are more fully described in Note 7.

In addition, effective as of August 24, 2009, Costar entered into a Revolving Credit and Security Agreement with BBVA Compass Bank ("Compass") (the "Costar Loan Agreement", and together with the Sielox Loan Agreement the "Loan Agreements"). The Costar Loan Agreement provides Costar with up to \$4,000 in revolving lines of credit due on August 25, 2010. As of December 31, 2009, the Company was not in compliance with its Tangible Net Worth covenant in its agreement with Compass. This violation represents an event of default whereby Compass could accelerate payment of the total debt outstanding. Such an event would have a materially negative impact on the Company's operations, cash flow, liquidity and ability to meet other obligations. The Company is in discussions with Compass regarding the issuing of a waiver for this covenant. The provisions of the Costar Loan Agreement are more fully described in Note 7.

The Company has taken measures to reduce expenses in the second half of 2009 and 2010. One of those measures is the decision to suspend its reporting obligations under the Securities Exchange Act of 1934, as amended. On March 30, 2010, the Company filed Form 15. As a result, the Company will cease to file current and periodic reports with the SEC. There can be no assurance that the Company will be successful in reducing expenses.

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

NOTE 3 - LIQUIDITY AND GOING CONCERN CONSIDERATION (continued)

The Company's existing and future obligations include expenses associated with developing synergies between the Company's operating subsidiaries and 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 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. The Company's access control product line is sold through a national network of authorized business partners. For the twelve months ended December 31, 2009, the Company's two largest customers accounted for approximately \$6,108 or 31.3% of the Company's total revenue, those same customers owed \$496 or 19.3% of the outstanding receivable balance.

CONCENTRATION OF SUPPLIERS

For the twelve months ended December 31, 2009, the Company made purchases from one main supplier of approximately 27.0% of total purchases, amounts owed to this supplier were approximately 25.5% of the total accounts payable balance.

NOTE 5 - FIXED ASSETS

Fixed assets 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.

Fixed assets at December 31, 2009 were as follows.

		<u>2009</u>
Office Furniture and Equipment	\$	565
Demonstration and Technical Equipment		244
Leasehold Improvements		<u>90</u>
		899
Less accumulated depreciation		<u>(617)</u>
Total	\$	<u>282</u>

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

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 at December 31, 2009.

	<u>December 31, 2009</u>	
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>
Amortized Intangible Assets		
Customer Relationships	\$1,598	\$932
Distribution Agreement	1,468	257
Proprietary Technology	<u>500</u>	<u>151</u>
	3,566	1,340
Unamortized Intangible Assets		
Trade Name Costar	800	
Trade Name Sielox, LLC	<u>170</u>	
	<u>\$4,536</u>	

The weighted average amortization period is 12 years. The estimated useful life for customer relationships distribution agreements and proprietary technology are 6, 20 and 8 years, respectively.

Amortization expense was \$403 in 2009. Estimated amortization expense for each of the ensuing years through December 31, 2013 is:

	<u>December 31,</u>
2010	\$403
2011	403
2012	269
2013	136
2014	136

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

NOTE 7 - 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 are due on August 25, 2010 and accrue 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 contains 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, approximately \$867 was owed to Summit.

Effective as of August 25, 2009, Costar entered into the Costar Loan Agreement with Compass. The Costar Loan Agreement provides Costar with up to \$4,000 in revolving lines of credit due on August 25, 2010. 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.

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 Costar and the Company to maintain a specific Tangible Net Worth. As of December 31, 2009, the Company was not in compliance with the Tangible Net Worth covenant. This violation represents an event of default whereby Compass could accelerate payment of the total debt outstanding. Such an event would have a materially negative impact on the Company's operations, cash flow, liquidity and ability to meet other obligations. The Company is in discussions with Compass regarding the issuing of a waiver for this covenant. As of December 31, 2009 approximately \$1,262 was owed to Compass.

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

NOTE 8 - STOCKHOLDERS' EQUITY

At December 31, 2009, the authorized capital stock of the Company consisted of (i) 90,000,000 shares of voting common stock with a par value of \$0.001 per share and (ii) 10,000,000 shares of preferred stock with a par value of \$0.001 per share. The Company's Board has the authority to determine the voting powers, designations, preferences, privileges and restrictions of the preferred shares.

NOTE 9 - EARNOUT, CONTINGENT PURCHASE PRICE

Pursuant to that certain Asset Purchase Agreement, dated as of June 20, 2006, by and between Southern Imaging, Inc., Video Solutions Technology Center, LLC, and certain shareholders of Southern Imaging, Costar and Video Solutions Technology Center, LLC, whereby the Company acquired substantially all of the assets of Southern Imaging and Video Solutions (the "Southern Imaging Agreement," included as Exhibit 2.1 to the Company's 8-K filed on June 26, 2006), the Company was obligated to make an earn out payment of \$773 on April 1, 2009 (the "2008 earn out payment"). The Company was unable to pay, in full, the 2008 earn out payment. Since that date, several payments have been made that include principal and interest at 9% per annum. As of December 31, 2009, the unpaid balance was \$554.

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 proposed payments were made. The Company agreed to make a new proposal to the previous owners of Southern Imaging concerning the repayment of the balance due on or before January 15, 2010.

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 15th 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,

2010	\$261
2011	285
2012	8

NOTE 10- LEASE AGREEMENTS

The Company leases certain of its facilities under operating leases which expire in 2010 and 2011. Future minimum annual rent payments are approximately as follows:

Year Ending December 31,

2010	\$224
2011	15

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

NOTE 11 – 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, 2009 are as follows (in thousands):

	<u>December 31,</u> <u>2009</u>
Net operating loss carry forwards	\$9,269
Valuation allowance	<u>(9,269)</u>
Net deferred tax assets	\$ -----

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, 2009, 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 2029.

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 \$458 in 2009.

NOTE 12 - 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 the Company's 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.

SIELOX, INC. AND SUBSIDIARIES
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(\$ in thousands)

NOTE 12 - LEGAL PROCEEDINGS (continued)

As a result, the only claims that remain against the Company are those arising under Section 11 of the Securities Act. In June 2004, a stipulation of settlement between the plaintiffs and issuer defendants was submitted to the Court (the "Settlement"). In August 2005, the Court granted preliminary approval of the Settlement. In December 2006, the Court of Appeals for the Second Circuit overturned the certification of classes in the six focus cases that were selected by the underwriter defendants and plaintiffs in the coordinated proceedings. Neither the Company nor L Q Corporation was a party in one of the six focus cases. Because class certification was a condition of the Settlement, it was unlikely that the Settlement would receive final court approval. On June 25, 2007, the Court entered an order terminating the Settlement based upon a stipulation among the parties to the Settlement. Plaintiffs have filed amended master allegations and amended complaints in the six focus cases. On March 26, 2008, the Court denied in substantial part the motions to dismiss the amended complaints in the six focus cases. Plaintiffs also filed new motions for class certification, which the issuer defendants and the underwriter defendants separately opposed. The plaintiffs have recently voluntarily withdrawn their motion for class certification without prejudice.

The parties have reached a global settlement of the litigation. Plaintiffs filed their motion for preliminary approval and supporting papers with the Court on April 2, 2009. Under the proposed settlement, which remains subject to Court approval, the insurers would pay the full amount of settlement share allocated to the Company, and the Company would bear no financial liability. The Company, as well as the officer and director defendants who were previously dismissed from the action pursuant to tolling agreements, would receive complete dismissals from the case. On June 9, 2009, the Court preliminarily approved the proposed global settlement, directed that notice be provided to the class, and scheduled a settlement fairness hearing, at which members of the class may object to the proposed settlement, for September 10, 2009. The parties have reached a global settlement of the coordinated litigation.

Under the proposed settlement, the insurers will pay the full amount of settlement share allocated to the Company, and the Company will bear no financial liability. The Company, as well as the officer and director defendants who were previously dismissed from the action pursuant to tolling agreements, will receive complete dismissal from the case. On October 5, 2009, the court entered an order granting final approval of the settlement. Several appeals have been filed objecting to the definition of the settlement class and fairness of the settlement and those appeals remain pending. While there can be no assurance as to the ultimate outcome of these proceedings, we currently believe that the final results of these actions will have no material effect on the Company's consolidated financial condition, results of operations or cash flows.

SIELOX, INC. AND SUBSIDIARIES
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NOTE 12 - 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, the Company's 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.

Under the terms of the settlement, the Company repurchased approximately 180,000 shares from Mr. Berger at approximately \$0.82 per share in a treasury stock transaction which was recorded as of December 31, 2008 at the estimated fair value of the shares as of the July 31, 2007 merger date with the offsetting amount recorded as litigation settlement.

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 (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 whereby the Company will make a payment on or about the 15th of each month, of \$25, including principal and interest at 9% per annum. This payment schedule, through May 31, 2010, was adhered to. 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
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NOTE 13 - SUBSEQUENT EVENT

On February 26, 2010, the Company issued a press release announcing its intention to file a Form 15 with the Securities and Exchange Commission (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 deregistering its common stock. As a result, the Company has ceased filing 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.

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 will not continue to be quoted on the OTCBB; instead its shares will be quoted on the Pink Sheets, LLC, electronic network through which participating broker-dealers can make markets, and enter orders to buy and sell shares of companies.