

**COSTAR TECHNOLOGIES, INC.
AND SUBSIDIARIES
(FORMERLY KNOWN AS SIELOX, INC.)**

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

SEPTEMBER 30, 2012

Rothstein Kass

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES
(FORMERLY KNOWN AS SIELOX, INC.)

CONTENTS

Independent Accountants' Compilation Report	1
Financial Statements	
Consolidated Balance Sheets	2
Consolidated Statements of Operations	3
Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income	4
Consolidated Statements of Cash Flows	5
Notes to Consolidated Financial Statements	6-17

Rothstein Kass

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 Subsidiaries (collectively, the "Company") (formerly known as Sielox, Inc.) as of September 30, 2012, and the related consolidated statements of operations for the three and nine month periods ended September 30, 2012 and 2011, and the consolidated statements of changes in stockholders' equity and comprehensive income, and cash flows for the nine month periods ended September 30, 2012 and 2011. We have not audited or reviewed the accompanying consolidated September 2012 and 2011 financial statements and, accordingly, do not express an opinion or provide any assurance about whether the consolidated 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 Subsidiaries, as of December 31, 2011, 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 April 20, 2012, but we have not performed any procedures in connection with that review engagement since that date.



Dallas, Texas
November 12, 2012

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES
(FORMERLY KNOWN AS SIELOX, INC.)

CONSOLIDATED BALANCE SHEETS
(AMOUNTS SHOWN IN THOUSANDS)

	September 30, 2012	December 31, 2011
ASSETS		
Current assets		
Cash	\$ 203	\$ 193
Accounts receivable, less allowance for doubtful accounts of \$114 and \$107 in 2012 and 2011, respectively	2,190	2,907
Inventories, net of reserve for obsolescence of \$675 in 2012 and 2011	4,750	6,859
Prepaid expenses	459	483
Total current assets	<u>7,602</u>	<u>10,442</u>
Non-current assets		
Property and equipment, net	110	128
Trade names	925	925
Distribution agreement, net	1,009	1,064
Customer relationships, net	106	255
Covenant not to compete	35	47
Promissory note	409	500
Total assets	<u>\$ 10,196</u>	<u>\$ 13,361</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Liabilities		
Current liabilities		
Accounts payable	\$ 706	\$ 2,722
Accrued expenses and other	247	129
Lines of credit	1,142	2,974
Current liabilities, contingent purchase price		100
Total current liabilities	<u>2,095</u>	<u>5,925</u>
Stockholders' Equity		
Common stock	2	2
Additional paid in capital	155,893	155,879
Accumulated deficit	(143,270)	(143,921)
Less common stock held in treasury	(4,524)	(4,524)
Total stockholders' equity	<u>8,101</u>	<u>7,436</u>
Total liabilities and stockholders' equity	<u>\$ 10,196</u>	<u>\$ 13,361</u>

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES
(FORMERLY KNOWN AS SIELOX, INC.)

CONSOLIDATED STATEMENTS OF OPERATIONS
(AMOUNTS SHOWN IN THOUSANDS)

	For the Three Month Periods Ended September 30,		For the Nine Month Periods Ended September 30,	
	2012	2011	2012	2011
Net revenues	\$ 4,037	\$ 4,231	\$ 15,361	\$ 12,052
Cost of revenues	<u>2,844</u>	<u>3,135</u>	<u>10,903</u>	<u>9,013</u>
Gross profit	1,193	1,096	4,458	3,039
Selling, general and administrative expenses	<u>1,177</u>	<u>948</u>	<u>3,702</u>	<u>2,964</u>
Income from operations	<u>16</u>	<u>148</u>	<u>756</u>	<u>75</u>
Other income (expenses)				
Interest expense	(26)	(31)	(125)	(88)
Other income and expense, net	<u>12</u>	<u>1</u>	<u>20</u>	<u>16</u>
Total other income (expense), net	<u>(14)</u>	<u>(30)</u>	<u>(105)</u>	<u>(72)</u>
Net income from continuing operations	<u>2</u>	<u>118</u>	<u>651</u>	<u>3</u>
Net loss from discontinued operations				<u>(1)</u>
Net income	<u>\$ 2</u>	<u>\$ 118</u>	<u>\$ 651</u>	<u>\$ 2</u>
Per share of common stock				
Income from continuing operations	\$ 0.00	\$ 0.08	\$ 0.45	\$ 0.00
Income (loss) from discontinued operations	<u>0.00</u>	<u>0.00</u>	<u>0.00</u>	<u>(0.00)</u>
Net income per share	<u>\$ 0.00</u>	<u>\$ 0.08</u>	<u>\$ 0.45</u>	<u>\$ 0.00</u>
Weighted average shares outstanding	<u>1,447</u>	<u>1,447</u>	<u>1,447</u>	<u>1,437</u>

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

(FORMERLY KNOWN AS SIELOX, INC.)

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME

(AMOUNTS SHOWN IN THOUSANDS)

For the Nine Month Periods Ended September 30, 2012 and 2011

	Common Stock		Additional Paid - In Capital	Treasury Stock		Accumulated Other Comprehensive Income	Accumulated Deficit	Total Stockholders' Equity	Comprehensive Income
	Shares	Amount		Shares	Amount				
Balances at December 31, 2010	1,680	\$ 2	\$ 155,845	252	\$ (4,524)	\$ 260	\$ (144,083)	\$ 7,500	
Net income							2	2	\$ 2
Stock based compensation			32	(19)				32	
Comprehensive income									\$ 2
Balances at September 30, 2011	1,680	\$ 2	\$ 155,877	233	\$ (4,524)	\$ 260	\$ (144,081)	\$ 7,534	
Balances at December 31, 2011	1,680	\$ 2	\$ 155,879	233	\$ (4,524)		\$ (143,921)	\$ 7,436	
Net income							651	651	\$ 651
Stock based compensation			14					14	
Comprehensive income									\$ 651
Balances at September 30, 2012	1,680	\$ 2	\$ 155,893	233	\$ (4,524)	\$ -	\$ (143,270)	\$ 8,101	

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

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

(FORMERLY KNOWN AS SIELOX, INC.)

**CONSOLIDATED STATEMENTS OF CASH FLOWS
(AMOUNTS SHOWN IN THOUSANDS)****For the Nine Month Periods Ended September 30,****2012****2011****Cash flows from operating activities**

Net income	\$	651	\$	2
Adjustments to reconcile net income to net cash provided by (used in) operating activities:				
Stock based compensation		14		32
Depreciation and amortization		248		288
Provision for doubtful accounts		7		(35)
Provision for obsolete inventory				126
Changes in operating assets and liabilities:				
Accounts receivable, net		710		(331)
Inventory		2,109		(599)
Prepaid expenses		24		(56)
Accounts payable		(2,016)		(6)
Accrued expenses and other		118		(217)
Net cash provided by (used in) operating activities		<u>1,865</u>		<u>(796)</u>
Net cash used in discontinued operations				<u>(65)</u>
Net cash provided by (used in) operating activities		<u>1,865</u>		<u>(861)</u>

Cash flows from investing activities

Purchase of property and equipment		(14)		(118)
Payment of earnout provision related to Southern Imaging				(294)
Business purchase related to IVS		(100)		
Long term note related to the sale of Sielox LLC assets		91		
Net cash used in investing activities		<u>(23)</u>		<u>(412)</u>

Cash flows provided by (used in) financing activity

Proceeds (repayment) on lines of credit		<u>(1,832)</u>		<u>1,055</u>
Net increase (decrease) in cash		<u>10</u>		<u>(218)</u>
Cash, beginning of period		<u>193</u>		<u>407</u>
Cash, end of period	\$	<u>203</u>	\$	<u>189</u>

Supplemental disclosure of cash flow information:

Cash paid during the period for interest	\$	<u>125</u>	\$	<u>83</u>
Cash paid during the period for taxes	\$	<u>47</u>	\$	<u>51</u>

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

(FORMERLY KNOWN AS SIELOX, INC.)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(AMOUNTS SHOWN IN THOUSANDS)

1. Nature of operations

Costar Technologies, Inc. (formerly known as Sielox, Inc.) (“Costar Technologies”) was incorporated in the State of Delaware in February 1997 under the name “Fairmarket, Inc.”. Costar Technologies, and its wholly owned subsidiaries, Costar Video Systems, LLC (“Costar”) and LQ Corporation (“LQ”) (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. Through December 31, 2010 the Company operated another business line through Sielox, LLC (“Sielox”), a wholly owned subsidiary of LQ.

As of December 31, 2010, the Company sold substantially all of its assets in its indirect wholly owned subsidiary, Sielox. The results of Sielox’s operations have been classified in discontinued operations for the nine months ended September 30, 2011 (See Note 3).

Effective March 2, 2012, the Company’s shares started trading on the OTC Markets Group under the ticker symbol “CSTI” to reflect the Company’s new name, Costar Technologies, Inc. The shares formerly traded on the OTC Markets Group under the stock ticker symbol “SLXN”. The Company has also changed the address of its website from www.sieloxinc.com to www.costartechnologies.com.

Effective April 27, 2012, the Company executed a 1:25 reverse stock split of the Company’s common stock. All of the share and per share amounts discussed and shown in the consolidated financial statements and the notes to the consolidated financial statements have been adjusted to reflect the effect of this reverse stock split.

2. Summary of significant accounting policies

Basis of Presentation

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 Costar Technologies and its wholly owned subsidiaries, for the nine months ended September 30, 2012. As of December 31, 2010, the Company sold substantially all of its assets in its indirect wholly owned subsidiary, Sielox. All material intercompany transactions have been eliminated in consolidation.

These consolidated financial statements were approved by management and available for issuance on November 12, 2012. Subsequent events have been evaluated through this date.

Use of Estimates

The preparation of consolidated 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 consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash Equivalents

The Company considers all highly liquid debt instruments with original maturities of three months or less to be cash equivalents. As of September 30, 2012 and December 31, 2011, the Company had no such cash equivalents.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

(FORMERLY KNOWN AS SIELOX, INC.)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(AMOUNTS SHOWN IN THOUSANDS)

2. Summary of significant accounting policies (continued)

Accounts Receivable and Allowance for Doubtful Accounts

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

Inventories

Inventories are recorded on the first in first out basis and are stated at the lower of average cost or market. A provision is made to reduce excess or obsolete inventories to their net realizable value. As of September 30, 2012 and December 31, 2011, the Company had \$4,750 and \$6,859 in finished goods, respectively.

Property and Equipment

Property and equipment are 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 as follows.

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 asset 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 consolidated 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, the Company reviews 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 consolidated 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.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(AMOUNTS SHOWN IN THOUSANDS)

2. Summary of significant accounting policies (continued)

Comprehensive Income

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

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 and 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 generally 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.

During the nine months ended September 30, 2012 the Company recognized \$14 in stock based compensation expense in its consolidated financial statements relating to the issuance of 31 stock options. The Company recorded \$32 in stock based compensation expense during the nine months ended September 30, 2011 relating to the issuance of 18 stock grants.

The fair value of the 2012 stock options were estimated on the date of grant using the Black-Sholes valuation model based on the following assumptions for the nine months ended September 30, 2012:

Expected dividend yield	0.00%
Expected stock price volatility	15.60%
Risk-free interest rate	2.00%
Expected life in years	10 years
Weighted-average fair value of options granted	\$0.46

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(AMOUNTS SHOWN IN THOUSANDS)

2. 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 consolidated 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 consolidated 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 consolidated 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 increases the accumulated deficit. Generally, the Company is no longer subject to income tax examination by major taxing authorities for the years before 2009.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(AMOUNTS SHOWN IN THOUSANDS)

3. Discontinued operations

As required under GAAP for the nine months ended September 30, 2011, the Company has classified the results of operations of Sielox within income from discontinued operations.

During December 2010, the Company entered into an agreement to sell certain assets and liabilities of Sielox, an indirect wholly owned subsidiary. Sielox 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 network of approved business partners. The terms and conditions that govern the sale of Costar products are stated in the Master Distribution Agreement (the "Agreement") entered into between Costar and HGW Acquisition Company ("HGW"). The term of the Agreement commences on January 1, 2011, and ends on December 31, 2013. During the term of the Agreement, HGW has agreed to purchase Costar products in the minimum amount of \$5,000. Actual purchases will be measured against a schedule of semi-annual purchase commitments (the "Purchase Commitment"). In furtherance of the Purchase Commitment, HGW delivered to Costar a secured promissory note with an original principal balance in the amount of \$500 and bearing interest on the unpaid balance at a rate equal to 7% per annum. The promissory note is secured by a first priority security interest in HGW's accounts receivable. In the event that HGW fails to purchase Costar products in an amount equal to the Purchase Commitment as of the end of an applicable semi-annual period, HGW will have a period of 30 days to remedy the purchase default. That remedy will be in the form of a payment to Costar, of an amount equal to 25% of the shortfall, plus interest.

The results of discontinued operations included in the consolidated statements of operations for the nine months ended September 30, 2011 are as follows:

Net revenues	\$
Cost of revenues	
Gross Profit	
Selling, general & administrative expenses	1
Operating income (loss)	(1)
Other income (expenses)	
Gain on sale of assets, net of costs \$100	
Interest expense	
Net income (loss)	\$ (1)

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(AMOUNTS SHOWN IN THOUSANDS)

4. Business combination

On October 20, 2011, Costar acquired substantially all of the assets of Industrial Vision Source (“IVS”), a division of Mace Security Products, Inc. for \$517. Additionally, the “IVS Asset Purchase Agreement” calls for an additional earn-out payment of \$100 if IVS reaches certain ninety day revenue targets. Pursuant to the IVS Asset Purchase Agreement, the minimum ninety day revenue target was achieved as of January 2012, and the \$100 owed has been recorded in the accompanying consolidated balance sheet as of December 31, 2011.

The acquisition of these properties meets the definition of a business combination under GAAP. The following table presents a summary of the fair value of assets acquired and liabilities assumed during the year ended December 31, 2011:

Assets acquired:	
Inventory	\$ 336
Accounts receivable	73
Trade name	125
Customer relations	125
Covenant not to compete	50
Total assets acquired	<u>709</u>
Liability assumed:	
Accounts payable	<u>92</u>
Total assets acquired and liabilities assumed, net	<u>\$ 617</u>

5. Property and equipment

Property and equipment at September 30, 2012 and December 31, 2011, were as follows:

	<u>2012</u>	<u>2011</u>
Office furniture and equipment	\$ 403	\$ 389
Demonstration and technical equipment	28	41
	<u>431</u>	<u>430</u>
Less accumulated depreciation	(321)	(302)
Total property and equipment, net	<u>\$ 110</u>	<u>\$ 128</u>

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES
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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(AMOUNTS SHOWN IN THOUSANDS)

6. Intangible assets

The following is a summary of amortized and unamortized intangible assets from continuing operations at September 30, 2012 and December 31, 2011.

	September 30, 2012	
	Gross Amount	Accumulated Amortization
Amortized intangible assets		
Customer relations - Southern Imaging	\$ 1,599	\$ 1,599
Distribution agreement - Southern Imaging	1,468	459
Customer relations – IVS	125	19
Covenant not to compete – IVS	50	15
Total amortized intangible assets	<u>3,242</u>	<u>2,092</u>
Unamortized intangible assets		
Trade name - Costar	800	
Trade name - IVS	125	
Total unamortized intangible assets	<u>925</u>	
Total intangible assets	<u>\$ 4,167</u>	<u>\$ 2,092</u>
	December 31, 2011	
	Gross Amount	Accumulated Amortization
Amortized intangible assets		
Customer relations - Southern Imaging	\$ 1,599	\$ 1,466
Distribution agreement - Southern Imaging	1,468	404
Customer relations – IVS	125	3
Covenant not to compete – IVS	50	3
Total amortized intangible assets	<u>3,242</u>	<u>1,876</u>
Unamortized intangible assets		
Trade name - Costar	800	
Trade name - IVS	125	
Total unamortized intangible assets	<u>925</u>	
Total intangible assets	<u>\$ 4,167</u>	<u>\$ 1,876</u>

The weighted average amortization period for the Company's intangible assets is 12 years. The estimated useful lives for customer relationships, distribution agreements and covenant not to compete are 6, 20 and 3 years, respectively.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

(FORMERLY KNOWN AS SIELOX, INC.)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(AMOUNTS SHOWN IN THOUSANDS)

6. Intangible assets (continued)

Amortization expense for the nine months ended September 30, 2012 and 2011 was \$217 and \$255, respectively. Future amortization expense, as of September 30, 2012, is as follows:

Year Ending September 30,	
2013	\$ 111
2014	111
2015	96
2016	94
2017	94
Thereafter	<u>644</u>
Total future amortization expense	<u>\$ 1,150</u>

7. Lines of credit

Effective as of August 21, 2009, and amended effective as of June 1, 2010 and November 21, 2010 Costar entered into the "Costar Loan Agreement" with Compass Bank ("Compass"). The Costar Loan Agreement provided Costar with up to \$4,000 in revolving lines of credit. The obligations under the Costar Loan Agreement are evidenced by a Master Revolving Promissory Note made by Costar in favor of Compass. The obligations under the Costar Loan Agreement are secured by a lien on substantially all accounts receivable, inventory, equipment, general intangibles, including intellectual property, chattel paper, instruments and documents of Costar, as set forth in the Costar Loan Agreement. The Company is a guarantor of Costar's obligations under the Costar Loan Agreement pursuant to the unlimited guaranty made by the Company in favor of Compass. Borrowings under the Costar Loan Agreement accrued interest at a rate equal to the greater of (i) 5% per annum and (ii) the 30-day LIBOR plus 3% per annum.

Effective as of September 23, 2011, the Company did not renew their Revolving Credit and Costar Loan Agreement with Compass, but rather entered into a Loan and Security Agreement with Briar Capital L.P. ("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 contain financial covenants restricting capital expenditures of Costar and requiring Costar and the Company to maintain a specific Tangible Net Worth. As of September 30, 2012 and December 31, 2011, approximately \$1,142 and \$2,974, respectively, was owed to Briar.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

(FORMERLY KNOWN AS SIELOX, INC.)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(AMOUNTS SHOWN IN THOUSANDS)

7. Lines of credit (continued)

For the nine months ended September 30, 2012, the Company earned net income of \$651 versus \$2 for the nine months ended September 30, 2011. The Company had net cash provided by operations of \$1,865 versus net cash outflows from operations of \$(861) for the nine months ended September 30, 2012 and 2011, respectively. Since the Briar Loan and Security Agreement allows for up to \$3,500 in revolving lines of credit with a three year maturity, Company's Management believes the Company has the financial wherewithal to meet its ongoing liquidity needs.

8. Deferred income taxes

Deferred tax 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 September 30, 2012 and December 31, 2011 are as follows:

	<u>2012</u>	<u>2011</u>
Net operating loss carryforward	\$ 51,361	\$ 51,562
Valuation allowance	<u>(51,361)</u>	<u>(51,562)</u>
Total net deferred tax asset	<u>\$</u>	<u>\$</u>

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 September 30, 2012 and December 31, 2011, the Company has approximately \$151,000 and \$151,600 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.

9. Stockholders' equity (shown in whole amounts)

At September 30, 2012, the authorized capital stock of the Company consisted of (i) 10,000,000 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. At December 31, 2011, prior to the 1:25 reverse stock split, 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. As of September 30, 2012 and December 31, 2011, there was no preferred stock issued and outstanding. The Company's Board has the authority to determine the voting powers, designations, preferences, privileges and restrictions of the preferred shares.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES
(FORMERLY KNOWN AS SIELOX, INC.)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(AMOUNTS SHOWN IN THOUSANDS)

10. Stock option plan (shown in whole amounts)

The Company's 2000 Stock Option and Incentive Plan (the "2000 Incentive Plan") provides for awards in the form of incentive stock options, non-qualified stock options, restricted stock awards and other forms of awards to officers, directors, employees and consultants of the Company. At September 30, 2012 there were 142,394 share options issued under this plan. At September 30, 2012, there were 117,941 shares available for issuance under the 2000 Incentive Plan.

The Board of Directors of the Company determines the term of each option, the option price, and the number of shares for which each option is granted and the times at which each option vests. For holders of 10% or more of the Company's outstanding common stock, incentive stock options may not be granted at less than 110% of the fair market value of the common stock at the date of grant.

The following table summarizes information about stock options outstanding at September 30, 2012:

Options Outstanding				Options Fully Vested and Exercisable	
Range of Exercise Price Per Share	Number Outstanding	Remaining Contractual Life (In Years)	Weighted Average Exercise Price Per Share	Number Exercisable	Weighted Average Exercise Price Per Share
\$0.725-\$14.00	142,394	5.61	\$5.23	113,871	\$6.17

Stock option activity for the nine month periods ended September 30, 2012 and 2011 is as follows:

	2012		2011	
	Number of Shares	Weighted Average Exercise Price Per Share	Number of Shares	Weighted Average Exercise Price Per Share
Outstanding at beginning of period	123,267	\$6.75	119,267	\$6.83
Granted	31,400	\$1.67		
Exercised				
Canceled	12,273	\$10.46		
Outstanding at period end	142,394	\$5.23	119,267	\$6.83
Options exercisable at period end	113,871	\$6.17	112,576	\$7.17
Weighted average fair value of options granted during the period at fair value		\$0.46		

During the nine months ended September 30, 2012 the Company recognized approximately \$14,000 in stock based compensation expense in its consolidated financial statements relating to the issuance of 31,400 stock options. The Company recorded \$32,000 in stock based compensation expense relating to the issuance of 18,480 stock-grants in the nine months ended September 30, 2011.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES

(FORMERLY KNOWN AS SIELOX, INC.)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(AMOUNTS SHOWN IN THOUSANDS)

11. Lease agreements

On January 31, 2011 the Company entered into a new lease agreement for certain facilities that will expire in 2018. Future minimum annual rent payments are approximately as follows:

Year Ending September 30,	
2013	\$ 95
2014	107
2015	115
2016	123
2017	131
Thereafter	<u>139</u>
Total future minimum lease commitments	<u>\$ 710</u>

12. Legal proceedings

The Company, as well as the Company's subsidiary, LQ, were defendants in certain purported class action lawsuits 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 and secondary offering. The lawsuits were filed by individual shareholders who purported 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, and they were coordinated for pretrial purposes with similar lawsuits against more than 300 other companies as "In re Initial Public Offering Securities Litigation, 21 MC 92 (SAS)". On February 25, 2009, the parties to the coordinated litigation advised the District Court that they had reached an agreement-in-principle to settle the litigation in its entirety. A stipulation of settlement was filed with the District Court on April 2, 2009. On June 9, 2009, the District Court preliminarily approved the proposed global settlement. Notice was provided to the class, and a settlement fairness hearing, at which members of the class had an opportunity to object to the proposed settlement, was held on September 10, 2009. On October 6, 2009, the District Court issued an order granting final approval to the settlement. Ten appeals were filed objecting to the definition of the settlement class and fairness of the settlement. Five of those appeals were dismissed with prejudice on October 6, 2010. On May 17, 2011, the Court of Appeals dismissed four of the remaining appeals. On January 10, 2012, the last remaining appeal was dismissed with prejudice, as a result of which the settlement became final, by its terms, and all claims against the Company and its former officers and directors were dismissed with prejudice. The Company has no financial liability in connection with the settlement.

13. Risk concentrations

Concentration of Cash

The Company maintains its cash balances in financial institutions. These balances are insured by the Federal Deposit Insurance Corporation up to \$250 per institution. The Company is subject to credit risk to the extent any financial institution with which it conducts business is unable to fulfill contractual obligations on its behalf. Management monitors the financial condition of such financial institutions and does not anticipate any losses from these financial institutions.

COSTAR TECHNOLOGIES, INC. AND SUBSIDIARIES
(FORMERLY KNOWN AS SIELOX, INC.)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(AMOUNTS SHOWN IN THOUSANDS)

13. Risk concentrations (continued)

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; these customers use the Company's video systems to monitor activity on the production line. For the nine months ended September 30, 2012 and 2011, the Company's largest two customers accounted for approximately \$7,537 and \$4,921, or 49.1% and 40.8% of the Company's total revenue, respectively. The same customers accounted for \$1,079 and \$1,131, or 49.3% and 47.3% of the outstanding accounts receivable balance, as of September 30, 2012 and 2011, respectively.

Concentration of Suppliers

For the nine months ended September 30, 2012 and 2011, the Company made purchases from three main suppliers of approximately 55.5% and one main supplier of approximately 29.5% of total purchases, respectively. Amounts owed to these suppliers were approximately 51.5% and 61.0% of the total accounts payable balance, as of September 30, 2012 and 2011, respectively.