

SIELOX INC
Form 10-Q
August 14, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

Form 10-Q

**[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2009

**[] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

Commission file number 000-29423

SIELOX, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

04-3351937
(I.R.S. Employer Identification No.)

170 East Ninth Ave., Runnemede, NJ 08078

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(Address of principal executive offices - zip code)

(856) 861-4579

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes]

No]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

| | | |
|----------------------------|------------------------------|----------|
| Large Accelerated filer | Accelerated filer | |
| Non-accelerated filer | Smaller Reporting Company | X |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12-b-2 of the Exchange Act).

Yes]

No]

The number of shares outstanding of the registrant's common stock as of August 14, 2009 was 35,720,311

SIELOX, INC. AND SUBSIDIARIES

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ITEM 1. FINANCIAL STATEMENTS

SIELOX, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(\$ in thousands except share and per share amounts)

| | June 30, 2009 (unaudited) | December 31, 2008 |
|--|------------------------------|----------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 183 | \$ 249 |
| Short-term investments, at fair value | | 305 |
| Accounts receivable, net of allowance for doubtful accounts of \$124 and \$79 in 2009 and 2008, respectively | 4,016 | 4,925 |
| Inventory, net of reserve for obsolescence of \$236 and \$198 in 2009 and 2008, respectively | 6,643 | 5,679 |
| Prepaid expenses | 404 | 522 |
| Total current assets | 11,246 | 11,680 |
| Fixed assets, net | 346 | 319 |
| Goodwill | 1,229 | 1,229 |
| Trade Name Costar | 1,587 | 1,587 |
| Trademark Sielox, LLC | 300 | 300 |
| Distribution agreement, net | 1,248 | 1,284 |
| Customer relationships, net | 799 | 932 |
| Proprietary technology, net | 380 | 411 |
| Other Assets | 66 | 66 |
| Total assets | \$ 17,201 | \$ 17,808 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 2,683 | \$ 2,917 |
| Accrued expenses and other | 181 | 799 |
| Contingent purchase price, current portion | 732 | 773 |
| Deferred revenue, current | 29 | 27 |
| Line of credit | 2,736 | 1,274 |
| Total current liabilities | 6,361 | 5,790 |

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| | | |
|--|------------------|------------------|
| Long- term liability, contingent purchase price, less current portion | 270 | 270 |
| Total liabilities | 6,631 | 6,060 |
| Stockholders' equity: | | |
| Preferred Stock, \$0.001 par value; 10,000,000 shares authorized, and 0 shares issued and outstanding | | |
| Common stock, \$0.001 par value; 90,000,000 shares authorized; 42,016,924 shares issued and outstanding, in 2009 and 2008 respectively | 42 | 42 |
| Additional paid-in capital | 155,804 | 155,788 |
| Accumulated other comprehensive income | 260 | 260 |
| Accumulated deficit | (141,012) | (139,818) |
| | 15,094 | 16,272 |
| Less: Common stock held in treasury, at cost; 6,296,613 shares in 2009 and 2008, respectively | (4,524) | (4,524) |
| Total stockholders' equity | 10,570 | 11,748 |
| Total liabilities and stockholders' equity | \$ 17,201 | \$ 17,808 |

See accompanying notes to condensed consolidated interim financial statements.

SIELOX, INC. AND SUBSIDIARIES**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(\$ in thousands, except per share amounts, unaudited)

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|----------|------------------|-----------|
| | June 30, | | June 30, | |
| | 2009 | 2008 | 2009 | 2008 |
| Net revenues | \$ 5,210 | \$ 7,311 | \$ 9,886 | \$ 13,895 |
| Cost of revenues | 3,652 | 5,126 | 6,959 | 9,917 |
| Gross profit | 1,558 | 2,185 | 2,927 | 3,978 |
| Selling, general and administrative expenses | 1,963 | 2,173 | 4,073 | 4,403 |
| Income/(loss) from operations | (405) | 12 | (1,146) | (425) |
| Other income (expense) | | | | |
| Interest income | 4 | 9 | 7 | 25 |
| Interest expense | (19) | (31) | (55) | (63) |
| Total other income (expense), net | (15) | (22) | (48) | (38) |
| Net loss | \$ (420) | \$ (10) | \$ (1,194) | \$ (463) |
| Net loss per share: | | | | |
| Basic and diluted | \$ (0.01) | \$ | \$ (0.03) | \$ (0.01) |
| Weighted average number of common shares outstanding: | | | | |
| Basic and diluted | 35,720 | 35,982 | 35,720 | 35,982 |

See accompanying notes to condensed consolidated interim financial statements.

SIELOX, INC. AND SUBSIDIARIES**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

(\$ in thousands; unaudited)

| | Six Months Ended | |
|---|-------------------------|--------------|
| | 2009 | 2008 |
| | June 30 | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | \$ (1,194) | \$ (463) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Stock - based compensation | 16 | 14 |
| Depreciation and amortization | 297 | 287 |
| Provision for doubtful accounts | 45 | 14 |
| Change in cash attributable to changes in operating assets and liabilities: | | |
| Accounts receivable, net | 864 | (384) |
| Inventories, net | (964) | 1,311 |
| Prepaid expenses | 118 | 83 |
| Long- term prepaid expenses | 0 | (14) |
| Accounts payable | (234) | (1,263) |
| Accrued expenses and other current liabilities | (616) | (164) |
| Net cash used in operating activities | (1,668) | (579) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchase of fixed assets | (124) | (25) |
| Proceeds from sale of short-term investments, at fair value | 305 | 484 |
| Payment of earnout provision related to Southern Imaging | (41) | (634) |
| Net cash provided by (used in) investing activities | 140 | (175) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from debt | 1,462 | 47 |
| Deposits | 0 | 1 |
| Net cash provided by financing activities | 1,462 | 48 |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (66) | (706) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD | 249 | 1,422 |

| | | | | |
|--|----|-----|----|-----|
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$ | 183 | \$ | 716 |
|--|----|-----|----|-----|

SUPPLEMENTAL DISCLOSURE CASH FLOW INFORMATION:

| | | | | |
|--|----|----|----|----|
| Cash paid during the period for interest | \$ | 55 | \$ | 39 |
|--|----|----|----|----|

See accompanying notes to condensed consolidated interim financial statements.

SIELOX, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(\$ in thousands, except for shares, unaudited)

NOTE 1 - THE COMPANY

Sielox, Inc., formerly known as Dynabazaar, Inc. (the Company), was incorporated in the State of Delaware in February 1997 under the name Fairmarket, Inc. 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 Video Systems, LLC (Costar) and Sielox, LLC (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.

NOTE 2. LIQUIDITY AND GOING CONCERN CONSIDERATION

The Company has continued to incur losses and negative cash flows from operations. For the six months ended June 30, 2009, the Company incurred a net loss of approximately \$1,194 and negative cash flows from operations of approximately \$1,668. As of June 30, 2009, the Company had an accumulated deficit of approximately \$141,000 and outstanding debt in the amount of \$2,736 from a line of credit which expires on December 16, 2009. The Company's management is aware that its current cash resources may not be adequate to fund its operations over the next year.

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. Furthermore, due to the current credit crisis, it is uncertain whether the Company's current line of credit can be renewed when it comes due on acceptable terms. The Company is currently in violation of a certain financial ratio related to its line of credit which constitutes a default under the line of credit. In addition, the Company has received a notice from the lender that the Stipulation related to the Berger v. L Q Corp. appraisal rights litigation disclosed in note 6 constitutes a default under the line of credit. The Company disagrees with the lender's assertion and is currently in discussions with the lender regarding this matter. Due to these violations, the Company's line of credit is currently frozen and limited to \$2,736, which is the amount outstanding at June 30, 2009. These conditions, among others, raise substantial doubt as to the Company's ability to continue as a going concern. No adjustment has been made in the condensed 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.

SIELOX, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(\$ in thousands, except for shares, unaudited)

NOTE 2. LIQUIDITY AND GOING CONCERN CONSIDERATION (continued)

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 is unable to obtain additional financing on terms favorable to the Company, there could be a material adverse effect on the financial position, results of operations and cash flows of the Company.

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

BASIS OF PRESENTATION AND CONSOLIDATION

The accompanying condensed consolidated financial statements include the accounts of Sielox, Inc. and its wholly-owned subsidiaries, Costar Video Systems, LLC and Sielox, LLC. All material intercompany transactions have been eliminated in consolidation. Certain reclassifications of prior year amounts have been made to conform with the presentation of current year information.

The accompanying condensed consolidated financial statements of the Company for the three and six months ended June 30, 2009 and 2008 are unaudited and have been prepared on a basis substantially consistent with the Company's audited consolidated financial statements for the year ended December 31, 2008. The condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles and all relevant SEC accounting rules and regulations for interim financial information. Consequently, these statements do not include all disclosures normally required by U.S. generally accepted accounting principles for annual financial statements. These condensed consolidated interim financial statements should be read in conjunction with the Company's audited consolidated financial statements for the year ended December 31, 2008, which are contained in the Company's Annual Report on Form 10-K filed with the SEC on March 31, 2009. The condensed consolidated interim financial statements, in the opinion of management, reflect all adjustments (including all normal recurring accruals) necessary to present fairly the Company's financial position, results of operations and cash flows for the three and six months ended June 30, 2009 and 2008. The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the fiscal year.

USE OF ESTIMATES IN THE PREPARATION OF CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The preparation of the condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from those estimates.

CASH AND CASH EQUIVALENTS

The Company considers all highly liquid investment instruments purchased with an original maturity of three months or less to be cash equivalents. Cash equivalents consist of cash placed in an overnight investment account, commercial paper and money market accounts. The Company maintains cash balances in certain financial institutions that may exceed the Federal Deposit Insurance Corporation coverage of \$250. At June 30, 2009, and at various times during the quarter ended June 30, 2009, balances of cash at financial institutions exceeded the federally insured limit. The Company has not experienced any losses in such accounts and believes it is not subject to any significant credit risk on cash and cash equivalents.

SIELOX, INC. AND SUBSIDIARIES**NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

(\$ in thousands, except for shares, unaudited)

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Cash and cash equivalents consist of the following

| | June 30, 2009 | | December 31, 2008 | |
|--------------------|----------------------|-----|--------------------------|-----|
| | (unaudited) | | | |
| Cash | \$ | 28 | \$ | 197 |
| Money market funds | | 155 | | 52 |
| | \$ | 183 | \$ | 249 |

SHORT TERM INVESTMENTS

The Company's short term investments at December 31, 2008 consist solely of an investment in a capital reserve fund (the Fund) at a financial institution. These securities have been classified as available-for-sale and are carried at fair value. Management determines the appropriate classification of its short-term investments at the time of purchase and evaluates such designation as of each balance sheet date. Interest earned on the short-term investments is included in interest income. Short-term investments totaled \$0 and \$305 at June 30, 2009 and December 31, 2008, respectively. There were no realized or unrealized losses incurred on these securities for the periods ended June 30, 2009 and December 31, 2008, respectively. As of May 20, 2009, the Company received \$243 as a complete liquidation of its position in the Fund.

VALUATION OF INVESTMENTS IN SECURITIES AT FAIR VALUE

Effective January 1, 2008, the Company adopted the provisions of Statement of Financial Accounting Standards (SFAS) No. 157, Fair Value Measurements (SFAS 157), for its financial assets and liabilities that are re-measured and reported at fair value at each reporting period (see note 5). (SFAS 157) establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy is based upon the transparency of inputs to the valuation of financial asset or liability as of the measurement date. In February 2008, FASB issued FASB Staff Position (FSP) No. 157-2, Effective Date of FASB Statement No. 157, which delayed the effective date of SFAS 157 for certain non-financial assets and non-financial liabilities to fiscal years beginning after November 15, 2008, and

interim periods within those fiscal years. The Company adopted SFAS 157 for financial assets and liabilities on January 1, 2008. It did not have any impact on the Company's results of operations or financial position.

The three levels are defined as follows:

Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement. The following is a description of the valuation methodologies used for instruments measured at fair value, including the general classification of such instruments pursuant to the valuation hierarchy.

VALUATION TECHNIQUES

Cash Equivalents-Money Market Mutual Funds

Money market mutual funds are recorded at fair value on a recurring basis and include money market funds classified as Level 1. The fair value of the money market funds, recognized as cash equivalents, is determined through active market, observable and corroborated sources.

FINANCIAL INSTRUMENTS

The Company complies with the accounting and reporting requirements of SFAS No. 107, Disclosures about Fair Value of Financial Instruments .

SIELOX, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(\$ in thousands, except for shares, unaudited)

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

RISKS AND UNCERTAINTIES

The Company has no significant concentration of credit risk such as foreign exchange contracts, option contracts or other foreign hedging arrangements. Financial instruments that potentially subject the Company to concentrations of credit risk primarily consist of cash and cash equivalents, short-term investments and trade accounts receivable. The Company places its cash, cash and equivalents and short-term investments with what the Company believes are high credit quality financial institutions.

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 three and six months ended June 30, 2009, the Company's largest customers accounted for approximately \$2,035 or 39.1% and \$3,097 or 31.3% of the Company's total revenue, respectively. This compares to \$3,789 or 27.3% and \$1,817 or 24.9% for the same periods in 2008. For the three and six months ended June 30, 2009, those same customers owed \$1,504 or 37.4% of the outstanding receivable balance. This compares to \$811 or 18.9% for the same periods in 2008.

CONCENTRATION OF SUPPLIERS

For the three and six months ended June 30, 2009, the Company made purchases from two main suppliers of approximately 41.5% of total purchases and 27.1% from one major supplier respectively. This compares to 24.1% and 18.8% for the same periods in 2008 from one main supplier. For the three and six months ended June 30, 2009, amounts owed to these suppliers were approximately 43.0% of the total accounts payable balance. This compares to 16.1% for the same period in 2008.

CREDIT LINE

The Company maintains a line of credit with the Bank of Texas. The line has a limit of \$5,000 and interest is charged on the outstanding balance. Pursuant to the Amended and Restated Loan Agreement (the Loan Agreement), dated as of December 10, 2008, between Costar, Sielox, the Company and the Bank of Texas, interest is charged at the BOKF National Prime Rate Index as determined by BOK Financial Corporation (4.0% at June 30, 2009). The line is secured by accounts receivable and inventories of Costar and Sielox and the Loan Agreement requires the maintenance of certain financial ratios and monthly payments of accrued interest. As of June 30, 2009, the Company was in violation of these financial ratios as prescribed in the Loan Agreement. The line of credit is required to be repaid on December 16, 2009. As of June 30, 2009 and December 31, 2008, approximately \$2,736 and \$1,274 were outstanding under the line of credit, respectively.

A Petition for Appraisal of Stock was filed in the Delaware Court of Chancery against L Q Corporation, our wholly owned subsidiary (See note 6). On March 31, 2009, the Delaware Court of Chancery entered the Stipulation submitted by the parties as an Order of the Court, dismissing the action with prejudice. The Company has received a notice from the Bank of Texas that the Stipulation disclosed in note 6 constitutes a default under the Loan Agreement. The Company disagrees with the Bank of Texas' assertion and is currently in discussions with the Bank of Texas regarding this matter. Due to the violations cited above, the Company's line of credit is currently frozen and limited to \$2,736, which is the amount outstanding at June 30, 2009.

INVENTORIES, NET

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 June 30, 2009, the Company had \$154 in raw materials and \$6,489 in finished goods. This compares to \$137 in raw materials and \$5,542 in finished goods as of December 31, 2008.

GOODWILL AND INTANGIBLE ASSETS

Goodwill and Other Intangible Assets, intangible assets with indefinite lives are not amortized, but instead tested for impairment. Goodwill and intangible assets with indefinite lives are tested for impairment annually or whenever events or changes in business circumstances indicate the carrying value of the assets may not be recoverable. Impairment losses are recognized if the implied fair value of the asset is less than its carrying value.

SIELOX, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(\$ in thousands, except for shares, unaudited)

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

GOODWILL AND INTANGIBLE ASSETS (continued)

Intangible assets with finite useful lives are amortized over their estimated useful lives. The Company reviews for possible impairment whenever circumstances indicate the carrying value 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. There were no impairments and no impairment loss was recorded during the six months ended June 30, 2009 and 2008.

REVENUE RECOGNITION

The Company ships and invoices its sales in accordance with signed purchase orders. In conformity with the guidelines provided in SEC's Staff Accounting Bulletin (SAB) Topic 13 Revenue Recognition, the Company only recognizes revenue when it is realized and earned. The Company considers its revenues 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.

The Company accounts for maintenance contracts in accordance with FASB Technical Bulletin No. 90-1, Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts. 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 AND DEVELOPMENT COSTS

The Company complies with the accounting and reporting requirements of SFAS No. 2, Accounting For Research and Development Costs . Expenditures for research, development and engineering of software and hardware products, that are included in selling, general and administrative expenses in the condensed consolidated statements of operations, are expensed as incurred.

STOCK-BASED COMPENSATION

The Company complies with the accounting and reporting requirements of SFAS No. 123(R) Accounting for Stock-Based Compensation (SFAS No. 123(R)). SFAS No. 123(R) requires companies to record compensation expense for share-based awards issued to employees in exchange for services provided. The amount of the compensation expense is based on the estimated fair value of the awards on their grant dates and is recognized over the applicable vesting period.

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

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

During the three and six months ended June 30, 2009, the Company recognized \$1 and \$16 respectively in stock-based compensation expense in its condensed consolidated interim financial statements. During the three and six months ended June 30, 2008, the Company recognized no stock-based compensation expense in its condensed consolidated interim financial statements, as it issued no stock-based compensation to its employees.

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. The Company complies with provisions of SFAS No. 130, Reporting Comprehensive Income

(SFAS No. 130) . SFAS No. 130 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 sources.

SIELOX, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(\$ in thousands, except for shares, unaudited)

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

NEWLY ISSUED AND ADOPTED ACCOUNTING PRONOUNCEMENTS

On October 10, 2008, the FASB issued FSP FAS 157-3 which clarifies the application of SFAS No. 157 in an inactive market and provides an example to demonstrate how the fair value of a financial asset is determined when the market for that financial asset is inactive. FSP FAS 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. The adoption of FSP FAS 157-3 did not have an impact on the Company's results of consolidated operations, cash flows or financial position.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an Amendment of ARB No. 51, Consolidated Financial Statement (SFAS 160). SFAS 160 establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. It clarifies that a noncontrolling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. This statement is effective as of the beginning of an entity's first fiscal year that begins after December 15, 2008 with retrospective application. The Company has adopted the provisions of SFAS 160 which did not have an impact on the Company's consolidated financial position, results of operations or cash flows.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), Business Combinations (FAS 141R). FAS 141R establishes principles and requirements for how the acquirer in a business combination recognizes and measures in its financial statements the fair value of identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree at the acquisition date. FAS 141R determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. FAS 141R is effective for fiscal years beginning after December 15, 2008. The Company adopted FAS 141R on January 1, 2009, which did not have an impact on the Company's consolidated financial position, results of operations or cash flows.

In April 2008, the FASB issued Staff Position (FSP) No. FAS 142-3, Determination of the Useful Life of Intangible Assets (FAS 142-3). The FSP amends the factors an entity should consider in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, Goodwill and Other Intangible Assets. The new guidance applies to (1) intangible assets that are acquired individually or with a group of other assets and (2) both intangible assets acquired in business combinations and asset acquisitions. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008,

and interim periods within those fiscal years. Early adoption is prohibited. The Company does not expect the adoption of FAS 142-3 will have a material impact on its consolidated financial statements.

In January 2009, the FASB issued FSP No. EITF 99-20-1, Amendments to the Impairment Guidance of EITF Issue No. 99-20. This FSP amends the impairment guidance in EITF 99-20, Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests that Continue to be Held by a Transferor in Securitized Financial Assets, to achieve more consistent determination of whether an other-than-temporary impairment has occurred. The FSP also retains and emphasizes the objective of an other-than-temporary impairment assessment and the related disclosure requirements in SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, and other related guidance. This FSP is effective for the first reporting period, interim or annual, ending after December 15, 2008, which for the Company was the year ended December 31, 2008. The adoption of this FSP has had no effect on disclosures in our financial statements.

SIELOX, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(\$ in thousands, except for shares, unaudited)

NOTE 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

NEWLY ISSUED AND ADOPTED ACCOUNTING PRONOUNCEMENTS (continued)

Effective this quarter, the Company implemented SFAS 157 for nonfinancial assets and liabilities that are re-measured at fair value on a non-recurring basis. The adoption of SFAS 157 for nonfinancial assets and liabilities did not impact the Company's financial position or results of operations; however, it could have an impact in future periods. In addition, the Company may have additional disclosure requirements in the event an acquisition is completed or an impairment of the Company's assets is incurred in future periods.

In May 2009, FASB issued SFAS No. 165, Subsequent Events (SFAS 165). SFAS 165 establishes general standards of accounting for disclosing events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for selecting that date, that is, whether that date represents the date the financial statements were issued or were available to be issued. SFAS 165 is effective for interim or annual financial periods ending after June 15, 2009. The implementation of SFAS 165 did not impact the Company's consolidated financial statements.

In June 2009, FASB issued SFAS No. 167, Amendments to FASB Interpretation No. 46(R) (SFAS 167). SFAS 167 amends FASB Interpretation No. 46, Consolidation of Variable Interest Entities (revised December 2003) an interpretation of ARB No. 51 (FIN 46(R)), to require an enterprise to determine whether its variable interest or interests give it a controlling financial interest in a variable interest entity. The primary beneficiary of a variable interest entity is the enterprise that has both (1) the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and (2) the obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity. SFAS 167 also amends FIN 46(R) to require ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity. SFAS 167 is effective for all variable interest entities and the relationships with variable interest entities existing as of January 1, 2010. The Company does not expect the adoption of the SFAS 167 to have an impact on its financial position or results of operations.

In June 2009, FASB issued SFAS No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 162 (SFAS 168). SFAS 168 replaces SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles, to establish the FASB

Accounting Standards Codification as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in preparation of financial statements in conformity with generally accepted accounting principles in the United States. SFAS 168 is effective for interim and annual periods ending after September 15, 2009. The Company does not expect the adoption of the SFAS 168 to have an impact on its financial position or results of operations.

NOTE 4. EARNINGS (LOSS) PER SHARE

Basic net income (loss) per common share is computed using the weighted average number of common shares outstanding during the period. Diluted net income (loss) per common share is computed using the weighted average number of common shares outstanding during the period plus the effect of any dilutive potential common shares. Dilutive potential common equivalent shares consist of the assumed exercise of stock options, the proceeds of which are then assumed to have been used to repurchase outstanding stock using the treasury stock method, and the assumed conversion of convertible preferred stock and warrants. For the three and six months ended June 30, 2009 the additional shares of common stock outstanding have been excluded from the calculation of diluted net loss per common share because the effect would be anti-dilutive.

SIELOX, INC. AND SUBSIDIARIES**NOTES TO CONDENSED CONSOLIDATED INTERIM, FINANCIAL STATEMENTS**

(\$ in thousands, except for shares, unaudited)

NOTE 5 - FAIR VALUE MEASUREMENTS

The Company's assets recorded at fair value have been categorized based upon a fair value hierarchy in accordance with SFAS No. 157. See Note 3 for a discussion of the Company's accounting policies.

The following tables present information about the Company's assets, that are measured at fair value as of June 30, 2009, and December 31, 2008.

| Description | June 30, 2009 (unaudited) | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---------------------------------------|--|--|--|--|
| Assets: | | | | |
| Cash and cash equivalents | | | | |
| (money market funds) | \$ 155 | \$ 155 | | \$ |
| Short-term investments, at fair value | | | | |
| (capital reserve fund) | | | | |
| Total | \$ 155 | \$ 155 | | \$ |

| Description | December 31, 2008 (audited) | Quoted Prices in Active Markets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---------------------------|--|--|--|--|
| Assets: | | | | |
| Cash and cash equivalents | | | | |
| (money market funds) | \$ 52 | \$ 52 | | \$ |
| | 305 | | 305 | |

Short-term investments, at fair
value

(capital reserve fund)

| | | | | | | | |
|-------|----|-----|----|----|----|-----|----|
| Total | \$ | 357 | \$ | 52 | \$ | 305 | \$ |
|-------|----|-----|----|----|----|-----|----|

NOTE 6 - 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. 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.

SIELOX, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

(\$ in thousands, except for shares, unaudited)

NOTE 6 - LEGAL PROCEEDINGS (continued)

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. It is uncertain whether the settlement will receive final Court approval. If the settlement does not receive final Court approval, and litigation against the Company continues, the Company believes that it has meritorious defenses and intends to defend the action vigorously. An unfavorable outcome in such litigation, however, which was not covered by the Company's insurers, could have a material adverse affect on the Company's business, results of operations and cash flows.

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

A Petition For Appraisal of Stock (the "Petition") under Delaware's General Corporation Law (the "DGCL"), 8 Del. C. § 262, was filed in the Delaware Court of Chancery on November 19, 2007 against L Q Corporation, our wholly owned subsidiary, by Andrew T. Berger ("Berger"), a purported beneficial owner of 49,014 shares of common stock in L Q Corporation, and by Cede & Co., the purported record owner of the shares beneficially owned by Berger. The Petition demanded appraisal of Berger's shares in L Q Corporation, the payment of the fair value of such shares to Berger under Section 262 of the DGCL, and an award of fees and costs in connection with the filing and prosecution of the Petition. L Q Corporation moved to dismiss the Petition on December 19, 2007. In response to L Q Corporation's motion to dismiss, Berger amended the petition for appraisal (the "Amended Petition") on January 11, 2008. L Q Corporation filed a motion to dismiss the Amended Petition on January 23, 2008. L Q Corporation subsequently withdrew its motion to dismiss the Amended Petition on April 24, 2008, and answered the Amended Petition on May 1, 2008. On February 11, 2009, the parties agreed to mediate this action pursuant to Court of Chancery Rule 174 in an effort to settle this action, and a mediation conference was held on March 19, 2009. At the mediation conference, the parties reached an agreement in principle to settle the action. Thereafter, the partner negotiated an agreement of dismissal and release (the "Agreement") and the Agreement was executed by the parties on or about March 25, 2009. After the Agreement was executed by the parties, the parties executed a stipulation of dismissal of the action on March 31, 2009 (the "Stipulation"), submitted the Stipulation to the Court of Chancery and requested that the Court of Chancery enter the Stipulation as an Order of the Court of Chancery, which would dismiss the action with prejudice. On March 31, 2009, the Court of Chancery entered the stipulation as an Order of the Court of Chancery which dismissed the action with prejudice.

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. The Company has received a notice from the Bank of Texas that the Stipulation constitutes a default under the Loan Agreement. The Company disagrees with the Bank of Texas' assertion and is currently in discussions with the Bank of Texas regarding this matter.

NOTE 7 SUBSEQUENT EVENTS

These condensed consolidated interim financial statements were approved by management and were issued on August 13, 2009. Subsequent events have been evaluated through this date.

SIELOX, INC. AND SUBSIDIARIES

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW AND BUSINESS SUMMARY

We develop, design and distribute a range of security solution products such as surveillance cameras, lenses, digital video recorders, high speed domes and access control systems. We also develop, design and distribute industrial vision products to observe repetitive production and assembly lines, thereby increasing efficiency by detecting faults in the production process.

From our organization in 1997 through September 3, 2003, we operated under the name of Fairmarket, Inc. as an online auction and promotions technology service provider that enabled marketers to create results-oriented rewards programs and helped commerce companies automate the process of selling their excess inventory online to wholesale and retail buyers. On September 4, 2003, we sold substantially all of our operating assets to eBay, Inc. for consideration of \$4.5 million in cash, and promptly changed our name to Dynabazaar, Inc.

From January 2003 until June 20, 2006, we had no operations and were settling our remaining claims and liabilities while reviewing alternatives for the use or disposition of our remaining assets.

On July 20, 2006, we purchased substantially all of the assets of each of Southern Imaging, Inc., which designed, sourced and distributed video and imaging products for the security and industrial markets, and Video Solutions Technology Center, Inc., which provided product design and development, technical support and repair services support for Southern Imaging.

Effective July 31, 2007, our wholly-owned subsidiary, L Q Merger Corp., merged with L Q Corporation, Inc., which develops, designs, and distributes a complete line of access control software, programmable controllers and related accessories through its Sielox, LLC subsidiary, and provided strategic security and business protection solutions and corporate investigations through its SES Resources International Inc. subsidiary. As a result of the merger, L Q Corporation became our wholly-owned subsidiary. Immediately following the merger, we changed our name to Sielox, Inc.

Effective November 30, 2007, we shut down the operations of SES Resources and sold our equity interest in that company, together with its net fixed assets, to its minority shareholder for \$10. In connection with this sale, we

recorded certain liabilities for salary and benefits in accordance with the employment contract with Bradley Schnur, President of SES, in the amount of \$28. The operations of SES Resources did not have a material impact on our operations or revenues for the year ended December 31, 2007.

CRITICAL ACCOUNTING POLICIES

While our significant accounting policies are more fully described in Note 2, Summary of Significant Accounting Policies, to our audited consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2008, we believe the following accounting policies to be critical:

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Revenue recognition

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Allowance for doubtful accounts

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Accounting for income taxes

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Impairment of long-lived assets

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Goodwill and intangible assets

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Fair value measurements

Revenue Recognition

The Company ships and invoices its sales in accordance with signed purchase orders. In conformity with the guidelines provided in SEC's Staff Accounting Bulletin (SAB) Topic 13 Revenue Recognition, the Company only recognizes revenue when it is realized and earned. The Company considers its revenues 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.

SIELOX, INC. AND SUBSIDIARIES

The Company accounts for maintenance contracts in accordance with FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*. 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. In proportion to the costs expected to be incurred in performing services under the contract.

Allowance for Doubtful Accounts

Accounts receivable are recorded at net realizable values. We maintain an allowance for estimated losses resulting from the failure of customers to make the 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 the 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.

Accounting for Income Taxes

We comply with SFAS No. 109, *Accounting for Income Taxes*, 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 statements 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.

On January 1, 2007, we adopted Financial Accounting Standard Board Interpretation No 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No 109 (FIN 48). FIN 48 prescribes a measurement process for recording in financial statements, uncertain tax positions taken, or expected to be taken, in a tax return. Additionally, FIN 48 provides guidance regarding uncertain tax positions relating to derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transitions. At June 30, 2009, we had no material uncertain tax positions.

Long-lived Assets

Pursuant to SFAS No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets*, 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.

Intangible Assets

Pursuant to SFAS No. 142 *Goodwill and Other Intangible Assets*, intangible assets with indefinite lives are not amortized, but instead tested for impairment. Intangible assets with indefinite lives 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 useful 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

Pursuant to SFAS 142 *Goodwill and other Intangible Assets*, 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.

SIELOX, INC. AND SUBSIDIARIES

VALUATION OF INVESTMENTS IN SECURITIES AND SECURITIES AT FAIR VALUE DEFINITION AND HIERARCHY

Fair Value Measurements

The Company adopted the provisions of SFAS No. 157, Fair Value Measurements (SFAS No. 157), effective January 1, 2008. Under SFAS No. 157, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (i.e., the exit price) in an orderly transaction between market participants at the measurement date. In determining fair value, the Company uses various valuation approaches. SFAS No. 157 establishes a fair value hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are those that market participants would use in pricing the asset or liability based on market data obtained from sources independent of the Company. Unobservable inputs reflect the Company's assumptions about the inputs market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The fair value hierarchy is categorized into three levels based on the inputs as follows:

Level 1 Valuations based on unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access. Valuation adjustments and block discounts are not applied to Level 1 securities. Since the valuations are based on quoted prices that are readily and regularly available in an active market, valuation of these securities does not entail a significant degree of judgment.

Level 2 Valuations based on quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.

Level 3 Valuations based on inputs that are unobservable.

In February 2008, the Financial FASB issued FSP No. 157-2 that delays the effective date of SFAS No. 157 for nonfinancial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) until fiscal years beginning after November 15, 2008. The delay is intended to allow the FASB and constituents additional time to consider the effect of various implementation issues that have arisen, or that may arise, from the application of SFAS No. 157. Further information about the application of SFAS No. 157 may be found in Note 2 to the condensed consolidated financial statements.

RESULTS OF OPERATIONS

Three Months Ended June 30, 2009 and 2008 (\$ in thousands)

Revenue

Total revenue was approximately \$5.2 million for the period ended June 30, 2009, compared to \$7.3 million for the same period in 2008. The decrease in revenue from 2008 to 2009 of \$2.1 million, or 28.8 %, is due primarily to a general downturn in the national economy. The security segment of our business sells into the general retail market which has, among other things, closed locations, scaled back new store openings and delayed all types of discretionary spending. More specifically, among other things, revenues in the second quarter were down by \$534 due to our largest customers using a quarterly versus monthly shipping schedule pursuant to their new contracts. The Company's industrial sales have been impacted by the overall curbing of capital spending in manufacturing and the semiconductor industry. The Company's access control sales have experienced a drop in revenues due to delayed spending by corporations, municipalities, hospitals, colleges and schools.

Cost of Revenue

Cost of revenue was approximately \$3.7 million for the period ended June 30, 2009, compared to \$5.1 million for the same period in 2008. The decrease in cost of revenue of \$1.4 million, or 27.5 %, is due primarily to lower sales as a result of the reasons stated above.

Gross Profit

Gross profit was approximately \$1.6 million, or 28.8 % of total revenue, in the three months ended June 30, 2009 and \$2.2 million, or 30.1%, of total revenue for the same period in 2008. The decrease in 2009 to 28.8% is primarily due to lower sales as a result of the reasons stated above.

SIELOX, INC. AND SUBSIDIARIES

General and Administrative

General and administrative expenses were approximately \$2.0 million for the period ended June 30, 2009, compared to approximately \$2.2 million for the same period in 2008. The decrease of \$0.2 million, or 9.1%, is primarily due to the implementation of a Company-wide effort to reduce expenses. Those efforts include a reduction in staff of five employees, the termination of a consulting contract, eliminating the accrual for bonus payments and decreasing the use of all utilities and office supplies.

Interest, Net

Interest expense net, was approximately \$15 for the period ended June 30, 2009, compared to interest expense net of approximately \$22 for the period ended June 30, 2008. The decrease in interest expense net of \$7, or 31.8% from 2009 to 2008, is primarily due to a lower average interest rate on the line of credit partially offset by lower interest income.

Net Loss

For the period ended June 30, 2009, we had a net loss of approximately \$420, compared to a net loss of approximately \$10 for the period ended June 30, 2008. The increase in our net loss of \$410 is due to the reasons expressed above. As a percentage of total revenue, net loss was 8.1% for the period ended June 30, 2009, compared to 0.1% for the period ended June 30, 2008.

RESULTS OF OPERATIONS

Six Months Ended June 30, 2009 and 2008 (\$ in thousands)

Revenue

Total revenue was approximately \$9.9 million for the six month period ended June 30, 2009, compared to \$13.9 million for the same period in 2008. The decrease of \$4 million, or 28.8%, is due primarily to a general downturn in the national economy.

Cost of Revenue

Cost of revenue was approximately \$7.0 million for the six month period ended June 30, 2009, compared to \$9.9 million for the same period in 2008. The decrease in cost of revenue of \$2.9 million, or 30.0%, is due primarily to lower sales as a result of the reasons stated above.

Gross Profit

Gross profit was approximately \$2.9 million, or 29.3% of total revenue, in the six months ended June 30, 2009, and \$4.0 million, or 28.6% of total revenue, for the same period in 2008. The decrease in 2009 to 29.3% is primarily due to lower sales as a result of the reasons stated above.

General and Administrative

General and administrative expenses were approximately \$4.1 million for the six month period ended June 30, 2009, compared to \$4.4 million for the same period in 2008. The decrease of \$0.3 million, or 6.8%, is primarily due to the implementation of a company wide effort to reduce expenses. Those efforts include a reduction in staff of five employees, the termination of a consulting contract, eliminating the accrual for bonus payments and decreasing the use of all utilities and office supplies.

Interest, Net

Interest expense net, was approximately \$48 for the six month period ended June 30, 2009, compared to interest expense net of \$38 for the period ended June 30, 2008. The increase in interest expense net of \$10, or 26.3%, is primarily due to lower interest income resulting from a decline in short-term interest rates and lower average cash balances partially offset by lower interest expense on the line of credit.

Net Loss

For the six month period ended June 30, 2009, we had a net loss of approximately \$1,194, compared to a net loss of \$463 for the period ended June 30, 2008. The increase in our net loss of \$731, or 157.9%, is due to the reasons stated above. As a percentage of total revenue, net loss was 12.1% for the period ended June 30, 2009, compared to 3.3% for the period ended June 30, 2008.

At June 30, 2009, cash and cash equivalents totaled \$183, as compared to \$249 at December 31, 2008.

SIELOX, INC. AND SUBSIDIARIES

LIQUIDITY AND CAPITAL RESOURCES (\$ in thousands)

Cash used in operating activities was \$1,668 for the six months ended June 30, 2009, compared to cash used of \$579 for the six months ended June 30, 2008. Cash used in operating activities for the period ended June 30, 2009 primarily reflects the activities of our operating subsidiaries, Costar and Sielox, and the compliance expenses associated with being a public company. Major changes in operating assets and liabilities reflect a decrease in accounts receivable of \$864 and a decrease in accounts payable of \$234, offset by depreciation and amortization of \$297 and an increase in inventories of \$964.

Cash provided by investing activities for the six months ended June 30, 2009 was \$140, compared to cash used of \$175 for the six months ended June 30, 2008. The cash provided in the period ended June 30, 2009 primarily represents the sale of short term investments, offset by the purchase of fixed assets and a payment related to the earnout payable to the previous owners of Southern Imaging. The cash provided for the period ended June 30, 2008 represents the sale of short term investments, offset by the purchase of fixed assets and the payment of the earnout.

Cash provided by financing activities for the six months ended June 30, 2009 was \$1,462, compared to \$48 for the six months ended June 30, 2008. The cash provided for the six months ended June 30, 2009 and June 30, 2008 reflects a draw on the line of credit with the Bank of Texas.

At December 31, 2008, the Company's short term investments consisted of an investment in a capital reserve fund (the Fund) at a financial institution. These securities have been classified as available-for-sale and are carried at fair value on the accompanying consolidated balance sheets. Management determines the appropriate classification of its short-term investments at the time of purchase and evaluates such designation as of each balance sheet date. Interest earned on the short-term investments is included in interest income. Short-term investments totaled \$0 and \$305 at June 30, 2009 and December 31, 2008, respectively. Fair value approximates carrying value for short term investments. There were no realized or unrealized losses incurred on these securities for the years ended December 31, 2008 and 2007, respectively. As of May 20, 2009, the Company received \$243 as a complete liquidation of its position in the Fund.

The Company has continued to incur losses and negative cash flows from operations. For the six months ended June 30, 2009, the Company incurred a net loss of approximately \$1,194 and negative cash flows from operations of approximately \$1,668. As of June 30, 2009, the Company had an accumulated deficit of approximately \$141 million and outstanding debt in the amount of \$2,736 from a line of credit which expires on December 16, 2009. The Company's management is aware that its current cash resources may not be adequate to fund its operations over the next year.

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. Furthermore, due to the current credit crisis, it is uncertain whether the Company's current line of credit can be renewed when it comes due on acceptable terms. The Company is currently in violation of certain financial ratios related to its line of credit which constitutes a default under the line of credit. In addition, the Company has received a notice from the lender that the Stipulation disclosed in note 6 constitutes a default under the line of credit. The Company disagrees with the lender's assertion and is currently in discussions with the lender regarding this matter. Due to these violations, the Company's line of credit is currently frozen and limited to \$2,736, which is the amount outstanding at June 30, 2009. While the Company is currently in negotiations with respect to two new credit facilities, no assurances can be given that definitive agreements will be entered into with respect to such new credit facilities. During this period of negotiation, the current lender has ceased to draw from the Company's current account to make payments against the line of credit and the Company is able to use current cash receipts to fund operations. Nevertheless, these conditions, among others, raise substantial doubt as to the Company's ability to continue as a going concern. No adjustment has been made in the condensed 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.

Management recognizes that the Company must generate additional revenue, improve gross profits and reduce expenses in order to achieve profitable operations and generate positive cash flows. Management's plans to increase revenues include, among other things, the continued development of its customer base and product lines. The Company's management expects that operations will improve during the second half of 2009 when the Company will begin to benefit from a Company-wide effort to reduce expenses. The Company's management has completed an evaluation of both personnel and general expense, in order to more effectively align the Company's operating costs structure with changing market conditions. For the three and six month periods ended June 30, 2009, several Company-wide cost saving measures were implemented, including, among other things, a reduction in staff of five employees and the termination of a consulting contract. Also during this period we completed the payment of severance to the three employees at our engineering facility in Anaheim, California that were terminated in connection with the closing of this facility. As a result, the Company will now begin to benefit from cost savings derived from closing that facility. The Company believes these measures will result in reduced expenses in the second half of 2009 and potentially larger reductions in 2010.

SIELOX, INC. AND SUBSIDIARIES

NOTE 2. LIQUIDITY AND CAPITAL RESOURCES (\$ in thousands) (continued)

In addition, the Company expects that Sielox's financial performance will improve during the second half of 2009. Sielox's hardware and software systems have been upgraded and new products, with higher gross margins, are being introduced. Included among these new products is a new controller and an interface that will enable access control products to interface with Costar cameras.

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 is unable to obtain additional financing on terms favorable to the Company, there could be a material adverse effect on the financial position, results of operations and cash flows of the Company.

FACTORS THAT MAY AFFECT RESULTS OF OPERATIONS AND FINANCIAL CONDITION

This Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act) and Section 21E of the Securities Exchange Act, of 1934 as amended (the Exchange Act). You can identify forward-looking statements by the use of the words believe, expect, anticipate, intend, estimate, assume and other similar expressions which predict or indicate future events and trends and which do not relate to historical matters. You should not rely on forward-looking statements, because they involve known and unknown risks, uncertainties and other factors, some of which are beyond our control. Our actual results could differ materially from those set forth in the forward-looking statements.

Forward-looking statements herein are based on information, plans and estimates at the date of this Form 10-Q, and we do not promise to update any forward-looking statements to reflect changes in underlying assumptions or factors, new information, future events or other changes.

ITEM 4T. CONTROLS AND PROCEDURES

Disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) are controls and other procedures that are designed to provide reasonable assurance that the information that we are required to disclose in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the

time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

In connection with the preparation of this quarterly Report, our management, with the participation of our Chief Executive Officer and our Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of June 30, 2009. Management based its assessment on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Management's assessment included evaluation of such elements as the design and operating effectiveness of key financial reporting controls, process documentation, accounting policies, and our overall control environment. Based on its evaluation, the Company identified a material weakness in its disclosure controls namely, that the Company lacked appropriate resources in the accounting and finance department, including a lack of personnel that are appropriately qualified in the areas of U.S. GAAP and SEC reporting. While this material weakness did not have an effect on our reported results or any related disclosures, it nevertheless constitutes a deficiency in our controls and led our Chief Executive Officer and Chief Financial Officer to conclude that our disclosure controls and procedures continue to not be effective at the reasonable assurance level as of June 30, 2009. Despite this deficiency, management believes that there are no material inaccuracies or omissions of fact in this quarterly report. Due to our small size and limited resources it is difficult for us to attract qualified personnel. As soon as finances allow, we will add resources to our corporate and finance department to remediate this deficiency.

Changes in Internal Control over Financial Reporting

There have been no material changes in our internal control over financial reporting during the quarter ended June 30, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

SIELOX, INC. AND SUBSIDIARIES

PART II. OTHER INFORMATION

ITEM 1. 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. 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. It is uncertain whether the settlement will receive final Court approval. If the settlement does not receive final Court approval, and litigation against the Company continues, the Company believes that it has meritorious defenses and intends to defend the action vigorously. An unfavorable outcome in such litigation, however,

which was not covered by the Company's insurers, could have a material adverse effect on the Company's business, results of operations and cash flows.

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

A Petition For Appraisal of Stock (the "Petition") under Delaware's General Corporation Law (the "DGCL"), 8 Del. C. § 262, was filed in the Delaware Court of Chancery on November 19, 2007 against L Q Corporation, our wholly owned subsidiary, by Andrew T. Berger ("Berger"), a purported beneficial owner of 49,014 shares of common stock in L Q Corporation, and by Cede & Co., the purported record owner of the shares beneficially owned by Berger. The Petition demanded appraisal of Berger's shares in L Q Corporation, the payment of the fair value of such shares to Berger under Section 262 of the DGCL, and an award of fees and costs in connection with the filing and prosecution of the Petition. L Q Corporation moved to dismiss the Petition on December 19, 2007. In response to L Q Corporation's motion to dismiss, Berger amended the petition for appraisal (the "Amended Petition") on January 11, 2008. L Q Corporation filed a motion to dismiss the Amended Petition on January 23, 2008. L Q Corporation subsequently withdrew its motion to dismiss the Amended Petition on April 24, 2008, and answered the Amended Petition on May 1, 2008. On February 11, 2009, the parties agreed to mediate this action pursuant to Court of Chancery Rule 174 in an effort to settle this action, and a mediation conference was held on March 19, 2009. At the mediation conference, the parties reached an agreement in principle to settle the action. Thereafter, the parties 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.

ITEM 1. LEGAL PROCEEDINGS (continued)

Under the terms of the settlement, the Company repurchased approximately 180,000 shares from Mr. Berger at approximately \$0.82 per share. This transaction resulted in the Company repurchasing the above mentioned shares 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. The Company has received a notice from the Bank of Texas that the Stipulation constitutes a default under the Loan Agreement. The Company disagrees with the Bank of Texas assertion and is currently in discussions with the Bank of Texas regarding this matter.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

On June 30,2009, we granted options to purchase an aggregate of 50,000 shares of the Company's common stock to directors of the Company. Such options are exercisable at \$0.06 per share (the market price on the grant date), vest immediately, and expire after ten years. The stock options were not registered under the Securities Act of 1933, as amended (the Securities Act) because such grants either did not involve an offer or sale for purposes of Section 2(a)(3) of the Securities Act, in reliance on the fact that the stock options were granted for no consideration, or were offered and sold in transactions not involving a public offering, exempt from registration pursuant to Section 4(2) of the Securities Act.

ITEM 6. EXHIBITS

31.1

Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2

Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1

Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2

Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SIELOX, INC.

Date: August 14, 2009

By: /s/ James Pritchett
James Pritchett
President and Chief Executive Officer
(Principal Executive Officer)

Date: August 14, 2009

By: /s/ Melvyn Brunt
Melvyn Brunt
Chief Financial Officer
(Principal Financial and Accounting
Officer)