

AIR INDUSTRIES GROUP
Form 10-Q
November 14, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

FOR THE QUARTERLY PERIOD ENDED September 30, 2016

OR

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM _____ TO _____.

Commission file number 001-35927

Air Industries Group
(Exact name of Registrant as specified in its charter)

Nevada
(State or other jurisdiction of
incorporation or organization)

80-0948413
(IRS Employer
Identification No.)

360 Motor Parkway, Suite 100, Hauppauge, New York 11788
(Address of principal executive offices)

(631) 881-4920
(Issuer's telephone number)

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

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Large accelerated filer Accelerated filer

Non-accelerated filer (do not check if smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes No

As of November 10, 2016, the registrant had outstanding 7,583,165 shares of common stock.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, or Securities Act, and Section 21E of the Securities Exchange Act of 1934, or Exchange Act. Forward-looking statements are predictive in nature and can be identified by the fact that they do not relate strictly to historical or current facts and generally include words such as "expects," "anticipates," "intends," "plans," "believes," "estimates" and similar expressions. Certain of the matters discussed herein concerning, among other items, our operations, cash flows, financial position and economic performance including, in particular, future sales, product demand, competition and the effect of economic conditions, include forward-looking statements.

Although we believe that these statements are based upon reasonable assumptions, including projections of orders, sales, operating margins, earnings, cash flow, research and development costs, working capital, capital expenditures, distribution channels, profitability, new products, adequacy of funds from operations, and general economic conditions, these statements and other projections contained herein expressing opinions about future outcomes and non-historical information, are subject to uncertainties and, therefore, there is no assurance that the outcomes expressed in these statements will be achieved. Investors are cautioned that forward-looking statements are not guarantees of future performance and actual results or developments may differ materially from the expectations expressed in forward-looking statements contained herein. Given these uncertainties, you should not place any reliance on these forward-looking statements which speak only as of the date hereof. Factors that could cause actual results to differ materially from those reflected in the forward-looking statements include, but are not limited to, those discussed under the heading "Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2015 and elsewhere in this report and the risks discussed in our other filings with the SEC.

We undertake no obligation to publicly update any forward-looking statement, whether as a result of new information, future events or otherwise, except as may be required under the securities laws of the United States.

PART I

FINANCIAL INFORMATION

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AIR INDUSTRIES GROUP

Condensed Consolidated Balance Sheets

| | September 30, 2016 (Unaudited) | December 31, 2015 |
|--|--------------------------------------|----------------------|
| ASSETS | | |
| Current Assets | | |
| Cash and Cash Equivalents | \$ 1,297,000 | \$ 529,000 |
| Accounts Receivable, Net of Allowance for Doubtful Accounts of \$656,000 and \$985,000, respectively | 9,935,000 | 13,662,000 |
| Inventory | 43,026,000 | 36,923,000 |
| Prepaid Expenses and Other Current Assets | 1,328,000 | 1,583,000 |
| Assets Held for Sale Net | - | 1,700,000 |
| Total Current Assets | 55,586,000 | 54,397,000 |
| Property and Equipment, Net | 16,238,000 | 15,299,000 |
| Capitalized Engineering Costs - Net of Accumulated Amortization of \$4,875,000 and \$4,595,000, respectively | 1,391,000 | 1,027,000 |
| Deferred Financing Costs, Net, Deposits and Other Assets | 1,136,000 | 1,094,000 |
| Intangible Assets, Net | 2,893,000 | 3,852,000 |
| Deferred Tax Asset, Net | 4,178,000 | 2,063,000 |
| Goodwill | 10,518,000 | 10,518,000 |
| TOTAL ASSETS | \$ 91,940,000 | \$ 88,250,000 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities | | |
| Notes Payable and Capitalized Lease Obligations - Current Portion | \$ 34,106,000 | \$ 40,893,000 |
| Accounts Payable and Accrued Expenses | 14,375,000 | 12,053,000 |
| Deferred Gain on Sale - Current Portion | 38,000 | 38,000 |
| Deferred Revenue | 1,070,000 | 958,000 |
| Income Taxes Payable | 34,000 | 14,000 |
| Total Current Liabilities | 49,623,000 | 53,956,000 |
| Long Term Liabilities | | |
| Notes Payable and Capitalized Lease Obligations - Net of Current Portion | 8,493,000 | 3,912,000 |
| Deferred Gain on Sale - Net of Current Portion | 342,000 | 371,000 |
| Deferred Rent | 1,216,000 | 1,206,000 |
| TOTAL LIABILITIES | 59,674,000 | 59,445,000 |
| Commitments and Contingencies | | |
| Stockholders' Equity | | |
| PrPreferred Stock, par value \$.001-Authorized 1,000,000 shares | 1,000 | - |

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Designated as Series A Convertible Preferred Stock - par value \$.001, Authorized 900,000 shares, 732,297 shares and 0 shares issued and outstanding as of September 30, 2016 and December 31, 2015, respectively, Aggregate liquidation preference \$7,322,970 and \$0 as of September 30, 2016 and December 31, 2015, respectively.

Common Stock - par value \$.001 - Authorized 25,000,000 shares, 7,583,165 and 7,560,040 shares issued and outstanding as of September 30, 2016 and December 31, 2015, respectively

| | | |
|-----------------------------------|-------------------|-------------------|
| | 7,000 | 7,000 |
| Additional Paid-In Capital | 51,644,000 | 44,155,000 |
| Accumulated Deficit | (19,386,000) | (15,357,000) |
| TOTAL STOCKHOLDERS' EQUITY | 32,266,000 | 28,805,000 |

| | | |
|---|----------------------|----------------------|
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 91,940,000 | \$ 88,250,000 |
|---|----------------------|----------------------|

See Notes to Condensed Consolidated Financial Statements

AIR INDUSTRIES GROUP
Condensed Consolidated Statements of Operations
(Unaudited)

| | Three Months Ended September | | Nine Months Ended September | |
|---|------------------------------|---------------|-----------------------------|---------------|
| | 2016 | 30, 2015 | 2016 | 30, 2015 |
| Net Sales | \$ 15,710,000 | \$ 21,076,000 | \$ 50,257,000 | \$ 56,944,000 |
| Cost of Sales | 13,713,000 | 16,898,000 | 41,284,000 | 44,500,000 |
| Gross Profit | 1,997,000 | 4,178,000 | 8,973,000 | 12,444,000 |
| Operating Expenses | 4,302,000 | 4,152,000 | 12,896,000 | 11,880,000 |
| (Loss) Income from Operations | (2,305,000) | 26,000 | (3,923,000) | 564,000 |
| Interest and Financing Costs | (894,000) | (451,000) | (1,771,000) | (1,341,000) |
| Loss on extinguishment of debt | (172,000) | - | (172,000) | - |
| Other Income, Net | 4,000 | 36,000 | 35,000 | 98,000 |
| Loss before Income Taxes | (3,367,000) | (389,000) | (5,831,000) | (679,000) |
| Benefit from Income Taxes | 1,320,000 | 726,000 | 2,102,000 | 519,000 |
| Net (Loss) Income | (2,047,000) | 337,000 | (3,729,000) | (160,000) |
| Less: Cumulative preferred stock dividends | (252,000) | - | (334,000) | - |
| Net (Loss) Income attributable to common stockholders | \$ (2,299,000) | \$ 337,000 | \$ (4,063,000) | \$ (160,000) |
| (Loss) Income per share - basic | \$ (0.30) | \$ 0.04 | \$ (0.54) | \$ (0.02) |
| (Loss) Income per share - diluted | \$ (0.30) | \$ 0.04 | \$ (0.54) | \$ (0.02) |
| Weighted average shares outstanding - basic | 7,610,220 | 7,559,501 | 7,594,215 | 7,450,707 |
| Weighted average shares outstanding - diluted | 7,610,220 | 7,686,287 | 7,594,215 | 7,450,707 |

See Notes to Condensed Consolidated Financial Statements

AIR INDUSTRIES GROUP

Condensed Consolidated Statements of Cash Flows For the Nine Months Ended September 30,
(Unaudited)

| | 2016 | 2015 |
|--|--------------------|--------------------|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net Loss | \$ (3,729,000) | \$ (160,000) |
| Adjustments to reconcile net loss to net cash provided by (used in) operating activities | | |
| Depreciation of property and equipment | 2,808,000 | 2,679,000 |
| Amortization of intangible assets | 960,000 | 923,000 |
| Amortization of capitalized engineering costs | 280,000 | 238,000 |
| Bad debt expense | (3,000) | 76,000 |
| Non-cash compensation expense | 126,000 | 77,000 |
| Amortization of deferred financing costs | 356,000 | 142,000 |
| Deferred gain on sale of real estate | (29,000) | (28,000) |
| Loss on sale of fixed assets held for sale | 5,000 | - |
| Deferred income taxes | (2,145,000) | (650,000) |
| Loss on extinguishment of debt | 172,000 | - |
| Amortization of convertible notes payable | 184,000 | - |
| Changes in Assets and Liabilities | | |
| (Increase) Decrease in Operating Assets: | | |
| Accounts receivable | 3,730,000 | (114,000) |
| Inventory | (6,389,000) | (10,031,000) |
| Prepaid expenses and other current assets | 285,000 | 12,000 |
| Deposits and other assets | (199,000) | (108,000) |
| Increase (Decrease) in Operating Liabilities: | | |
| Accounts payable and accrued expenses | 2,356,000 | 5,065,000 |
| Deferred rent | 10,000 | 26,000 |
| Deferred revenue | 112,000 | 475,000 |
| Income taxes payable | (14,000) | (71,000) |
| NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES | (1,124,000) | (1,449,000) |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Capitalized engineering costs | (644,000) | (465,000) |
| Purchase of property and equipment | (1,341,000) | (967,000) |
| Proceeds from the sale of fixed assets | 1,671,000 | - |
| Cash paid for acquisitions | - | (6,945,000) |
| Cash acquired in acquisitions | - | 605,000 |
| NET CASH PROVIDED BY (USED IN) INVESTING ACTIVITIES | (314,000) | (7,772,000) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Note payable - revolver, net | (3,782,000) | 10,328,000 |
| Proceeds from note payable - term loans | - | 3,500,000 |
| Payments of note payable - term loans | (2,814,000) | (1,466,000) |
| Capital lease obligations | (908,000) | (487,000) |

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| | | |
|---|---------------------|-------------------|
| Proceeds from capital lease financing | - | 500,000 |
| Proceeds from issuance of preferred stock | 5,250,000 | - |
| Proceeds from notes payable issuances – related party | 2,900,000 | - |
| Proceeds from notes payable issuances | 2,720,000 | - |
| Deferred financing costs | (199,000) | (362,000) |
| Notes payable - sellers | - | (41,000) |
| Payments related to lease impairment | - | (44,000) |
| Expense for issuance of preferred stock | (663,000) | - |
| Expenses for issuance of convertible debt | (298,000) | - |
| Dividends paid | - | (3,334,000) |
| NET CASH PROVIDED BY FINANCING ACTIVITIES | 2,206,000 | 8,594,000 |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 768,000 | (627,000) |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR | 529,000 | 1,418,000 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$ 1,297,000 | \$ 791,000 |

AIR INDUSTRIES GROUP

Condensed Consolidated Statements of Cash Flows For the Nine Months Ended September 30, (Continued)

(Unaudited)

| | 2016 | 2015 |
|---|--------------|--------------|
| Supplemental cash flow information | | |
| Cash paid during the period for interest | \$ 1,678,000 | \$ 1,172,000 |
| Cash paid during the period for income taxes | \$ 13,000 | \$ 445,000 |
| Supplemental disclosure of non-cash transactions | | |
| Preferred stock issued for notes payable - related party | \$ 1,750,000 | \$ - |
| Extinguishment of related party notes payable, net of issuance of convertible related party notes payable | \$ - | \$ - |
| Preferred shares issued for PIK dividends | \$ 300,000 | - |
| Acquisition of property and equipment financed by capital lease | \$ 2,096,000 | \$ 1,811,000 |
| Dividends payable | \$ - | \$ 1,134,000 |
| Placement agent warrants issued | \$ 26,000 | \$ - |
| Purchase of assets of Compac and assumption of liabilities in the acquisition of liabilities in the acquisition as follows: | | |
| Fair Value of tangible assets acquired | \$ - | \$ 406,000 |
| Intangible assets | - | 600,000 |
| Goodwill | - | 560,000 |
| Liabilities assumed | - | (95,000) |
| Cash paid for acquisition | \$ - | \$ 1,471,000 |
| Purchase of stock of The Sterling Engineering Corporation and assumption of liabilities in the acquisition as follows: | | |
| Fair Value of tangible assets acquired | \$ - | \$ 8,281,000 |
| Goodwill | - | 3,346,000 |
| Cash acquired | - | 588,000 |
| Liabilities assumed | - | (2,538,000) |
| Common stock issued | - | (4,203,000) |
| Cash paid for acquisition | \$ - | \$ 5,474,000 |

See Notes to Condensed Consolidated Financial Statements

AIR INDUSTRIES GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. FORMATION AND BASIS OF PRESENTATION

Organization

On August 30, 2013, Air Industries Group, Inc. (“Air Industries Delaware”) changed its state of incorporation from Delaware to Nevada as a result of a merger with and into its newly formed wholly-owned subsidiary, Air Industries Group, a Nevada corporation (“Air Industries Nevada” or “AIRI”) and the surviving entity, pursuant to an Agreement and Plan of Merger. The reincorporation was approved by the stockholders of Air Industries Delaware at its 2013 Annual Meeting of Stockholders. Air Industries Nevada is deemed to be the successor.

The accompanying consolidated financial statements presented are those of AIRI, and its wholly-owned subsidiaries; Air Industries Machining Corp. (“AIM”), Welding Metallurgy, Inc. (“WMI” or “Welding”), Miller Stuart, Inc. (“Miller Stuart”), Nassau Tool Works, Inc. (“NTW”), Woodbine Products, Inc. (“Woodbine” or “WPI”), Decimal Industries, Inc. (“Decimal”), Eur-Pac Corporation (“Eur-Pac” or “EPC”), Electronic Connection Corporation (“ECC”), AMK Welding, Inc. (“AMK”), Air Realty Group, LLC (“Air Realty”), The Sterling Engineering Corporation (“Sterling”) effective March 1, 2015, and Compac Development Corporation (“Compac”) effective September 1, 2015 (together, the “Company”).

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with Rule 8-03 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and footnotes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015, as filed with the Securities and Exchange Commission.

Reclassifications

Certain account balances in 2015 have been reclassified to conform to the current period presentation.

Note 2. ACQUISITIONS

The Company accounts for all business combinations in accordance with Financial Accounting Standards Board (“FASB”) ASC 805, “Business Combinations” (“ASC 805”), using the acquisition method of accounting. Under this method, assets and liabilities, including any remaining non-controlling interests, are recognized at fair value at the date of acquisition. The excess of the purchase price over the fair value of assets acquired, net of liabilities assumed, and non-controlling interests is recognized as goodwill. Certain adjustments to the assessed fair values of the assets, liabilities, or non-controlling interests made subsequent to the acquisition date, but within the measurement period, which is up to one year, are recorded as adjustments to goodwill. Any adjustments subsequent to the measurement period are recorded in income. Results of operations of the acquired entity are included in the Company’s results from the date of the acquisition onward and include amortization expense arising from acquired tangible and intangible

assets. The Company expenses all costs as incurred related to an acquisition in the condensed consolidated statements of income.

Sterling

On March 1, 2015, the Company acquired all of the common stock of Sterling for \$5.4 million in cash and 425,005 shares of the common stock of AIRI. The common stock was valued at \$9.89 per share, which was the closing share price on February 27, 2015. The cash consideration is subject to adjustment for working capital changes. The Company has also entered into employment and non-compete agreements for two and three year periods with three of the principals of Sterling. The Company financed the acquisition of Sterling with the proceeds from the issuance of Term Loan D (see Note 7).

AIR INDUSTRIES GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Sterling founded in 1941 manufactures components for aircraft and ground turbine engines.

The acquisition of Sterling was accounted for under ASC 805. The purchase price allocation is set forth below.

| | |
|---|--------------|
| Fair value of tangible assets acquired | \$ 8,281,000 |
| Goodwill | 1,963,000 |
| Cash acquired | 588,000 |
| Liabilities assumed | (1,216,000) |
| Total | \$ 9,616,000 |

The below table sets forth selected unaudited proforma financial information for the Company as if Sterling were owned for the entire three and nine months ended September 30, 2015.

| | Three Months Ended September 30, 2015 |
|------------------------|--|
| Net Sales | \$ 21,076,000 |
| Income from operations | \$ 26,000 |

| | Nine Months Ended September 30, 2015 |
|------------------------|---|
| Net Sales | \$ 58,783,000 |
| Income from operations | \$ 711,000 |

The below table sets forth selected financial information for Sterling for the three and nine months ended September 30, 2016 and the portions of the three and nine months ended September 30, 2015 during which Sterling was a subsidiary of the Company.

| | Three Months Ended | |
|----------------------|-----------------------|-----------------------|
| | September 30, 2016 | September 30, 2015 |
| Net Sales | \$ 1,442,000 | \$ 1,853,000 |
| Loss from Operations | \$ (684,000) | \$ (570,000) |

| | Nine Months Ended | |
|----------------------|-----------------------|-----------------------|
| | September 30, 2016 | September 30, 2015 |
| Net Sales | \$ 4,722,000 | \$ 5,152,000 |
| Loss from Operations | \$ (1,516,000) | \$ (585,000) |

AIR INDUSTRIES GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principal Business Activity

AIM is primarily engaged in manufacturing aircraft structural parts, and assemblies for prime defense contractors in the aerospace industry in the United States. NTW is a manufacturer of aerospace components, principally landing gear for F-16 and F-18 fighter aircraft. Welding is a specialty welding and products provider whose significant customers include the world's largest aircraft manufacturers, subcontractors, and original equipment manufacturers. Eur-Pac's primary business is "kitting" of supplies for all branches of the United States Defense Department including ordnance parts, hose assemblies, hydraulic, mechanical and electrical assemblies. AMK is a provider of sophisticated welding and machining services for diversified aerospace and industrial customers. Sterling manufactures components for aircraft and ground turbine engines. Compac specializes in the manufacture of RFI/EMI (Radio Frequency Interference – Electro-Magnetic Interference) shielded enclosures for electronic components. The Company's customers consist mainly of publicly traded companies in the aerospace industry.

Inventory Valuation

The Company does not take physical inventories at interim quarterly reporting periods. Approximately 48% of the inventory value at September 30, 2016 has been estimated using a gross profit percentage based on sales of previous periods to the net sales of the current period, as management believes that the gross profit percentage on these items are materially consistent from period to period.

The remainder of the inventory value at September 30, 2016 is estimated based on the Company's standard cost perpetual inventory system, as management believes the perpetual system computed value for these items provides a better estimate of value for that inventory.

The Company valued inventory at December 31, 2015 at the lower of cost on a first-in-first-out basis or market.

AIR INDUSTRIES GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Credit and Concentration Risks

There was one customer that represented 14.2% and there were four customers that represented 55.3% of total sales for the three months ended September 30, 2016 and 2015, respectively. This is set forth in the table below.

| Customer | Percentage of Sales | |
|----------|---------------------|---------------------|
| | 2016 (Unaudited) | 2015 (Unaudited) |
| 1 | 14.2 | 18.8 |
| 2 | * | 15.3 |
| 3 | * | 11.1 |
| 4 | * | 10.1 |

* Customer was less than 10% of sales for the quarter ended September 30, 2016

There were four customers that represented 53.3% and four customers that represented 62.1% of total sales for the nine months ended September 30, 2016 and 2015, respectively. This is set forth in the table below.

| Customer | Percentage of Sales | |
|----------|---------------------|---------------------|
| | 2016 (Unaudited) | 2015 (Unaudited) |
| 1 | 19.8 | 17.0 |
| 2 | 11.9 | 14.9 |
| 3 | 10.9 | 17.3 |
| 4 | 10.7 | 12.9 |

There were three customers that represented 44.5% of gross accounts receivable and four customers that represented 61.1% of gross accounts receivable at September 30, 2016 and December 31, 2015, respectively. This is set forth in the table below.

| Customer | Percentage of Receivables | |
|----------|----------------------------------|------------------|
| | September 2016 (Unaudited) | December 2015 |
| | 1 | 18.5 |
| 2 | 14.5 | 10.4 |
| 3 | 11.5 | 13.6 |
| 4 | * | 10.5 |

* Customer was less than 10% of Gross Accounts Receivable at September 30, 2016

As of September 30, 2016 and December 31, 2015, the Company had occasionally maintained balances in its bank accounts that were in excess of the FDIC limit. The Company has not experienced any losses on these accounts.

The Company has several key sole-source suppliers of various parts that are important for one or more of its products. These suppliers are its only source for such parts and, therefore, in the event any of them were to go out of business or be unable to provide parts for any reason, the Company's business could be severely harmed.

AIR INDUSTRIES GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Earnings per share

Basic earnings per share is computed by dividing the net income applicable to common stockholders by the weighted-average number of shares of common stock outstanding for the period. Potentially dilutive shares, using the treasury stock method, are included in the diluted per-share calculations for all periods when the effect of their inclusion is dilutive.

The following is a reconciliation of the denominators of basic and diluted earnings per share computations:

| | Three Months Ended | | Nine Months Ended | |
|--|---|---|---|---|
| | September 30, 2016 (Unaudited) | September 30, 2015 (Unaudited) | September 30, 2016 (Unaudited) | September 30, 2015 (Unaudited) |
| Weighted average shares outstanding used to compute basic earnings per share | 7,610,220 | 7,559,501 | 7,594,215 | 7,450,707 |
| Effect of dilutive stock options and warrants | - | 126,786 | - | - |
| Weighted average shares outstanding and dilutive securities used to compute diluted earnings per share | 7,610,220 | 7,686,287 | 7,594,215 | 7,450,707 |

The following table sets forth the number of shares issuable upon exercise of outstanding options and warrants which were excluded from the diluted per share calculation because the exercise price was greater than the average market price of the common shares:

| | Three and Nine Months Ended | |
|---------------|---|---|
| | September 30, 2016 (Unaudited) | September 30, 2015 (Unaudited) |
| Stock Options | 202,694 | 258,391 |
| Warrants | - | 46,800 |
| | 202,694 | 305,191 |

The following table sets forth the number of shares issuable upon conversion or exercise of outstanding convertible preferred stock, options and warrants which were excluded from the diluted per share calculation even though the exercise price was less than the average market price of the common shares and unvested restricted stock because the effect of including these potential shares was anti-dilutive due to the net loss applicable to common stockholders incurred during that period:

| | September 30, 2016 (Unaudited) | September 30, 2015 (Unaudited) |
|-----------------------------|--------------------------------------|---|
| Convertible Preferred Stock | 1,488,394 | - |

| | | |
|---------------------------|-----------|---------|
| Stock Options | 443,648 | 322,675 |
| Warrants | 519,573 | 117,785 |
| Unvested Restricted Stock | 52,000 | - |
| | 2,503,615 | 440,460 |

Stock-Based Compensation

The Company accounts for stock-based compensation in accordance with FASB ASC 718, "Compensation – Stock Compensation." Under the fair value recognition provision of the ASC, stock-based compensation cost is estimated at the grant date based on the fair value of the award. The Company estimates the fair value of stock options and warrants granted using the Black-Scholes-Merton option pricing model. Stock based compensation amounted to \$43,000 and \$23,000 for the three months ended September 30, 2016 and 2015, respectively, and \$126,000 and \$77,000 for the nine months ended September 30, 2016 and 2015, respectively, and was included in operating expenses on the accompanying Condensed Consolidated Statements of Operations.

AIR INDUSTRIES GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Goodwill

Goodwill represents the excess of the acquisition cost of businesses over the fair value of the identifiable net assets acquired. The goodwill amount of \$10,518,000 at September 30, 2016 and December 31, 2015 relates to the acquisitions of Welding \$291,000, NTW \$162,000, Woodbine \$2,565,000, Eur-Pac \$1,656,000, ECC \$109,000, AMK \$635,000, Sterling \$4,540,000 and Compac \$560,000. Goodwill is not amortized, but is tested for impairment annually, or if circumstances occur that more likely than not reduce the fair value of the reporting unit below its carrying amount.

The Company has determined that there has been no impairment of goodwill at September 30, 2016 and December 31, 2015.

Debt Issuance Costs

Effective January 1, 2016, the Company adopted FASB ASU 2015-15 “Interest-Imputation of Interest (Subtopic 835-30), Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements, Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting”. The amendments to the SEC paragraphs in this update state that given the absence of authoritative guidance within ASU 2015-03 for debt issuance costs related to line-of-credit arrangements, the SEC staff would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. The adoption of this amended guidance did not have a significant impact on the Company’s consolidated financial statements.

Recently Issued Accounting Pronouncements

In January 2016, the FASB issued ASU 2016-01, “Recognition and Measurement of Financial Assets and Financial Liabilities (Subtopic 825-10)” (“ASU 2016-01”). The main objective of ASU 2016-01 is enhancing the reporting model for financial instruments to provide users of financial statements with more decision-useful information. The amendments address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. ASU 2016-01 is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not expect the adoption of this amendment to have a significant impact on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, “Leases (Topic 842)” (“ASU 2016-02”). The main objective of ASU 2016-02 is to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. To meet that objective, the FASB is amending the FASB Accounting Standards Codification and creating Topic 842, Leases. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company does not expect the adoption of this amendment to have a significant impact on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, “Compensation—Stock Compensation (Topic 718) Improvements to Employee Share-Based Payment” (“ASU 2016-09”). ASU 2016-09 is part of the FASB Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of generally accepted accounting

principles for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements. ASU 2016-09 will affect all entities that issue share-based payment awards to their employees. The areas for simplification involve several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. ASU 2016-09 is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company does not expect the adoption of these amendments to have a significant impact on its consolidated financial statements.

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In April 2016, the FASB issued ASU 2016-10 “Revenue from Contracts with Customers (Topic 606)” (“ASU 2016-10”). The core principle of the guidance in Topic 606 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The amendments in ASU 2016-10 affect the guidance in ASU 2014-09, “Revenue from Contracts with Customers”, which is not yet effective. The effective date and transition requirements of ASU 2016-10 are the same as the effective date and transition requirements of ASU 2014-09. They are effective prospectively for reporting periods beginning after December 15, 2017 and early adoption is not permitted. The Company is currently assessing the impact of the adoption of these amendments on its consolidated financial statements.

In May 2016, the FASB issued Accounting Standards Update No. 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients. The amendments do not change the core revenue recognition principle in Topic 606. The amendments provide clarifying guidance in certain narrow areas and add some practical expedients. These amendments are effective at the same date that Topic 606 is effective. Topic 606 is effective for public entities for annual reporting periods beginning after December 15, 2017, including interim reporting periods therein (i.e., January 1, 2018, for a calendar year entity). Topic 606 is effective for nonpublic entities one year later. The Company is currently assessing the impact of the adoption of the amendments to Topic 606 and these amendments on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments”. The standard provides guidance on how certain cash receipts and payments are presented and classified in the statement of cash flows, including beneficial interests in securitization, which would impact the presentation of the deferred purchase price from sales of receivables. The standard is intended to reduce current diversity in practice. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of these amendments to have a significant impact on its consolidated financial statements.

Effective July 1, 2016, the Company adopted FASB Accounting Standards Update 2015-17, Balance Sheet Classification of Deferred Taxes. The ASU is part of the Board’s simplification initiative aimed at reducing complexity in accounting standards. To simplify presentation, the new guidance requires that all deferred tax assets and liabilities, along with any related valuation allowance, be classified as noncurrent on the balance sheet. As a result, each jurisdiction will now only have one net noncurrent deferred tax asset or liability. Importantly, the guidance does not change the existing requirement that only permits offsetting within a jurisdiction - that is, companies are still prohibited from offsetting deferred tax liabilities from one jurisdiction against deferred tax assets of another jurisdiction. The Company early adopted the new standard effective and reclassified the prior year deferred tax asset presented as of December 31, 2015 to conform with the new guidance.

The Company does not believe that any other recently issued, but not yet effective, accounting standards if currently adopted would have a material effect on the accompanying consolidated financial statements.

Subsequent Events

Management has evaluated subsequent events through the date of this filing.

Note 4. PROPERTY AND EQUIPMENT

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The components of property and equipment consisted of the following:

| | September 30, 2016 (Unaudited) | December 31, 2015 | |
|---------------------------------------|--------------------------------------|----------------------|---------------|
| Land | \$ 300,000 | \$ 300,000 | |
| Buildings & Improvements | 1,650,000 | 1,658,000 | 31.5 years |
| Machinery and Equipment | 16,078,000 | 15,109,000 | 5 - 8 years |
| Capital Lease Machinery and Equipment | 6,265,000 | 5,869,000 | 3 - 5 years |
| Capital Lease Facility | 1,700,000 | - | Term of Lease |
| Tools and Instruments | 7,491,000 | 6,993,000 | 1.5 - 7 years |
| Automotive Equipment | 217,000 | 191,000 | 5 years |
| Furniture and Fixtures | 462,000 | 425,000 | 5 - 8 years |
| Leasehold Improvements | 979,000 | 910,000 | Term of Lease |
| Computers and Software | 567,000 | 482,000 | 4-6 years |
| Total Property and Equipment | 35,709,000 | 31,937,000 | |
| Less: Accumulated Depreciation | (19,471,000) | (16,638,000) | |
| Property and Equipment, net | \$ 16,238,000 | \$ 15,299,000 | |

Depreciation expense for the three months ended September 30, 2016 and 2015 was approximately \$957,000 and \$1,045,000, respectively. Depreciation expense for the nine months ended September 30, 2016 and 2015 was

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\$2,808,000 and \$2,679,000, respectively. Assets held under capitalized lease obligations are depreciated over the shorter of their related lease terms or their estimated productive lives. Depreciation of assets under capital leases is included in depreciation expense for 2016 and 2015. Accumulated depreciation on these assets was approximately \$2,056,000 and \$1,065,000 as of September 30, 2016 and December 31, 2015, respectively.

Note 5. INTANGIBLE ASSETS

The components of intangibles assets consisted of the following:

| | September 30, 2016 (Unaudited) | December 31, 2015 | |
|--------------------------------|--------------------------------------|----------------------|---------------------------|
| Customer Relationships | \$ 6,555,000 | \$ 6,555,000 | 5 to 14 years 15 to 20 |
| Trade Names | 1,480,000 | 1,480,000 | years |
| Technical Know-how | 660,000 | 660,000 | 10 years |
| Non-Compete | 150,000 | 150,000 | 5 years |
| Professional Certifications | 15,000 | 15,000 | .25 to 2 years |
| Total Intangible Assets | 8,860,000 | 8,860,000 | |
| Less: Accumulated Amortization | (5,967,000) | (5,008,000) | |
| Intangible Assets, net | \$ 2,893,000 | \$ 3,852,000 | |

Amortization expense for the three months ended September 30, 2016 and 2015 was approximately \$320,000 and \$309,000, respectively. Amortization expense for the nine months ended September 30, 2016 and 2015 was approximately \$960,000 and \$923,000, respectively.

Note 6. SALE AND LEASEBACK TRANSACTION

On April 11, 2016, the Company executed a Sale - Leaseback Arrangement, whereby the Company sold the building and real property located in South Windsor, Connecticut (the "Property") for a purchase price of \$1,700,000. The net proceeds from the sale of the property were applied to the amounts owed to PNC Bank.

At September 30, 2016, the Company classified the Property as a Capital Lease Facility. The valuation of the property at the time of reclassification was \$1,700,000. Amortization expense for the three and nine months ended September 30, 2016 was approximately, \$9,000 and \$12,000, respectively.

Simultaneous with the closing of the sale of the Property, the Company entered into a 15-year lease (the "Lease") with the purchaser for the property. Base annual rent is approximately \$155,000 for the first year and increases approximately 3% per year, each year thereafter. The Lease grants the Company an option to renew the Lease for an additional period of five years. Pursuant to the terms of the Lease, the Company is required to pay all of the costs associated with the operation of the facilities, including, without limitation, insurance, taxes and maintenance. The Lease also contains representations, warranties, obligations, conditions and indemnification provisions in favor of the purchaser and grants the purchaser remedies upon a breach of the Lease by the Company, including the right to terminate the Lease and hold the Company liable for any deficiency in future rent.

The Company will account for the transaction under the provisions of FASB ASC 840-40, "Leases - Sale-Leaseback Transactions".

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Note 7. NOTES PAYABLE AND CAPITAL LEASE OBLIGATIONS

Notes payable and capital lease obligations consist of the following:

| | September 30, 2016 (Unaudited) | December 31, 2015 |
|---|--------------------------------------|----------------------|
| Revolving credit note payable to PNC Bank N.A. ("PNC") | \$ 25,822,000 | \$ 29,604,000 |
| Term loans, PNC | 7,019,000 | 9,833,000 |
| Capital lease obligations | 6,206,000 | 5,018,000 |
| Related party notes payable | 1,378,000 | 350,000 |
| Notes payable (private placement) | 2,174,000 | - |
| Subtotal | 42,599,000 | 44,805,000 |
| Less: Current portion of notes and capital obligations | (34,106,000) | (40,893,000) |
| Notes payable and capital lease obligations, net of current portion | 8,493,000 | 3,912,000 |

PNC Bank N.A. ("PNC")

The Company has a credit facility with PNC (the "Loan Facility") secured by substantially all of its assets. The Loan Facility has been amended many times during its term. The Loan Facility was amended in June 2016 (the "Twelfth Amendment") and September 2016 (the "Thirteenth Amendment"). In connection with the Twelfth Amendment, the Company paid PNC a fee of \$100,000 and reimbursed it for the fees and expenses of its counsel. The Twelfth Amendment provides for a \$33,000,000 revolving loan. In addition, in the Twelfth Amendment the four term loans (Term Loan A, Term Loan B, Term Loan C and Term Loan D) then outstanding were consolidated into a single term loan with the initial principal amount of \$7,387,854. Further, in the Twelfth Amendment the Company acknowledged that there were then outstanding excess advances under the revolving loan in the amount of \$12,500,000.

Under the terms of the Loan Facility, as amended, the revolving loan now bears interest at (a) the sum of the Alternate Base Rate plus one and three-quarters of one percent (1.75%) with respect to Domestic Rate Loans; and (b) the sum of the LIBOR Rate plus four and one-half of one percent (4.50%) with respect to LIBOR Rate Loans. The amount outstanding under the revolving loan, exclusive of the excess advance, was \$25,822,000 and \$29,604,000, as of September 30, 2016 and December 31, 2015, respectively.

The Loan Facility was further amended pursuant to the Thirteenth Amendment, to modify the advance rate with respect to our inventory to be the lesser of (i) 75% of the eligible inventory, an increase from 50%, and (ii) 90% of the liquidation value of the eligible inventory, an increase from 85%, subject to the inventory sublimit of \$12,500,000 and such reserves as PNC may deem proper. In addition, in the Thirteenth Amendment the lender waived any default resulting from the Company's obligation to comply with the minimum EBITDA covenant for the period ended June 30, 2016, consented to the issuance of the Company's 12% Subordinated Convertible Notes and the amendment to the Company's Articles of Incorporation to increase the authorized number of shares of Preferred Stock and Series A Preferred Stock.

The repayment terms of Term Loan A had been amended in April 2014, when the Company borrowed \$2,676,000, representing an additional \$1,328,000 to partially fund the acquisition of Woodbine. Term Loan A, as amended in 2014, was to be repaid in monthly installments of \$31,859 continuing until November 2016. On October 1, 2014, the Company borrowed \$3,500,000 under Term Loan B for the acquisition of AMK. Term Loan B was to be repaid in sixty consecutive monthly principal installments of \$58,333 continuing until November 2019.

Prior to the Twelfth Amendment, Term Loans A and B bore interest at (a) the sum of the Alternate Base Rate plus one and three quarters of one percent (1.75%) with respect to Domestic Rate Loans and (b) the sum of the LIBOR Rate plus three percent (3.00%) with respect to LIBOR Rate Loans.

On December 31, 2014, the Company borrowed \$2,500,000 under Term Loan C to refinance the Seller Note and Mortgage of \$2,500,000 issued as part of the acquisition of AMK. The maturity date of Term Loan C was the first business day of January 2021, and it was to be paid in seventy two consecutive monthly principal installments, which commenced on the first business day of February 2015, and continued on the first business day of each month

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thereafter. The first seventy-one of the installments were to be in the amount of \$34,722 with a seventy second and final payment of any unpaid principal and interest on the first business day of January 2021. Term Loan C bore interest at (a) the sum of the Alternate Base Rate plus two percent (2.00%) with respect to Domestic Rate Loans and (b) the sum of the LIBOR Rate plus three and one-quarter percent (3.25%) with respect to LIBOR Rate Loans.

On March 9, 2015, the Company borrowed \$3,500,000 under Term Loan D for the acquisition of Sterling. The repayment of Term Loan D consisted of twenty consecutive monthly principal installments, the first nineteen in the amount of \$62,847 which commenced on the first business day of April 2015, and continued on the first business day of each month thereafter, with a twentieth and final payment of any unpaid balance of principal and interest on the last business day of November 2016. Term Loan D bore interest at (a) the sum of the Alternate Base Rate plus two and one quarter percent (2.25%) with respect to Domestic Rate Loans and (b) the sum of the LIBOR Rate plus three and one-half percent (3.50%) with respect to LIBOR Rate Loans.

The repayment terms of the Term Loan provided for in the Twelfth Amendment consist of sixty (60) consecutive monthly principal installments, the first fifty-nine (59) of which shall be in the amount of \$123,133 commencing on the first business day of July, 2016, and continuing on the first business day of each month thereafter, with a sixty (60th) and final payment of any unpaid balance of principal and interest payable on the last business day of June, 2021. Under the terms of the Loan Facility, as amended, the revolving loan now bears interest at (a) the sum of the Alternate Base Rate plus one and three-quarters of one percent (1.75%) with respect to Domestic Rate Loans; and (b) the sum of the LIBOR Rate plus four and one-half of one percent (4.50%) with respect to LIBOR Rate Loan.

At the closing of the Twelfth Amendment the Company paid \$1,500,000 to reduce the outstanding excess under the revolving loan from \$12,500,000 to \$11,000,000. It also agreed that the excess advances will be paid down by \$100,000 each week commencing the second week after the closing of the Twelfth Amendment. The outstanding excess under the revolving loan is \$7,019,000 at September 30, 2016.

To the extent that the Company disposes of collateral used to secure the Loan Facility, other than inventory, the Company must promptly repay the draws on the credit facility in the amount equal to the net proceeds of such sale.

The terms of the Loan Facility require that among other things, the Company maintain a specified Fixed Charge Coverage Ratio and maintain a minimum EBITDA. In addition, the Company is limited in the amount of Capital Expenditures it can make. The Company is also limited to the amount of dividends it can pay its shareholders as defined in the Loan Facility. As of December 31, 2015, the Company was not in compliance with the Fixed Charge Coverage Ratio covenant. As of December 31, 2015, the Company was in compliance with all other terms of the Loan Facility. The failure to maintain the requisite Fixed Charge Coverage Ratio constitutes a default under the Loan Facility and PNC at its option may give notice to the Company that all amounts under the Loan Facility are immediately due and payable consequently, all amounts due under the Term Loans are also classified as current. For the three months ended September 30, 2016, PNC has excluded the Fixed Coverage Charge Ratio requirement. As of September 30, 2016, the Company was not in compliance with the minimum EBITDA requirement. The Company has requested a waiver from PNC for the failure to meet the minimum EBITDA covenant. Because the revolving loans contain a subjective acceleration clause which could permit PNC to require repayment prior to maturity, all of the loans outstanding with PNC are classified with the current portion of notes and capital lease obligations.

Each day, the Company's cash collections are swept directly by the bank to reduce the revolving loans and the Company then borrows according to a borrowing base formula. The Company's receivables are payable directly into a

lockbox controlled by PNC (subject to the terms of the Loan Facility). PNC may use some elements of subjective business judgment in determining whether a material adverse change has occurred in the Company's condition, results of operations, assets, business, properties or prospects allowing it to demand repayment of the Loan Facility.

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As of September 30, 2016, the scheduled future minimum principal payments for the term loans are as follows, however as discussed above, the balance of the term loans have been classified as current:

| For the twelve months ending | Amount |
|------------------------------------|--------------|
| For the 12 Months Ended 9/30/17 | \$ 1,478,000 |
| For the 12 Months Ended 9/31/18 | 1,478,000 |
| For the 12 Months Ended 9/31/19 | 1,478,000 |
| For the 12 Months Ended 9/31/20 | 1,478,000 |
| For the 12 Months Ended 9/31/21 | 1,107,000 |
| PNC Term Loan payable | 7,019,000 |
| Less: Current portion | (7,019,000) |
| Long-term portion | \$ - |

Capitalized Lease Obligations

The Company is committed under several capital leases for property and equipment. Each equipment lease has a bargain purchase option exercisable at the termination of the lease. The present value of the minimum lease payments required under the property lease is greater than 90% of the fair value of the asset at acquisition. Capital lease obligations totaled \$6,206,000 and \$5,018,000 as of September 30, 2016 and December 31, 2015, respectively, with various interest rates ranging from approximately 4% to 14%.

As of September 30, 2016, the aggregate future minimum lease payments, including imputed interest, with remaining terms of greater than one year are as follows:

| For the twelve months ending | Amount |
|--------------------------------------|--------------|
| For the 12 Months Ended 9/30/2017 | \$ 1,599,000 |
| For the 12 Months Ended 9/30/2018 | 1,602,000 |
| For the 12 Months Ended 9/30/2019 | 1,431,000 |
| For the 12 Months Ended 9/30/2020 | 952,000 |
| For the 12 Months Ended 9/30/2021 | 218,000 |
| Thereafter | 2,012,000 |

| | |
|-------------------------------------|-------------|
| Total future minimum lease payments | 7,814,000 |
| Less: imputed interest | (1,608,000) |
| Less: current portion | (1,265,000) |
| Total Long Term Portion \$ | 4,941,000 |

Related Party Notes Payable

On September 8, 2015, the Company issued a promissory note (the “Taglich Note A”) to Michael Taglich in the principal amount of \$350,000. The Taglich Note A bore interest at the rate of 4% per annum. The Company's obligation under the Taglich Note A was subordinated to its indebtedness to PNC.

On April 8, 2016, the Company issued a promissory note (the “Taglich Note B”) to Michael Taglich in the principal amount of \$350,000. The Taglich Note B bore interest at the rate of 7% per annum. The Company's obligation under the Taglich Note B was subordinated to its indebtedness to PNC.

On April 8, 2016, the Company issued a promissory note (the “Taglich Note C”) to Robert Taglich in the principal amount of \$350,000. The Taglich Note C bore interest at the rate of 7% per annum. The Company's obligation under the Taglich Note C was subordinated to its indebtedness to PNC.

On May 6, 2016, the Company issued a promissory note (the “Taglich Note D”) to Michael Taglich in the principal amount of \$400,000. The Taglich Note D bore interest at the rate of 7% per annum. The Company's obligation under the Taglich Note D was subordinated to its indebtedness to PNC.

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On May 6, 2016, the Company issued a promissory note (the "Taglich Note E") to Robert Taglich in the principal amount of \$300,000. The Taglich Note E bore interest at the rate of 7% per annum. The Company's obligation under the Taglich Note E was subordinated to its indebtedness to PNC.

On May 25, 2016, the Company issued 110,000 and 65,000 shares of Series A Preferred Stock to Michael Taglich and Robert Taglich, respectively upon surrender of Taglich Notes A – E, in the aggregate principal of \$1,100,000 and \$650,000, respectively.

On August 1, 2016, the Company issued a promissory note (the "Taglich Note F") to Michael Taglich, in the principal amount of \$1,000,000. The Taglich Note F bore interest at the rate of 7% per annum. The Company's obligation under the Taglich Note F was subordinated to its indebtedness to PNC.

On August 4, 2016, the Company issued a promissory note (the "Taglich Note G") to Michael Taglich, in the principal amount of 500,000. The Taglich Note G bore interest at the rate of 7% per annum. The Company's obligation under the Taglich Note G was subordinated to its indebtedness to PNC.

On August 19, 2016 the Company issued to Michael Taglich a Note in the principal amount of \$1,520,703, together with Warrants to purchase 61,817 shares of common stock, upon surrender for cancellation of Taglich Notes F & G in the aggregate principal amount of \$1,500,000, together with accrued interest thereon and on notes previously exchanged for Series A Preferred Stock of \$20,703. In addition, the Company issued to Robert Taglich a Note in the principal amount of \$4,373, together with Warrants to purchase 177 shares of common stock, in consideration of the forgiveness of interest of \$4,373 accrued on notes previously exchanged for Series A Preferred Stock.

On November 10, 2016, one of the principal stockholders of the Company loaned the Company \$1,000,000. The terms of this loan have yet to be determined.

12% Subordinated Convertible Notes

On August 19, 2016, the Company entered into a Placement Agency Agreement with Taglich Brothers, Inc., as placement agent (the "Placement Agent"), pursuant to which the Placement Agent agreed to offer on behalf of the Company, on a best efforts basis, up to \$4,250,000 of the Company's 12% Subordinated Convertible Notes due December 31, 2017 (the "Notes") to accredited investors (the "Offering"), together with five-year warrants to purchase 4,065 shares of common stock (the "Warrants") for each \$100,000 principal amount of Notes purchased, in a private placement exempt from the registration requirements of the Securities Act of 1933, as amended (the "Securities Act").

The Notes are convertible, at the option of the holders, into shares of the Company's common stock at an initial conversion price of \$4.92 per share, subject to adjustment for certain events. The Notes are automatically convertible into shares of the Company's Series A Convertible Preferred Stock ("Series A Preferred Stock") at a price of \$10.00 per share, the stated value of the Series A Preferred Stock, upon the filing of a certificate of amendment to the Company's Articles of Incorporation increasing the number of shares of Series A Preferred Stock so that a sufficient number of shares are available for issuance upon conversion of the Notes and for issuance in lieu of payment of cash dividends (the "Certificate of Amendment") in accordance with the provisions of the certificate of designation authorizing the issuance of the Series A Preferred Stock. The amendment is subject to the approval of the Company's stockholders. The Company will submit the amendment to its stockholders for their approval at its 2016 Annual Meeting of Stockholders, which it expects to hold in the fourth quarter of 2016.

Under the terms of the Placement Agency Agreement, the Placement Agent is entitled to a placement agent fee equal to 7% of the gross proceeds of the offering, five year warrants to purchase 8% of the number of shares of the Company's common stock issuable upon conversion of the Notes at an exercise price of \$6.15 per share, equal to 125% of the initial conversion price per share of the Notes, and reimbursement for its actual out-of-pocket expenses not to exceed in the aggregate \$25,000.

In August 2016, the Company issued and sold a total of \$2,720,000 principal amount of the Notes, together with Warrants to purchase an aggregate of 110,556 shares of common stock, yielding net proceeds to the Company of approximately \$2,422,000, pursuant to a Securities Purchase Agreements with accredited investors. The Company also issued to Michael Taglich a Note in the principal amount of \$1,520,703, together with Warrants to purchase 61,817 shares of common stock, upon surrender for cancellation of Taglich Notes F and G in the aggregate principal amount of \$1,500,000, together with accrued interest thereon and on notes previously exchanged for Series A Preferred Stock of \$20,703. In addition, the Company issued to Robert Taglich a Note in the principal amount of \$4,373, together with Warrants to purchase 179 shares of common stock, in consideration of the forgiveness of interest of \$4,373 accrued on notes previously exchanged for Series A Preferred Stock.

The Warrants including those issued to the placement agent are classified within stockholders' equity, pursuant to ASC 480, Distinguishing Liabilities from Equity and ASC 815-40, Derivatives and Hedging: Contracts in Own Equity. The Notes contain a contingent put that results in early settlement of the Notes upon the filing of a certificate of amendment to the Company's Articles of Incorporation, increasing the number of shares of Series A Preferred Stock

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so that a sufficient number of shares are available for issuance upon conversion of the Notes. The embedded put feature is required to be separately measured at fair value with changes in value recognized in the statement of operations, pursuant to ASC 815-15, "Derivatives and Hedging: Embedded Derivatives", as the put feature is not clearly and closely related to the convertible promissory note.

The proceeds received upon issuing the Notes and Warrants was allocated to each instrument on a relative fair value basis. The initial fair value of the Warrants was determined using the Black Scholes Merton valuation model with the following assumptions: expected term of 5 years; risk free interest rate of 1.2%; and volatility of 90%. The allocated value of the Notes was further reduced for the initial fair value of the embedded put of approximately \$755,000. The resulting discount to the Notes, including the allocated transactions costs, is amortized to interest expense using the effective interest method over the term of the Notes.

Note 8. STOCKHOLDERS' EQUITY

Preferred Stock Offering

On May 25, 2016, the Company, entered into a Placement Agency Agreement (the "Agreement") with Craig-Hallum Capital Group LLC and Taglich Brothers, Inc., as placement agents (the "Placement Agents"), pursuant to which the Placement Agents agreed to offer on behalf of the Company, on a best efforts basis, up to \$7,000,000 of the Company's securities, (the "Offering"), in a private placement exempt from the registration requirements of the Securities Act of 1933.

Pursuant to the Agreement on May 25, 2016, and June 1, 2016, the Company completed a private placement of 700,000 shares of its Series A Convertible Stock (the "Series A Preferred Stock") from which it derived gross proceeds of \$5,250,000, net of \$1,750,000 of principal amount of the Company's promissory notes exchanged by Michael Taglich and Robert Taglich for shares of Series A Preferred Stock. The shares of Series A Preferred Stock have a stated value of \$10.00 per share ("Stated Value") and are initially convertible into shares of Common Stock at a price of \$4.92 per share (subject to adjustment upon the occurrence of certain events). In connection with the placement the Company incurred approximately \$606,000 of direct offering costs and \$57,000 in legal expenses and granted to the Placement Agents warrants to purchase 8% of the number of shares of the Company's common stock (113,822) issuable upon conversion of the Series A Preferred Stock sold in the offering (the "Placement Agent Warrants").

The Placement Agent Warrants are exercisable in whole or in part, at an initial exercise price per share of \$6.15, and are exercisable for cash or on a cashless basis for a period commencing on November 26, 2016 and expiring on May 26, 2021. The exercise price and number of shares of common stock issuable upon the exercise of the Placement Agent Warrants are subject to adjustment for stock dividends, splits, combinations and similar events.

Dividends on the Series A Preferred Stock (the "Preferred Shares") are payable on a cumulative basis at an annual rate for the first two years after the date the Preferred Shares were issued (the "Original Issue Date") of 12% of the Stated Value per share and thereafter at the annual rate of 16% of the Stated Value per share. Dividends are payable on the fifteenth day of March, June, September and December of each year, commencing on September 15, 2016. The Company may pay dividends in cash or in additional Preferred Shares ("PIK Shares"). If during the first two years after the Original Issue Date the Company fails to pay in respect of any dividend period a dividend at an annual rate of at least 8% of the Stated Value per share in cash, in addition to paying a sufficient number of PIK Shares so that the sum

of the cash dividends and PIK Shares paid equals 12% per annum the Company will issue PIK Shares in an amount equal to the product of the proportion of the cash dividend not paid times 3% per annum. Thereafter if the Company fails to pay in respect of any dividend period a dividend at an annual rate of at least 10% of the Stated Value per share in cash, in addition to paying a sufficient number of PIK Shares so that the sum of the cash dividends and PIK Shares paid equals 16% per annum, the Company will issue PIK Shares in an amount equal to the product of the proportion of the cash dividend not paid times 3% per annum. If the Company pays any portion of the dividends payable during any dividend period in PIK Shares, it will not be permitted to declare or pay any cash dividends on its common stock during that dividend period.

Accordingly, we computed earned but undeclared preferred dividends at the stated rate of 12.0% through September 15, 2016, when the form of the dividend was announced and declared by our Board of Directors. Since the Board of Directors declared dividends in the form of PIK Shares for the dividend payment period ended September 15, 2016, the earned dividend was increased to 15% (from the 12% cash rate), as per the terms of the Series A Preferred Stock. The Company recognized the PIK dividend at the estimated fair value of the shares issued.

The Company recorded the issuance of 32,297 of PIK Shares during the three and nine months ended September 30, 2016 as a preferred dividend, with a fair value of \$300,000. Accordingly, accumulated deficit and Additional Paid In Capital were increased by that amount during the three and nine months ended September 30, 2016. The fair value was determined using the closing market price of the Company's common stock of \$4.57 per share on the date of issuance of the PIK Shares, taking into consideration that the Series A Preferred Shares were convertible into the common stock. For earning per share purposes, for the three and nine months ended September 30, 2016, the fair value of the PIK Shares issued as a dividend was less than the amounts previously earned by \$23,000. At September 30, 2016 and December 31, 2015, the amounts of cumulative perpetual dividends earned and not declared on the Series A Preferred Stock were \$35,000 and \$0, based on the stated cash dividend rate of 12%, or \$0.05 and \$0 per Series A Preferred share, respectively.

AIR INDUSTRIES GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Under Nevada law and the terms of the Series A Preferred Stock, dividends are payable only when, as and if authorized and declared by the Company's board of directors. After payment of all liabilities and outstanding debt obligations, holders of Series A Preferred Stock are entitled to receive \$10.00 plus accrued and unpaid dividends prior to the payment of amounts available for distribution to holders of the Company's common stock upon the liquidation and dissolution of the Company.

Holders of Series A Preferred Stock may elect at any time to convert their Preferred Shares into shares of common stock at the conversion rate of 2.0325 shares of common stock for each Preferred Share, equivalent to an initial conversion price of approximately \$4.92 per share of common stock. The conversion rate and the corresponding conversion price will be subject to certain anti-dilution and other adjustments, including stock splits, distributions in respect of the common stock and in the event of certain fundamental transactions such as mergers and other business combinations.

The Company may at its option, at any time and from time to time after the market price of a share of common stock is in excess of \$9.84 for 30 consecutive trading days, cause all of the Preferred Shares to be converted into shares of common stock at the then-prevailing conversion rate, subject to the certain conditions set forth in the certificate of designations.

Commencing May 26, 2018, the Company may redeem all of the Preferred Shares for a redemption price of \$10.00, plus accrued and unpaid dividends.

Holders of Preferred Shares will vote on an as-converted basis, together with holders of common stock, as a single class, on the election of directors and all other matters presented to stockholders, except for matters as to which under applicable law and the certificate of designation a class vote of the holders of the Series A Preferred Stock is required. The Company may not, without the affirmative vote of the record holders of a majority of the then outstanding shares of the Series A Preferred Stock voting together as a single class (a) alter or change adversely the powers, preferences or rights given to the Series A Preferred Stock or alter or amend the Certificate of Designation authorizing the Series A Preferred Stock, (b) amend its articles of incorporation or other charter documents in any manner that adversely affects any rights of the holders, (c) increase the number of authorized shares of Series A Preferred Stock, unless such increase is necessary to pay PIK Dividends, (d) authorize a new series of preferred stock with dividend, liquidation or redemption rights senior or pari passu to the Series A Preferred Stock or (e) enter into any agreement with respect to any of the foregoing.

Common Stock Issuances

During the year ended December 31, 2015, the Company granted 52,000 shares of restricted common stock pursuant to an agreement in connection with the acquisition of Sterling. During the three and nine months ended September 30, 2016, 25,000 shares of that restricted stock has vested and is included in shares issued and outstanding. In addition, the Company issued an aggregate of 13,125 shares of common stock upon the exercise of options by certain of its directors.

Stock Options

On March 30, 2015, the Board of Directors adopted the Company's 2015 Equity Incentive Plan ("2015 Plan") which was approved by affirmative vote of the Company's stockholders on June 25, 2015. The Plan authorized the grant of rights

with respect to up to 350,000 shares.

In June 2016, the Board of Directors adopted the Company's 2016 Equity Incentive Plan ("2016 Plan") which authorized the grant of rights with respect to up to 350,000 shares. The 2016 Plan will be submitted to stockholders for approval at the 2016 Annual Meeting of Stockholders.

During the three and nine months ended September 30, 2016 the Company granted options to purchase 0 and 138,000 shares of common stock to certain of its employees, respectively. The weighted average fair value of the granted options was estimated using the Black-Scholes option pricing model with the following assumptions: risk free interest rate of 1.36%; expected volatility factors of 25.00%; expected dividend yield of 0%; and estimated option term of 5 years.

AIR INDUSTRIES GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 9. INCOME TAXES

The provision for income taxes for the nine months ended September 30, 2016 and 2015 is set forth below:

| | 2016 | 2015 |
|--|-------------|-----------|
| Current: | | |
| Federal | - | 117,000 |
| State | 13,000 | 14,000 |
| Prior year (over)/under Accrual | | |
| Federal | 30,000 | - |
| Total current expense | 43,000 | 131,000 |
| Deferred tax (benefit) expense | (2,145,000) | (650,000) |
| Total tax (benefit) expense | (2,102,000) | (519,000) |

The components of net deferred tax assets are set forth below:

| | September 30, 2016 | December 31, 2015 |
|--|-----------------------|----------------------|
| Deferred Tax Assets | | |
| Net operating losses | 2,275,000 | 462,000 |
| Bad debts | 230,000 | 336,000 |
| Accounts payable, accrued expenses and reserves | - | 8,000 |
| Inventory - 263A adjustment | 1,035,000 | 919,000 |
| Capitalized engineering costs | 415,000 | 432,000 |
| Deferred rent | 413,000 | 410,000 |
| Loss on extinguishment of debt | 59,000 | - |
| Deferred gain on sale of real estate | 116,000 | 126,000 |
| Lease impairment | - | - |
| Stock based compensation - options and restricted stock | 132,000 | 79,000 |
| Intangibles NTW | 958,000 | 789,000 |
| Capital loss carry forwards | - | - |
| Section 1231 loss carry forward | 4,000 | 4,000 |
| Inventory | 725,000 | 680,000 |
| Other | 131,000 | 257,000 |
| Total non-current deferred tax assets before valuation allowance | 6,493,000 | 4,502,000 |
| Valuation allowance | (4,000) | (4,000) |
| Total non-current deferred tax assets after valuation allowance | 6,489,000 | 4,498,000 |

Deferred Tax Liabilities

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| | | |
|--|-------------|-------------|
| Property and equipment | (1,996,000) | (2,091,000) |
| Amortization - Welding Transaction | (270,000) | (313,000) |
| Amortization - NTW Goodwill | (16,000) | (13,000) |
| Amortization - AMK Goodwill | (29,000) | (18,000) |
| Total non-current deferred tax liabilities | (2,311,000) | (2,435,000) |
| | | |
| Total Net Deferred Tax Assets | 4,178,000 | 2,063,000 |

AIR INDUSTRIES GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

During the year ended December 31, 2015, the Company provided a valuation allowance on the deferred tax assets related to capital loss and section 1231 loss carryforwards. The valuation allowance at both September 30, 2016 and December 31, 2015 amounted to \$4,000. Management believes that the remainder of the net deferred tax assets are more likely than not to be realized.

The Company received a notice dated August 8, 2016 from the Internal Revenue Service for examination of its corporate tax return for the year ended December 31, 2014. Since the audit has not been completed, the Company cannot determine if any additional taxes, interest or penalties will be assessed.

Note 10. SEGMENT REPORTING

In accordance with FASB ASC 280, "Segment Reporting" ("ASC 280"), the Company discloses financial and descriptive information about its reportable operating segments. Operating segments are components of an enterprise about which separate financial information is available and regularly evaluated by the chief operating decision maker in deciding how to allocate resources and in assessing performance.

The Company follows ASC 280, which establishes standards for reporting information about operating segments in annual and interim financial statements, and requires that companies report financial and descriptive information about their reportable segments based on a management approach. ASC 280 also establishes standards for related disclosures about products and services, geographic areas and major customers.

The Company currently divides its operations into three operating segments: Complex Machining which consists of AIM and NTW; Aerostructures & Electronics which consists of WMI, WPI, Miller Stuart, Eur-Pac, ECC and Compac; and Turbine Engine Components which consists of AMK and Sterling.

The accounting policies of each segment are the same as those described in the Summary of Significant Accounting Policies. The Company evaluates performance based on revenue, gross profit contribution and assets employed.

AIR INDUSTRIES GROUP
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Financial information about the Company's operating segments for the three and nine months ended September 30, 2016 and 2015 are as follows:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|---------------------|------------------------------------|---------------------|
| | 2016 (Unaudited) | 2015 (Unaudited) | 2016 (Unaudited) | 2015 (Unaudited) |
| COMPLEX MACHINING | | | | |
| Net Sales | \$ 9,254,000 | \$ 10,687,000 | \$ 27,022,000 | \$ 29,281,000 |
| Gross Profit | 1,476,000 | 2,568,000 | 5,898,000 | 6,886,000 |
| Pre Tax (Loss) Income | (963,000) | 549,000 | (856,000) | 733,000 |
| Assets | 54,159,000 | 47,811,000 | 54,159,000 | 47,811,000 |
| AEROSTRUCTURES & ELECTRONICS | | | | |
| Net Sales | 3,738,000 | 7,408,000 | 14,939,000 | 19,468,000 |
| Gross Profit | 674,000 | 1,449,000 | 3,068,000 | 5,008,000 |
| Pre Tax (Loss) Income | (893,000) | (126,000) | (1,832,000) | 598,000 |
| Assets | 19,562,000 | 22,683,000 | 19,562,000 | 22,683,000 |
| TURBINE ENGINE COMPONENTS | | | | |
| Net Sales | 2,718,000 | 2,981,000 | 8,296,000 | 8,195,000 |
| Gross Profit | (153,000) | 161,000 | 7,000 | 550,000 |
| Pre Tax (Loss) Income | (1,248,000) | (812,000) | (2,900,000) | (2,010,000) |
| Assets | 17,645,000 | 18,078,000 | 17,645,000 | 18,078,000 |
| CORPORATE | | | | |
| Net Sales | - | - | - | - |
| Gross Profit | - | - | - | - |
| Pre Tax (Loss) Income | (263,000) | - | (243,000) | - |
| Assets | 574,000 | 596,000 | 574,000 | 596,000 |
| CONSOLIDATED | | | | |
| Net Sales | 15,710,000 | 21,076,000 | 50,257,000 | 56,944,000 |
| Gross Profit | 1,997,000 | 4,178,000 | 8,973,000 | 12,444,000 |
| Pre Tax (Loss) Income | (3,367,000) | (389,000) | (5,831,000) | (679,000) |
| Benefit from Income Taxes | 1,320,000 | 726,000 | 2,102,000 | 519,000 |
| Net Loss | (2,047,000) | 337,000 | (3,729,000) | (160,000) |
| Assets | \$ 91,940,000 | \$ 89,168,000 | \$ 91,940,000 | \$ 89,168,000 |

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

The following discussion of our financial condition and results of operations should be read in conjunction with the unaudited consolidated financial statements and the notes to those statements included elsewhere in this Form 10-Q and with the audited consolidated financial statements and the notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2015 (the "2015 Form 10-K"). This discussion contains forward-looking statements that involve risks and uncertainties. You should specifically consider the various risk factors identified in the 2015 Form 10-K and our Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2016 (the "Q2 2016 Form 10-Q") that could cause actual results to differ materially from those anticipated in these forward-looking statements.

Business Overview

We are an aerospace company operating primarily in the defense industry, though the proportion of our business represented by the commercial and industrial sector is increasing. We manufacture and design structural parts and assemblies that focus on flight safety, including landing gear, arresting gear, engine mounts, flight controls, throttle quadrants, and other components. We also provide sheet metal fabrication of aerostructures, tube bending, welding and kitting services. Our Turbine Engine Components segment makes components and provides services for jet engines and ground-power turbines. Our products are currently deployed on a wide range of high profile military and commercial aircraft including Sikorsky's UH-60 Blackhawk and CH-47 Chinook helicopters, Lockheed Martin's F-35 Joint Strike Fighter, Northrop Grumman's E2D Hawkeye, the US Navy F-18 and USAF F-16 fighter aircraft, Boeing's 777 and Airbus' 380 commercial airliners. Our Turbine Engine segment makes components for jet engines that are used on the USAF F-15 and F-16, the Airbus A-330 and A-380, and the Boeing 777, in addition to a number of ground-power turbine applications.

Air Industries Machining, Corp. ("AIM") became a public company in 2005 when its net sales were approximately \$30 million. AIM has manufactured components and subassemblies for the defense and commercial aerospace industry for over 45 years and has established long-term relationships with leading defense and aerospace manufacturers. Since becoming public, we have completed a series of acquisitions of defense aerospace and recently commercial aerospace businesses which have enabled us to broaden the range of products and services beyond those which were provided by AIM. For example, where AIM was primarily a machine shop, as a result of acquisitions, Air Industries Group now has capabilities and expertise in metal fabrication, welding and tube bending; the production of electromechanical systems, harness and cable assemblies; the fabrication of electronic equipment and printed circuit boards; the machining of turbine engine components, and the assembly of packages or "kits" containing supplies for all branches of the United States Defense Department, including ordnance parts, hose assemblies, hydraulic, mechanical and electrical assemblies.

In March 2015 we acquired the Sterling Engineering Corporation ("Sterling"). Sterling provides complex machining services and its business is concentrated with aircraft jet engine and ground turbine manufacturers. Sterling's results are reported as part of our Turbine Engine Components segment.

In September 2015 we acquired the business and operations of Compac Development Corporation ("Compac") in an asset acquisition. Compac specializes in the manufacture of RFI/EMI (Radio Frequency Interference – Electro-Magnetic Interference) shielded enclosures for electronic components. Its results are reported as part of our Aerostructures & Electronics segment.

The aerospace market is highly competitive in both the defense and commercial sectors and we face intense competition in all areas of our business. Nearly all of our revenues are derived by producing products to customer

specifications after being awarded a contract through a competitive bidding process. As the commercial aerospace and defense industries continue to consolidate and major contractors seek to streamline supply chains by buying more complete sub-assemblies from fewer suppliers, we have sought to remain competitive not only by providing cost-effective world class service but also by increasing our ability to produce more complex and complete assemblies for our customers.

Our ability to operate profitably is determined by our ability to win new contracts and renewals of existing contracts, and then fulfill these contracts on a timely basis at costs that enable us to generate a profit based upon the agreed upon contract price. Winning a contract generally requires that we submit a bid containing a fixed price for the product or products covered by the contract for an agreed upon period of time. Thus, when submitting bids, we are required to estimate our future costs of production and, since we often rely upon subcontractors, the prices we can obtain from our subcontractors.

While our revenues are largely determined by the number of contracts we are awarded, the volume of product delivered and price of product under each contract, our costs are determined by a number of factors. The principal factors impacting our costs are the cost of materials and supplies, labor, financing and the efficiency at which we can produce our products. The cost of materials used in the aerospace industry is highly volatile. In addition, the market for the skilled labor we require to operate our plants is highly competitive. The profit margin of the various products we sell varies based upon a number of factors, including the complexity of the product, the intensity of the competition for such product and, in some cases, the ability to deliver replacement parts on short notice. Thus, in assessing our performance from one period to another, a reader must understand that changes in profit margin can be the result of shifts in the mix of products sold.

A very large percentage of the products we produce are used on military as opposed to civilian aircraft. These products can be replacements parts for aircraft already in the fleet of the armed services or for the production of new aircraft. Reductions to the Defense Department budget and decreased usage of aircraft by the military have reduced the demand for both new production and replacement spares. This has reduced our sales, particularly in our complex machining segment. In response to the reduction in military sales, we are focusing greater efforts on the civilian aircraft market though we still remain heavily dependent upon the military for an overwhelming portion of our revenues.

Segment Data

We follow Financial Accounting Standards Board ("FASB") ASC 280, "Segment Reporting" ("ASC 280"), which establishes standards for reporting information about operating segments in annual and interim financial statements, and requires that companies report financial and descriptive information about their reportable segments based on a management approach. ASC 280 also establishes standards for related disclosures about products and services, geographic areas and major customers.

We currently divide our operations into three operating segments: Complex Machining; Aerostructures & Electronics; and Turbine Engine Components. We separately report our corporate overhead (which was comprised of certain operating costs that were not directly attributable to a particular segment). Effective January 1, 2015, all operating costs are allocated to the Company's three operating segments. As our businesses continue to develop and evolve, and we acquire additional companies, we may deem it appropriate to reallocate our companies into different operating segments and, once we achieve sufficient integration among our businesses, report as a unified company.

The accounting policies of each of the segments are the same as those described in the Summary of Significant Accounting Policies. We evaluate performance based on revenue, gross profit contribution and assets employed.

Results of Operations

The following discussion of our results of operations constitutes management's review of the factors that affected our financial and operating performance for the three and nine months ended September 30, 2016 and 2015. This discussion should be read in conjunction with the financial statements and notes thereto contained elsewhere in this report. The results of operations of the businesses we have acquired are included in our financial results from their respective dates of acquisition.

Selected Financial Information:

| Three Months Ended September 30, | | Nine Months Ended September 30, | |
|----------------------------------|-------------|---------------------------------|-------------|
| 2016 | 2015 | 2016 | 2015 |
| (Unaudited) | (Unaudited) | (Unaudited) | (Unaudited) |

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| | | | | | | | | |
|--|----|-------------|----|------------|----|-------------|----|------------|
| Net Sales | \$ | 15,710,000 | \$ | 21,076,000 | \$ | 50,257,000 | \$ | 56,944,000 |
| Cost of Sales | | 13,713,000 | | 16,898,000 | | 41,284,000 | | 44,500,000 |
| Gross Profit | | 1,997,000 | | 4,178,000 | | 8,973,000 | | 12,444,000 |
| Operating Expenses and interest costs | | 5,196,000 | | 4,603,000 | | 14,667,000 | | 13,221,000 |
| Other Income, Net | | 4,000 | | 36,000 | | 35,000 | | 98,000 |
| Benefit from Income Taxes | | 1,320,000 | | 726,000 | | 2,102,000 | | 519,000 |
| Net (Loss) Income | | (2,047,000) | | 337,000 | | (3,729,000) | | (160,000) |

Balance Sheet Data:

| | September 30, 2016 (Unaudited) | December 31, 2015 (Unaudited) |
|----------------------------|--------------------------------------|-------------------------------------|
| Cash and Cash Equivalents | \$ 1,297,000 | \$ 529,000 |
| Working Capital | 5,963,000 | 441,000 |
| Total Assets | 91,940,000 | 88,250,000 |
| Total Stockholders' Equity | 32,266,000 | 28,805,000 |

The following sets forth the results of operations for each of our segments individually and on a consolidated basis for the periods indicated:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|----------------------------------|---------------------|---------------------------------|---------------------|
| | 2016 (Unaudited) | 2015 (Unaudited) | 2016 (Unaudited) | 2015 (Unaudited) |
| COMPLEX MACHINING | | | | |
| Net Sales | \$ 9,254,000 | \$ 10,687,000 | \$ 27,022,000 | \$ 29,281,000 |
| Gross Profit | 1,476,000 | 2,568,000 | 5,898,000 | 6,886,000 |
| Pre Tax (Loss) Income | (963,000) | 549,000 | (856,000) | 733,000 |
| Assets | 54,159,000 | 47,811,000 | 54,159,000 | 47,811,000 |
| AEROSTRUCTURES & ELECTRONICS | | | | |
| Net Sales | 3,738,000 | 7,408,000 | 14,939,000 | 19,468,000 |
| Gross Profit | 674,000 | 1,449,000 | 3,068,000 | 5,008,000 |
| Pre Tax (Loss) Income | (893,000) | (126,000) | (1,832,000) | 598,000 |
| Assets | 19,562,000 | 22,683,000 | 19,562,000 | 22,683,000 |
| TURBINE ENGINE COMPONENTS | | | | |
| Net Sales | 2,718,000 | 2,981,000 | 8,296,000 | 8,195,000 |
| Gross Profit | (153,000) | 161,000 | 7,000 | 550,000 |
| Pre Tax Loss (Loss) Income | (1,248,000) | (812,000) | (2,901,000) | (2,010,000) |
| Assets | 17,645,000 | 18,078,000 | 17,645,000 | 18,078,000 |
| CORPORATE | | | | |
| Net Sales | - | - | - | - |
| Gross Profit | - | - | - | - |
| Pre Tax (Loss) Income | (263,000) | - | (243,000) | - |
| Assets | 574,000 | 596,000 | 574,000 | 596,000 |
| CONSOLIDATED | | | | |
| Net Sales | 15,710,000 | 21,076,000 | 50,257,000 | 56,944,000 |
| Gross Profit | 1,997,000 | 4,178,000 | 8,973,000 | 12,444,000 |
| Pre Tax (Loss) Income | (3,367,000) | (389,000) | (5,831,000) | (679,000) |

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| | | | | |
|---------------------------|---------------|---------------|---------------|---------------|
| Benefit from Income Taxes | 1,320,000 | 726,000 | 2,102,000 | 519,000 |
| Net Loss | (2,047,000) | 337,000 | (3,729,000) | (160,000) |
| Assets | \$ 91,940,000 | \$ 89,168,000 | \$ 91,940,000 | \$ 89,168,000 |

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Results of Operations for the three months ended September 30, 2016

Consolidated net sales for the three months ended September 30, 2016 were approximately \$15,710,000, a decrease of (\$5,366,000), or (25.5%), compared with \$21,076,000 for the three months ended September 30, 2015. The decrease in sales resulted from decreases in sales in all of our segments. Sales decreased (\$1,433,000) at Complex Machining, (\$3,670,000) at Aerostructures & Electronics and (\$263,000) in Turbine Engine Components.

- The decrease in Complex Machining resulted primarily from a decrease in orders and deliveries at Air Industries Machining partially offset by increases at Nassau Tool Works.
- The decline at Aerostructures & Electronics reflected decreased customer demand together with operational and execution issues.
- The modest decline in the Turbine Engine Components segment reflected gains at AMK offset by decreases at Sterling Engineering. The decline at Sterling reflects the fact that during the quarter a high percentage of its operations were devoted to new products under development and not yet in full rate production.

As indicated in the table below, one customer represented 14.2% and four customers represented 55.3% of total sales for the three months ended September 30, 2016 and 2015, respectively.

| Customer | Percentage of Sales | |
|------------------------------|---------------------|---------------------|
| | 2016 (Unaudited) | 2015 (Unaudited) |
| Sikorsky Aircraft | 14.2 | 18.8 |
| Goodrich Landing Gear | * | 15.3 |
| US DoD | * | 11.1 |
| Northrop Grumman Corporation | * | 10.1 |

*Customer was less than 10% of sales for the quarter ended September 30, 2016

Sikorsky Aircraft and Goodrich Landing Gear Systems are units of United Technologies Corporation.

Gross Profit:

Consolidated gross profit from operations for the three months ended September 30, 2016 was \$1,997,000 a decrease of approximately (\$2,181,000), or (52.2%), as compared to gross profit of \$4,178,000 for the three months ended September 30, 2015. Consolidated gross profit as a percentage of sales was 12.7% and 19.8% for the three months ended September 30, 2016 and 2015, respectively.

- Gross profit at Complex Machining segment decreased by \$1,092,000 for the three months ended September 30, 2016 as a result of lower sales and decreased absorption of factory overhead particularly at Air Industries Machining.

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Gross Profit at Aerostructures & Electronics segment decreased by \$775,000 for the three months ended September 30, 2016, resulting from lower sales and under absorption of factory overhead.

- Gross profit at Turbine Engine Component segment declined by \$314,000 for the three months ended September 30, 2016 due to lower revenues at Sterling Engineering resulting in under absorption of factory overhead. Gross profit at AMK increased slightly.

Operating Expenses:

Consolidated Operating Expenses for the three months ended September 30, 2016 were \$4,302,000 and increased by \$150,000, or 3.6%, compared to \$4,152,000 for the three months ended September 30, 2015. Operating costs increased due to increased legal and accounting expense resulting from several equity capital placements and amendments to our loan agreements.

Interest and financing costs for the three months ended September 30, 2016 were approximately \$894,000 an increase of approximately \$443,000, or 98.2% compared to \$451,000 for the three months ended September 30, 2015 reflecting both an increase in the amount of our debt and the interest rate payable as a result of the modifications of our Loan Facility.

Loss before income taxes for the three months ended September 30, 2016 was (\$3,367,000), an increase of \$2,978,000 compared to loss before income taxes of (\$389,000) for the three months ended September 30, 2015.

The Company recognized a benefit from taxes of \$1,297,000 for three months ended September 30, 2016 compared to a benefit from taxes of approximately \$726,000 for three months ended September 30, 2015, a difference of \$571,000.

Net loss for the three months ended September 30, 2016 was (\$2,047,000) a decrease of (\$2,384,000), or 707.4%, compared to net gain of \$337,000 for the three months ended September 30, 2015 for the reasons discussed above.

Results of Operations for the nine months ended September 30, 2016

Consolidated net sales for the nine months ended September 30, 2016 were approximately \$50,257,000, a decrease of (\$6,687,000), or (11.7%), compared with \$56,944,000 for the nine months ended September 30, 2015. A slight \$101,000 increase in sales during the nine months of \$8,296,000 or 1.2% at our Turbine & Engine segment was more than offset by sales decreases of (\$2,259,000) or (7.7%) at Complex Machining and (\$4,529,000) or 23.3% at Aerostructures & Electronics.

- The decrease at Complex Machining resulted primarily from a decrease in orders and deliveries at Air Industries Machining partially offset by increases at Nassau Tool Works.
- The decline at Aerostructures & Electronics resulted from declines in sales for all of its business units and reflected decreased customer demand together with operational and execution issues.
- The increase in the Turbine Engine Components segment reflected gains at both AMK and Sterling Engineering.

As indicated in the table below, four customers represented 53.3% and 62.1% of total sales for the nine months ended September 30, 2016 and 2015, respectively.

| Customer | Percentage of Sales | |
|------------------------------------|---------------------|---------------------|
| | 2016 (Unaudited) | 2015 (Unaudited) |
| Sikorsky Aircraft | 19.8 | 17.0 |
| Goodrich Landing Gear | 11.9 | 14.9 |
| Northrop Grumman Corporation | 10.9 | 17.3 |
| US DoD | 10.7 | 12.9 |

Gross Profit:

Consolidated gross profit from operations for the nine months ended September 30, 2016 was \$8,973,000 a decrease of approximately (\$3,471,000), or (27.9%), as compared to gross profit of \$12,444,000 for the nine months ended September 30, 2015. Consolidated gross profit as a percentage of sales was 17.9% and 21.9% for the nine months ended September 30, 2016 and 2015, respectively. The decline in gross profit reflects the decline in sales and the underabsorption of factory overhead.

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- Gross profit at Complex Machining decreased by (\$988,000) for the nine months ended September 30, 2016 resulting from lower sales and under absorption of factory overhead.
- Gross Profit at Aerostructures & Electronics decreased by (\$1,940,000) for the nine months ended September 30, 2016 resulting from the absence of a biennial contract which generated significant revenues in 2015 and under absorption of factory overhead.
- Gross profit at our Turbine Engine Component segment decreased by (\$543,000) for the nine months ended September 30, 2016 due to decreased revenues at both AMK and Sterling Engineering.

Operating Expenses:

Consolidated Operating Expenses for the nine months ended September 30, 2016 totaled approximately \$12,896,000 and increased by \$1,016,000, or 8.6%, compared to \$11,880,000 for the nine months ended September 30, 2015.

Interest and financing costs for the nine months ended September 30, 2016 were approximately \$1,771,000 an increase of approximately \$430,000, or 32.1%, compared to \$1,341,000 for the nine months ended September 30, 2015. The increase in financing costs reflects the costs of raising capital, the increase in our outstanding debt and in the rates payable on our debt.

Loss before taxes for the nine months ended September 30, 2016 was (\$5,831,000), an increase in our loss of (\$5,152,000) or 759.1%, compared to a loss before taxes of (\$679,000) for the nine months ended September 30, 2015.

The Company recognized a benefit for income taxes of approximately \$2,102,000 for nine months ended September 30, 2016 compared to a benefit for taxes of approximately \$519,000 for nine months ended September 30, 2015, an increase of \$1,583,000 primarily from the increased net operating losses generated by the Company.

Net loss for the nine months ended September 30, 2016 was (\$3,729,000), a decrease in performance of (\$3,569,000), or 2,230.6%, compared to net loss of (\$160,000) for the nine months ended September 30, 2015. The decrease in net income results primarily from the impact of the losses incurred at each of our operating segments.

LIQUIDITY AND CAPITAL RESOURCES

We are highly leveraged and rely upon our ability to continue to borrow from PNC Bank N.A. ("PNC") to support operations and acquisitions. Substantially all of our assets are pledged as collateral under our existing loan agreements with PNC. Our Company is required to maintain a lockbox account with PNC, into which substantially all of our cash receipts are paid. If PNC were to cease lending, we would lack funds to continue our operations. Over the past twelve months we have also relied upon our ability to borrow money from certain stockholders and raise equity capital to support our operations. Should we continue to need to borrow funds from our principal stockholders or raise equity, there is no assurance that we will be able to do so or that the terms on which we borrow funds or raise equity will be favorable to us or our existing shareholders.

We have a credit facility with PNC (the "Loan Facility") secured by substantially all of our assets. The Loan Facility has been amended many times during its term. The Loan Facility was amended in June 2016 (the "Twelfth Amendment") and September 2016 (the "Thirteenth Amendment"). In connection with the Twelfth Amendment, we paid a fee of \$100,000 and reimbursed PNC for the fees and expenses of its counsel. The Twelfth Amendment provides for a \$33,000,000 revolving loan. In addition, in the Twelfth Amendment the four term loans (Term Loan A, Term Loan B, Term Loan C and Term Loan D) then outstanding were consolidated into a single term loan with the initial principal amount of \$7,387,854. Further, in the Twelfth Amendment we acknowledged that there were then outstanding excess advances under the revolver in the amount of \$12,500,000.

Under the terms of the Loan Facility, as amended, the revolving loan now bears interest at (a) the sum of the Alternate Base Rate plus one and three-quarters of one percent (1.75%) with respect to Domestic Rate Loans; and (b) the sum of the LIBOR Rate plus four and one-half of one percent (4.50%) with respect to LIBOR Rate Loans. The amount outstanding under the revolving loan, exclusive of the excess advance, was \$25,822,000 and \$29,604,000, as of September 30, 2016 and December 31, 2015, respectively.

The Loan Facility was further amended pursuant to the Thirteenth Amendment, to modify the advance rate with respect to our inventory to be the lesser of (i) 75% of the eligible inventory, an increase from 50%, and (ii) 90% of the liquidation value of the eligible inventory, an increase from 85%, subject to the inventory sublimit of \$12,500,000 and such reserves as PNC may deem proper. In addition, in the Thirteenth Amendment the lender waived any default resulting from our obligation to comply with the minimum EBITDA covenant for the period ended June 30, 2016, consented to the issuance of our 12% Subordinated Convertible Notes and the amendment to our Articles of Incorporation to increase the authorized number of shares of Preferred Stock and Series A Preferred Stock.

The repayment terms of Term Loan A had previously been amended in 2014 when the Company borrowed \$2,676,000, representing an additional \$1,328,000 and Term Loan A as amended was to be repaid in monthly installments of \$31,859 continuing until November 2016. On October 1, 2014, the Company borrowed \$3,500,000 under Term Loan B for the acquisition of AMK. Term Loan B was to be repaid in sixty consecutive monthly principal installments of \$58,333 continuing until November 2019. Prior to the Twelfth Amendment, Term Loans A and B bore interest at (a) the sum of the Alternate Base Rate plus one and three quarters of one percent (1.75%) with respect to Domestic Rate Loans and (b) the sum of the LIBOR Rate plus three percent (3.00%) with respect to LIBOR Rate Loans.

On December 31, 2014, we borrowed \$2,500,000 under Term Loan C to refinance the Seller Note and Mortgage of \$2,500,000 issued as part of the acquisition of AMK. Term Loan C was originally to be repaid in monthly installments of \$34,722 continuing until January 2021. Prior to the Twelfth Amendment, Term Loan C bore interest at (a) the sum of the Alternate Base Rate plus two percent (2.00%) with respect to Domestic Rate Loans and (b) the sum of the LIBOR Rate plus three and one-quarter percent (3.25%) with respect to LIBOR Rate Loans.

On March 9, 2015, we borrowed \$3,500,000 under Term Loan D for the acquisition of Sterling. Prior to the Twelfth Amendment, Term Loan D was to be repaid through twenty consecutive monthly installments of \$62,847 continuing until November 2016. Term Loan D bore interest at (a) the sum of the Alternate Base Rate plus two and one quarter percent (2.25%) with respect to Domestic Rate Loans and (b) the sum of the LIBOR Rate plus three and one-half percent (3.50%) with respect to LIBOR Rate Loans.

The repayment terms of the Term Loan provided for in the Twelfth Amendment consist of sixty (60) consecutive monthly principal installments, the first fifty-nine (59) of which shall be in the amount of \$123,133 commencing on the first business day of July, 2016, and continuing on the first business day of each month thereafter, with a sixty (60th) and final payment of any unpaid balance of principal and interest payable on the last business day of June, 2021. Under the terms of the Loan Facility, as amended, the revolving loan now bears interest at (a) the sum of the Alternate Base Rate plus one and three-quarters of one percent (1.75%) with respect to Domestic Rate Loans; and (b) the sum of the LIBOR Rate plus four and one-half of one percent (4.50%) with respect to LIBOR Rate Loan.

At the closing of the Twelfth Amendment we paid \$1,500,000 to reduce the outstanding excess under the revolving loan. It also agreed that to reduce the excess advances by \$100,000 each week commencing the second week after the closing of the Twelfth Amendment.

The terms of the Loan Facility require that, among other things, we maintain a specified Fixed Charge Coverage Ratio and maintain a minimum EBITDA. In addition, we are limited in the amount of Capital Expenditures we can make. We are also limited to the amount of dividends we can pay our shareholders as defined in the Loan Facility. As of December 31, 2015, we were not in compliance with the Fixed Charge Coverage Ratio covenant. As of December 31, 2015, we were in compliance with all other terms of the Loan Facility. The failure to maintain the requisite Fixed Charge Coverage Ratio constitutes a default under the Loan Facility and PNC at its option may give notice to us that all amounts under the Loan Facility are immediately due and payable. Consequently, all amounts due under the Term Loans are also classified as current. For the three months ended September 30, 2016, PNC has excluded the Fixed Coverage Charge Ratio requirement. As of September 30, 2016, we were not in compliance with the minimum EBITDA requirement. We have requested a waiver from PNC for the failure to meet the minimum EBITDA covenant.

As of September 30, 2016, our debt to PNC in the amount of \$32,841,000 consisted of the revolving credit note due to PNC in the amount of \$25,822,000, the term loans due to PNC in the amount of \$7,019,000, and capitalized lease obligations of \$6,206,000.

Subordinated Loans, Issuance of Preferred Stock and Note Offering

During the period September 2015 through May 2016, we borrowed an aggregate of \$1,750,000 from two of our principal stockholders. The September 2015 loan bore interest at the rate of 4% per annum and was to be paid on September 7, 2016. The other loans bore interest at the rate of 7% per annum and were to be repaid on June 30, 2016, or, if earlier, upon the sale of the Company's equity from which it derived proceeds of \$2,000,000. The indebtedness related to these loans was converted into a total of 175,000 shares of Series A Preferred Stock in connection the private placement discussed below.

On May 25, 2016, and June 1, 2016, we completed a private placement of 700,000 shares of our Series A Preferred Stock from which we derived gross proceeds of \$5,250,000, net of \$1,750,000 of principal amount of our promissory notes exchanged by Michael Taglich and Robert Taglich for shares of Series A Preferred Stock. The shares of Series A Preferred Stock have a stated value of \$10.00 per share and are initially convertible into shares of Common Stock at a price of \$4.92 per share (subject to adjustment upon the occurrence of certain events). In connection with the placement we incurred approximately \$606,000 of direct offering costs and \$57,000 in legal expenses and granted to the Placement Agents warrants to purchase 8% of the number of shares of our common stock (113,822 shares) issuable upon conversion of the Series A Preferred Stock sold in the offering. The warrants are exercisable in whole or in part, at an initial exercise price per share of \$6.15, and are exercisable for cash or on a cashless basis commencing on November 26, 2016 and expiring on May 26, 2021. The exercise price and number of shares of common stock issuable under the warrants are subject to adjustments for stock dividends, splits, combinations and similar events.

Of the proceeds generated by the sale of our Preferred Shares, \$1,500,000 was paid to PNC to reduce the amount outstanding under our Loan Facility.

In August 2016, we borrowed an aggregate of \$1,500,000 from one of our principal stockholders. The loans are evidenced by promissory notes bearing interest at the rate of 7% per annum and are to be repaid on December 31, 2016, or, if earlier, upon the sale of our equity securities from which we derived proceeds of \$2,000,000.

On September 1, 2016 we completed the private placement of \$2,720,000 principal amount of our 12% Subordinated Convertible Notes due December 31, 2017 (the "Notes"), together with Investor Warrants to purchase an aggregate of 110,658 shares of common stock, for a total purchase price of \$2,720,000. We issued the Notes since we did not have sufficient shares of preferred stock available. The Notes are automatically convertible into shares of Series A Preferred Stock at a price of \$10.00 per share, the stated value of the Series A Preferred Stock, upon the filing of an amendment to our charter increasing the number of authorized shares of Series A Preferred Stock. The Company received net proceeds of approximately \$2,319,800 from the sale of the Notes, which was used to pay down our indebtedness under the Loan Agreement and for working capital. The Company also issued to Michael Taglich a Note in the principal amount of \$1,520,713, together with Investor Warrants to purchase 61,817 shares of common stock, upon surrender for cancellation of promissory notes in the aggregate principal amount of \$1,500,000, together with accrued interest thereon and on notes previously exchanged for Series A Preferred Stock of \$20,713. In addition, we issued to Robert Taglich a Note in the principal amount of \$4,373, together with Investor Warrants to purchase 177 shares of Common Stock, in consideration of the forgiveness of interest of \$4,373 accrued on notes previously exchanged for Series A Preferred Stock.

As compensation for its services as placement agent for the offering, we paid Taglich Brothers a fee of \$295,400 and issued to Taglich Brothers five-year warrants to purchase 68,617 shares of Common Stock at an initial exercise price of \$6.15, subject to certain anti-dilution and other adjustments, including stock splits, distributions in respect of the common stock and in the event of certain fundamental transactions such as mergers and other business combinations.

On September 15, 2016, we issued 32,297 shares of Series A Preferred Stock in lieu of payment of cash dividends on the 700,000 shares of Series A Preferred Stock issued in the Preferred Stock Offering.

The issuance of the Notes in August 2016 increased our indebtedness by \$2,720,000 after giving effect to the retirement of a \$1,500,000 promissory note exchanged as a portion of the consideration for a Note in the principal amount of \$1,520,703. As a result of the automatic conversion of the Notes, the indebtedness represented by the Notes will be eliminated, but the number of outstanding shares of Series A Preferred Stock will increase from 700,000 shares to approximately 1,140,000 shares. The Notes, which are payable on December 31, 2018, bear interest at the rate of 12% per annum, the same nominal rate as dividends accrue on the Series A Preferred Stock through June 15, 2018. The dividend rate on the Series A Preferred Stock increases to 15% per annum if we issue PIK Shares in lieu of payment of cash dividends payable until June 15, 2018, and the number of outstanding shares of Series A Preferred Stock as of such date would increase to approximately 1,500,000 shares if we elected to pay all dividends due on the Series A Preferred Stock by issuing PIK Shares. The dividend rate on the Series A Preferred Stock increases to 16% per annum after June 2018, 19% per annum to the extent dividends are paid in PIK Shares.

Interest payable on the Notes and dividends payable in respect of the Series A Preferred Stock will reduce the amount of net income, if any, or increase the amount of net loss attributable to holders of common stock. While the issuance of PIK Shares in payment of all or a portion of the dividends payable in respect of any dividend period preserves our cash, the increase in the rate of dividend which must be paid when we choose to issue PIK Shares in lieu of cash dividends further reduces the amount of net income, if any, or increases the amount of net loss attributable to holders of common stock. In addition, the issuance of PIK Shares will dilute the interests of our common stockholders. Furthermore, under the terms of the Certificate of Designation authorizing the issuance of our Series A Preferred

Stock, we are not permitted to declare or pay any cash dividends on our common stock during any dividend period if we pay all or a portion of the dividends on the Series A Preferred Stock in PIK Shares. Although holders of Series A Preferred Stock may convert their shares into common stock they are unlikely to convert if we are unable to pay cash dividends and the price of the common stock does not increase significantly above \$4.92 per share, the conversion price, for a sustained period. We have the right to redeem the Series A Preferred Stock after May 26, 2018 for a redemption price of \$10.00, plus accrued and unpaid dividends; however, we may not have sufficient cash available to effect such redemption.

Anticipated Uses of Cash

As a requirement of our Loan Facility substantially all of our cash receipts from operations are deposited into our lockbox account at PNC. These cash receipts are used to reduce our indebtedness under our revolving credit note and are then borrowed according to a borrowing base to support our operations. In addition, dividends on the Preferred Shares are payable on a cumulative basis at an annual rate for the first two years after the date the Preferred Shares were issued of 12% of the Stated Value per share and thereafter at the annual rate of 16% of the Stated Value per share. The Company may pay dividends in cash or in additional Preferred Shares (“PIK Shares”). If during the first two years after the date of issuance the Company fails to pay dividends in respect of any dividend period a dividend at an annual rate of at least 8% of the Stated Value per share in cash, in addition to paying a sufficient number of PIK Shares so that the sum of the cash dividends and PIK Shares paid equals 12% per annum the Company will issue PIK Shares in an amount equal to the product of the proportion of the cash dividend not paid times 3% per annum.

Cash Flow

The following table summarizes our net cash flow from operating, investing and financing activities for the periods indicated below:

| | September 30, 2016 (Unaudited) | September 30, 2015 |
|--|--------------------------------------|-----------------------|
| Cash provided by (used in) | | |
| Operating activities | \$ (1,124,000) | \$ (1,449,000) |
| Investing activities | (314,000) | (7,772,000) |
| Financing activities | 2,206,000 | 8,594,000 |
| Net increase (decrease) in cash and cash equivalents | \$ 768,000 | \$ (627,000) |

Cash Provided By Operating Activities

Cash provided by operating activities primarily consists of our net income (loss) adjusted for certain non-cash items and changes to working capital.

For the nine months ended September 30, 2016, the net cash used in our operating activities of (\$1,124,000) was comprised of a net loss of (\$3,729,000), reduced by (\$2,145,000) due to changes in deferred income taxes, a loss on extinguishment of debt \$172,000, and \$184,000 related to amortization of convertible notes payable, offset by adjustments for non-cash items of \$4,535,000. Adjustments for non-cash items consisted primarily of depreciation of property and equipment of \$2,808,000, amortization of capitalized engineering costs, intangibles and other items of \$1,598,000, and non-cash compensation of \$126,000. These non-cash items were offset by (\$29,000) of deferred gain on the sale of real estate. The net decrease in operating assets was comprised of an increase in inventory of \$6,389,000, a decrease in accounts receivable of \$3,730,000 due to the timing of shipments to and cash receipts from customers, a decrease in prepaid expenses and other current assets of \$255,000, offset by an increase in deposits and other assets of (\$199,000). The net increase in operating liabilities was comprised of increases in accounts payable and accrued expenses of \$2,356,000 due to the timing of the receipt and payment of invoices, a decrease in income taxes payable of \$14,000, and increases in deferred rent of \$10,000 and deferred revenue of \$112,000.

Cash Used in Investing Activities

Cash used in investing activities consists of capital expenditures for property and equipment, capitalized engineering costs and the cash payments for the businesses we acquired. A description of capitalized engineering costs can be found below and in Note 3 Summary of Significant Accounting Policies in our Consolidated Financial Statements for the year ended December 31, 2015.

For the nine months ended September 30, 2016, cash used by investing activities was (\$314,000). This was comprised of (\$644,000) of capitalized engineering costs, (\$1,341,000) used for the purchase of property and equipment, offset by the proceeds of the sale of fixed assets of \$1,671,000.

Cash Provided By (Used In) Financing Activities

Cash provided by or used in financing activities primarily consists of the proceeds of the sale of our equity securities, borrowings and repayments under our credit facilities with our senior lender, increases in and repayments of capital lease obligations and other notes payable, and dividend payments.

For the nine months ended September 30, 2016, cash provided by financing activities was \$2,206,000. This was comprised of the net proceeds from the issuance of notes payable of \$5,620,000 and the net proceeds from the issuance of preferred stock of \$5,250,000, offset in part by repayments of (\$6,596,000) on our revolving line of credit and term loans and (\$908,000) on our capital lease obligations, (\$199,000) of deferred financing costs, and expenses of (\$663,000) related to the issuances of preferred stock and (\$298,000) for the issuance of convertible debt.

OFF-BALANCE SHEET ARRANGEMENTS

We did not have any off-balance sheet arrangements as of September 30, 2016.

Critical Accounting Policies

We have identified the policies below as critical to our business operations and the understanding of our financial results.

Inventory Valuation

For interim reporting, the Company computes its inventory using the “gross profit” method for some subsidiaries.

For annual reporting, the Company values inventory at the lower of cost on a first-in-first-out basis or market.

We generally purchase raw materials and supplies uniquely for the production of larger more complex parts, such as landing gear, only when non-cancellable contracts for orders have been received for finished goods. We occasionally produce products, in excess of purchase order quantities in anticipation of future purchase order demand. Historically this excess has been used in fulfilling future purchase orders. We purchase supplies and materials useful in a variety of products as deemed necessary even though orders have not been received. The Company periodically evaluates inventory items that are not secured by purchase orders and establishes reserves for obsolescence accordingly. The Company also reserves for excess quantities, slow-moving goods, and for other impairments of value.

The Company presents inventory net of progress billings in accordance with the specified contractual arrangements with the United States Government, which results in the transfer of title of the related inventory from the Company to the United States Government, when such progress payments are received.

Capitalized Engineering Costs

The Company has contractual agreements with customers to produce parts, which the customers design. Though the Company has not designed and thus has no proprietary ownership of the parts, the manufacturing of these parts requires pre-production engineering and programming of our machines. The pre-production costs associated with a particular contract are capitalized and then amortized beginning with the first shipment of product pursuant to such contract. These costs are amortized on a straight line basis over the shorter of the estimated length of the contract, or three years.

If the Company is reimbursed for all or a portion of the pre-production expenses associated with a particular contract, only the unreimbursed portion would be capitalized. The Company may also progress bill customers for certain engineering costs being incurred. Such billings are recorded as deferred revenues until the appropriate revenue recognition criteria have been met. The Terms and Conditions contained in customer purchase orders may provide for liquidated damages in the event that a stop-work order is issued prior to the final delivery of the product.

Revenue Recognition

The Company recognizes revenue in accordance with Staff Accounting Bulletin No. 104, "Revenue Recognition." The Company recognizes revenue when products are shipped and/or the customer takes ownership and assumes risk of loss, collection of the relevant receivable is probable, persuasive evidence of an arrangement exists, and the sales price is fixed or determinable. Payments received in advance from customers for products delivered are recorded as customer deposits until earned, at which time revenue is recognized. The Terms and Conditions contained in our customer purchase orders often provide for liquidated damages in the event that a stop work order is issued prior to the final delivery. The Company utilizes a Returned Merchandise Authorization or RMA process for determining whether to accept returned products. Customer requests to return products are reviewed by the contracts department and if the request is approved, a credit is issued upon receipt of the product. Net sales represent gross sales less returns and allowances. Freight out is included in operating expenses.

The Company recognizes certain revenues under a bill and hold arrangement with two of its large customers. For any requested bill and hold arrangement, the Company makes an evaluation as to whether the bill and hold arrangement qualifies for revenue recognition. The customer must initiate the request for the bill and hold arrangement. The customer must have made this request in writing in addition to their fixed commitment to purchase the item. The risk of ownership has passed to the customer, payment terms are not modified and payment will be made as if the goods had shipped.

Income Taxes

The Company accounts for income taxes in accordance with accounting guidance now codified as FASB ASC 740, "Income Taxes," which requires that the Company recognize deferred tax liabilities and assets based on the differences between the financial statement carrying amounts and the tax bases of assets and liabilities, using enacted tax rates in effect in the years the differences are expected to reverse. Deferred income tax benefit (expense) results from the change in net deferred tax assets or deferred tax liabilities. A valuation allowance is recorded when it is more likely than not that some or all deferred tax assets will not be realized.

The Company accounts for uncertainties in income taxes under the provisions of FASB ASC 740-10-05, "Accounting for Uncertainty in Income Taxes." The ASC clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. The ASC prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The ASC provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

Stock-Based Compensation

The Company accounts for stock-based compensation expense in accordance with FASB ASC 718, "Compensation – Stock Compensation." Under the fair value recognition provision of the ASC, stock-based compensation cost is estimated at the grant date based on the fair value of the award. The Company estimates the fair value of stock options and warrants granted using the Black-Scholes-Merton option pricing model.

Goodwill

Goodwill represents the excess of the acquisition cost of businesses over the fair value of the identifiable net assets acquired. Goodwill is not amortized, but is tested at least annually for impairment, or if circumstances change that will more likely than not reduce the fair value of the reporting unit below its carrying amount.

The Company accounts for the impairment of goodwill under the provisions of ASU 2011-08 ("ASU 2011-08"), "Intangibles Goodwill and Other (Topic 350): Testing Goodwill for Impairment." ASU 2011-08 updated the guidance on the periodic testing of goodwill for impairment. The updated guidance gives companies the option to perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount.

The Company performs impairment testing for goodwill annually, or more frequently when indicators of impairment exist, using a three-step approach. Step "zero" is a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. Step one compares the fair value of the net assets of the relevant reporting unit (calculated using a discounted cash flow method) to its carrying value, a second step is performed to compute the amount of the impairment. In this process, a fair value for goodwill is estimated, based in part on the fair value of the operations, and is compared to its carrying value. The shortfall of the fair value below

carrying value represents the amount of goodwill impairment.

Long-Lived and Intangible Assets

Identifiable intangible assets are amortized using the straight-line method over the period of expected benefit. Long-lived assets and intangible assets subject to amortization to be held and used are reviewed for impairment whenever events or changes in circumstances indicate that the related carrying amount may be impaired. The Company records an impairment loss if the undiscounted future cash flows are found to be less than the carrying amount of the asset. If an impairment loss has occurred, a charge is recorded to reduce the carrying amount of the asset to fair value. There has been no impairment as of September 30, 2016 and December 31, 2015.

Recently Issued Accounting Pronouncements

In January 2016, the FASB issued ASU 2016-01, “Recognition and Measurement of Financial Assets and Financial Liabilities (Subtopic 825-10)” (“ASU 2016-01”). The main objective of ASU 2016-01 is enhancing the reporting model for financial instruments to provide users of financial statements with more decision-useful information. The amendments address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. ASU 2016-01 is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not expect the adoption of this amended to have a significant impact on its consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, “Leases (Topic 842)” (“ASU 2016-02”). The main objective of ASU 2016-02 is to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. To meet that objective, the FASB is amending the FASB Accounting Standards Codification and creating Topic 842, Leases. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company does not expect the adoption of this amended to have a significant impact on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-09, “Compensation—Stock Compensation (Topic 718) Improvements to Employee Share-Based Payment” (“ASU 2016-09”). ASU 2016-09 is part of the FASB Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of generally accepted accounting principles for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements. ASU 2016-09 will affect all entities that issue share-based payment awards to their employees. The areas for simplification involve several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. ASU 2016-09 is effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company does not expect the adoption of this amended to have a significant impact on its consolidated financial statements.

In April 2016, the FASB issued ASU 2016-10 “Revenue from Contracts with Customers (Topic 606)” (“ASU 2016-10”). The core principle of the guidance in Topic 606 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The amendments in ASU 2016-10 affect the guidance in ASU 2014-09, “Revenue from Contracts with Customers”, which is not yet effective. The effective date and transition requirements of ASU 2016-10 are the same as the effective date and transition requirements of ASU 2014-09. They are effective prospectively for reporting periods beginning after December 15, 2017 and early adoption is not permitted. The Company is currently assessing the impact of the adoption of these amendments on its consolidated financial statements.

In May 2016, the FASB issued Accounting Standards Update No. 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients. The amendments do not change the core revenue recognition principle in Topic 606. The amendments provide clarifying guidance in certain narrow areas and add some practical expedients. These amendments are effective at the same date that Topic 606 is effective. Topic 606 is effective for public entities for annual reporting periods beginning after December 15, 2017, including interim reporting periods therein (i.e., January 1, 2018, for a calendar year entity). Topic 606 is effective for nonpublic entities one year later. The Company is currently assessing the impact of the adoption of the amendment to Topic 606 and these amendments on its consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments". The standard provides guidance on how certain cash receipts and payments are presented and classified in the statement of cash flows, including beneficial interests in securitization, which would impact the presentation of the deferred purchase price from sales of receivables. The standard is intended to reduce current diversity in practice. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of these amendments to have a significant impact on its consolidated financial statements.

The Company does not believe that any other recently issued, but not yet effective, accounting standards if currently adopted would have a material effect on the accompanying financial statements.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

Our senior management is responsible for establishing and maintaining a system of disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, (the "Exchange Act") designed to ensure that the information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

When we evaluated the effectiveness of the design and operation of our disclosure controls and procedures as of December 31, 2015, our Chief Executive Officer and our Chief Accounting Officer concluded that as of such date, our disclosure controls and procedures were not effective due to a material weakness related to (i) the inability of our internal accounting personnel to identify, analyze, record and disclose the tax and financial reporting implications of certain complex accounting matters related to non-standard and unusual transactions and (ii) inventory accounting, in particular with respect to tracking for the aging of certain items reserving for slow moving inventory and obsolescence and, consequently, valuation of our inventory. In an effort to eliminate such weakness, we added Marianne Giglio to our accounting department and entered into an agreement with Chord Advisors, LLC, an advisory firm that provides financial accounting and advisory services to public companies, to assist our internal accounting staff in determining the appropriate tax and financial accounting treatment of our significant transactions and in connection with such other financial reporting matters as our management deems appropriate. More recently, effective October 3, 2016, Michael Recca became our Chief Financial Officer. Those actions have yet to have a significant impact on the effectiveness of our disclosure controls and procedures

We have evaluated the effectiveness of the design and operation of our disclosure controls and procedures under the supervision of and with the participation of management, including the Chief Executive Officer and our Chief Accounting Officer as of the end of the period covered by this Report. Based on that evaluation, our Chief Executive Officer and our Chief Accounting Officer have concluded that as of the end of the period covered by this report, our disclosure controls and procedures were not effective.

(b) Changes in Internal Control over Financial Reporting

There have not been any changes in our internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, during our most recently completed fiscal quarter which is the subject of this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II

OTHER INFORMATION

Item 1A. Risk Factors.

Reference is made to the risks and uncertainties disclosed in our 2015 Form 10-K and Q2 2016 Form 10-Q, which are incorporated by reference into this report. Prospective investors are encouraged to consider the risks described in our 2015 Form 10-K, Q2 2016 Form 10-Q, our Management's Discussion and Analysis of Financial Condition and Results of Operations contained in this Report and other information publicly disclosed or contained in documents we file with the Securities and Exchange Commission before purchasing our securities.

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Item 6. Exhibits

| No. | Description |
|------|--|
| 4.1 | Form of Warrant issued to purchasers of Notes in connection with Note Offering (incorporated herein by reference to Exhibit 4.1 to the Company's Current Report on Form 8-K filed on August 22, 2016). |
| 4.2 | Placement Agent Warrant issued to Taglich Brothers, Inc. in connection with Note Offering. |
| 10.1 | Thirteenth Amendment to PNC Loan Agreement (incorporated herein by reference to exhibit 10.4 to the Company's Current Report on Form 8-K filed on September 21, 2016). |
| 10.2 | Promissory note in the principal amount of \$500,000 payable to Michael Taglich (incorporated herein by reference to exhibit 10.1 to the Company's Current Report on Form 8-K filed on August 5, 2016). |
| 10.3 | Promissory note in the principal amount of \$1,000,000 payable to Michael Taglich (incorporated herein by reference to exhibit 3.1 to the Company's Current Report on Form 8-K filed on August 5, 2016). |
| 10.4 | Placement Agency Agreement dated August 19, 2016 between the Company and Taglich Brothers, Inc. (incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on August 22, 2016). |
| 10.5 | Securities Purchase Agreement by and among the Company and the purchasers named therein (incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on August 22, 2016). |
| 10.6 | The Company's 12% Convertible Subordinated Note due December 31, 2017(incorporated herein by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed on August 22, 2016). |
| 10.7 | Joinder Agreement among the purchasers of the Notes and the Company (incorporated herein by reference to Exhibit 10.4 to the Company's Current Report on Form 8-K filed on August 22, 2016). |
| 10.8 | Amendment to Registration Rights Agreement (incorporated herein by reference to Exhibit 10.6 to the Company's Current Report on Form 8-K filed on August 22, 2016). |
| 10.9 | 2016 Equity Incentive Plan. |
| 31.1 | Certification of the Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended. |
| 31.2 | |

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Certification of the Principal Financial Officer pursuant to Rule 13a-14(a)/15d-14(a) of the Securities Exchange Act of 1934, as amended.

- 32.1 Certification of the Principal Executive Officer pursuant to Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of the Principal Financial Officer pursuant to Rule 13a-14(b) or Rule 15d-14(b) of the Securities Exchange Act of 1934, as amended, and 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

- 101.INS XBRL Instance Document*
- 101.SCH XBRL Taxonomy Extension Schema*
- 101.CAL XBRL Taxonomy Extension Calculation*
- 101.DEF XBRL Taxonomy Extension Definition*
- 101.LAB XBRL Taxonomy Extension Label*
- 101.PRE XBRL Taxonomy Extension Presentation*

* To be filed by Amendment

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

Dated: November 14, 2016

AIR INDUSTRIES GROUP

By: /s/ Daniel R. Godin
Daniel R. Godin
President and CEO
(Principal Executive Officer)

By: /s/ Michael Recca
Michael Recca
Chief Financial Officer
(Principal Financial Officer)