

**AIR INDUSTRIES GROUP, INC**  
**CONSOLIDATED FINANCIAL STATEMENTS**  
**and FOOTNOTES**  
**with INDEPENDENT ACCOUNTANTS’**  
**REVIEW REPORT**  
**September 30, 2011 and 2010**

**Air Industries Group, Inc.**

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# RotenbergMeril

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## INDEPENDENT ACCOUNTANTS' REVIEW REPORT

To the Board of Directors and Stockholders of  
Air Industries Group, Inc.  
Bay Shore, NY 11706

We have reviewed the accompanying consolidated balance sheet of Air Industries Group, Inc. and Subsidiaries (the "Company") as of September 30, 2011, and the related statements of operations, stockholders' equity, and cash flows for the nine months ended September 30, 2011 and 2010. A review includes primarily applying analytical procedures to management's financial data and making inquiries of Company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.

Our responsibility is to conduct the review in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"). Those standards require us to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. We believe that the results of our procedures provide a reasonable basis for our report.

Based on our review, we are not aware of any material modifications that should be made to the accompanying consolidated financial statements in order for them to be in conformity with accounting principles generally accepted in the United States.

We have previously audited, in accordance with auditing standards of the PCAOB, the consolidated balance sheet of the Company as of December 31, 2010, and the related consolidated statements of operations, stockholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated March 15, 2011, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying consolidated balance sheet as of December 31, 2010, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

*Rotenberg Meril Solomon Bertiger & Guttilla, P.C.*

Rotenberg Meril Solomon Bertiger & Guttilla, P.C.  
Saddle Brook, New Jersey  
November 17, 2011

**AIR INDUSTRIES GROUP, INC.**  
**Consolidated Balance Sheets**

	<u>September 30,</u>	<u>December 31,</u>
	<u>2011</u>	<u>2010</u>
	<u>(Unaudited)</u>	
<b>ASSETS</b>		
Current Assets		
Cash and Cash Equivalents	\$ 420,000	\$ 537,000
Accounts Receivable, Net of Allowance for Doubtful Account of \$772,000 and \$523,000	6,644,000	4,381,000
Inventory	22,911,000	21,443,000
Prepaid Expenses and Other Current Assets	104,000	207,000
Taxes Receivable	-	16,000
Deposits - Customers	8,000	59,000
Total Current Assets	<u>30,087,000</u>	<u>26,643,000</u>
Property and Equipment, net	4,013,000	3,935,000
Capitalized Engineering Costs - net of Accumulated Amortization of \$2,870,000 and \$2,410,000	983,000	1,039,000
Deferred Financing Costs, net, deposit and other assets	659,000	701,000
Intangible Assets, net	1,649,000	1,775,000
Goodwill	291,000	291,000
<b>TOTAL ASSETS</b>	<u>\$ 37,682,000</u>	<u>\$ 34,384,000</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities		
Current Portion Notes Payable and Capitalized Lease Obligations	\$ 13,892,000	\$ 12,940,000
Accounts Payable and Accrued Expenses	7,329,000	5,866,000
Lease Impairment - Current	88,000	96,000
Deferred Gain on Sale - Current Portion	38,000	38,000
Income Taxes Payable	41,000	-
Total Current Liabilities	<u>21,388,000</u>	<u>18,940,000</u>
Long term liabilities		
Notes Payable and Capitalized Lease Obligation - Net of Current Portion	10,674,000	11,536,000
Lease Impairment - Net of Current Portion	195,000	260,000
Deferred Gain on Sale - Net of Current Portion	532,000	561,000
Deferred Rent	943,000	800,000
Total Liabilities	<u>33,732,000</u>	<u>32,097,000</u>
Commitments and contingencies		
Stockholders' Equity		
Preferred Stock Par Value \$.001-Authorized 8,003,716 shares Designated as Series "A" Convertible Preferred - \$.001 par Value, 1,000 Shares Authorized 0 Shares issued and outstanding as of September 30, 2011 and December 31, 2010, respectively.	-	-
Designated as Series "B" Convertible Preferred -\$.001 Par Value, 4,000,000 shares authorized, 0 and 0 shares issued and outstanding as of September 30, 2011 and December 31, 2010, respectively; Liquidation Value, \$ 0	-	-
Common Stock - \$.001 Par, 20,000,000 Shares Authorized, 3,579,114 and 3,579,114 Shares Issued and Outstanding as of September 30, 2011 and December 31, 2010, respectively	4,000	4,000
Additional Paid-In Capital	26,110,000	26,009,000
Accumulated Deficit	(22,164,000)	(23,726,000)
Total Stockholders' Equity	<u>3,950,000</u>	<u>2,287,000</u>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<u>\$ 37,682,000</u>	<u>\$ 34,384,000</u>

See Independent Accountant's Review Report and notes to consolidated financial statements

**AIR INDUSTRIES GROUP, INC.**  
**Consolidated Statements of Operations for the Nine Months ended September 30,**  
**(Unaudited)**

	<u>2011</u>	<u>2010</u>
Net Sales	\$ 38,978,000	\$ 36,678,000
Cost of Sales - Operational	31,112,000	29,916,000
Gross Profit	<u>7,866,000</u>	<u>6,762,000</u>
Operating Expenses	4,683,000	5,186,000
Total Operating Expenses	<u>4,683,000</u>	<u>5,186,000</u>
Income from operations	<u>3,183,000</u>	<u>1,576,000</u>
Interest and financing costs	(1,576,000)	(3,208,000)
Other Expense (income), net	12,000	(77,000)
Income (loss) before provision for income taxes	<u>1,619,000</u>	<u>(1,709,000)</u>
Provision for income taxes	57,000	-
Income (Loss) From Continuing Operations	<u>1,562,000</u>	<u>(1,709,000)</u>
Income From Discontinued Operations	-	395,000
Net Income (Loss)	<u>1,562,000</u>	<u>(1,314,000)</u>
Dividend attributable to preferred stockholders	-	1,436,000
Net income (loss) attributable to common stockholders	<u>\$ 1,562,000</u>	<u>\$ (2,750,000)</u>
Income (Loss) per share (basic)		
Continuing Operations	\$ 0.44	\$ (3.26)
Discontinued Operations	-	0.41
Total	<u>\$ 0.44</u>	<u>\$ (2.85)</u>
Income (Loss) per share (basic)		
Continuing Operations	\$ 0.44	\$ (3.26)
Discontinued Operations	-	0.41
Total	<u>\$ 0.44</u>	<u>\$ (2.85)</u>
Weighted average shares outstanding (basic)	<u>3,579,114</u>	<u>963,831</u>
Weighted average shares outstanding (diluted)	<u>3,579,258</u>	<u>963,831</u>

See Independent Accountant's Review Report and notes to consolidated financial statements

**AIR INDUSTRIES GROUP, INC.**  
**Consolidated Statements of Stockholders' Equity**  
(Unaudited)

**Nine Months ended September 30, 2011**

	Series A		Series B		Common Stock		Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Equity
	Preferred Stock		Preferred Stock		Preferred Stock				
	Shares	Amount	Shares	Amount	Shares	Amount			
<b>Balance, January 1, 2011</b>	-	\$ -	-	\$ -	3,579,114	\$ 4,000	\$ 26,009,000	\$ (23,726,000)	\$ 2,287,000
Stock compensation expense	-	-	-	-	-	-	101,000	-	101,000
Net income	-	-	-	-	-	-	-	1,562,000	1,562,000
<b>Balance, September 30, 2011</b>	-	\$ -	-	\$ -	3,579,114	\$ 4,000	\$ 26,110,000	\$ (22,164,000)	\$ 3,950,000

**Nine Months ended September 30, 2010**

	Series A		Series B		Common Stock		Additional Paid-in Capital	Accumulated Deficit	Total Stockholders' Equity
	Preferred Stock		Preferred Stock		Preferred Stock				
	Shares	Amount	Shares	Amount	Shares	Amount			
<b>Balance, January 1, 2010</b>	-	\$ -	2,627,714	\$ 3,000	179,245	\$ -	\$ 24,063,000	\$ (20,817,000)	\$ 3,249,000
Non-cash dividends for Series B Preferred Stock	-	-	839,108	-	-	-	-	-	-
Dividend on Series B Preferred Stock - 2009	-	-	-	-	-	-	460,000	-	460,000
Issuance of Series B Preferred Stock -2010	-	-	1,900,926	3,000	-	-	-	-	3,000
Issuance of Series B Preferred Stock on exercise of warrant	-	-	137,138	-	-	-	-	-	-
Conversion of Series B Preferred Stock to Common Stock	-	-	(5,504,886)	(6,000)	3,399,869	4,000	-	-	(2,000)
Stock compensation expense	-	-	-	-	-	-	338,000	-	338,000
Net Loss	-	-	-	-	-	-	-	(1,314,000)	(1,314,000)
<b>Balance, September 30, 2010</b>	-	\$ -	-	\$ -	3,579,114	\$ 4,000	\$ 24,861,000	\$ (22,131,000)	\$ 2,734,000

See Independent Accountant's Review Report and notes to consolidated financial statements

AIR INDUSTRIES GROUP, INC.  
Consolidated Statements of Cash Flows For the Nine Months Ended September 30,

	2011	2010
	(Unaudited)	
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net Income (Loss)	\$ 1,562,000	\$ (1,314,000)
Adjustments to Reconcile Net Income (Loss) to Net Cash provided by Operating Activities		
Depreciation of property and equipment	1,140,000	1,385,000
Amortization of intangible assets	126,000	126,000
Amortization of capitalized engineering costs	460,000	749,000
Bad debt expense	249,000	274,000
Non-cash compenstion expense	101,000	338,000
Non-cash interest expense including amortization of debt discounts	-	1,323,000
Amortization of deferred financing costs	122,000	241,000
Gain on sale of real estate	(28,000)	(28,000)
 Changes in Assets and Liabilities		
(Increase) Decrease in Operating Assets:		
Accounts Receivable	(2,512,000)	(23,000)
Assets Held for Sale	-	15,000
Inventory	(1,468,000)	(1,472,000)
Prepaid Expenses and Other Current Assets	102,000	124,000
Deposits	50,000	59,000
Other Assets	(61,000)	(206,000)
Increase (Decrease) in Operating Liabilities		
Accounts payable and accrued expenses	1,464,000	691,000
Deferred Rent	143,000	143,000
Income Taxes payable	57,000	-
Liabilities Held For Sale	-	(745,000)
 NET CASH PROVIDED BY OPERATING ACTIVITIES	1,507,000	1,680,000
 <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Capitalized engineering costs	(404,000)	(206,000)
Purchase of property and equipment	(422,000)	(344,000)
NET CASH USED IN INVESTING ACTIVITIES	(826,000)	(550,000)
 <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Issuance of Preferred Stock through exercise of Warrant	-	1,000
Notes payable - Sellers	(293,000)	(144,000)
Capital lease obligations	(296,000)	(273,000)
Notes payable - SFFC	-	(180,000)
Notes payable - Revolver	635,000	90,000
Notes payable - Term Loan PNC	(750,000)	-
Cash paid for deferred financing costs	(20,000)	(40,000)
Payments related to Lease Impairment	(74,000)	(162,000)
NET CASH USED IN FINANCING ACTIVITIES	(798,000)	(708,000)
 NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(117,000)	422,000
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	537,000	462,000
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 420,000	\$ 884,000
 Supplemental cash flow information		
Cash paid during the period for interest	\$ 1,266,000	\$ 1,430,000
 Supplemental cash flow information		
Cash paid during the period for income taxes	\$ -	\$ -
 Supplemental schedule of non-cash investing and financing activities		
Property and equipment acquired under capital leases	\$ 827,000	\$ -
Non-cash dividends on Series B Preferred Stock	\$ -	\$ 1,436,000

See Independent Accountant's Review Report and notes to consolidated financial statements

AIR INDUSTRIES GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 1. FORMATION AND BASIS OF PRESENTATION**

**Organization**

Air Industries Group, Inc. (the "Company" or "AIRI"), a Delaware corporation, was incorporated on January 13, 2006.

The financial statements presented are those of AIRI, and its wholly-owned subsidiaries; Air Industries Machining Corporation ("AIM"), Welding Metallurgy, Inc. ("Welding") and Sigma Metals Inc. (discontinued as of October 31, 2008) ("Sigma"). See Note 2 Disposition.

At a Special Meeting of Stockholders on July 29, 2010, the stockholders approved an amendment to the certificate of incorporation to effect a one-for-four hundred (1-for-400) reverse split of our common stock. All share figures and results are reflected on a post-split basis.

**Basis of Presentation**

The Company is highly leveraged and will need to generate substantial cash flow from operations to satisfy its debt service obligations. As of September 30, 2011, the Company's gross indebtedness was approximately \$24,566,000, including approximately \$14,049,000 payable to its bank lenders secured by substantially all its assets. Because the Company is required to maintain a "lock box" account with PNC Bank N.A. ("PNC") into which substantially all of the Company's cash receipts are paid, if PNC was to cease lending, the Company would lack the funds to continue its operations. On November 30, 2010, the Company refinanced its bank debt with PNC for a term of three years. See Note 8 Notes Payable and Capital Lease Obligations.

The ability of the Company to maintain its current level of operations is subject to the cooperation of PNC and other parties which hold its notes. If PNC was to reduce the amounts loaned to the Company, the Company would have no choice other than to reduce its operations and seek to liquidate certain assets. Any forced liquidation of assets would likely yield less than the amounts at which such assets are valued by the Company.

Certain account balances in 2010 have been reclassified to conform with the current period presentation.

**Note 2. DISPOSITION**

**Sigma**

On April 16, 2007, the Company purchased all of the outstanding capital stock of Sigma for approximately \$7,500,000.

During 2008, Sigma's results began to deteriorate and we concluded that to revive the business would require a significant investment. Therefore, in the third quarter of 2008, the Board of Directors decided to discontinue the operations of Sigma. Operations were discontinued on October 31, 2008.

The Company reached an agreement to sell certain assets of the business to the former stockholders of Sigma in October 2008. In January 2009, the sale was closed. The Company sold assets including certain accounts receivable, property and equipment, customer list and the rights, title and interest in the name Sigma Metals, Inc. and the domain name Sigmametalsinc.com.

On December 30, 2010, the Company entered into an Asset purchase agreement, between its subsidiaries to transfer any remaining assets. Immediately following that transaction, the Company sold its holdings in Sigma to a member of management. The Company recognized the transaction as an increase of additional paid-in capital of \$1,118,000.

AIR INDUSTRIES GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Company's financial statements reflect Sigma as discontinued operations. The results of operations of this entity is treated as income from discontinued operations, net of tax and separately stated on the Consolidated Statements of Operations below income (loss) from continuing operations. See Note 15 Discontinued Operations.

**Note 3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Principal Business Activity**

The Company through its AIM subsidiary is primarily engaged in manufacturing aircraft structural parts, and assemblies for prime defense contractors in the aerospace industry in the United States. The Company's customers consist mainly of publicly-traded companies in the aerospace industry. Welding is a specialty welding and products provider whose significant customers include the world's largest aircraft manufacturers, subcontractors, and original equipment manufacturers.

**Principles of Consolidation**

The accompanying consolidated financial statements include accounts of the Company and its wholly-owned subsidiaries. Significant inter-company accounts and transactions have been eliminated in consolidation.

**Cash and Cash Equivalents**

Cash and cash equivalents include all highly liquid instruments with an original maturity of three months or less.

**Accounts Receivable**

Accounts receivable are reported at their outstanding unpaid principal balances net of allowances for uncollectible accounts. The Company provides for allowances for uncollectible receivables based on management's estimate of uncollectible amounts considering age, collection history, and any other factors considered appropriate. The Company writes off accounts receivable against the Allowance for Doubtful Accounts when a balance is determined to be uncollectible.

	<b>September 30, 2011</b>	<b>December 31, 2010</b>
	<u>(Unaudited)</u>	<u></u>
Accounts Receivable Gross	\$ 7,416,000	\$ 4,904,000
Allowance for Doubtful Accounts	<u>(772,000)</u>	<u>(523,000)</u>
Accounts Receivable Net	<u>\$ 6,644,000</u>	<u>\$ 4,381,000</u>

**Inventory Valuation**

At September 30, 2011 and 2010, the Company used the gross profit method for determining the value of its inventory. At December 31, 2010, the Company valued inventory at the lower of cost on a first-in-first-out basis or market.

AIM generally purchases inventory only when it has non-cancellable contracts from its customers for orders of its finished goods. Welding generally produces pursuant to customer orders and maintains relatively low inventory levels. AIM occasionally produces finished goods in excess of purchase order quantities in anticipation of future purchase order demand; historically this excess has been used in

AIR INDUSTRIES GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

fulfilling future purchase orders. 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 impairment of value.

**Capitalized Engineering Cost**

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 require 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 estimated length of the contract, or if shorter, 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 progress billings (a reduction of the associated inventory) 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.

**Property and Equipment**

Property and equipment are carried at cost net of accumulated depreciation and amortization. Repair and maintenance charges are expensed as incurred. Property, equipment, and improvements are depreciated using the straight-line method over the estimated useful lives of the assets or the particular improvements. Expenditures for repairs and improvements in excess of \$1,000 that add to the productive capacity or extend the useful life of an asset are capitalized. Upon disposition, the cost and related accumulated depreciation are removed from the accounts and any related gain or loss is reflected in earnings.

**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, 2011 and December 31, 2010.

**Deferred Financing Costs**

Costs incurred with obtaining and executing debt arrangements are capitalized and amortized on the effective interest method over the term of the related debt.

**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 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 advance payments 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

AIR INDUSTRIES GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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. Shipping costs are included in cost of sales.

**Use of Estimates**

In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts in the financial statements and accompanying notes. The more significant management estimates are the useful lives of property and equipment, provisions for inventory obsolescence, accrued expenses and various contingencies. Actual results could differ from those estimates. Changes in facts and circumstances may result in revised estimates, which are recorded in the period in which they become known.

**Credit and Concentration Risks**

There were four customers that represented \$31,775,000 or 81.6 % of the total sales for the nine months ended September 30, 2011 and \$29,844,000 or 80.2 % for the nine months ended September 30, 2010. One customer accounted for 46.3% and 51.1% of total sales for the nine months ended September 30, 2011 and 2010, respectively. Sales to this customer are subject to General Ordering Agreements which extend through 2015. Accounts receivable from this customer at September 30, 2011 and December 31, 2010 were \$1,299,000 or 17.4% and \$934,000 or 20.9% of gross accounts receivable, respectively. The second customer accounted for 18.8% and 16.7% of total sales for the nine months ended September 30, 2011 and 2010, respectively, and \$1,410,000 or 18.9% and \$851,000 or 19.0% of gross accounts receivable at September 30, 2011 and December 31, 2010, respectively. A third customer accounted for 9.1% and 6.6% of total sales for the nine months ended September 30, 2011 and 2010, respectively, and \$1,485,000 or 19.94% and \$564,000 or 12.6% of gross accounts receivable at September 30, 2011 and December 31, 2010, respectively. The fourth customer accounted for 7.4% and 5.8% of total sales for the nine months ended September 30, 2011 and 2010, respectively, and \$1,249,000 or 16.8% and \$295,000 or 6.6% of gross accounts receivable at September 30, 2011 and December 31, 2010, respectively.

During the year, 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.

Substantially all of the workforce at AIM is subject to a union contract with the United Service Workers Union TUJAT Local 355 (the "Union"). The contract expires on December 31, 2011.

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

**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 has adopted 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

AIR INDUSTRIES GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

tax return. The ASC provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition.

**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 securities have been excluded from the calculation as their effect would be anti-dilutive:

	<u>September 30,</u> <u>2011</u>	<u>September 30,</u> <u>2010</u>
Stock Options	291,428	291,460
Warrants	19,865	19,865

**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.

**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 \$291,000 relates to the acquisition of Welding Metallurgy. 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 performs impairment testing for goodwill annually, or more frequently when indicators of impairment exist, using a two-step approach. 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.

The Company has determined that there has been no impairment at September 30, 2011 and December 31, 2010.

**Subsequent Events**

Management has evaluated subsequent events through November 17, 2011, the date at which the financial statements were available to be issued.

AIR INDUSTRIES GROUP, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Note 4. INVENTORY**

At September 30, 2011 and 2010, the Company used the gross profit method for determining the value of its inventory.

The components of inventory at December 31, 2010 consisted of the following:

Raw Materials	\$ 7,558,000
Work In Progress	9,408,000
Finished Goods	6,548,000
Inventory Reserve	(2,071,000)
Total Inventory	<u>\$ 21,443,000</u>

**Note 5. PROPERTY AND EQUIPMENT**

The components of property and equipment consisted of the following:

	<u>September 30,</u> <u>2011</u>	<u>December 31,</u> <u>2010</u>	
	<b>(Unaudited)</b>		
Machinery and Equipment	\$ 3,612,000	\$ 3,483,000	5 - 8 years
Capital Lease Machinery and Equipment	3,877,000	2,695,000	5 - 8 years
Tools and Instruments	3,200,000	3,105,000	1.5 - 7 years
Automotive Equipment	55,000	55,000	5 years
Furniture and Fixtures	216,000	212,000	5 - 8 years
Leasehold Improvements	595,000	595,000	Term of Lease
Computers and Software	158,000	158,000	4-6 years
Deposit on new Machinery	-	192,000	
Total Property and Equipment	<u>11,713,000</u>	<u>10,495,000</u>	
Less: Accumulated Depreciation	<u>(7,700,000)</u>	<u>(6,560,000)</u>	
Property and Equipment, net	<u>\$ 4,013,000</u>	<u>\$ 3,935,000</u>	

Depreciation expense for the nine months ended September 30, 2011 and 2010 were approximately \$1,140,000 and \$1,385,000, respectively.

In May 2011, the Company acquired new machinery in the amount of \$1,182,000. The Company paid \$355,000 in cash and the balance was financed by a new capital lease in the amount of \$827,000.

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**Note 6. INTANGIBLE ASSETS**

The components of the intangibles assets consisted of the following:

	<b>September 30, 2011</b>	<b>December 31, 2010</b>	
	<b>(Unaudited)</b>		
Customer Relationships	\$ 890,000	\$ 890,000	11 to 14 years
Trade Names	770,000	770,000	20 years
Technical Know-how	660,000	660,000	10 years
Professional Certifications	15,000	15,000	.25 to 2 years
Total Intangible Assets	2,335,000	2,335,000	
Less: Accumulated Amortization	(686,000)	(560,000)	
Intangible Assets, net	\$ 1,649,000	\$ 1,775,000	

The expense for the amortization of the intangibles for both the nine months ended September 30, 2011 and 2010 were \$126,000 .

Future amortization of intangibles is as follows :

<u>For the twelve months ending</u>	<u>Amount</u>
September 30, 2012	\$ 168,000
September 30, 2013	168,000
September 30, 2014	168,000
September 30, 2015	168,000
September 30, 2016	168,000
Thereafter	809,000
Total	\$ 1,649,000

**Note 7. SALE AND LEASEBACK TRANSACTION**

On October 24, 2006, the Company consummated a Sale & Leaseback Arrangement, whereby the Company sold the buildings and real property comprising its corporate headquarters in Bay Shore, New York (the "Property") for a purchase price of \$6,200,000. The Company accounted for the transaction under the provisions of FASB ASC 840-40, "Leases – Sale-Leaseback Transactions." The Company realized a gain on the sale of \$1,051,000 of which \$300,000 was recognized during the year ended December 31, 2006. The remaining \$751,000 is being recognized ratably over the remaining term of the twenty year lease at approximately \$38,000 per year. The gain is included in Other Income in the accompanying Consolidated Statement of Operations. The unrecognized portion of the gain in the amount of \$570,000 and \$599,000 as of September 30, 2011 and December 31, 2010, respectively, is classified as Deferred Gain on Sale in the accompanying Consolidated Balance Sheet.

Simultaneous with the closing of the sale of the Property, the Company entered into a 20-year triple-net lease (the "Lease") with the Purchaser for the property. Base annual rent is approximately \$540,000 for the first five years, \$560,000 for the sixth year, and thereafter increases 3% per year. The Lease grants AIM an option to renew the Lease for an additional period of five years. The Company has on deposit with the Purchaser \$127,500 as security for the performance of its obligations under the Lease. In addition, the Company deposited \$393,000 with the landlord as security for the completion of certain repairs and upgrades to the Property. This amount is included in the caption Deferred Finance costs, net, Deposit and

AIR INDUSTRIES GROUP, INC.  
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Other Assets on the accompanying Consolidated Balance Sheet. 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. These costs will be offset against the funds that are deposited with the landlord. The lease also contains customary representations, warranties, obligations, conditions and indemnification provisions and grants the Purchaser customary 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. See Note 11 Commitments and Contingencies.

**Note 8. NOTES PAYABLE AND CAPITAL LEASE OBLIGATIONS**

Notes payable and capital leases obligations consist of the following:

	<b>September 30,</b>	<b>December 31,</b>
	<b><u>2011</u></b>	<b><u>2010</u></b>
	<b>(Unaudited)</b>	
Revolving credit notes payable to PNC Bank N.A. ("PNC") and secured by substantially all assets	\$ 11,799,000	\$ 11,164,000
Term loan, PNC	2,250,000	3,000,000
Capital lease obligations	2,007,000	1,508,000
Notes payable to sellers of acquired businesses	2,061,000	2,354,000
Junior subordinated notes	6,450,000	6,450,000
Subtotal	<u>24,567,000</u>	<u>24,476,000</u>
Less: Current portion of notes and capital obligations	<u>(13,892,000)</u>	<u>(12,940,000)</u>
Notes payable and capital lease obligations, net of current portion	<u>\$ 10,675,000</u>	<u>\$ 11,536,000</u>

**PNC Bank N.A. ("PNC")**

On November 30, 2005, the Company executed a credit facility with PNC (the "Loan Facility"), secured by substantially all of its assets. The Loan Facility provided for maximum borrowings of \$19,000,000 consisting of the following:

- (i) a \$14,000,000 revolving loan
- (ii) a \$3,500,000 term loan and
- (iii) a \$1,500,000 equipment financing loan

On November 30, 2010, the Company executed a renewal and amendment to the Loan Facility with PNC providing for the following:

- (i) a \$16,000,000 revolving loan
- (ii) a \$3,000,000 term loan and
- (iii) included Welding Metallurgy as one of the borrowers

The revolving loan originally bore interest, at the option of the Company, that is based on (i) the higher of (A) PNC's base commercial lending rate as published from time to time ("PNC Rate") plus 0.25% or (B) the Federal Funds rate plus 0.5%, or (ii) the Eurodollar Rate for the Interest Period selected by the Company plus 2.5%. The revolving loan had an interest rate of 5.50% per annum at both September 30, 2011 and December 31, 2010, and an outstanding balance of \$11,799,000 and \$11,164,000, respectively. The revolving loan was payable in full in April 2010 but the maturity date was extended to November 15, 2013 by the renewal and amendment executed on November 30, 2010 as discussed below. The interest rates were amended as part of the Ninth Amendment to the Loan Facility (see discussion below).

AIR INDUSTRIES GROUP, INC.  
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Each day, the Company's cash collections are swept directly by the bank to reduce the revolving loans and we then borrow according to a borrowing base. As such, the Company generally has no cash on hand. Because the revolving loans contain a subjective acceleration clause which could permit PNC to require repayment prior to maturity, the loans are classified with the current portion of notes and capital lease obligations.

The new term loan in the amount of \$3,000,000 matures in December 2013 and bears interest, at the option of the Company equal to (a) the greater of (i) the sum of the PNC Rate plus 6.5% and (ii) 11.5%, with respect to Domestic Rate Loans or (b) the greater of (i) the sum of the Eurodollar Rate plus 8.5% and (ii) 10.5%, with respect to Eurodollar Rate Loans. Repayment under the term loan shall consist of 36 consecutive monthly principal installments, the first 35 of which will be in the amount of \$83,330 commencing on the first business day of January 2011, with the 36<sup>th</sup> and final payment of any unpaid balance of principal and interest payable on the first business day of December 2013. Additionally, there is a mandatory prepayment of equal to 50% of Excess Cash Flow (as defined) for each fiscal year commencing with the fiscal year 2011, payable upon the delivery of the financial statements to PNC for such fiscal period, but no later than 90 days after the end of the fiscal year. The proceeds of this term loan were used to repay the entire balance due Steel City Capital Funding LLC (see below).

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 amount equal to the net proceeds of such sale.

The terms of the Loan Facility require that, among other things, the Company maintain certain financial ratios and levels of working capital. As of September 30, 2011 and December 31, 2010, the Company was in compliance with all terms of its credit facility with PNC bank.

The Loan Facility also is secured by all assets of the Company and 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.

The Company executed Amendments Eleven to Fourteen to the Loan Facility in 2010. These Amendments included the following:

- Waived prior defaults
- Amended the financial ratios
- Amended the formula to determine the amounts of revolving advances permitted to be borrowed under the Loan Facility.
- Reduced the availability reserve so that the excess availability created by the reduction will be utilized to payoff in full the term loan and equipment loans.
- Amended the revolving interest rate to (a) the sum of PNC Rate plus 2.25% or (b) the greater of (i) the sum of the Eurodollar rate plus 3.5% and (ii) 5.5%.
- The Company paid amendment fees ranging from \$10,000 to \$25,000.

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Effective November 30, 2010, the Fifteenth Amendment to the Loan Facility was signed. The terms of the Fifteenth Amendment included the following:

- Waived prior defaults
- Extended the due date of the Loan Facility to November 15, 2013
- Amend the financial ratios
- Increase the inventory sub-limit to \$11,250,000
- Increase the Maximum Revolving advance to \$16,000,000
- Include Welding Metallurgy as a borrower under the revolving portion of the Loan Facility
- Include a term loan in the amount of \$3,000,000 (discussed above)
- The Company paid an amendment fee of \$95,000.

**Steel City Capital Funding LLC ("SCCF")**

In connection with the Welding acquisition, SCCF provided a Term Loan (the "SCCF Loan Agreement") of \$4,500,000, which was originally payable on August 24, 2010. Borrowings under the SCCF Loan Agreement originally bore interest, payable monthly, generally at a rate of 6% over the base commercial lending rate of PNC as publicly announced to be in effect from time to time. The interest rate on the outstanding indebtedness under the SCCF Loan Agreement was approximately 10.75% at September 30, 2010. At both September 30, 2011 and December 31, 2010, there was no balance owed on the SCCF Loan Agreement.

The Company executed Amendments Five through Eight to the SCCF Loan Agreement in 2010. These Amendments included the following:

- Waived prior defaults
- Amended the financial ratios and now includes all entities (except Sigma) in the calculations
- Amended the interest rate to (a) the sum of (i) the greater of (1) PNC Rate or (2) 4.75% plus (ii) 6% for domestic loans and (b) the sum of (i) the greater of (1) the Eurodollar Rate or (2) 2.25% plus (ii) 8.5% for Eurodollar Rate loans.
- Prohibited cash payments to vendors of Sigma in excess of \$150,000 in the aggregate during each of (i) the period September 1, 2009 through December 31, 2009, and (ii) each calendar year commencing January 1, 2010.
- The Company paid amendment fees of ranging from \$10,000 to \$15,000.

On November 30, 2010, the Company entered into a renewal and amendment of the credit facility with PNC. Under the terms of that amendment, SCCF was paid in full. This payment was funded by the proceeds of the \$3,000,000 term loan with PNC as well as with proceeds from the revolving line of credit. The Company paid a fee of \$10,000 to SCCF to terminate the SCCF Loan Agreement.

At September 30, 2011, future minimum principal payments of the new PNC term loan are as follows:

<u>For the twelve months ending</u>	<u>Amount</u>
September 30, 2012	\$ 1,000,000
September 30, 2013	1,000,000
September 30, 2014	<u>250,000</u>
PNC Term Loan Payable	2,250,000
Less: Current portion	<u>(1,000,000)</u>
Long-term portion	<u><u>\$ 1,250,000</u></u>

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Interest expense related to these credit facilities amounted to approximately \$695,000 and \$762,000 for the nine months ended September 30, 2011 and 2010, respectively.

**Capital Leases Payable – Equipment**

The Company is committed under several capital leases for manufacturing and computer equipment. All leases had bargain purchase options exercisable at the termination of each lease. Capital lease obligations totaled \$2,007,000 and \$1,508,000 as of September 30, 2011 and December 31, 2010, respectively, with various interest rates ranging from 7.7% to 9.5%.

As of September 30, 2011, the aggregate future minimum lease payments, including imputed interest, with remaining terms of greater than one year are as follows:

<u>For the twelve months ending</u>	<u>Amount</u>
September 30, 2012	\$ 711,000
September 30, 2013	711,000
September 30, 2014	550,000
September 30, 2015	207,000
September 30, 2016	155,000
Total future minimum lease payments	<u>2,334,000</u>
Less: imputed interest	(327,000)
Less: current portion	<u>(562,000)</u>
Total Long Term Portion	<u><u>\$ 1,445,000</u></u>

In May 2011, the Company entered into a five-year capital lease for new machinery. The purchase price of the machinery was approximately \$1,182,000. The Company paid approximately \$355,000 in cash and entered into a new capital lease in the amount of \$827,000. Monthly payments on the new lease began in July 2011 in the amount of \$17,267 through June 2016. The interest rate on this lease is 9.2%.

**Notes Payable - Sellers**

As of September 30, 2011 and December 31, 2010, the balances owed to the sellers by acquisition are:

	<b>September 30.</b>	<b>Decemeber 31,</b>
	<b><u>2011</u></b>	<b><u>2010</u></b>
	<b>(Unaudited)</b>	
AIM	\$ -	\$ 48,000
Welding	2,061,000	2,306,000
Subtotal	<u>2,061,000</u>	<u>2,354,000</u>
Less: Current Portion	(531,000)	(378,000)
Total long-term portion	<u><u>\$ 1,530,000</u></u>	<u><u>\$ 1,976,000</u></u>

AIR INDUSTRIES GROUP, INC.  
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**AIM**

On November 30, 2005, in connection with the acquisition of AIM, the Company issued notes payable for an aggregate of \$1,627,000 to three former AIM shareholders, two of whom have remained as part of the Company's senior management and are also stockholders of the Company.

The remaining principal balance at December 31, 2010 of \$48,000 along with accrued interest in the amount of \$500 was paid on January 4, 2011 and there is no further obligation under this note.

**Welding**

In connection with the acquisition of Welding, the Company incurred a note payable ("Old Note") to the former stockholders of Welding.

In August 2008, the Company and the former stockholders reached an agreement restructuring the Company's obligation under this note by executing an Amended and Restated Subordinated Promissory Note, the "New Note". The principal balance of this New Note was \$2,050,000 (consisting of \$2,000,000 principal amount of the promissory note dated August 25, 2007, plus an unpaid working capital adjustment in the amount of \$50,000) bearing interest at 7% per annum. Payments due under the New Note were: \$25,000 on each of October 31, 2008 and December 31, 2008, an additional \$50,000 on March 31, 2009, followed by 19 equal consecutive quarterly installments of \$100,000, commencing on June 30, 2009 and continuing through December 31, 2013, payable on the last business day of each March, June, September and December, commencing June 30, 2009 and continuing through and including December 31, 2013, with one final payment of \$50,000 on March 31, 2014, plus accrued interest thereon at the rate of 7% per annum from August 28, 2008..

The Company made the payments due on October 31, 2008 and December 31, 2008, leaving a principal balance due of \$2,044,000 due at December 31, 2008. The balance owed at December 31, 2009 amounted to \$2,044,000.

Our obligation under the Old Note and New Note were subordinate to our indebtedness to PNC and SCCF. In March 2009, the Company received a notice from SCCF, exercising their right to block payments under the New Note. Accordingly, the payment due on March 31, 2009 was not made. In April 2009, the Company received a notice from the holders of the New Note that an event of default had occurred, and accordingly, interest under the New Note would now accrue at 11% per annum. Per the terms of the fourth amendment to the SCCF Loan, all payments have been blocked until April 30, 2010. As a result of this, the Company had entered into a modification agreement with the holder of the New Note to amend the payment terms. The Company paid a fee to the holder of \$50,000 to modify the loan agreement to block the payments until April 30, 2010 and accrue interest at a rate of 9% per annum.

On October 1, 2010, the Company entered into letter agreement with the former stockholders of Welding. It was agreed that all interest that had been accrued and not yet paid would be capitalized into the principal balance of the note, making the new balance of the note \$2,397,967. Payments on the note began on October 1, 2010. It was further agreed that payments would be made according to the following schedule: equal monthly installments of \$40,000 on the first business day of each month until December 31, 2011, followed by equal monthly installments of \$60,000 on the first business day of each month commencing on January 1, 2012 and continuing until the entire principal amount of the obligation is paid in full, which is estimated to be in January 2015. Interest shall accrue at the rate of 7% per annum, and each payment will first apply to interest and then principal.

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As of September 30, 2011, the future minimum payments for the note payable to the former stockholders of Welding Metallurgy are as follows:

<u>For the twelve months ending</u>	Amount
September 30, 2012	\$ 531,000
September 30, 2013	633,000
September 30, 2014	679,000
September 30, 2015	218,000
Former WMI Shareholder Notes Payable	<u>2,061,000</u>
Less: Current portion	(531,000)
Long-term portion	<u><u>\$ 1,530,000</u></u>

Interest expense related to notes payable to the former stockholder was \$114,000 and \$155,000 for the nine months ended September 30, 2011 and 2010, respectively.

### Junior Subordinated Notes

In June 2008, the Company sold in a private placement to accredited investors, \$2,950,000 of principal in junior subordinated notes (the "Old Notes"), together with 983,324 shares of our common stock, for total cash consideration of \$2,950,000. The Old Notes bore interest at rates ranging up to 36% per annum and were originally payable on May 31, 2010, or earlier upon completion of one or a series of financings resulting in aggregate gross proceeds of at least \$10 million.

In September 2008 and October 2008, the Company sold in a private placement to accredited investors an additional \$2,595,000 of principal in junior subordinated notes, (the "New Notes") together with 207,600 shares of Series B Preferred, for a total purchase price of \$2,595,000. The New Notes, which were originally payable on May 31, 2010, or earlier upon completion of one or a series of financings resulting in aggregate gross proceeds of at least \$10 million, bear interest at the rate of 1% per month (or 12% per annum).

The terms of the New Notes and the Old Notes are identical, except that the rate of interest on the Old Notes was adjusted to 1% per month (12% per year) upon the issuance of the New Notes.

In October 2008, holders of the Old Notes exchanged their Old Notes for an equal principal amount of New Notes and also received 236,000 shares of Series B Preferred.

The Company recorded discounts of \$3,175,000 for the issuances of Series B Preferred and common stock in 2008.

In the first quarter ended March 31, 2009, the Company sold in a private placement to accredited investors, an additional \$445,000 of principal in New Notes together with 35,600 shares of our Series B Preferred for a total purchase price of \$445,000. For financial reporting purposes, the Company recorded a discount of \$239,000 to reflect the value of the Series B Preferred issued.

The New Notes are subordinated to the Company's senior indebtedness.

In connection with the offering of the Company's junior subordinated notes and Series B Preferred which commenced in September 2008 (see Note 9 Stockholders' Equity), the Company issued to Taglich Brothers, Inc. ("Taglich"), as placement agent, a junior subordinated note in the principal amount of \$510,000 and 39,640 shares of Series B Preferred. The terms of the note issued to Taglich are identical to the New Notes. In addition, the Company issued a warrant to purchase 137,138 shares of its Series B Preferred to Taglich (see Note 9 Stockholders' Equity). For financial reporting purposes, the Company

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recorded a discount of \$1,306,000 to reflect the commission, the value of the warrants issued and the value of the Series B Preferred issued. In connection with the amounts raised in 2009, the Company issued Taglich 3,560 shares of Preferred Series B and will issue to Taglich a note on the same terms as the junior subordinated note referred to above for commission of \$44,500. For financial reporting purposes, the Company recorded a discount of \$68,000 to reflect the commission, the value of the warrants issued and the value of the Series B Preferred issued.

In May 2010, the maturity dates of the New Notes were extended by the holders to September 30, 2010. On October 1, 2010, a payment in the amount of \$50,000 was made to one of the note holders in full satisfaction of a note. During November 2010, the maturity dates of the New Notes were extended to November 18, 2013.

The balance owed at both September 30, 2011 and December 31, 2010 amounted to \$6,450,000.

Amortization of debt discount amounted to \$0 and \$1,323,000 for the nine months ended September 30, 2011 and 2010, respectively. Interest expense amounted to \$583,000 and \$594,000 for the nine months ended September 30, 2011 and 2010, respectively.

#### **Note 9. STOCKHOLDERS' EQUITY**

##### **Authorized Shares**

At a Special Meeting of Stockholders on April 3, 2008, the stockholders approved an amendment to the certificate of incorporation increasing the number of shares of Common Stock the Company is authorized to issue to 250,000,000.

At a Special Meeting of Stockholders on July 29, 2010, the stockholders approved an amendment to the certificate of incorporation to effect a one-for-four hundred (1-for-400) reverse split of our common stock, conversion of our Series B Convertible Stock into 3,400,000 shares of common stock and reduce the number of authorized shares of common stock from 250,000,000 to 20,000,000.

##### **Common Stock Issuances**

There were no issuances of common stock during the nine months ended September 30, 2011 and 2010.

On July 29, 2010 at a Special Meeting of Stockholders, the stockholders approved an amendment to the certificate of designation for the Series B Preferred Stock providing for the automatic conversion of the outstanding shares of Series B Preferred Stock, together with any dividends that are or may become payable prior to the conversion date, into 3,400,000 shares of Common Stock.

##### **Series B Convertible Preferred Stock**

The Company established, designated and fixed the terms, preferences, limitations and relative rights of four million (4,000,000) shares of the authorized and unissued preferred stock of the Company as Series B Preferred. Rights included the following:

1. Holders of the shares of Series B Preferred were entitled to receive 7% cumulative dividend of the original Series B Preferred issue price.
2. Dividends accrued and were payable quarterly on January 2, April 1, July 1 and October 1 of each year.
3. The Company could elect to deliver additional shares of Series B Preferred in lieu of cash payments.
4. The liquidation value was an amount equal to the greater of \$10 per share or such amount per share as would have been payable had each such share been converted into Common Stock immediately prior to a liquidation event (as defined).

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5. Each holder of outstanding shares of Series B Preferred was entitled to the number of votes equal to the number of whole shares of Common Stock into which the shares of Series B Preferred held by such holder are then convertible, at each meeting of stockholders of the Corporation (or by written action of stockholders in lieu of meeting) with respect to all matters presented to the stockholders of the Corporation for their action or consideration. The holders of Series B Preferred will generally vote together with the holders of Common Stock as a single class.
6. Each share of Series B Preferred was convertible, at the option of the holder thereof, at any time and from time to time, and without the payment of additional consideration by the holder thereof, into such number of fully paid and no assessable shares of Common Stock as is determined by dividing (i) the Series B Original Issue Price (\$10) by (ii) the Series B Conversion Price (as defined) in effect at the time of conversion.

Issuances and conversions of Series B Preferred for the nine ended September 30, 2010 were as follows:

For the nine months ended September 30, 2010, the Company issued 839,108 shares of Series B Preferred as dividends for the quarter ended December 31, 2009 and 1,004,926 shares of Series B Preferred as dividends for the quarter ended March 31, 2010 in lieu of cash payments. Dividends amounted to \$1,436,000 for the nine months ended September 30, 2010.

On January 5, 2010, the Company issued 137,138 shares of Series B Preferred for the exercise of 137,138 warrants. See Note 14 Related Party Transactions.

On July 29, 2010, at a Special Meeting of Stockholders, the stockholders approved an amendment to the certificate of designation for the Series B Preferred Stock providing for the automatic conversion of the outstanding shares of Series B Preferred Stock, together with any dividends that are or may become payable prior to the conversion date, into 3,400,000 shares of Common Stock. This represents approximately 95% of the outstanding shares of Common Stock after giving effect to the one-for-four hundred (1-for-400) reverse stock split.

**Note 10. EMPLOYEE BENEFITS PLANS**

The Company employs both union and non-union employees and maintains several benefit plans.

Medical benefits for union employees are provided through a policy with Insperity (f/k/a Administaff), the costs of which are substantially borne by the Company. In addition, the Company is obligated to contribute to a welfare fund and a security fund for the benefit of each union employee of between \$50 and \$250 per month.

All other Company employees including those of Welding are covered under a co-employment agreement with Insperity.

The Company has two defined contribution plans under Section 401(k) of the Internal Revenue Code (the "Plans"). Pursuant to the Plans, qualified employees may contribute a percentage of their pretax eligible compensation to the Plan. The Company does not match any contributions that employees may make to either Plan.

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**Note 11. COMMITMENTS AND CONTINGENCIES**

**Real Estate Leases**

The Company leases its facilities under various operating lease agreements, which contain renewal options and escalation provisions. Rent expense was \$1,057,000 and \$950,000 for the nine months ended September 30, 2011 and 2010, respectively. The Company is responsible for paying all operating costs under the term of the lease. As of September 30, 2011, the aggregate future minimum lease payments are as follows:

<u>For the twelve months ending</u>	<u>Plant Avenue</u>	<u>Fifth Avenue</u>	<u>Total Rents</u>
	<u>Annual Rent</u>	<u>Annual Rent</u>	
September 30, 2012	\$ 575,000	\$ 621,000	\$ 1,196,000
September 30, 2013	592,000	640,000	1,232,000
September 30, 2014	610,000	659,000	1,269,000
September 30, 2015	628,000	678,000	1,306,000
September 30, 2016	158,000	699,000	857,000
Thereafter	-	8,253,000	8,253,000
<b>Total Rents</b>	<b>\$ 2,563,000</b>	<b>\$ 11,550,000</b>	<b>\$ 14,113,000</b>

The leases provide for scheduled increases in base rent. Rent expense is charged to operations using the straight-line method over the term of the lease which results in rent expense being charged to operations at inception of the lease in excess of required lease payments. This excess is shown as deferred rent in the accompanying balance sheet.

Sigma was located in the Plant Avenue facility and following discontinuing operations, a portion of the facility is vacant. The Company recorded a charge for \$579,000 at December 31, 2009 representing the estimated discounted future cost of part of the Plant Avenue facility.

As of September 30, 2011, the estimated discounted future cost will be charged to expense as follows:

<u>For the twelve months ending</u>	<u>Amount</u>
September 1, 2012	\$ 88,000
September 1, 2013	75,000
September 1, 2014	62,000
September 1, 2015	48,000
September 1, 2016	10,000
Total future minimum lease payments	283,000
Less: current portion	(88,000)
Total Long-Term Portion	<u>\$195,000</u>

On July 1, 2010, the Company entered into a sub-lease with a third party to rent a portion of the vacant space at the Plant Avenue facility. Under the terms of the sub-lease, the sub-tenant would occupy approximately 17,787 square feet for the months of July 2010 through October 2010. Beginning in November 2010, the sub-tenant would occupy approximately 27,787 square feet. The space is being sub-leased for \$3.00 per square foot, with a discount in the first month of 50%. The sub-lease is a month-to-month lease and can be terminated by either party with 90 days written notice.

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**Litigation**

Sigma Metals, Inc: Several former vendors to Sigma had commenced legal action against Sigma seeking to recover amounts owed to them. All of these have been settled except for one that is still deciding to commence litigation seeking the recovery of approximately \$71,000. Settlement discussions have commenced with this vendor but there is not yet a definitive resolution.

**Employment Contracts**

In September 2005, the Company entered into employment agreements (the "Agreements") with two senior executives that became effective November 30, 2005. The Agreements are for an initial period of five years until September 2010 and, absent notice of non-renewal given ninety (90) days prior thereto, are automatically extended for successive three (3) one year periods unless terminated. The Board, at its sole discretion, determines whether a bonus is issued, provided that in the case of two executives, the amount of the bonus shall be predicated on their performance and the achievement by the Company of its operating targets set forth in its annual budget, and in the case of these two executives, provided further, in no event shall the amount of their bonuses be less than 50% of their salary at that time.

On June 21, 2010, notice of non-renewal was given to the executive officers and the Agreements terminated in accordance with their terms on September 25, 2010.

On July 29, 2010, the Company granted five-year options to each senior executive to purchase 51,716 shares of Common Stock at a price of \$4.50 per share. These options vested immediately upon issuance.

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**Note 12. INCOME TAXES**

The provision for income taxes at September 30, 2011 was comprised of federal alternative minimum tax of \$57,000.

The components of net deferred tax assets as of September 30, 2011 and December 31, 2010, are set forth below:

	<b>September 30,</b>	<b>December 31,</b>
	<b><u>2011</u></b>	<b><u>2010</u></b>
	<b>(Unaudited)</b>	
Deferred tax assets:		
Net operating loss carry forwards	\$ 171,000	\$ 1,322,000
Capital loss carry forwards	1,088,000	1,088,000
Bad debts	309,000	291,000
Stock based compensation - options and restricted stock	454,000	413,000
Capitalized engineering costs	31,000	-
Goodwill and Intangibles	-	1,511,000
Account payable, accrued expenses and reserves	9,000	18,000
Deferred rent	377,000	320,000
Deferred gain on sale of real estate	228,000	240,000
Total deferred tax assets before valuation allowance	<u>2,667,000</u>	<u>5,203,000</u>
Valuation allowance	<u>(1,244,000)</u>	<u>(3,366,000)</u>
Total deferred tax assets after valuation allowance	<u>1,423,000</u>	<u>1,837,000</u>
Deferred tax liabilities:		
Property and equipment	(118,000)	(365,000)
Capitalized engineering costs	-	(122,000)
Amortization - Welding Transaction	(659,000)	(777,000)
Inventory - 263A adjustment	(646,000)	(573,000)
Total Deferred Tax Liability	<u>(1,423,000)</u>	<u>(1,837,000)</u>
Net deferred tax asset	<u>\$ -</u>	<u>\$ -</u>

Realization of deferred tax assets is dependent on future earnings. Due to the uncertainty of realization of the net deferred tax assets, the Company has provided a valuation allowance. In assessing the realizability of it, management considers whether it is more likely than not that some or perhaps all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making the assessment. The valuation allowance at September 30, 2011 and December 31, 2010 amounted to \$1,244,000 and \$3,366,000, respectively.

The Company has net operating losses totaling \$428,000 which will expire in fiscal 2028, 2029 and 2030. The Company also has a capital loss carry forward from the sale of Sigma of \$2,719,000 which will expire in fiscal 2015.

At September 30, 2011 and 2010, the Company had no material unrecognized tax benefits and no adjustments to liabilities or operations were required. The Company does not expect that its unrecognized

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tax benefits will materially increase within the next twelve months. The Company recognizes interest and penalties related to uncertain tax positions in general and administrative expense. As of September 30, 2011 and 2010, the Company has not recorded any provisions for accrued interest and penalties related to uncertain tax positions.

In certain cases, the Company's uncertain tax positions are related to tax years that remain subject to examination by the relevant tax authorities. The Company files U.S. and state income tax returns in jurisdictions with varying statutes of limitations. The 2007 through 2010 tax years generally remain subject to examination by federal and state tax authorities.

**Note 13. STOCK OPTIONS AND WARRANTS**

**Stock-Based Compensation**

During 2005, the Company's Board of Directors approved a stock option plan and reserved 25,000 shares of its Common Stock for issuance under the plan. The stock option plan permits the Company to grant non-qualified and incentive stock options to employees, directors, and consultants. The fair value of each option grant is estimated on the date of grant using the Black Scholes option pricing model

Certain of the Company's stock options contain features which include variability in grant prices. A portion of the currently issued stock options will be priced based on average trading prices of the Company's Common Stock at the end of a given future period. Due to this variable feature, these stock options are not deemed to be granted for purposes of applying FASB ASC 718 and accordingly, their fair value will be calculated and expensed in future periods.

During the quarter ended September 30, 2011, the Board of Directors approved the issuance of 15,000 options to the non-employee members of the Company's Board of Directors. These options vested immediately.

At a Special Meeting of Stockholders held on July 29, 2010, the stockholders approved the 2010 Equity Incentive Plan and the issuance of 275,788 options under the plan to various key employees of the Company. This plan had previously been unanimously adopted by the Board of Directors.

The Company recorded expenses of \$101,000 and \$338,000 in its consolidated statement of operations for the nine months ended September 30, 2011 and 2010, respectively, and is included as a component of general and administrative expense.

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A summary of the status of the Company's stock options as of September 30, 2011 and 2010, and changes during the nine months then ended is presented below.

**For the nine months ended September 30, 2011**

	<b>Options</b>	<b>Wtd. Avg. Exercise Price</b>
Balance, December 31, 2010	291,428	\$ 10.68
Granted during the period	15,000	2.95
Exercised during the period	-	-
Terminated/Expired during the period	-	-
Balance, September 30, 2011	<u>306,428</u>	<u>\$ 10.30</u>

**For the nine months ended September 30, 2010**

	<b>Options</b>	<b>Wtd. Avg. Exercise Price</b>
Balance, December 31, 2009	15,922	\$ 119.35
Granted during the period	275,788	4.50
Exercised during the period	-	-
Terminated/Expired during the period	(250)	104.08
Balance, September 30, 2010	<u>291,460</u>	<u>\$ 10.69</u>

Exercisable at September 30, 2011	<u>304,132</u>	<u>\$ 9.83</u>
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The following table summarizes information about stock options at September 30, 2011:

Range of Exercise Prices	<b>Remaining Number Outstanding</b>	<b>Wtd. Avg. Life</b>	<b>Wtd. Avg. Exercise Price</b>
\$0.00 - 5.00	290,788	4 years	\$ 4.42
\$5.01 - 90.00	1,350	6 years	\$ 88.00
\$90.01 - 100.00	5,905	3 years	\$ 92.19
\$100.01 - 110.00	833	3 years	\$ 108.00
\$110.01 - 170.00	3,602	2 years	\$ 111.86
\$170.01 - 200.00	3,950	3 years	\$ 181.00
	<u>306,428</u>	4 years	<u>\$ 10.30</u>

As of September 30, 2011, there was \$165,000 of unrecognized compensation cost related to non-vested stock option awards, which is to be recognized over the remaining weighted average vesting period of four years.

The aggregate intrinsic value at September 30, 2011 was \$0. The aggregate intrinsic value was calculated based on the positive difference between the closing market price of the Company's Common Stock and the exercise price of the underlying options.

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**Warrants**

The following tables summarize the Company's outstanding warrants as of September 30, 2011 and 2010 and changes during the nine months then ended:

**For the nine months ended September 30, 2011**

	<b>Warrants</b>	<b>Wtd. Avg. Exercise Price</b>
Balance, December 31, 2010	19,865	\$ 99.26
Granted during the period	-	-
Exercised during the period	-	-
Terminated/Expired during the period	-	-
Balance, September 30, 2011	<u>19,865</u>	<u>\$ 99.26</u>

**For the nine months ended September 30, 2010**

	<b>Warrants</b>	<b>Wtd. Avg. Exercise Price</b>
Balance, December 31, 2009	20,208	\$ 100.00
Granted during the period	-	-
Exercised during the period	(343)	110.64
Terminated/Expired during the period	-	-
Balance, September 30, 2010	<u>19,865</u>	<u>\$ 99.26</u>
Exercisable at September 30, 2011	<u>19,865</u>	<u>\$ 99.26</u>

The following table summarizes information about warrants at September 30, 2011:

Range of Exercise Prices	<b>Warrants</b>	<b>Wtd. Avg. Life</b>	<b>Wtd. Avg. Exercise Price</b>
\$ 0.00 - 5.00	250	2 years	\$ 43.60
\$ 5.01 - 90.00	1,704	1 year	\$ 76.00
\$ 90.01 - 100.00	10,347	1 year	\$ 88.00
\$ 100.01 - 110.00	7,564	1 year	\$ 121.74
	<u>19,865</u>	1 year	\$ 99.26

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**Note 14. RELATED PARTY TRANSACTIONS**

On December 31, 2008, the Company issued a warrant to purchase 137,138 shares of its Series B Preferred to Taglich for nominal consideration. The Company believes that the terms of the warrant are not less favorable than could have been obtained from an unaffiliated third party. On January 5, 2010, Taglich exercised this warrant and were issued 137,138 shares of Series B Preferred. See Note 9 Stockholders' Equity.

In connection with the offering of the Company's junior subordinated notes and Series B Preferred raised in 2009, the Company issued Taglich 3,560 shares of Preferred Series B and will pay Taglich a commission of \$44,500. See Note 8 Notes Payable and Capital Lease Obligation. In addition, the Company granted Taglich the right to designate a total of three nominees for election to our Board of Directors,

**Note 15. DISCONTINUED OPERATIONS**

During the quarter ended September 30, 2008, the Company's Board of Directors decided to discontinue the operations at Sigma. Operations were discontinued on October 31, 2008. On December 30, 2010, the Company's holdings in Sigma were sold. See Note 2 Disposition. Accordingly, Sigma's results of operations have been reported as discontinued operations for nine months ended September 30, 2010.

	<b>September 30,</b> <b><u>2010</u></b>
Net Sales	\$ -
Cost of Sales	-
Gross loss	-
Operating costs and expenses	<u>23,000</u>
Loss from operations	(23,000)
Interest and financing costs	(7,000)
Other Income	<u>425,000</u>
Income	<u><u>\$ 395,000</u></u>

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**Note 16. SEGMENT REPORTING**

In accordance with FASB ASC 280, "Segment Reporting", 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 is operating in two segments. As discussed above, Sigma was discontinued in October 2008. Financial information about the Company's operating segments for the nine months ended September 30, 2011 and 2010 are as follows:

	<u><b>Nine Months Ended September 30,</b></u>	<u><b>2011</b></u>	<u><b>2010</b></u>
<b><i>Air Industries Machining</i></b>			
Net Sales	\$ 31,063,000	\$ 30,324,000	
Gross Profit	5,649,000	4,983,000	
Pre Tax Income	2,588,000	1,161,000	
Assets	28,677,000	29,171,000	
<b><i>Sigma Metals</i></b>			
Income From Discontinued Operations	-	395,000	
Assets Held for Sale	-	825,000	
<b><i>Welding Metallurgy</i></b>			
Net Sales	7,915,000	6,354,000	
Gross Profit	2,217,000	1,779,000	
Pre Tax Income	1,022,000	1,092,000	
Assets	8,491,000	7,228,000	
<b><i>Corporate</i></b>			
Net Sales	-	-	
Gross Profit	-	-	
Pre Tax Loss	(1,991,000)	(3,962,000)	
Assets	8,840,000	9,796,000	
<b><i>Consolidated</i></b>			
Net Sales	38,978,000	36,678,000	
Gross Profit	7,866,000	6,762,000	
Income from Discontinued Ops	-	395,000	
Pre Tax Income (Loss)	1,619,000	(1,709,000)	
Provision for Taxes	57,000	-	
Net Income (Loss)	1,562,000	(1,314,000)	
Elimination of Assets	(8,326,000)	(9,506,000)	
Assets	37,682,000	37,514,000	