

SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

Form 10-QSB

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended September 30, 2006

Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 000-29245

GALES INDUSTRIES INCORPORATED  
(Exact name of small business as specified in its charter)

Delaware

20-4458244

(State or other jurisdiction of incorporation or organization)

(IRS Employer Identification Number)

1479 Clinton Avenue, Bay Shore, New York 11706  
(Address of principal executive offices)

(631) 968-5000  
(Issuer's telephone number, including area code)

Indicate by check mark whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 57,269,301 shares of Common Stock, \$.001 per share, as of October 30, 2006.

Transitional Small Business Disclosure Format (check one): Yes  No

GALES INDUSTRIES INCORPORATED

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Item 1:

Gales Industries Incorporated  
Condensed Consolidated Balance Sheet

|   | September<br>30, 2006 | December 31,<br>2005 |
|---|-----------------------|----------------------|
|   | -----<br>(Unaudited)  | -----<br>(Audited)   |
| <b>ASSETS</b>   |                       |                      |
| Current Assets  |                       |                      |
| Cash and Cash Equivalents   | \$ 295,070            | \$ 1,058,416         |
| Accounts Receivable, Net of Allowance for Doubtful Accounts<br>of \$45,000 for September 30, 2006 and December 31, 2005<br>respectively   | 3,199,204             | 2,623,612            |
| Inventory   | 13,584,677            | 12,603,810           |
| Prepaid Expenses and Other Current Assets   | 71,320                | 210,124              |
| Deposits  | 147,801               | 65,595               |
|   | -----                 | -----                |
| Total Current Assets  | 17,298,072            | 16,561,557           |
| Property, Plant, and Equipment, net   | 7,518,923             | 7,716,469            |
| Cash Surrender Value - Officer's Life   | 35,373                | 66,216               |
| Deferred Financing Costs  | 399,802               | 486,207              |
| Other Assets  | 41,222                | 41,306               |
| Goodwill  | 1,265,963             | 1,265,963            |
|   | -----                 | -----                |
| <b>TOTAL ASSETS</b>   | <b>\$ 26,559,355</b>  | <b>\$ 26,137,718</b> |
|   | =====                 | =====                |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                       |                      |
| Current liabilities   |                       |                      |
| Accounts Payable and Accrued Expenses   | \$ 5,348,835          | \$ 5,294,629         |
| Advance Payment - Customers   | 188,199               | 188,199              |
| Notes Payable and Revolver - Current Portion  | 6,911,033             | 6,322,665            |
| Notes Payable - Sellers - Current Portion   | 96,200                | 192,400              |
| Capital Lease Obligations - Current Portion   | 372,215               | 359,197              |
| Due to Sellers  | 74,310                | 91,232               |
|   | -----                 | -----                |
| Total current liabilities   | 12,990,792            | 12,448,322           |
| Long term liabilities   |                       |                      |
| Notes Payable - Net of Current Portion  | 3,562,863             | 3,648,131            |
| Notes Payable - Sellers - Net of Current Portion  | 1,386,762             | 1,434,862            |
| Capital Lease Obligations - Net of Current Portion  | 539,517               | 820,375              |
| Deferred Tax Liability  | 676,394               | 676,394              |
|   | -----                 | -----                |
| Total liabilities   | 19,156,328            | 19,028,084           |
|   | -----                 | -----                |
| Commitments and contingencies   |                       |                      |
| Stockholders' Equity  |                       |                      |
| Series A Convertible Preferred - \$.001 Par value, 8,003,716<br>Shares Authorized; No Shares Outstanding September<br>30, 2006 and 900 Shares issued and outstanding December<br>31, 2005                     |                       | 1                    |
| Common Stock - \$.001 Par value, 120,055,746 Shares<br>Authorized; 57,269,301 Shares issued and outstanding as of<br>September 30, 2006 and 14,723,421 Shares Issued and<br>Outstanding for December 31, 2005 | 57,269                | 14,723               |
| Additional Paid-In Capital  | 8,311,685             | 7,844,614            |
| Accumulated Deficit   | (965,927)             | (749,704)            |
|   | -----                 | -----                |
| Total Stockholders' Equity  | 7,403,027             | 7,109,634            |
|   | -----                 | -----                |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>   | <b>\$ 26,559,355</b>  | <b>\$ 26,137,718</b> |
|   | =====                 | =====                |

See notes to condensed consolidated financial statements

Gales Industries Incorporated (1)(2)  
Condensed Consolidated Statement of Operations  
(Unaudited)

|   | Three months ended<br>September 30 |                     | Nine months ended<br>September 30 |                     |
|---|------------------------------------|---------------------|-----------------------------------|---------------------|
|   | 2006                               | Predecessor<br>2005 | 2006                              | Predecessor<br>2005 |
| Net sales                                       | \$ 7,883,485                       | \$ 7,773,187        | \$ 26,001,922                     | \$ 21,851,532       |
| Cost of sales                                   | 6,362,076                          | 6,776,665           | 21,214,968                        | 19,050,166          |
| Gross profit                                    | 1,521,409                          | 996,522             | 4,786,954                         | 2,801,366           |
| Operating costs and expenses:                   |                                    |                     |                                   |                     |
| Selling and marketing                           | 175,515                            | 74,856              | 473,760                           | 244,125             |
| General and administrative                      | 1,108,651                          | 545,499             | 2,982,584                         | 1,287,727           |
| Income from operations                          | 237,243                            | 376,167             | 1,330,610                         | 1,269,514           |
| Interest and financing costs                    | (290,853)                          | (164,271)           | (978,029)                         | (411,493)           |
| Gain on sale of life insurance policy           | --                                 | --                  | 53,047                            | --                  |
| Other Income                                    | --                                 | 152                 | 803                               | 152                 |
| Income (loss) before income taxes               | (53,610)                           | 212,048             | 406,431                           | 858,173             |
| Benefit (provision) for income taxes (2)        | 21,455                             | --                  | (162,654)                         | --                  |
| Net income(loss)                                | (32,155)                           | \$ 212,048<br>===== | 243,777                           | \$ 858,173<br>===== |
| Less: Dividend for preferred stockholders       | (100,000)                          |                     | (460,000)                         |                     |
| Net loss attributable to common<br>stockholders | \$ (132,155)<br>=====              |                     | \$ (216,223)<br>=====             |                     |
| Loss per share:                                 |                                    |                     |                                   |                     |
| Basic   | \$ 0.000<br>=====                  |                     | \$ 0.000<br>=====                 |                     |
| Weighted average shares outstanding             |                                    |                     |                                   |                     |
| Basic   | 41,545,824                         |                     | 23,762,472                        |                     |

(1) For the period from October 28, 2004 (date of inception) through September 30, 2005 the Company (Original Gales) had no business activity other than the issuance of a \$22,500 convertible bridge note and the \$150,000 bridge loan that accrued approximately \$2,077 and \$1,420 in interest for the nine and three month period ended September 30, 2005 respectively. The note and respective accrued interest were subsequently converted to shares of the Company's Common Stock as part of the merger and the bridge loan was paid back at the time of closing. The Company has presented the Statements of Operations of Air Industries Machining Corp. (AIM), as the Company has succeeded all of the business activity of AIM.

(2) AIM was a privately held subchapter S Corporation prior to the merger and accordingly the financial statements of the Successor and Predecessor are not comparable in all material respects, and accordingly since AIM was an "S" Corporation a provision for income taxes was not recorded.

See notes to condensed consolidated financial statements

GALES INDUSTRIES INCORPORATED (1) (2)  
Condensed Consolidated Statement of Cash Flows  
(Unaudited)

|  | Nine Months September 30, |                     |
|--|---------------------------|---------------------|
|  | 2006                      | 2005<br>Predecessor |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>   |                           |                     |
| Net Income   | \$ 243,777                | \$ 858,173          |
| Adjustments to Reconcile Net Income to Net<br>Cash Provided by (Used in) Operating Activities: |                           |                     |
| Depreciation and amortization of property and equipment  | 409,361                   | 347,732             |
| Amortization of deferred financing costs   | 86,405                    |                     |
| Gain on sale of officer's life insurance policy  | (53,047)                  |                     |
| Non cash compensation expense  | 108,271                   |                     |
| Warrants issued for services   | 41,345                    |                     |
| (Increase) Decrease in Assets:   |                           |                     |
| Accounts receivable  | (575,592)                 | 373,757             |
| Inventory  | (980,867)                 | (925,913)           |
| Prepaid expenses and other current assets  | 138,804                   | 55,674              |
| Deposits   | (82,206)                  | 21,160              |
| Cash surrender value - officer's life insurance  | (2,110)                   | 211,302             |
| Other assets   | 84                        | 31,278              |
| Decrease (Increase) in Liabilities:  |                           |                     |
| Accounts payable and accrued expenses  | (45,794)                  | 450,245             |
| Advance Payments Customers   |                           | (686,494)           |
| <b>NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES</b>                                     | <b>(711,569)</b>          | <b>736,914</b>      |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>   |                           |                     |
| Purchase of property and equipment   | (211,815)                 | (740,572)           |
| <b>NET CASH USED IN INVESTING ACTIVITIES</b>   | <b>(211,815)</b>          | <b>(740,572)</b>    |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>   |                           |                     |
| Principal payments of capital lease obligations, net   | (267,840)                 | 1,156,992           |
| Proceeds from sale of officer's life insurance policy  | 86,000                    |                     |
| Repayment of notes payable to and due sellers  | (161,222)                 | --                  |
| Proceeds from ( payment of) notes payable, net   | 503,100                   | (924,915)           |
| <b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>   | <b>160,038</b>            | <b>232,077</b>      |
| Net (decrease) increase in cash and cash equivalents   | (763,346)                 | 228,419             |
| Cash and cash equivalents at the beginning of period   | 1,058,416                 | 10,308              |
| Cash and cash equivalents at the end of period   | \$ 295,070                | \$ 238,727          |
| <b>Supplemental schedule of noncash financing and investing activities</b>                     |                           |                     |
| Issuance of Common Shares:   |                           |                     |
| Conversion of Preferred to Common Stock  | \$ 40,909                 |                     |
| Conversion of PIK Dividend to Common Shares  | \$ 360,000                |                     |
| <br>Supplemental disclosure of cash flow information:  |                           |                     |
| Cash paid during the period for interest   | \$ 788,409                | \$ 369,772          |

- (1) For the period from October 28, 2004 (date of inception) through September 30, 2005 the Company (Original Gales) had no business activity other than the issuance of a \$22,500 convertible bridge note and the \$150,000 bridge loan that accrued approximately \$2,077 and \$1,420 in interest for the nine and three month period ended September 30, 2005 respectively. The note and respective accrued interest were subsequently converted to shares of the Company's Common Stock as part of the merger and the bridge loan was paid back at the time of closing. The Company has presented the Statements of Operations of Air Industries Machining Corp. (AIM), as the Company has succeeded all of the business activity of AIM.
- (2) The Company has presented the Statement of Cash Flows of AIM, as the Company has succeeded to all of the business activity of AIM. AIM was a privately held subchapter S Corporation prior to the merger and accordingly the financial statements of the Company and Predecessor are not comparable in all material respects. See notes to condensed consolidated financial statements

Note 1:

## FORMATION, BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

### Merger and Acquisition

Ashlin Development Corp. (the "Company" or "Ashlin"), a Florida corporation and its newly-formed subsidiary Merger Sub, entered into a Merger Agreement (the "Merger Agreement") on November 14, 2005 with Gales Industries Incorporated, a privately-held Delaware corporation ("Original Gales"). On November 30, 2005 (the "Closing Date") Original Gales merged (the "Merger") into Merger Sub. Pursuant to the Merger Agreement, the Company issued 10,773,107 shares of Common Stock (representing 73.6% of Ashlin's outstanding shares) and 900 shares of Series A Convertible Preferred Stock which was initially convertible into 40,909,500 shares of Common Stock of the Company for all the issued and outstanding shares of Original Gales the "Successor". As a result of the transaction, the former stockholders of Original Gales became the controlling stockholders of Ashlin. Additionally, since Ashlin had no substantial assets prior to the merger, the transaction was treated for accounting purposes as a reverse acquisition of a public shell. Accordingly, for financial statement presentation purposes, Original Gales is the surviving entity.

On February 15, 2006, Ashlin changed its name to Gales Industries Incorporated and its state of domicile from Florida to Delaware.

Prior to the closing of the Merger, Original Gales, which did not have any business operations other than in connection with the transactions contemplated by the Merger Agreement, acquired (the "Acquisition") all of the outstanding capital stock of Air Industries Machining, Corp. ("AIM"). Because of the change in ownership, management and control that occurred in connection with the Acquisition, in accordance with Statement of Financial Accounting Standards ("SFAS") 141, Business Combinations, the transaction was accounted for as a purchase. Accordingly, the purchase price was allocated to assets acquired and liabilities assumed based on SFAS No. 141. Simultaneously with the Acquisition, AIM entered into a bank facility (the "New Loan Facility") and used proceeds from the facility to acquire real estate (the "Real Estate Acquisition").

Prior to the Acquisition, Original Gales raised bridge financing. In connection with the Acquisition, Original Gales procured a private placement of Series A Preferred Stock, the proceeds of which were used to acquire AIM. Immediately prior to the Merger, Original Gales had outstanding certain bridge notes convertible into shares of Original Gales' common stock and certain bridge warrants to purchase shares of Original Gales' common stock.

Original Gales was formed in October 2004 and, since prior to the acquisition it did not have any business operations or activity other than the transactions contemplated with the merger and succeeded substantially all of the business operations of AIM, AIM is the "Predecessor" to Original Gales. The Company is required to separately present the historical statement of operations and cash flows of the Predecessor. The financial information presented in these financial statements may not reflect the combined financial position. The operating results and cash flows of the Predecessor and Successor are not compatible in all material respects.

Certain information and footnote disclosures normally included in the annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The Company believes that the disclosures are adequate to make the financial information presented not misleading. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2005, filed with the Securities and Exchange Commission on April 17, 2006. All adjustments were of a normal recurring nature unless otherwise disclosed. In the opinion of management, all adjustments necessary for a fair statement of the results of operations for the interim period have been included. The results of operations for such interim periods are not necessarily indicative of the results for the full year.

### Reverse stock split

Pursuant to the terms of the Merger Agreement, prior to the Merger, Ashlin effected a 1-for-1.249419586 reverse split of its Common Stock (the "Reverse Split"). The Reverse Split became effective November 21, 2005. The Reverse Split reduced the number of shares of Common Stock which the Company had outstanding on a fully diluted basis to 3,868,000. As a result of the Reverse Split, the conversion of the outstanding shares of Original

Gales pursuant to the Merger for new shares of the Company's Common Stock was on a one-for-one basis. Any of the Company's shareholders who, as a result of the Reverse Split, held a fractional share of Common Stock received a whole share of Common Stock in lieu of such fractional share. After giving effect to the Reverse Split, prior to the Merger, the Company had outstanding 3,823,980 shares of Common Stock which continued to be outstanding after the Merger.

#### 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, unamortized finance costs, 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.

#### Stock-Based Compensation

In December 2004, the FASB issued SFAS 123(R) which is a revision of SFAS No. 123 and supersedes Accounting Principles Board Opinion No. 25. SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values at the date of grant. The Company recorded an expense of \$42,866 in the accompanying statement of operations for the three month period ended September 30, 2006 and an expense of \$108,271 for the nine month period ended September 30, 2006, in accordance with the measurement requirements under SFAS No. 123(R)

#### Note 2:

##### CASH SURRENDER VALUE - LIFE INSURANCE

During the quarter ended March 31, 2006, the Company sold one of its key-man life insurance policies. Proceeds from the sale of the insurance policy were \$86,000 which was offset by the cash surrender value of \$32,953. The resulting gain of \$53,047 was recognized as Other Non-Operating Income in the accompanying Statement of Operations for the nine month period ended September 30, 2006.

#### Note 3:

##### STOCK-BASED COMPENSATION ARRANGEMENTS

During 2005, the Company's Board of Directors approved a stock option plan and reserved 10,000,000 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. Awards granted under the Company's plans vest over four and seven years.

The Company accounts for its stock option plans under the measurement provisions of Statement of Financial Accounting Standards No. 123(R) (revised 2004), Share-Based Payment ("SFAS 123R"). The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. During the nine months September 30, 2006 no stock options were granted.

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 issued 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 SFAS 123(R) and accordingly, their fair value will be calculated and expensed in future periods.



A summary of the status of the Company's stock options as of September 30, 2006, and changes during the period then ended is presented below:

|   | Number<br>of<br>Options | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual Term | Aggregate<br>Intrinsic<br>Value |
|---|-------------------------|--|--|---------------------------------|
| Outstanding at<br>January 1, 2006                       | 2,370,000               | \$ 0.38                                  |  |                                 |
| Outstanding at<br>January 1, 2006                       | 2,480,000               | *  |  |                                 |
| Granted   | --                      |  |  |                                 |
| Forfeited or expire                                     | --                      | --                                       |  |                                 |
| Exercised   | --                      | --                                       |  |                                 |
| Outstanding at<br>September 30, 2006                    | <u>4,850,000</u>        | <u>\$ 0.38</u>                           | <u>9</u>   | <u>\$ 39,500</u>                |
| Options vested and exercisable at<br>September 30, 2006 | <u>1,580,000</u>        | <u>\$ 0.32</u>                           | <u>9</u>   | <u>\$ 39,500</u>                |

\* The exercise price of such options will be based upon future market prices of the underlying shares.

The Company recorded a compensation expense of \$42,866 in its consolidated condensed statement of operations for the three month period ended September 30, 2006 and a stock option expense of \$108,271 for the nine month period ended September 30, 2006. The stock option expense relates to stock options granted in the previous fiscal year. The Company granted no stock options during the quarter ended September 30, 2006. The following table illustrates stock options granted through September 30, 2006:

| Range of Exercise<br>Prices     | Options Outstanding   |  |   | Options Vested and Exercisable |  |
|---------------------------------|-----------------------|--|---|--------------------------------|--|
|                                 | Number<br>Outstanding | Weighted-<br>Average<br>Remaining<br>Contractual<br>Life (Years) | Weighted-<br>Average<br>Exercise<br>Price | Number<br>Exercisable          | Weighted-<br>Average<br>Exercise Price |
| \$0.22                          | 790,000               | 9  | \$ 0.220                                  | 790,000                        | \$ 0.22                                |
| \$0.428                         | 790,000               | 9  | \$ 0.428                                  | 790,000                        | \$ 0.428                               |
| \$0.48                          | 790,000               | 9  | \$ 0.480                                  | --                             | --                                     |
| Based on future<br>market price | 2,480,000             | 9  | NA  | --                             | --                                     |
|                                 | <u>4,850,000</u>      | <u>9</u>   | <u>\$ 0.38</u>                            | <u>1,580,000</u>               | <u>\$ 0.32</u>                         |

A summary of the status of the Company's non-vested options as of September 30, 2006 and changes during the nine month ended September 30, 2006 is presented below:

|   | Number of<br>Options<br>----- | Weighted Average<br>Exercise Price<br>Per Option<br>----- | Weighted Average<br>Remaining<br>Contractual Term<br>(in years)<br>----- |
|---|-------------------------------|---|--|
| Non-vested Options at<br>January 1, 2006    | 1,580,000                     | \$ 0.453  | 9  |
| Options based on future<br>market price     | 2,480,000                     | N/A   | N/A  |
| Options granted                             | --                            |   | --   |
| Options vested                              | (790,000)                     | \$ 0.428  | --   |
| Options forfeited or<br>expired             | --                            | --  | --   |
|   | -----                         | -----   | -----  |
| Non-vested Options at<br>September 30, 2006 | <u>3,270,000</u>              | <u>\$ 0.45</u>  | <u>9</u>   |

As of September 30, 2006, there was \$225,471 of unrecognized compensation cost related to non vested stock option awards, which is to be recognized over the remaining weighted average vesting period of eleven months.

During the quarter ended September 30, 2006, the company issued to a consulting firm, in return for services an aggregate of 31,251 warrants, exercisable during a five year term, to purchase 31,251 shares of the company's Common Stock. Such warrants have a "cashless exercise" feature and have varying exercise prices equal to 120% of the average closing price of the Company's Common Stock during the month immediately preceding the date of issuance. The warrants were valued using the Black-Scholes model and the Company recorded an expense of \$23,219 and \$41,345 in its consolidated condensed statement of operations for the three and nine month period ended September 30, 2006. The Company's agreement with this consultant was terminated during the first week of September 2006.

The following table summarizes the Company's outstanding warrants as of September 30, 2006 and changes during the period then ended:

|                                   | Number<br>of<br>Warrants<br>----- | Weighted<br>Average<br>Exercise<br>Price<br>----- | Weighted<br>Average<br>Remaining<br>Contractual Life<br>(Years)<br>----- |
|-----------------------------------|-----------------------------------|---|--|
| Outstanding January 1, 2006       | 5,229,589                         | \$ 0.21   | 4.1  |
| Cancelled                         | --                                | --  |  |
| Granted                           | 72,919                            | \$ 1.23   | 4.8  |
| Exercised                         | --                                | --  |  |
|                                   | -----                             | -----   | -----  |
| Outstanding at September 30, 2006 | <u>5,302,508</u>                  | <u>\$ 0.22</u>                                    | <u>4.1</u>   |

Note 4.

#### STOCKHOLDERS' EQUITY

On August 4, 2006 Gales Industries Incorporated's Registration Statement on Form SB-2 became effective and as a result the outstanding preferred stock of 900 shares automatically converted to 40,909,500 shares of common stock, exclusive of the 1,636,380 shares of common stock which were paid as a dividend on the 900 shares of preferred stock. An additional dividend of \$100,000 on the preferred shares, for the period of June 15, 2006 through August 4, 2006, is included in accrued expenses as of September 30, 2006.

## Item 2.

### Management's Discussion and Analysis or Plan of Operation

#### General

We, through our wholly owned subsidiary AIM, manufacture aircraft structural parts and assemblies principally for prime defense contractors in the defense/aerospace industry. Approximately 85% of AIM's revenues are derived from sales of parts and assemblies directed toward military applications, although direct sales to the military (U.S. and NATO) constitute less than 8.5% of AIM's revenues. The remaining 15% of revenues represent sales in the airframe manufacturing sector to major aviation manufacturers.

AIM has evolved from being an individual parts manufacturer to being a manufacturer of subassemblies (i.e. being an assembly constructor) and being an engineering integrator. AIM currently produces over 2,400 individual products (SKU's) that are assembled by a skilled labor force into electromechanical devices, mixer assemblies, rotorhub components, rocket launching systems, arresting gear, vibration absorbing assemblies, landing gear components and many other subassembly packages.

Sales of parts and services to one customer accounted for approximately 66% of AIM's revenue in the third quarter of 2006, and are subject to General Ordering Agreements which were recently renegotiated and extended through 2010.

During the nine month period ending September 30, 2006, the Company received an initial contract applicable to the Memorandum of Agreement from The Goodrich Corporation for the manufacture of A380 (AirBus) Drag Brace assemblies. This Memorandum of Agreement covers approximately five years starting in 2006 through 2011. The value of deliveries currently projected for the time period covered by the Agreement is estimated to reach \$20,450,000. As orders for A380 aircraft increase, delivery obligations and revenues for Air Industries will increase correspondingly. In addition to this A380 contract Air Industries received approximately \$26 million in additional contracts from other aerospace customers during the period. As a result of these contracts, the Company's 18-month "firm backlog" currently stands at \$30 million. Furthermore, management's "projected backlog" for the same 18-month period, which includes both the firm backlog as well as anticipated order releases against long term general purchase agreements ("GPA's") with the Company's prime aerospace contractors currently stands at approximately \$60 million. Although the forecasted releases against GPA's within the forward 18-month period are included in the "projected backlog", the Company may actually receive additional substantial "follow-on" awards through the balance of a GPA contract period, some of which currently extend through 2012.

AIM historically operated as a private company. There can be no assurance that our future operating results will be comparable to those achieved by AIM in the past. It should also be noted that, prior to the Acquisition, AIM operated as a Subchapter "S" company and incurred no income taxes.

#### Results of Operations

Prior to the acquisition of AIM, the Company had limited business operations or activities other than the transactions contemplated by the Merger Agreement between the Company and Gales Industries, See Note 1 to the condensed consolidated financial statements. The Company succeeded to substantially all of the business operations of AIM and AIM represents substantially all of the Company's current operations. AIM is considered to be the Predecessor to the Company and for financial reporting purposes the Company is required to present the historical statement of operations and cash flows of AIM for periods prior to its acquisition by the Company. The financial information of AIM for the period ended September 30, 2005, presented in the condensed consolidated financial statements is not comparable in all material respects to that of the Company for subsequent periods as adjustments resulting from the Merger, the Acquisition and the Real Estate Acquisition are not reflected in the Predecessor financial statements. These adjustments include, among others interest expense from the refinancing, taxes from the change in "S" to "C" Corporation status, increased amortization due to a step-up in the basis of certain assets, additional officers' salaries, and the change in officers' functions which caused a reallocation of salary expense from cost of goods sold to general administrative expense.

Three months ended September 30, 2006 compared with the three months ended September 30, 2005.

**Net Sales.** Net sales were \$7,883,485 for the three months ended September 30 2006 ("Third Quarter 2006"), an increase of \$110,298 (or 1.4%) from net sales of \$7,773,187 for the three months ended September 30, 2005 ("Third Quarter 2005"). The increase in net sales was attributable to increased shipments of parts and related defense components to two (2) customers which caused the portion of our revenues derived these customers to increase from approximately 60.1% % in 2005 to approximately 74.4% % in the Third Quarter 2006.

The Company's net sales for the nine month period ended September 30, 2006, were substantially greater than the Company's net sales for the comparable period in 2005. Nevertheless, net sales during the Third Quarter 2006 were less than the amounts recorded during each of the first and second quarters of 2006, but modestly higher (1.4%) than the same period in 2005. This decrease in net sales for the Third Quarter resulted primarily from the need to prepare for production of subassemblies for the Joint Strike Fighter ("JSF") landing gear, the E2D arresting gear and the A380 drag brace. We anticipate that the delivery of the first article of each of these products will occur no later than the end of this year, in the case of the JSF landing gear, during the first quarter of 2007 in the case of the E2D arresting gear and during the first half of 2007 in the case of the A380 drag brace. Management believes that the necessary tooling and testing for each of the products mentioned above has been substantially completed.

Sales during the Third Quarter were also negatively impacted by a decision by one of our largest customers to delay deliveries of units previously projected to be delivered during this time period. These delivery delays may continue through the fourth quarter and will be reflected in higher inventory levels and potentially lower revenue. These delivery delays are the result of a strike at aforementioned customer's facility earlier in the year and its inability to achieve complete production recovery prior to the year-ended 2006.

**Gross Profit.** Gross profit was \$1,521,409 for the three months ended September 30, 2006, 19.3% of net sales, compared to gross profit of \$996,522 for the three months ended September 30, 2005, 12.8% of net sales. The increase in gross profit primarily reflects an increase in the sale of higher margin products and the increase in net sales. The increase in gross profit as a percentage of net sales represents a slight increase in the sales of higher margin products, as well as the elimination of rent paid on the Company's facilities as a result of the Real Estate Acquisition, partially offset by the mortgage interest and depreciation of the Company's facilities allocated to sales, and lower salaries as a result of the reallocation of the costs of certain executives.

**Selling and Marketing Expenses.** Selling and marketing expenses were \$175,515 for the three months ended September 30, 2006, an increase of 134.5% from selling and marketing expenses of \$74,856 for the three months ended September 30, 2005. The increase in selling and marketing expenses reflects the up-front recognition of costs related to leased automobiles for the Company's executives and increased travel and entertainment expenses related to increased sales activity.

**General and Administrative Expenses.** General and administrative expenses were \$1,108,651 the three months ended September 30, 2006, an increase of \$563,152 or 103%, from general and administrative expenses of \$545,499 for the three months ended September 30, 2005. The increase reflects (i) higher depreciation relating to the step-up in basis of the Company's real property, partially offset by the elimination of rent expense, and (ii) higher salaries as a result of the reallocation of the costs of certain executives and higher professional fees due to the increase in accounting, legal and consulting expenses associated with being a public company.

**Interest and Financing Costs.** Interest and financing costs were \$290,853 for the three months ended September 30, 2006, an increase of \$126,582, or 77.1%, from interest and financing costs of \$164,271 for the three months ended September 30, 2005. The increase in interest and financing costs resulted from higher interest rates, interest accruing on the promissory notes issued to the former shareholders of AIM in connection with the AIM Acquisition, interest accruing on the new term loan and larger revolving credit facility, portions of which were used to finance the costs of the Acquisition and the Real Estate Acquisition.

Income/ (loss) before Income Taxes. Net (loss)/ income before provision for income taxes was \$(53,610) for the three months ended September 30, 2006 and \$212,048 for the three months ended September 30, 2005.

Net Loss. Net loss was \$ (32,155) for the three months ended September 30, 2006. A comparison of net income with prior year is not informative because the predecessor company was an "S" Corporation.

Net Loss Attributable to Common Stock. During the Third Quarter 2006 the Company accrued a cash dividend payable on its preferred stock of \$100,000. The accrual of such dividends stopped as of August 4, 2006 the date the Company's registration statement was declared effective. The cash dividend results from the failure to cause the company's registration statement to become effective within the time period required by the terms of the preferred stock.

Nine months ended September 30, 2006 compared with the nine months ended September 30, 2005.

Net Sales. Net sales were \$26,001,922 for the nine months ended September 30, 2006; an increase of \$4,150,390, or 19%, from net sales of \$21,851,532 for the nine months ended September 30, 2005. The increase in net sales was attributable to increased shipments of parts and related defense components to two (2) customers which caused the portion of our revenues derived these customers to increase from approximately 56.7 % in 2005 to approximately 72.6 % in the first nine months of 2006.

Gross Profit. Gross profit was \$4,786,954 for the nine months ended September 30, 2006 (18.4% of net sales), compared to gross profit of \$2,801,366, (12.8% of net sales), for the nine months ended September 30, 2005. The increase in gross profit primarily reflects the increase in net sales. The increase in gross profit as a percentage of net sales represents a slight increase in the sales of higher margin products, as well as the elimination of rent paid on the Company's facilities as a result of the Real Estate Acquisition, partially offset by the mortgage interest and depreciation of the Company's facilities allocated to sales, and lower salaries as a result of the reallocation of the costs of certain executives.

Selling and Marketing Expenses. Selling and marketing expenses were \$473,760 for the nine months ended September 30, 2006, an increase of 94.1% from selling and marketing expenses of \$244,125 for the nine months ended September 30, 2005. The increase in selling and marketing expenses reflects the up-front recognition of costs related to leased automobiles for the Company's executives and increased travel and entertainment expenses related to increased sales activity.

General and Administrative Expenses. General and administrative expenses were \$2,982,584 for the nine months ended September 30, 2006 an increase of \$1,694,857 or 132.0%, from general and administrative expenses of \$1,287,727 for the nine months ended September 30, 2005. The increase reflects (i) higher depreciation relating to the step-up in basis of the Company's real property, partially offset by the elimination of rent expense, and (ii) higher salaries as a result of the reallocation of the costs of certain executives and (iii) higher professional fees due to the increase in accounting, legal and consulting expenses associated with being a public company.

Interest and Financing Costs. Interest and financing costs were \$978,029 for the nine months ended September 30, 2006 an increase of \$566,536 or 137.63%, from interest and financing costs of \$411,493 for the nine months ended September 30, 2005. The increase in interest and financing costs resulted from higher interest rates, interest accruing on the promissory notes issued to the former shareholders of AIM in connection with the AIM Acquisition, interest accruing on the new term loan and larger revolving credit facility.

Gain on the Sale of Life Insurance Policy. Gain on the sale of life insurance policy was \$53,047 in the first nine months of 2006 and was a one-time gain.

Income before Income Taxes. Net income before provision for income taxes was \$406,431 for the nine months ended September 30, 2006 and \$858,173 for the nine months ended September 30, 2005. The decrease in net income is attributable; in part, to the expenses incurred in connection with the Company's reporting obligations as a public company.

Net Income. Net income was \$243,777 for the nine months ended September 30, 2006. A comparison of net income with prior year is not informative because the predecessor company was an "S" Corporation.

Net Loss Attributable to Common Stock. Net Loss was \$(216,223) for the nine months ended September 30, 2006. Dividends are \$460,000 resulting from PIK and cash dividends of \$360,000 and \$100,000 respectively. PIK dividend resulted from the quarterly accrued dividends at 8% per annum that were declared resulting from effective filing of registration statement. Cash dividend results from the penalty incurred in not going effective by the agreed date in accordance with the preferred shareholder agreement.

#### Impact of Inflation

Inflation has not had a material effect on our financial position, results of operations, or cash flows.

#### Liquidity and Capital Resources

We used approximately \$711,569 in our operations during the nine months ended September 30, 2006. The use of cash in operations reflects in the increase in our accounts receivable and inventory of \$575,592 and \$980,867 respectively offset by net income after non cash adjustments.

At September 30, 2006, we had cash and cash equivalents of \$295,070 and working capital of \$4,307,280 as compared to \$1,058,416 and \$4,113,235 as of December 31, 2005. We believe that our cash requirements in the next twelve months will be met by our revenues from operations, our cash reserves, and the amounts available under the New Loan Facility put in place in connection with the acquisition of AIM.

AIM had financed its operations and investments up to the date it was acquired by us principally through revenues from operations. As a private company, AIM did not have many of the expenses which we have as a public company. As a result of the AIM Acquisition, we have significantly increased cash requirements relating to the filing of financial statements, our compliance with requirements under the Securities Exchange Act of 1934, the registration of shares under the Securities Act of 1933, and other requirements applicable to public companies. We expect such increased cash requirements to be approximately \$750,000 in 2006, subject to a substantial increase if we become obligated to comply with Section 404 of Sarbanes-Oxley.

In connection with the Acquisition of AIM, we entered into the New Loan Facility and incurred notes payable obligations to the sellers in the aggregate principal amount of \$1,627,262 of which \$665,262 are in the form of convertible promissory notes held by senior members of our management. The original terms of the New Loan Facility are set forth in our Consolidated Financial Statements included in our Annual Report on Form 10-KSB for the year ended December 31, 2005. Under the New Loan Facility, as of September 30, 2006, we had revolving loan balances of \$6,911,033 and a term loan balance of \$3,151,663. As of September 30, 2006, we had capital lease and equipment loan obligations totaling \$1,322,932. In addition, as of September 30, 2006, \$1,482,962 million remained outstanding on the notes held by the sellers of AIM.

On October 24, 2006, we completed the sale and lease-back of our corporate headquarters for a gross sales price of \$6,200,000. The net proceeds of the sale were applied to outstanding payables, including \$ 4.9 million used to reduce the amounts due under the New Loan Facility, of which \$2.8 million was used to reduce the outstanding principal amount due under the term loan. Giving effect to such payment, the amount outstanding under the New Loan Facility (term and revolver) as of September 30, 2006, would have been reduced by approximately 49% to approximately \$5.2 million down from \$10.1 million. The reduction in the amount due under the New Loan Facility has resulted in approximately \$2.1 million of increased availability under our existing loan agreements and this increased availability is planned to be used as the cornerstone of our contemplated acquisition program. In addition, at current interest rates, such reduction will result in lower interest payments and reduced principal payments approximately equal to the initial rent under our new lease. The sale and lease back of the of the Company's real estate resulted in a net taxable gain to the Company and any taxes resulting there from will be paid out of future cash flows or borrowings under the New Loan Facility.

As part of the payment under the New Loan Facility, the Term Note Agreement was reduced by \$2.8 million and the remaining balance of \$383,330 became an Amended and Restated Term Note. To reflect the changes in the balances due under the New Loan Facility, on November 10, 2006, the Company and PNC amended the terms of the New Loan Facility and the Company delivered to PNC an Amended and Restated Term Note in the principal amount of \$383,330 providing for principal payments of \$10,648 per month. The corresponding section in the New Loan Facility was amended to reflect the change in principal amount and the monthly principal installment amount due under the Term Note, as well as the change in the Maturity Date to the first business day of October 2009.





In addition to the foregoing, the New Loan Facility was further amended to allow for the Company to borrow or to obtain the issuance, renewal, extension and increase of standby letters of credit, up to an aggregate availability of \$500,000, for its account until the Termination Date, which will occur on November 30, 2009.

As of September 30, 2006, one customer accounted for approximately 38% of our accounts receivable. In addition, this customer accounted for approximately 59% of our total revenue for the quarter ended September 30, 2006. In the event such customer is unable or unwilling to pay us our accounts receivable from such customer, or in the event our relationship with such customer is severed or negatively affected, our results of operations will be materially adversely affected and we may not have the resources to meet our capital obligations.

#### Forward Looking Statements

The Company desires to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. This report contains a number of forward-looking statements that reflect management's current views and expectations with respect to our business, strategies, future results and events and financial performance. All statements made in this Report other than statements of historical fact, including statements that address operating performance, events or developments that management expects or anticipates will or may occur in the future, including statements related to distributor channels, volume growth, revenues, profitability, adequacy of funds from operations, statements expressing general optimism about future operating results and non-historical information, are forward looking statements. In particular, the words "believe," "expect," "intend," "anticipate," "estimate," "may," "will," variations of such words, and similar expressions identify forward-looking statements, but are not the exclusive means of identifying such statements and their absence does not mean that the statement is not forward-looking. These forward-looking statements are subject to certain risks and uncertainties, including those discussed below. Our actual results, performance or achievements could differ materially from historical results as well as those expressed in, anticipated or implied by these forward-looking statements. We do not undertake any obligation to revise these forward-looking statements to reflect any future events or circumstances.

Readers should not place undue reliance on these forward-looking statements, which are based on management's current expectations and projections about future events, are not guarantees of future performance, are subject to risks, uncertainties and assumptions (including those described below) and apply only as of the date of this report. Our actual results, performance or achievements could differ materially from the results expressed in, or implied by, these forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed below in "Risk Factors" as well as those discussed elsewhere in this report, and the risks discussed in our press releases and other communications to shareholders issued by us from time to time which attempt to advise interested parties of the risks and factors that may affect our business. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

#### Risk Factors

If any of the events described below occurs, our operating results would be dramatically adversely affected, which in turn could cause the price of our Common Stock to decline, perhaps significantly. Further, we may not be able to continue our operations.

#### Risks of the Acquisition

There can be no assurance that any benefits to AIM's business will be achieved from its acquisition by Original Gales and the merger of Original Gales into the Company, the Real Estate Acquisition or the New Loan Facility (the "Transactions") or that the results of operations of AIM prior to the Merger will not be adversely impacted by the Transactions. As of November 30, 2005, Luis Peragallo and Jorge Peragallo, formerly the principal shareholders of AIM, resigned from their positions with AIM. Even though Peter Rettaliata and Dario Peragallo, two of AIM's officers (President and Executive Vice President, respectively), serve as officers of AIM and as officers of our Company, there can be no assurance that the management of our company will have the necessary experience to operate AIM's business. The process of combining the organizations of Original Gales, AIM and our Company could interrupt the activities of part or all of AIM's business, and could cause fundamental changes in AIM's business, which could have an adverse effect on the results of operations. The past results of AIM's operations are not necessarily indicative of the future results of our operations. In addition, AIM's results of operations will be affected by the significant increase in expenses relating to financial statements preparation and other requirements applicable to publicly traded companies.



The inability to successfully manage the growth of our business may have a material adverse effect on our business, results or operations and financial condition.

We expect to experience growth in the number of employees and the scope of our operations as a result of internal growth and acquisitions. Such activities could result in increased responsibilities for management.

Our future success will be highly dependent upon our ability to manage successfully the expansion of operations. Our ability to manage and support our growth effectively will be substantially dependent on our ability to implement adequate improvements to financial, inventory, management controls, reporting, union relationships, order entry systems and other procedures, and hire sufficient numbers of financial, accounting, administrative, and management personnel. There can be no assurance that we will be able to identify, attract and retain experienced personnel.

Our future success depends on our ability to address potential market opportunities and to manage expenses to match our ability to finance operations. The need to control our expenses will place a significant strain on our management and operational resources. If we are unable to control our expenses effectively, our business, results of operations and financial condition may be adversely affected.

The unsuccessful integration of a business or business segment we acquire could have a material adverse effect on our results.

As part of our business strategy, we expect to acquire assets and businesses relating to or complementary to our operations. These acquisitions will involve risks commonly encountered in acquisitions. These risks include, among other things, exposure to unknown liabilities of the acquired companies, additional acquisition costs and unanticipated expenses. Our quarterly and annual operating results will fluctuate due to the costs and expenses of acquiring and integrating new businesses. We may also experience difficulties in assimilating the operations and personnel of acquired businesses. Our ongoing business may be disrupted and our management's time and attention diverted from existing operations. Our acquisition strategy will likely require additional debt or equity financing, resulting in additional leverage or dilution of ownership. We cannot assure you that any future acquisition will be consummated, or that if consummated, that we will be able to integrate such acquisition successfully.

Any reduction in government spending on defense could materially adversely impact our revenues, results of operations and financial condition.

There are risks associated with programs that are subject to appropriation by Congress, which could be potential targets for reductions in funding to pay for other programs. Future reductions in United States Government spending on defense or future changes in the kind of defense products required by United States Government agencies could limit demand for our products, which would have a materially adverse effect on our operating results and financial condition.

In addition, potential shifts in responsibilities and functions within the defense and intelligence communities could result in a reduction of orders for defense products by segments of the defense industry that have historically been our major customers. As a result, demand for our products could decline, resulting in a decrease in revenues and materially adversely affecting our operating results and financial condition.

We depend on revenues from a few significant customer relationships and any loss, cancellation, reduction, or interruption in these relationships could harm our business.

As of September 30, 2006, one customer accounted for approximately 38% of our accounts receivable. In addition, this customer accounted for approximately 59% of our total revenue for the quarter ended September 30, 2006. In the event such customer is unable or unwilling to pay us our accounts receivable from such customer, or in the event our relationship with such customer is severed or negatively affected, our results of operations will be materially adversely affected and we may not have the resources to meet our capital obligations. In general, AIM has derived a material portion of its revenue from one or a limited number of customers. We expect that in future periods we may enter into contracts with customers which represent a significant concentration of our revenues. If such contracts were terminated, our revenues and net income could significantly decline. Our success will depend on our continued ability to

develop and manage relationships with significant customers. Any adverse change in our relationship with our significant customers could have a material adverse effect on our business. Although we are attempting to expand our customer base, we expect that our customer concentration will not change significantly in the near future. The markets in which we sell our products are dominated by a relatively small number of customers who have contracts with United States governmental agencies, thereby limiting the number of potential customers. We cannot be sure that we will be able to retain our largest customers or that we will be able to attract additional customers, or that our customers will continue to buy our products in the same amounts as in prior years. The loss of one or more of our largest customers, any reduction or interruption in sales to these customers, our inability to successfully develop relationships with additional customers or future price concessions that we may have to make, could significantly harm our business.

Continued competition in our markets may lead to a reduction in our revenues and market share.

The defense and aerospace component manufacturing market is highly competitive and we expect that competition will continue to increase. Current competitors have significantly greater technical, manufacturing, financial and marketing resources than we do. We expect that more companies will enter the defense and aerospace component manufacturing market. We may not be able to compete successfully against either current or future competitors. Increased competition could result in reduced revenue, lower margins or loss of market share, any of which could significantly harm our business.

Our future revenues are inherently unpredictable; our operating results are likely to fluctuate from period to period and if we fail to meet the expectations of securities analysts or investors, our stock price could decline significantly.

Our quarterly and annual operating results are likely to fluctuate significantly in the future due to a variety of factors, some of which are outside our control. Accordingly, we believe that period-to-period comparisons of our results of operations are not meaningful and should not be relied upon as future indications of performance. Some of the factors that could cause quarterly or annual operating results to fluctuate include conditions inherent in government contracting and our business such as the timing of cost and expense recognition for contracts, the United States Government contracting and budget cycles, introduction of new government regulations and standards, contract closeouts, variations in manufacturing efficiencies, our ability to obtain components and subassemblies from contract manufacturers and suppliers, general economic conditions and economic conditions specific to the defense market. Because we base our operating expenses on anticipated revenue trends and a high percentage of our expenses are fixed in the short term, any delay in generating or recognizing forecasted revenues could significantly harm our business. Fluctuations in quarterly results, competition or announcements of extraordinary events such as acquisitions or litigation may cause earnings to fall below the expectations of securities analysts and investors. In this event, the trading price of our Common Stock could significantly decline. In addition, there can be no assurance that an active trading market will be sustained for our Common Stock. These fluctuations, as well as general economic and market conditions, may adversely affect the future market price of our Common Stock, as well as our overall operating results.

We may lose sales if our suppliers fail to meet our needs.

Although we procure most of our parts and components from multiple sources or believe that these components are readily available from numerous sources, certain components are available only from sole sources or from a limited number of sources. While we believe that substitute components or assemblies could be obtained, use of substitutes would require development of new suppliers or would require us to re-engineer our products, or both, which could delay shipment of our products and could have a materially adverse effect on our operating results and financial condition.

Attracting and retaining key personnel is an essential element of our future success.

Our future success depends to a significant extent upon the continued service of our executive officers and other key management and technical personnel and on our ability to continue to attract, retain and motivate executive and other key employees, including those in managerial, technical, marketing and information technology support positions. Attracting and retaining skilled workers and qualified sales representatives is also critical to us. Experienced management and technical, marketing and support personnel in the defense and aerospace industries are in demand and competition for their talents is intense. The loss of the services of one or more of our key employees or our failure to attract, retain and motivate qualified personnel could have a

material adverse effect on our business, financial condition and results of operations.

Terrorist acts and acts of war may seriously harm our business, results of operations and financial condition.

United States and global responses to the Middle East conflict, terrorism, perceived nuclear, biological and chemical threats and other global crises increase uncertainties with respect to U.S. and other business and financial markets. Several factors associated, directly or indirectly, with the Middle East conflict, terrorism, perceived nuclear, biological and chemical threats, and other global crises and responses thereto, may adversely affect the Company.

While some of our products may experience greater demand as a result of increased U.S. Government defense spending, various responses could realign U.S. Government programs and affect the composition, funding or timing of our government programs and those of our customers. U.S. Government spending could shift to defense programs in which we and our customers do not participate. As a result of the September 11th terrorist attacks and given the current Middle East and global situation, U.S. defense spending is generally expected to increase over the next several years. Increased defense spending does not necessarily correlate to increased business, because not all the programs in which we participate or have current capabilities may be earmarked for increased funding.

Terrorist acts of war (wherever located around the world) may cause damage or disruption to us, our employees, facilities, partners, suppliers, distributors and resellers, and customers, which could significantly impact our revenues, expenses and financial condition. The terrorist attacks that took place in the United States on September 11, 2001 were unprecedented events that have created many economic and political uncertainties. The potential for future terrorist attacks, the national and international responses to terrorist attacks, and other acts of war or hostility have created many economic and political uncertainties, which could adversely affect our business and results of operations in ways that cannot presently be predicted. In addition, as a company with headquarters and significant operations located in the United States, we may be impacted by actions against the United States.

Our indebtedness and rent obligation may affect operations.

We incurred significant indebtedness under the New Loan Facility. This indebtedness far exceeds the amount of pre-Merger debt of AIM. As a result, we are significantly leveraged and our indebtedness is substantial in relation to our stockholders' equity. To reduce our debt, we completed the sale and lease-back of our corporate headquarters, as a result of which we are now obligated to pay rent for our corporate headquarters. Our ability to make principal and interest payments on our debt and our ability to make rent payments under our lease will depend on future performance, which is subject to many factors, some of which are outside our control. In addition, the New Loan Facility is secured by substantially all of our assets, including our rights as tenant. In the case of a continuing default under the New Loan Facility, the lender will have the right to foreclose on AIM's assets, which would have a material adverse effect on the Company. In the event of a failure to pay rent or otherwise comply with the terms of our lease, the landlord could evict us from our headquarters. Payment of principal and interest on the New Loan Facility may limit our ability to pay cash dividends to shareholders and the documents governing the New Loan Facility will prohibit the payment of cash dividends. Our leverage may also adversely affect our ability to finance future operations and capital needs, may limit our ability to pursue other business opportunities and may make our results of operations more susceptible to adverse economic conditions.

#### Absence of Principal Shareholders' Guarantees and Financial Accommodations

Historically, AIM obtained money and achieved other financial accommodations through arrangements guaranteed by the AIM's former shareholders. Since they sold their shares of AIM in connection with the Acquisition, such former shareholders of AIM will not be providing any financial assistance to us or AIM on a going-forward basis. Consequently, we are no longer able to rely upon the credit of AIM's former shareholders when seeking to borrow money or obtain other financial accommodations.

We may issue shares of our capital stock or debt securities to complete an acquisition, which would reduce the equity interest of our stockholders.

We will, in all likelihood, issue additional shares of our Common Stock or preferred stock, or a combination of common and preferred stock, to complete an acquisition. The issuance of additional shares of our Common Stock or any number of shares of our preferred stock may significantly reduce the equity interest of our current stockholders, may subordinate the rights of holders of our Common Stock if preferred stock is issued with rights senior to the Common Stock and may adversely affect prevailing market prices for our Common Stock.



Similarly, if we issue debt securities, it could result in default and foreclosure on our assets if our operating revenues after an acquisition were insufficient to pay our debt obligations, could result in the acceleration of our obligations to repay the indebtedness even if we have made all principal and interest payments when due if the debt security contains covenants that require the maintenance of certain financial ratios or reserves and any such covenant is breached without a waiver or renegotiation of that covenant, and could result in our inability to obtain additional financing if the debt security contains covenants restricting our ability to obtain additional financing while such security is outstanding.

Because of our limited resources and the significant competition for acquisitions, we may not be able to consummate an acquisition with growth potential.

We expect to encounter intense competition from other entities having a business objective similar to ours, including venture capital funds, leveraged buyout funds and operating businesses competing for acquisitions. Many of these entities are well established and have extensive experience in identifying and effecting business combinations directly or through affiliates. Many of these competitors possess greater technical, human and other resources than we do and our financial resources will be relatively limited when contrasted with those of many of these competitors. While we believe that there are numerous potential target businesses that we could acquire, our ability to compete in acquiring certain target businesses will be limited by our available financial resources. This inherent competitive limitation gives others an advantage in pursuing the acquisition of certain target businesses.

We may be unable to obtain additional financing, if required, to complete an acquisition or to fund the operations and growth of any business acquired, which could compel us to abandon a particular prospective acquisition.

If we require additional financing to complete an acquisition, we cannot assure you that such financing would be available on acceptable terms, if at all. To the extent that additional financing proves to be unavailable when needed to consummate a particular acquisition, we would be compelled to restructure the transaction or abandon that particular acquisition. In addition, if we consummate an acquisition, we may require additional financing to fund the operations or growth of the business acquired. The failure to secure additional financing could have a material adverse effect on the continued development or growth of our business.

There is only a limited public market for our securities.

The trading market for our Common Stock is limited and conducted on the OTC Bulletin Board. Our Common Stock is very thinly traded. There can be no assurance that we will ever achieve a listing of our securities on NASDAQ or a stock exchange or that a more active trading market will ever develop, or, if developed, that it will be sustained.

Potential Adverse Effect on Market Price of Securities from Future Sales of Common Stock.

Future sales of Common Stock pursuant to a registration statement or Rule 144 under the Securities Act, or the perception that such sales could occur, could have an adverse effect on the market price of the Common Stock. Our Registration Statement on Form SB-2 covering the resale by selling security holders of more than 61,000,000 shares of Common Stock was declared effective on August 4, 2006. Relative to the number of shares of our freely-trading Common Stock which had been outstanding prior to such declaration of effectiveness the number of shares which may be sold into the marketplace pursuant to our current Registration Statement is enormous.

We believe that any significant sales of our Common Stock may severely depress the market price of our Common Stock. We also intend to register on Form S-8 under the Securities Act an additional 10,000,000 shares of Common Stock, which are the shares available for issuance under our 2005 Stock Incentive Plan, of which, as of September 30, 2006, we have granted stock options to purchase 4,850,000 shares of our Common Stock. In addition, shares of our Common Stock held for one year or more will be eligible for public resale pursuant to Rule 144. In general, the shares of Common Stock which we issued in connection with the Merger and the Acquisition will become eligible for public resale under Rule 144 as of November 30, 2006. In addition, we may use our capital stock in the future to finance acquisitions and to compensate employees and management, which will further dilute the interests of our existing shareholders and could eventually significantly depress the trading price of our Common Stock.



## Dilution from Shares to Be Issued in Potential Acquisitions

Our business plan calls for our making acquisitions in the future. We will very likely issue a significant number of shares of our capital stock to pay for each such acquisition. Such issuances of shares will dilute the interests of our existing shareholders and could depress the trading price of our Common Stock.

## Effect of Stock Options

Our 2005 Stock Incentive Plan allows for the issuance of up to 10,000,000 shares of Common Stock, either as stock grants or options, to employees, officers, directors, advisors and consultants of the Company. As of November 30, 2005, options to purchase 4,850,000 shares of Original Gales' common stock became options to purchase shares of our Common Stock under our 2005 Stock Incentive Plan. The committee administering such plans will have sole authority and discretion to grant options under such plans. We may grant options which become immediately exercisable in the event of a change in control of the Company and in the event of certain mergers and reorganizations of the Company. The existence of such options could limit the price that certain investors might be willing to pay in the future for shares of our Common Stock and may have the effect of delaying or preventing a change in control of the Company. The issuance of additional shares upon the exercise of such options could also decrease the amount of earnings and assets available for distribution to the holders of the Common Stock and could result in the dilution of voting power of the Common Stock.

## The Series A Convertible Preferred Stock

On August 4, 2006, as a result of the effectiveness of our registration statement on Form SB-2, which was declared effective on August 4, 2006, the 900 shares of Series A Convertible Preferred Stock ("Preferred Stock") issued and outstanding immediately prior to such date were automatically converted into an aggregate of 40,909,500 shares of Common Stock. Those who previously held our Preferred Stock now, as a group, control a majority of the voting shares of the Company and have the ability to elect a majority of the members of our Board of Directors and otherwise control the Company.

Prior to November 30, 2005, AIM was not subject to Sarbanes-Oxley regulations and, therefore, may have lacked the financial controls and procedures of public companies.

Prior to November 30, 2005, AIM did not have the internal or financial control infrastructure necessary to meet the standards of a public company, including the standards required by the Sarbanes Oxley Act of 2002 ("Sarbanes Oxley"). Because AIM was not subject to Sarbanes Oxley, its internal and financial controls reflected its status as a non-public company. AIM did not have the internal infrastructure necessary to complete an attestation about its financial controls that would be required under Section 404 of Sarbanes Oxley. We are now required to comply with portions of Sarbanes Oxley and currently estimate that the costs of complying with Sarbanes Oxley and other requirements associated with being a public company will be \$750,000 during calendar year 2006, and such cost will likely increase at such time as we are required to comply with Section 404 of Sarbanes Oxley.

## Item 3: Controls and Procedures

As of the end of the period covered by this report, our management, including our principal executive officer and our principal financial officer, have conducted an evaluation of the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15 under the Securities Exchange Act of 1934). Based upon that evaluation, our principal executive officer and our chief financial officer have concluded that our disclosure controls and procedures are effective in timely alerting them of material information relating to us that is required to be disclosed by us in the reports we file or submit under the Exchange Act.

Because AIM was subject to stringent performance criteria imposed by its customers and as a consequence of its government contracts, in our management's estimation, its disclosure controls and procedures were superior to those of most privately held companies of comparable size. Nevertheless, its controls and procedures were not designed to facilitate the external financial reporting required of a publicly held company. Although no material weaknesses were found in our disclosure controls and procedures as of September 30, 2006, to ensure the reliability of future financial reports, our management has determined to complete the implementation of a total financial and operating control system that AIM installed during 2005. In addition, management has determined to hire

support personnel experienced with the reporting requirements imposed upon public companies to facilitate the timely preparation of accurate financial reports. Except for these planned changes and those resulting from the acquisition of AIM and the substitution of its accounting procedures for those of ours in effect prior to November 30, 2005, there have been no significant changes made in our internal controls or in other factors that could significantly affect our internal controls subsequent to September 30, 2006 or during the quarter ended September 30, 2006.

## PART II

### OTHER INFORMATION

#### Item 1: Legal Proceedings

We were involved in litigation with J.C. Herbert Bryant, III, a former officer, director and shareholder of our Company, and KMS-Thin Tab 100, Inc., which was settled in September 2002. As part of the settlement, we entered into a distribution agreement with KMS permitting it to purchase certain products from us and to exclusively distribute those products in Florida from Orlando south. In October 2003, we terminated the distribution agreement with KMS. On December 1, 2003, we filed suit against KMS in the Palm Beach County Circuit Court for breach of contract, trademark infringement and for a declaration of rights that the distribution agreement is terminated. KMS answered the complaint and filed its own counterclaim for fraud in the inducement, trademark infringement, dilution and fraudulent misrepresentation; the fraud-based counterclaims were dismissed with prejudice by the Court on summary judgment. KMS subsequently amended its counterclaim to allege a breach of contract under the distribution agreement. In January 2005, the State Court in Florida ruled that neither party should prevail and rejected a request for attorney's fees by KMS of approximately \$60,000. KMS subsequently filed a notice of appeal. Subsequent to our emergence from Bankruptcy, KMS requested that the Bankruptcy Court reopen our bankruptcy case and award it the attorney's fees previously rejected by the Florida State Court. The Bankruptcy Court granted the motion in so far as it allowed KMS to prosecute in the Fourth District Court of Appeal in Florida its appeal of the State Court decision. Subsequently, KMS filed its appeal and brief with the Fourth District seeking attorney's fees. We intend to contest this claim vigorously and are in the process of preparing our response.

In March 2004 Michael Gales, our Executive Chairman, acting on behalf of a then unformed company, entered into a "finder's agreement" with a third party. This party has advised a director of the Company that it believes that it is entitled to a fee as a result of the Company's acquisition of AIM and the completion of the financing with PNC. The Company believes that there is no merit to this claim, and, if it is brought, intends to contest it vigorously.

#### Item 4: Unregistered Sales of Equity Securities

Pursuant to a consulting agreement with a consultant that was terminated in September 2006, we remain obligated to deliver warrants to purchase an aggregate of 31,251 shares of our Common Stock, that were to have been delivered in increments of 10,417 shares as of the first day of each of July, August and September. The exercise price per share for such warrants to be issued will equal 120% of the average closing price of the Common Stock during the months of June, July and August, respectively. Upon delivery of such warrants we will have delivered an aggregate of 72,919 warrants to the same firm which are exercisable for an aggregate of 72,919 shares of Common Stock.

Such issuances of warrants to our consulting firm were, and will be, exempt from registration pursuant to Section 4(2) under the Securities Act of 1933, as amended.

The 900 shares of Preferred Stock accumulated \$360,000 in 8% Payable-In-Kind (PIK) dividends. This Payable-In-Kind dividend was earned during the six month period from December 15, 2005 to June 15, 2006 and is equal to 36 shares of preferred stock convertible into 1,636,380 shares of common stock. Such dividends, as well as the outstanding Preferred Stock, automatically converted into shares of Common Stock when our registration statement on Form SB-2 became effective on August 4, 2006.

Item 6. Exhibits

| Exhibit No. | Description of Exhibit  |
|-------------|---|
| 10.1        | Amended and Restated Term Note dated November 10, 2006  |
| 10.2        | First Amendment to Revolving Credit, Term Loan, Equipment Line of Credit and Security Agreement dated November 10, 2006 |
| 31.1        | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.          |
| 31.2        | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.          |
| 32.1        | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).    |
| 32.2        | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).    |

SIGNATURES

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

Dated: November 14 , 2006

GALES INDUSTRIES INCORPRATED

By: /s/ Michael A. Gales

-----  
Michael A. Gales,  
Executive Chairman

By: /s/ Louis A. Giusto

-----  
Louis A. Giusto,  
Chief Financial Officer  
(Principal Financial and Accounting  
Officer)

EXHIBIT INDEX

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\$383,330

November 10, 2006  
New York, New York

This Amended and Restated Term Note (this "Note") is executed and delivered under and pursuant to the terms of that certain Revolving Credit, Term Loan, Equipment Line of Credit and Security Agreement dated November 30, 2005 (as amended, restated, supplemented or modified from time to time, the "Loan Agreement") by and among AIR INDUSTRIES MACHINING, CORP., a corporation organized under the laws of the State of New York ("Borrower") and PNC BANK, NATIONAL ASSOCIATION ("PNC"), the various financial institutions named therein or which hereafter become a party thereto, (together with PNC, collectively, "Lenders") and PNC as agent for Lenders (in such capacity, "Agent"). Capitalized terms not otherwise defined herein shall have the meanings provided in the Loan Agreement.

FOR VALUE RECEIVED, Borrower hereby promises to pay to the order of PNC, at the office of Agent located at PNC Bank Center, Two Tower Center, 8th Floor, East Brunswick, New Jersey 08816, or at such other place as Agent may from time to time designate to Borrower in writing:

(i) the principal sum of THREE HUNDRED EIGHTY THREE THOUSAND THREE HUNDRED THIRTY AND 00/100 DOLLARS (\$383,330), payable in accordance with the provisions of the Loan Agreement and subject to acceleration upon the occurrence of an Event of Default under the Loan Agreement or earlier termination of the Loan Agreement pursuant to the terms thereof;

(ii) interest on the principal amount of this Note from time to time outstanding, payable at the Term Loan Rate in accordance with the provisions of the Loan Agreement. In no event, however, shall interest exceed the maximum interest rate permitted by law. Upon and after the occurrence of an Event of Default, and during the continuation thereof, interest shall be payable at the Default Rate; and

(iii) notwithstanding anything to the contrary herein, in the Loan Agreement and/or in any Other Document, all outstanding principal and interest hereunder is due and payable on the Termination Date.

This Note is one of the Term Notes referred to in the Loan Agreement and is secured, inter alia, by the liens granted pursuant to the Loan Agreement and the Other Documents, is entitled to the benefits of the Loan Agreement and the Other Documents and is subject to all of the agreements, terms and conditions therein contained.

This Note is subject to mandatory prepayment and may be voluntarily prepaid, in whole or in part, on the terms and conditions set forth in the Loan Agreement.

If an Event of Default under Section 10.7 or 10.8 of the Loan Agreement shall occur, then this Note shall immediately become due and payable, without notice, together with reasonable attorneys' fees if the collection hereof is placed in the hands of an attorney to obtain or enforce payment hereof. If any other Event of Default shall occur under the Loan Agreement or any of the Loan Documents, which is not cured within any applicable grace period, then this Note may, as provided in the Loan Agreement, be declared to be immediately due and payable, without notice, together with reasonable attorneys' fees, if the collection hereof is placed in the hands of an attorney to obtain or enforce payment hereof.

This Note is intended to amend, restate and replace in its entirety a certain Term Note executed by the Borrower in favor of the Agent, for the benefit of the Lenders, dated November 30, 2005 in the original principal amount of \$3,500,000, as amended and/or otherwise modified from time to time. This Note is not a novation.

This Note shall be construed and enforced in accordance with the laws of the State of New York.

Borrower expressly waives any presentment, demand, protest, notice of protest, or notice of any kind except as expressly provided in the Loan Agreement.

ATTEST: AIR INDUSTRIES MACHINING, CORP.

By: \_\_\_\_\_  
Name: LOUIS A. GIUSTO  
Title: Vice Chairman

By: \_\_\_\_\_  
Name: MICHAEL A. GALES  
Title: Executive Chairman



THIS FIRST AMENDMENT TO REVOLVING CREDIT, TERM LOAN, EQUIPMENT LINE OF CREDIT AND SECURITY AGREEMENT (this "Agreement") is entered into November 10, 2006 by and among AIR INDUSTRIES MACHINING, CORP. (as successor by merger with Gales Industries Acquisition Corp., Inc.), a corporation organized under the laws of the State of New York ("Borrower"), the financial institutions which are now or which hereafter become a party hereto (collectively, the "Lenders" and individually a "Lender") and PNC BANK, NATIONAL ASSOCIATION ("PNC"), as agent for Lenders (PNC, in such capacity, the "Agent").

#### RECITALS

Whereas, the Borrower and PNC entered into a certain Revolving Credit, Term Loan, Equipment Line of Credit and Security Agreement dated November 30, 2005 (as is being and may be further amended, replaced, restated, modified and/or extended, the "Loan Agreement"); and

Whereas, Borrower and PNC have agreed to modify the terms of the Loan Agreement as set forth in this Agreement.

Now, therefore, in consideration of PNC's continued extension of credit and the agreements contained herein, the parties agree as follows:

#### AGREEMENT

1) ACKNOWLEDGMENT OF BALANCE. Borrower acknowledges that the most recent statement of account sent to Borrower with respect to the Obligations is correct.

2) MODIFICATIONS. The Loan Agreement be and hereby is modified as follows:

(a) The following definitions in Section 1.2 of the Loan Agreement are hereby deleted, and are replaced to read as follows:

"Advances" shall mean and include the Revolving Advances and as well as Letters of Credit, the Term Loan, the Converted Equipment Loans and the Equipment Loans.

"Commitment Percentage" of any Lender shall mean the percentage set forth below such Lender's name on the signature page hereof as same may be adjusted upon any assignment by a Lender pursuant to Section 15.3(c) or (d) hereof.

"Purchasing Lender" shall have the meaning set forth in Section 15.3(c) hereof.

"Revolving Advances" shall mean the Advances made other than Letters of Credit, Equipment Loans, the Converted Equipment Loans and the Term Loan.

"Transferee" shall have the meaning set forth in Section 15.3(d) hereof.

(b) The following definitions are hereby added to Section 1.2 of the Loan Agreement to read as follows:

"Issuer" shall mean any Person who issues a Letter of Credit and/or accepts a draft pursuant to the terms hereof.

"Letter of Credit Fees" shall have the meaning set forth in Section 3.11.

"Letter of Credit Borrowing" shall have the meaning set forth in Section 2.17(d).

"Letter of Credit Sublimit" shall mean \$500,000.

"Letters of Credit" shall have the meaning set forth in Section 2.14.

"Maximum Face Amount" shall mean, with respect to any outstanding Letter of Credit, the face amount of such Letter of Credit including all automatic increases provided for in such Letter of Credit, whether or not any such automatic increase has become effective.

"Maximum Undrawn Amount" shall mean with respect to any outstanding Letter of Credit, the amount of such Letter of Credit that is or may become available to be drawn, including all automatic increases provided for in such Letter of Credit, whether or not any such automatic increase has become effective.



"Modified Commitment Transfer Supplement" shall have the meaning set forth in Section 15.3(d).

"Participation Commitment" shall mean each Lender's obligation to buy a participation of the Letters of Credit issued hereunder.

"Purchasing CL0" shall have the meaning set forth in Section 15.3(d) hereof.

"Register" shall have the meaning set forth in Section 15.3(e).

"First Amendment Closing Date" shall mean November 10, 2006.

(c) The initial paragraph of Subsection 2.1(a) of the Loan Agreement is deleted, and is replaced by a new initial paragraph of Subsection 2.1(a) to read as follows:

(a) Amount of Revolving Advances. Subject to the terms and conditions set forth in this Agreement including Section 2.1(b), each Lender, severally and not jointly, will make Revolving Advances to Borrower in aggregate amounts outstanding at any time equal to such Lender's Commitment Percentage of the lesser of (x) the Maximum Revolving Advance Amount less the aggregate Maximum Undrawn Amount of all outstanding Letters of Credit or (y) an amount equal to the sum of:

(d) Subsection 2.4(a) of the Loan Agreement is deleted, and is replaced by a new Subsection 2.4(a) to read as follows:

(a) Term Loan. Subject to the terms and conditions of this Agreement, each Lender, severally and not jointly, will make a Term Loan to Borrower in the sum equal to such Lender's Commitment Percentage of \$383,330. The Term Loan shall be advanced on the First Amendment Closing Date and shall be, with respect to principal, payable as follows, subject to acceleration upon the occurrence of an Event of Default under this Agreement or termination of this Agreement: thirty six (36) consecutive monthly principal installments, the first thirty five (35) of which shall be in the amount of \$10,648 commencing on the first Business Day of November, 2006, and continuing on the first Business Day of each month thereafter, with a thirty sixth (36th) and final payment of any unpaid balance of principal and interest payable on the first Business Day of October, 2009, subject to mandatory prepayment and acceleration upon the occurrence of an Event of Default hereunder or earlier termination of the Loan Agreement pursuant to the terms hereof. Notwithstanding anything to the contrary herein, in the Term Note and/or in any Other Document, all outstanding principal and interest hereunder is due and payable on the Termination Date in the event that the Termination Date is before the first Business Day of October, 2009. The Term Loan shall be evidenced by one or more secured promissory notes (collectively, the "Term Note") in substantially the form attached hereto as Exhibit 2.4a.

(e) Section 2.5 of the Loan Agreement is deleted, and is replaced by a new Section 2.5 to read as follows:

2.5 Maximum Advances. The aggregate balance of Revolving Advances outstanding at any time shall not exceed the lesser of (a) the Maximum Revolving Advance Amount or (b) the Formula Amount less, in each case, the aggregate Maximum Undrawn Amount of all issued and outstanding Letters of Credit.

(f) Subsection 2.12(a) of the Loan Agreement is deleted, and is replaced by a new Subsection 2.12(a) to read as follows:

(a) Borrower shall apply the proceeds of Advances to (i) purchase the Mortgaged Premises, (ii) repay existing indebtedness owed to Citibank, (iii) pay fees and expenses relating to this transaction, and (iv) provide for its working capital needs and reimburse drawings under Letters of Credit.

(g) Sections 2.14, 2.15, 2.16, 2.17, 2.18, 2.19, 2.20, 2.21, 2.22 and 2.23 are hereby added to the Loan Agreement to read as follows:

2.14. Letters of Credit. Subject to the terms and conditions hereof, Agent shall issue or cause the issuance of standby Letters of Credit ("Letters of Credit") for the account of the Borrower; provided, however, that Agent will not be required to issue or cause to be issued any Letters of Credit to the extent that the issuance thereof would then cause the sum of (i) the outstanding Revolving Advances plus (ii) the Maximum Undrawn Amount of all outstanding Letters of Credit to exceed the lesser of (x) the Maximum Revolving Advance Amount or (y) the Formula Amount. The Maximum Undrawn Amount of outstanding Letters of Credit shall not exceed in the aggregate at any time the Letter of Credit Sublimit. All disbursements or payments related to Letters of Credit shall be deemed to be Domestic Rate Loans consisting of Revolving Advances and shall bear interest at the applicable Contract Rate for Domestic Rate Loans; Letters of Credit that have not been drawn upon shall not bear interest.

2.15. Issuance of Letters of Credit.

(a) Borrower may request Agent to issue or cause the issuance of a Letter of Credit by delivering to Agent at the Payment Office, prior to 10:00 a.m. (New York time), at least five (5) Business Days' prior to the proposed date of issuance, Agent's form of Letter of Credit Application (the "Letter of Credit Application") completed to the satisfaction of Agent; and, such other certificates, documents and other papers and information as Agent may reasonably request. Borrower also has the right to give instructions and make agreements with respect to any application, any applicable letter of credit and security agreement, any applicable letter of credit reimbursement agreement and/or any other applicable agreement, any letter of credit and the disposition of documents, disposition of any unutilized funds, and to agree with Agent upon any amendment, extension or renewal of any Letter of Credit.

(b) Each Letter of Credit shall, among other things, (i) provide for the payment of sight drafts, other written demands for payment, or acceptances of usance drafts when presented for honor thereunder in accordance with the terms thereof and when accompanied by the documents described therein and (ii) have an expiry date not later than twenty-four (24) months after such Letter of Credit's date of issuance and in no event later than the last day of the Term. Each standby Letter of Credit shall be subject either to the Uniform Customs and Practice for Documentary Credits (1993 Revision), International Chamber of Commerce Publication No. 500, and any amendments or revision thereof adhered to by the Issuer ("UCP 500") or the International Standby Practices (ISP98-International Chamber of Commerce Publication Number 590) (the "ISP98 Rules"), as determined by Agent, and each trade Letter of Credit shall be subject to UCP 500.

(c) Agent shall use its reasonable efforts to notify Lenders of the request by Borrower for a Letter of Credit hereunder.

## 2.16. Requirements For Issuance of Letters of Credit.

(a) Borrower shall authorize and direct any Issuer to name the Borrower as the "Applicant" or "Account Party" of each Letter of Credit. If Agent is not the Issuer of any Letter of Credit, Borrower shall authorize and direct the Issuer to deliver to Agent all instruments, documents, and other writings and property received by the Issuer pursuant to the Letter of Credit and to accept and rely upon Agent's instructions and agreements with respect to all matters arising in connection with the Letter of Credit, the application therefor or any acceptance therefor.

(b) In connection with all Letters of Credit issued or caused to be issued by Agent under this Agreement, Borrower hereby appoints Agent, or its designee, as its attorney, with full power and authority if an Event of Default shall have occurred, (i) to sign and/or endorse Borrower's name upon any warehouse or other receipts, letter of credit applications and acceptances, (ii) to sign Borrower's name on bills of lading; (iii) to clear Inventory through the United States of America Customs Department ("Customs") in the name of Borrower or Agent or Agent's designee, and to sign and deliver to Customs officials powers of attorney in the name of Borrower for such purpose; and (iv) to complete in Borrower's name or Agent's, or in the name of Agent's designee, any order, sale or transaction, obtain the necessary documents in connection therewith, and collect the proceeds thereof. Neither Agent nor its attorneys will be liable for any acts or omissions nor for any error of judgment or mistakes of fact or law, except for Agent's or its attorney's willful misconduct. This power, being coupled with an interest, is irrevocable as long as any Letters of Credit remain outstanding.

## 2.17. Disbursements, Reimbursement.

(a) Immediately upon the issuance of each Letter of Credit, each Lender shall be deemed to, and hereby irrevocably and unconditionally agrees to, purchase from Agent a participation in such Letter of Credit and each drawing thereunder in an amount equal to such Lender's Commitment Percentage of the Maximum Face Amount of such Letter of Credit and the amount of such drawing, respectively.

(b) In the event of any request for a drawing under a Letter of Credit by the beneficiary or transferee thereof, Agent will promptly notify Borrower. Provided that Borrower shall have received such notice, the Borrower shall reimburse (such obligation to reimburse Agent shall sometimes be referred to as a "Reimbursement Obligation") Agent prior to 12:00 Noon, New York time on each date that an amount is paid by Agent under any Letter of Credit (each such date, a "Drawing Date") in an amount equal to the amount so paid by Agent. In the event Borrower fail to reimburse Agent for the full amount of any drawing under any Letter of Credit by 12:00 Noon, New York time, on the Drawing Date, Agent will promptly notify each Lender thereof, and Borrower shall be deemed to have requested that a Domestic Rate Loan be made by the Lenders to be disbursed on the Drawing Date under such Letter of Credit, subject to the amount of the unutilized portion of the lesser of Maximum Revolving Advance Amount or the Formula Amount and subject to Section 8.2 hereof. Any notice given by Agent pursuant to this Section 2.17(b) may be oral if immediately confirmed in writing; provided that the lack of such an immediate confirmation shall not affect the conclusiveness or binding effect of such notice.

(c) Each Lender shall upon any notice pursuant to Section 2.17(b) make available to Agent an amount in immediately available funds equal to its Commitment Percentage of the amount of the drawing, whereupon the participating Lenders shall (subject to Section 2.17(d)) each be deemed to have made a Domestic Rate Loan to Borrower in that amount. If any Lender so notified fails to make available to Agent the amount of such Lender's Commitment Percentage of such amount by no later than 2:00 p.m., New York time on the Drawing Date, then interest shall accrue on such Lender's obligation to make such payment, from the Drawing Date to the date on which such Lender makes such payment (i) at a rate per annum equal to the Federal Funds Rate during the first three days following the Drawing Date and (ii) at a rate per annum equal to the rate applicable to Domestic Rate Loans on and after the fourth day following the Drawing Date. Agent will promptly give notice of the occurrence of the Drawing Date, but failure of Agent to give any such notice on the Drawing Date or

in sufficient time to enable any Lender to effect such payment on such date shall not relieve such Lender from its obligation under this Section 2.17(c), provided that such Lender shall not be obligated to pay interest as provided in Section 2.17(c)(i) and (ii) until and commencing from the date of receipt of notice from Agent of a drawing.

(d) With respect to any unreimbursed drawing that is not converted into a Domestic Rate Loan to Borrower in whole or in part as contemplated by Section 2.17(b), because of Borrower's failure to satisfy the conditions set forth in Section 8.2 (other than any notice requirements) or for any other reason, Borrower shall be deemed to have incurred from Agent a borrowing (each a "Letter of Credit Borrowing") in the amount of such drawing. Such Letter of Credit Borrowing shall be due and payable on demand (together with interest) and shall bear interest at the rate per annum applicable to a Domestic Rate Loan. Each Lender's payment to Agent pursuant to Section 2.17(c) shall be deemed to be a payment in respect of its participation in such Letter of Credit Borrowing and shall constitute a "Participation Advance" from such Lender in satisfaction of its Participation Commitment under this Section 2.17.

(e) Each Lender's Participation Commitment shall continue until the last to occur of any of the following events: (x) Agent ceases to be obligated to issue or cause to be issued Letters of Credit hereunder; (y) no Letter of Credit issued or created hereunder remains outstanding and uncanceled and (z) all Persons (other than the Borrower) have been fully reimbursed for all payments made under or relating to Letters of Credit.

#### 2.18. Repayment of Participation Advances.

(a) Upon (and only upon) receipt by Agent for its account of immediately available funds from Borrower (i) in reimbursement of any payment made by the Agent under the Letter of Credit with respect to which any Lender has made a Participation Advance to Agent, or (ii) in payment of interest on such a payment made by Agent under such a Letter of Credit, Agent will pay to each Lender, in the same funds as those received by Agent, the amount of such Lender's Commitment Percentage of such funds, except Agent shall retain the amount of the Commitment Percentage of such funds of any Lender that did not make a Participation Advance in respect of such payment by Agent.

(b) If Agent is required at any time to return to Borrower, or to a trustee, receiver, liquidator, custodian, or any official in any insolvency proceeding, any portion of the payments made by Borrower to Agent pursuant to Section 2.18(a) in reimbursement of a payment made under the Letter of Credit or interest or fee thereon, each Lender shall, on demand of Agent, forthwith return to Agent the amount of its Commitment Percentage of any amounts so returned by Agent plus interest at the Federal Funds Effective Rate.

2.19. Documentation. The Borrower agrees to be bound by the terms of the Letter of Credit Application and by Agent's reasonable interpretations of any Letter of Credit issued on behalf of Borrower and by Agent's written regulations and customary practices relating to letters of credit, though Agent's interpretations may be different from Borrower's own. In the event of a conflict between the Letter of Credit Application and this Agreement, this Agreement shall govern. It is understood and agreed that, except in the case of gross negligence or willful misconduct (as determined by a court of competent jurisdiction in a final non-appealable judgment), Agent shall not be liable for any error, negligence and/or mistakes, whether of omission or commission, in following the Borrower's instructions or those contained in the Letters of Credit or any modifications, amendments or supplements thereto.

2.20. Determination to Honor Drawing Request. In determining whether to honor any request for drawing under any Letter of Credit by the beneficiary thereof, Agent shall be responsible only to determine that the documents and certificates required to be delivered under such Letter of Credit have been delivered and that they comply on their face with the requirements of such Letter of Credit and that any other drawing condition appearing on the face of such Letter of Credit has been satisfied in the manner so set forth.

2.21. Nature of Participation and Reimbursement Obligations. Each Lender's obligation in accordance with this Agreement to make the Revolving Advances or Participation Advances as a result of a drawing under a Letter of Credit, and the obligations of Borrower to reimburse Agent upon a draw under a Letter of Credit, shall be absolute, unconditional and irrevocable, and shall be performed strictly in accordance with the terms of this Section 2.21 under all circumstances, including the following circumstances:

(i) any set-off, counterclaim, recoupment, defense or other right which such Lender may have against Agent, Borrower or any other Person for any reason whatsoever;

(ii) the failure of Borrower or any other Person to comply, in connection with a Letter of Credit Borrowing, with the conditions set forth in this Agreement for the making of a Revolving Advance, it being acknowledged that such conditions are not required for the making of a Letter of Credit Borrowing and the obligation of the Lenders to make Participation Advances under Section 2.17;

(iii) any lack of validity or enforceability of any Letter of Credit;

(iv) any claim of breach of warranty that might be made by Borrower or any Lender against the beneficiary of a Letter of Credit, or the existence of any claim, set-off, recoupment, counterclaim, crossclaim, defense or other right which Borrower or any Lender may have at any time against a beneficiary, any successor beneficiary or any transferee of any Letter of Credit or the proceeds thereof (or any Persons for whom any such transferee may be acting), Agent or any Lender or any other Person, whether in connection with this Agreement, the transactions contemplated herein or any unrelated transaction (including any underlying transaction between Borrower or any Subsidiaries of Borrower and the beneficiary for which any Letter of Credit was procured);

(v) the lack of power or authority of any signer of (or any defect in or forgery of any signature or endorsement on) or the form of or lack of validity, sufficiency, accuracy, enforceability or genuineness of any draft, demand, instrument, certificate or other document presented under or in connection with any Letter of Credit, or any fraud or alleged fraud in connection with any Letter of Credit, or the transport of any property or provisions of services relating to a Letter of Credit, in each case even if Agent or any of Agent's Affiliates has been notified thereof;

(vi) payment by Agent under any Letter of Credit against presentation of a demand, draft or certificate or other document which does not comply with the terms of such Letter of Credit;

(vii) the solvency of, or any acts or omissions by, any beneficiary of any Letter of Credit, or any other Person having a role in any transaction or obligation relating to a Letter of Credit, or the existence, nature, quality, quantity, condition, value or other characteristic of any property or services relating to a Letter of Credit;

(viii) any failure by the Agent or any of Agent's Affiliates to issue any Letter of Credit in the form requested by Borrower, unless the Agent has received written notice from Borrower of such failure within three (3) Business Days after the Agent shall have furnished Borrower a copy of such Letter of Credit and such error is material and no drawing has been made thereon prior to receipt of such notice;

(ix) any Material Adverse Effect on Borrower;

(x) any breach of this Agreement or any Other Document by any party thereto;

(xi) the occurrence or continuance of an insolvency proceeding with respect to Borrower;

(xii) the fact that a Default or Event of Default shall have occurred and be continuing;

(xiii) the fact that the Term shall have expired or this Agreement or the Obligations hereunder shall have been terminated; and

(xix) any other circumstance or happening whatsoever, whether or not similar to any of the foregoing.

2.22. Indemnity. In addition to amounts payable as provided in Section 15.5, Borrower hereby agrees to protect, indemnify, pay and save harmless Agent and any of Agent's Affiliates that have issued a Letter of Credit from and against any and all claims, demands, liabilities, damages, taxes, penalties, interest, judgments, losses, costs, charges and expenses (including reasonable fees, expenses and disbursements of counsel and allocated costs of internal counsel) which the Agent or any of Agent's Affiliates may incur or be subject to as a consequence, direct or indirect, of the issuance of any Letter of Credit, other than as a result of (A) the gross negligence or willful misconduct of the Agent as determined by a final and non-appealable judgment of a court of competent jurisdiction or (b) the wrongful dishonor by the Agent or any of Agent's Affiliates of a proper demand for payment made under any Letter of Credit, except if such dishonor resulted from any act or omission, whether rightful or wrongful, of any present or future de jure or de facto Governmental Body (all such acts or omissions herein called "Governmental Acts").

2.23. Liability for Acts and Omissions. As between Borrower and Agent and Lenders, Borrower assumes all risks of the acts and omissions of, or misuse of the Letters of Credit by, the respective beneficiaries of such Letters of Credit. In furtherance and not in limitation of the respective foregoing, Agent shall not be responsible for: (i) the form, validity, sufficiency, accuracy, genuineness or legal effect of any document submitted by any party in connection with the application for an issuance of any such Letter of Credit, even if it should in fact prove to be in any or all respects invalid, insufficient, inaccurate, fraudulent or forged (even if Agent shall have been notified thereof); (ii) the validity or sufficiency of any instrument transferring or assigning or purporting to transfer or assign any such Letter of Credit or the rights or benefits thereunder or proceeds thereof, in whole or in part, which may prove to be invalid or ineffective for any reason; (iii) the failure of the beneficiary of any such Letter of Credit, or any other party to which such Letter of Credit may be transferred, to comply fully with any conditions required in order to draw upon such Letter of Credit or any other claim of Borrower against any beneficiary of such Letter of Credit, or any such transferee, or any dispute between or among Borrower and any beneficiary of any Letter of Credit or any such transferee; (iv) errors, omissions, interruptions or delays in transmission or delivery of any messages, by mail, cable, telegraph, telex or otherwise, whether or not they be in

cipher; (v) errors in interpretation of technical terms; (vi) any loss or delay in the transmission or otherwise of any document required in order to make a drawing under any such Letter of Credit or of the proceeds thereof; (vii) the misapplication by the beneficiary of any such Letter of Credit of the proceeds of any drawing under such Letter of Credit; or (viii) any consequences arising from causes beyond the control of Agent, including any Governmental Acts, and none of the above shall affect or impair, or prevent the vesting of, any of Agent's rights or powers hereunder. Nothing in the preceding sentence shall relieve Agent from liability for Agent's gross negligence or willful misconduct (as determined by a court of competent jurisdiction in a final non-appealable judgment) in connection with actions or omissions described in such clauses (i) through (viii) of such sentence. In no event shall Agent or Agent's Affiliates be liable to Borrower for any indirect, consequential, incidental, punitive, exemplary or special damages or expenses (including without limitation attorneys' fees), or for any damages resulting from any change in the value of any property relating to a Letter of Credit.

Without limiting the generality of the foregoing, Agent and each of its Affiliates (i) may rely on any oral or other communication believed in good faith by Agent or such Affiliate to have been authorized or given by or on behalf of the applicant for a Letter of Credit, (ii) may honor any presentation if the documents presented appear on their face substantially to comply with the terms and conditions of the relevant Letter of Credit; (iii) may honor a previously dishonored presentation under a Letter of Credit, whether such dishonor was pursuant to a court order, to settle or compromise any claim of wrongful dishonor, or otherwise, and shall be entitled to reimbursement to the same extent as if such presentation had initially been honored, together with any interest paid by Agent or its Affiliates; (iv) may honor any drawing that is payable upon presentation of a statement advising negotiation or payment, upon receipt of such statement (even if such statement indicates that a draft or other document is being delivered separately), and shall not be liable for any failure of any such draft or other document to arrive, or to conform in any way with the relevant Letter of Credit; (v) may pay any paying or negotiating bank claiming that it rightfully honored under the laws or practices of the place where such bank is located; and (vi) may settle or adjust any claim or demand made on Agent or its Affiliate in any way related to any order issued at the applicant's request to an air carrier, a letter of guarantee or of indemnity issued to a carrier or any similar document (each an "Order") and honor any drawing in connection with any Letter of Credit that is the subject of such Order, notwithstanding that any drafts or other documents presented in connection with such Letter of Credit fail to conform in any way with such Letter of Credit.

In furtherance and extension and not in limitation of the specific provisions set forth above, any action taken or omitted by Agent under or in connection with the Letters of Credit issued by it or any documents and certificates delivered thereunder, if taken or omitted in good faith and without gross negligence (as determined by a court of competent jurisdiction in a final non-appealable judgment), shall not put Agent under any resulting liability to Borrower or any Lender.

(h) Subsection 3.2(b) of the Loan Agreement is deleted, and is replaced by a new Subsection 3.2(b) to read as follows:

(b) Facility Fee. If, for any calendar quarter during the Term, the average daily unpaid balance of the Revolving Advances and undrawn amount of any outstanding Letters of Credit for each day of such calendar quarter does not equal the Maximum Revolving Advance Amount, then Borrower shall pay to Agent for the ratable benefit of Lenders a fee at a rate equal to one half of one percent (.50%) per annum on the amount by which the Maximum Revolving Advance Amount exceeds such average daily unpaid balance. Such fee shall be payable to Agent in arrears on the first day of each calendar quarter with respect to the previous calendar quarter.

(i) Sections 3.11 is hereby added to the Loan Agreement to read as follows:

3.11. Letter of Credit Fees.

(a) Borrower shall pay (x) to Agent, for the ratable benefit of Lenders, fees for each Letter of Credit for the period from and including the date of issuance of same to and including the date of expiration or termination, equal to the average daily face amount of each outstanding Letter of Credit multiplied per annum by two and one half of one percent (2.50%), such fees to be calculated on the basis of a 360-day year for the actual number of days elapsed and to be payable quarterly in arrears on the first day of each quarter and on the last day of the Term, and (y) to the Issuer, a fronting fee of one quarter of one percent (0.25%) per annum, together with any and all administrative, issuance, amendment, payment and negotiation charges with respect to Letters of Credit and all fees and expenses as agreed upon by the Issuer and the Borrower in connection with any Letter of Credit, including in connection with the opening, amendment or renewal of any such Letter of Credit and any acceptances created thereunder and shall reimburse Agent for any and all fees and expenses, if any, paid by Agent to the Issuer (all of the foregoing fees, the "Letter of Credit Fees"). All such charges shall be deemed earned in full on the date when the same are due and payable hereunder and shall not be subject to rebate or pro-ration upon the termination of this Agreement for any reason. Any such charge in effect at the time of a particular transaction shall be the charge for that transaction, notwithstanding any subsequent change in the Issuer's prevailing charges for that type of transaction. All Letter of Credit Fees payable hereunder shall be deemed earned in full on the date when the same are due and payable hereunder and shall not be subject to rebate or pro-ration upon the termination of this Agreement for any reason.

(b) On demand, Borrower will cause cash to be deposited and maintained in an account with Agent, as cash collateral, in an amount equal to one hundred and five percent (105%) of the Maximum Undrawn Amount of all outstanding Letters of Credit, and Borrower hereby irrevocably authorizes Agent, in its discretion, on Borrower's behalf and in Borrower's name, to open such an account and to make and maintain deposits therein, or in an account opened by Borrower, in the amounts required to be made by Borrower, out of the proceeds of Receivables or other Collateral or out of any other funds of Borrower coming into any Lender's possession at any time. Agent will invest such cash collateral (less applicable reserves) in such short-term money-market items as to which Agent and Borrower mutually agree and the net return on such investments shall be credited to such account and constitute additional cash collateral. Borrower may not withdraw amounts credited to any such account except upon the occurrence of all of the following: (x) payment and performance in full of all Obligations, (y) expiration of all Letters of Credit and (z) termination of this Agreement.

(j) Section 11.5 of the Loan Agreement is deleted, and is replaced by a new Section 11.5 to read as follows:

11.5. Allocation of Payments After Event of Default. Notwithstanding any other provisions of this Agreement to the contrary, after the occurrence and during the continuance of an Event of Default, all amounts collected or received by the Agent on account of the Obligations or any other amounts outstanding under any of the Other Documents or in respect of the Collateral may, at Agent's discretion, be paid over or delivered as follows:

FIRST, to the payment of all reasonable out-of-pocket costs and expenses (including reasonable attorneys' fees) of the Agent in connection with enforcing its rights and the rights of the Lenders under this Agreement and the Other Documents and any protective advances made by the Agent with respect to the Collateral under or pursuant to the terms of this Document;

SECOND, to payment of any fees owed to the Agent;

THIRD, to the payment of all reasonable out-of-pocket costs and expenses (including reasonable attorneys' fees) of each of the Lenders in connection with enforcing its rights under this Agreement and the Other Documents or otherwise with respect to the Obligations owing to such Lender;

FOURTH, to the payment of all of the Obligations consisting of accrued fees and interest;

FIFTH, to the payment of the outstanding principal amount of the Obligations (including the payment or cash collateralization of any outstanding Letters of Credit);



SIXTH, to all other Obligations and other obligations which shall have become due and payable under the Other Documents or otherwise and not repaid pursuant to clauses "FIRST" through "FIFTH" above; and

SEVENTH, to the payment of the surplus, if any, to whoever may be lawfully entitled to receive such surplus.

In carrying out the foregoing, (i) amounts received shall be applied in the numerical order provided until exhausted prior to application to the next succeeding category; (ii) each of the Lenders shall receive (so long as it is not a Defaulting Lender) an amount equal to its pro rata share (based on the proportion that the then outstanding Advances held by such Lender bears to the aggregate then outstanding Advances) of amounts available to be applied pursuant to clauses "FOURTH", "FIFTH" and "SIXTH" above; and (iii) to the extent that any amounts available for distribution pursuant to clause "FIFTH" above are attributable to the issued but undrawn amount of outstanding Letters of Credit, such amounts shall be held by the Agent in a cash collateral account and applied (A) first, to reimburse the Issuer from time to time for any drawings under such Letters of Credit and (B) then, following the expiration of all Letters of Credit, to all other obligations of the types described in clauses "FIFTH" and "SIXTH" above in the manner provided in this Section 11.5.

(k) Section 15.3 of the Loan Agreement is deleted, and is replaced by a new Section 15.3 to read as follows:

#### 15.3. Successors and Assigns; Participations; New Lenders.

(a) This Agreement shall be binding upon and inure to the benefit of Borrower, Agent, each Lender, all future holders of the Obligations and their respective successors and assigns, except that Borrower may not assign or transfer any of its rights or obligations under this Agreement without the prior written consent of Agent and each Lender.

(b) Borrower acknowledges that in the regular course of commercial banking business one or more Lenders may at any time and from time to time sell participating interests in the Advances to other financial institutions (each such transferee or purchaser of a participating interest, a "Participant"). Each Participant may exercise all rights of payment (including rights of set-off) with respect to the portion of such Advances held by it or other Obligations payable hereunder as fully as if such Participant were the direct holder thereof provided that Borrower shall not be required to pay to any Participant more than the amount which it would have been required to pay to Lender which granted an interest in its Advances or other Obligations payable hereunder to such Participant had such Lender retained such interest in the Advances hereunder or other Obligations payable hereunder and in no event shall Borrower be required to pay any such amount arising from the same circumstances and with respect to the same Advances or other Obligations payable hereunder to both such Lender and such Participant. Borrower hereby grants to any Participant a continuing security interest in any deposits, moneys or other property actually or constructively held by such Participant as security for the Participant's interest in the Advances.

(c) Any Lender, with the consent of Agent which shall not be unreasonably withheld or delayed, may sell, assign or transfer all or any part of its rights and obligations under or relating to Revolving Advances under this Agreement and the Other Documents to one or more additional banks or financial institutions and one or more additional banks or financial institutions may commit to make Advances hereunder (each a "Purchasing Lender"), in minimum amounts of not less than \$5,000,000, pursuant to a Commitment Transfer Supplement, executed by a Purchasing Lender, the transferor Lender, and Agent and delivered to Agent for recording. Upon such execution, delivery, acceptance and recording, from and after the transfer effective date determined pursuant to such Commitment Transfer Supplement, (i) Purchasing Lender thereunder shall be a party hereto and, to the extent provided in such Commitment Transfer Supplement, have the rights and obligations of a Lender thereunder with a Commitment Percentage as set forth therein, and (ii) the transferor Lender thereunder shall, to the extent provided in such Commitment Transfer Supplement, be released from its obligations under this Agreement, the Commitment Transfer Supplement creating a novation for that purpose. Such Commitment Transfer Supplement shall be deemed to amend this Agreement to the extent, and only to the extent, necessary to reflect the addition of such Purchasing Lender and the resulting adjustment of the Commitment Percentages arising from the purchase by such Purchasing Lender of all or a portion of the rights and obligations of such transferor Lender under

this Agreement and the Other Documents. Borrower hereby consents to the addition of such Purchasing Lender and the resulting adjustment of the Commitment Percentages arising from the purchase by such Purchasing Lender of all or a portion of the rights and obligations of such transferor Lender under this Agreement and the Other Documents. Borrower shall execute and deliver such further documents and do such further acts and things in order to effectuate the foregoing.

(d) Any Lender, with the consent of Agent which shall not be unreasonably withheld or delayed, may directly or indirectly sell, assign or transfer all or any portion of its rights and obligations under or relating to Revolving Advances under this Agreement and the Other Documents to an entity, whether a corporation, partnership, trust, limited liability company or other entity that (i) is engaged in making, purchasing, holding or otherwise investing in bank loans and similar extensions of credit in the ordinary course of its business and (ii) is administered, serviced or managed by the assigning Lender or an Affiliate of such Lender (a "Purchasing CLO" and together with each Participant and Purchasing Lender, each a "Transferee" and collectively the "Transferees"), pursuant to a Commitment Transfer Supplement modified as appropriate to reflect the interest being assigned ("Modified Commitment Transfer Supplement"), executed by any intermediate purchaser, the Purchasing CLO, the transferor Lender, and Agent as appropriate and delivered to Agent for recording. Upon such execution and delivery, from and after the transfer effective date determined pursuant to such Modified Commitment Transfer Supplement, (i) Purchasing CLO thereunder shall be a party hereto and, to the extent provided in such Modified Commitment Transfer Supplement, have the rights and obligations of a Lender thereunder and (ii) the transferor Lender thereunder shall, to the extent provided in such Modified Commitment Transfer Supplement, be released from its obligations under this Agreement, the Modified Commitment Transfer Supplement creating a novation for that purpose. Such Modified Commitment Transfer Supplement shall be deemed to amend this Agreement to the extent, and only to the extent, necessary to reflect the addition of such Purchasing CLO. Borrower hereby consents to the addition of such Purchasing CLO. Borrower shall execute and deliver such further documents and do such further acts and things in order to effectuate the foregoing.

(e) Agent shall maintain at its address a copy of each Commitment Transfer Supplement and Modified Commitment Transfer Supplement delivered to it and a register (the "Register") for the recordation of the names and addresses of each Lender and the outstanding principal, accrued and unpaid interest and other fees due hereunder. The entries in the Register shall be conclusive, in the absence of manifest error, and Borrower, Agent and Lenders may treat each Person whose name is recorded in the Register as the owner of the Advance recorded therein for the purposes of this Agreement. The Register shall be available for inspection by Borrower or any Lender at any reasonable time and from time to time upon reasonable prior notice. Agent shall receive a fee in the amount of \$3,500 payable by the applicable Purchasing Lender and/or Purchasing CLO upon the effective date of each transfer or assignment (other than to an intermediate purchaser) to such Purchasing Lender and/or Purchasing CLO.

(f) Borrower authorizes each Lender to disclose to any Transferee and any prospective Transferee any and all financial information in such Lender's possession concerning Borrower which has been delivered to such Lender by or on behalf of Borrower pursuant to this Agreement or in connection with such Lender's credit evaluation of Borrower.

3) ACKNOWLEDGMENTS. Borrower acknowledges and represents that:

(A) the Loan Agreement and Other Documents, as amended hereby, are in full force and effect without any defense, claim, counterclaim, right or claim of set-off;

(B) to the best of its knowledge, no default by the Agent or Lenders in the performance of their duties under the Loan Agreement or the Other Documents has occurred;

(C) all representations and warranties of the Borrower contained herein, in the Loan Agreement and in the Other Documents are true and correct in all material respects as of this date, except for any representation or warranty that specifically refers to an earlier date;

(D) Borrower has taken all necessary action to authorize the execution and delivery of this Agreement; and

(E) this Agreement is a modification of an existing obligation and is not a novation.

4) PRECONDITIONS. As a precondition to the effectiveness of any of the modifications, consents, or waivers contained herein, the Borrower agrees to:

(A) provide the Agent with this Agreement and the Amended and Restated Term Note, properly executed;

(B) provide the Agent with a resolution, in form and substance acceptable to the Agent, which approves the modification contemplated hereby;

(C) pay all legal fees incurred by the Agent in entering into this Agreement to Wilentz, Goldman & Spitzer via wire transfer; and

(D) pay all other fees and costs incurred by the Lenders in entering into this Agreement.

5) MISCELLANEOUS. This Agreement shall be construed in accordance with and governed by the laws of the State of New York, without reference to that state's conflicts of law principles. This Agreement, the Loan Agreement and the Other Documents constitute the sole agreement of the parties with respect to the subject matter thereof and supersede all oral negotiations and prior writings with respect to the subject matter thereof. No amendment of this Agreement, and no waiver of any one or more of the provisions hereof shall be effective unless set forth in writing and signed by the parties hereto. The illegality, unenforceability or inconsistency of any provision of this Agreement shall not in any way affect or impair the legality, enforceability or consistency of the remaining provisions of this Agreement, the Loan Agreement or the Other Documents. This Agreement, the Loan Agreement and the Other Documents are intended to be consistent. However, in the event of any inconsistencies among this Agreement, the Loan Agreement and/or any of the Other Documents, the terms of this Agreement, then the Loan Agreement, shall control. This Agreement may be executed in any number of counterparts and by the different parties on separate counterparts. Each such counterpart shall be deemed an original, but all such counterparts shall together constitute one and the same agreement.

6) DEFINITIONS. The terms used herein and not otherwise defined or modified herein shall have the meanings ascribed to them in the Loan Agreement. The terms used herein and not otherwise defined or modified herein or defined in the Loan Agreement shall have the meanings ascribed to them by the Uniform Commercial Code as enacted in State of New York.

[SIGNATURES TO FOLLOW]

SIGNATURE PAGE TO FIRST AMENDMENT  
TO REVOLVING CREDIT, TERM LOAN, EQUIPMENT LINE OF  
CREDIT AND SECURITY AGREEMENT

IN WITNESS WHEREOF, the undersigned have signed and sealed this Agreement  
the day and year first above written.

ATTEST: AIR INDUSTRIES MACHINING, CORP.

By: \_\_\_\_\_  
Name: LOUIS A. GIUSTO  
Title: Vice Chairman

By: \_\_\_\_\_  
Name: MICHAEL A. GALES  
Title: Executive Chairman

PNC BANK, NATIONAL ASSOCIATION  
Lender and as Agent

By: \_\_\_\_\_  
Name: STEPHEN V. MANGIANTE  
Title: Vice President

CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT TO  
SECTION 302(a) OF THE SARBANES-OXLEY ACT OF 2002

I, Michael A. Gales, Executive Chairman of Gales Industries Incorporated (the "Company"), certify that:

1. I have reviewed this quarterly report on Form 10-QSB of the Company;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this report;

4. The Company's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the Company and have:

a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b. Evaluated the effectiveness of the Company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c. Disclosed in this report any change in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter (the Company's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially effect, the Company's internal control over financial reporting; and

5. The Company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of Company's board of directors (or persons performing the equivalent functions):

a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Company's ability to record, process, summarize and report financial information; and

b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal control over financial reporting.

Date: November 14, 2006

/s/ Michael A. Gales

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Name: Michael A. Gales  
Title: Executive Chairman

CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT TO  
SECTION 302(a) OF THE SARBANES-OXLEY ACT OF 2002

I, Louis A. Giusto, Chief Financial Officer of Gales Industries Incorporated (the "Company"), certify that:

1. I have reviewed this quarterly report on Form 10-QSB of the Company;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this report;

4. The Company's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the Company and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Evaluated the effectiveness of the Company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the Company's most recent fiscal quarter (the Company's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially effect, the Company's internal control over financial reporting; and

5. The Company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Company's auditors and the audit committee of Company's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Company's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal control over financial reporting.

Date: November 14, 2006

/s/ Louis A. Giusto

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Name: Louis A. Giusto  
Title: Chief Financial Officer

CERTIFICATION OF CHIEF EXECUTIVE OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned officer of Gales Industries Incorporated (the "Company") does hereby certify, to such officer's knowledge, that the Quarterly Report on Form 10-QSB of the Company for the quarter ended September 30, 2006 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and information contained in that Form 10-QSB fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated November 14, 2006

/s/ Michael A. Gales

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Michael A. Gales,  
Executive Chairman



CERTIFICATION OF CHIEF FINANCIAL OFFICER  
PURSUANT TO 18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, the undersigned officer of Gales Industries Incorporated (the "Company") does hereby certify, to such officer's knowledge, that the Quarterly Report on Form 10-QSB of the Company for the quarter ended September 30, 2006 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and information contained in that Form 10-QSB fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: November 14,, 2006

/s/ Louis A. Giusto

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Louis A. Giusto  
Chief Financial Officer