

Galaxy Gaming, Inc.
Form 10-Q
November 14, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period from to

Commission file number: 000-30653

Galaxy Gaming, Inc.

(Exact name of small business issuer as specified in its charter)

Nevada 20-8143439
(State or other jurisdiction of
incorporation or organization) (IRS Employer
Identification No.)

6767 Spencer Street, Las Vegas, NV 89119
(Address of principal executive offices)

(702) 939-3254

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(Issuer's telephone number)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the issuer (1) 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 issuer 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 issuer has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller Reporting Company

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

State the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:
39,315,591 common shares as of November 14, 2016.

GALAXY GAMING, INC.

QUARTERLY REPORT ON FORM 10-Q FOR THE QUARTER ENDED SEPTEMBER 30, 2016

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PART I - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Our financial statements included in this Form 10-Q are as follows:

2 Condensed Balance Sheets as of September 30, 2016 (unaudited), and December 31, 2015

3 Condensed Statements of Operations for the three and nine months ended September 30, 2016 and 2015 (unaudited)

4 Condensed Statements of Comprehensive Income for the nine months ended September 30, 2016 and 2015
(unaudited)

5 Condensed Statements of Cash Flows for the nine months ended September 30, 2016 and 2015 (unaudited)

6 Notes to Financial Statements (unaudited)

GALAXY GAMING, INC.

CONDENSED BALANCE SHEETS

| | September 30, | December 31, |
|--|------------------|-----------------|
| | 2016 | 2015 |
| ASSETS | | |
| Current assets: | (Unaudited) | |
| Cash and cash equivalents | \$ 1,823,657 | \$ 570,623 |
| Restricted cash | 87,850 | 97,859 |
| Accounts receivable, net of allowance for bad debts of \$27,190 and \$30,944 | 1,937,343 | 1,828,669 |
| Inventory | 484,442 | 411,700 |
| Deferred tax asset | — | 43,017 |
| Prepaid expense and other | 99,905 | 108,827 |
| Total current assets | 4,433,197 | 3,060,695 |
| Property and equipment, net | 244,896 | 298,877 |
| Products leased and held for lease, net | 204,467 | 134,485 |
| Goodwill and other intangible assets, net | 13,235,698 | 14,352,636 |
| Deferred tax assets, net | — | 82,562 |
| Other assets, net | 299,918 | 41,793 |
| Total assets | \$ 18,418,176 | \$ 17,971,048 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 563,445 | \$ 1,421,848 |
| Accrued expenses | 976,834 | 823,964 |
| Income taxes payable | 1,106,600 | 170,331 |
| Deferred revenue | 870,628 | 717,690 |
| Jackpot liabilities | 91,602 | 106,671 |
| Deferred tax liabilities | 75,358 | — |
| Deferred rent, current portion | 12,753 | 6,197 |
| Current portion of long-term debt and capital lease obligations | 909,009 | 4,707,316 |
| Total current liabilities | 4,606,229 | 7,954,017 |
| Deferred rent, net | 42,532 | 52,643 |
| Capital lease obligations, net | 54,898 | 78,008 |
| Warrant liability | 806,698 | — |
| Long-term debt, net | 9,028,235 | 7,436,171 |
| Total liabilities | 14,538,592 | 15,520,839 |
| Commitments and Contingencies (See Note 10) | | |
| Stockholders' equity | | |
| Preferred stock, 10,000,000 shares authorized; \$.001 par value; | | |
| 0 shares issued and outstanding, respectively | — | — |
| Common stock, 65,000,000 shares authorized; \$.001 par value; | | |
| 39,315,591 and 39,215,591 shares issued and outstanding, respectively | 39,316 | 39,216 |
| Additional paid-in capital | 3,054,847 | 2,963,841 |

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| | | |
|--|--------------|--------------|
| Accumulated earnings (deficit) | 785,421 | (792,446) |
| Accumulated other comprehensive income | — | 239,598 |
| Total stockholders' equity | 3,879,584 | 2,450,209 |
| Total liabilities and stockholders' equity | \$18,418,176 | \$17,971,048 |

The accompanying notes are an integral part of the financial statements.

GALAXY GAMING, INC.

CONDENSED STATEMENTS OF OPERATIONS

(Unaudited)

| | FOR THE THREE MONTHS ENDED | | FOR THE NINE MONTHS ENDED | |
|---|-------------------------------|-------------|------------------------------|-------------|
| | September 30, 2016 | 2015 | September 30, 2016 | 2015 |
| Revenue: | | | | |
| Product leases and royalties | \$3,190,823 | \$2,747,774 | \$9,229,815 | \$8,003,469 |
| Product sales and service | 1,146 | 7,074 | 10,425 | 18,073 |
| Total revenue | 3,191,969 | 2,754,848 | 9,240,240 | 8,021,542 |
| Costs and expenses: | | | | |
| Cost of ancillary products and assembled components | 26,763 | 22,890 | 78,075 | 70,168 |
| Selling, general and administrative | 1,576,480 | 1,736,024 | 4,850,785 | 4,995,984 |
| Research and development | 89,513 | 101,822 | 270,734 | 371,251 |
| Depreciation and amortization | 419,540 | 416,918 | 1,252,860 | 1,251,614 |
| Share-based compensation | 41,075 | 17,909 | 91,006 | 72,850 |
| Total costs and expenses | 2,153,371 | 2,295,563 | 6,543,460 | 6,761,867 |
| Income from operations | 1,038,598 | 459,285 | 2,696,780 | 1,259,675 |
| Other income (expense): | | | | |
| Settlement income | 697,214 | — | 697,214 | — |
| Interest expense | (227,632) | (248,604) | (741,045) | (799,407) |
| Loss on extinguishment of debt | (87,578) | — | (87,578) | — |
| Change in estimated fair value of warrant liability | 2,933 | — | 2,933 | — |
| Interest income | 56 | 2,084 | 202 | 13,288 |
| Total other expense | 384,993 | (246,520) | (128,274) | (786,119) |
| Income before provision for income taxes | 1,423,591 | 212,765 | 2,568,506 | 473,556 |
| Provision for income taxes | (602,619) | (93,059) | (990,639) | (219,418) |
| Net income | \$820,972 | \$119,706 | \$1,577,867 | \$254,138 |
| Net income per share, basic and diluted | \$0.02 | \$0.00 | \$0.04 | \$0.01 |
| Weighted-average shares outstanding: | | | | |
| Basic | 39,315,591 | 39,040,775 | 39,372,944 | 39,040,775 |
| Diluted | 39,465,676 | 39,079,102 | 39,559,494 | 39,079,102 |

The accompanying notes are an integral part of the financial statements.

GALAXY GAMING, INC.

CONDENSED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

| | FOR THE THREE MONTHS ENDED | | FOR THE NINE MONTHS ENDED | |
|--|-------------------------------|-----------------------|------------------------------|-----------------------|
| | September 30, 2016 | September 30, 2015 | September 30, 2016 | September 30, 2015 |
| Net income | \$820,972 | \$119,706 | \$1,577,867 | \$254,138 |
| Other comprehensive income: | | | | |
| Foreign currency translation adjustments, net of tax | — | 120,193 | — | 89,401 |
| Total comprehensive income | \$820,972 | \$239,899 | \$1,577,867 | \$343,539 |

The accompanying notes are an integral part of the financial statements.

GALAXY GAMING, INC.

CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

FOR THE NINE
MONTHS ENDEDSeptember 30,
2016 2015

| | | |
|---|-------------|-------------|
| Cash flows from operating activities: | | |
| Net income | \$1,577,867 | \$254,138 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 1,252,860 | 1,251,614 |
| Amortization of debt issuance costs and debt discount | 136,710 | 156,474 |
| Provision for bad debt expense | — | 40,000 |
| Inventory reserve | — | 47,069 |
| Loss on extinguishment of debt | 87,578 | — |
| Change in estimated fair value of warrant liability | (2,933) | — |
| Deferred income tax provision | 54,370 | 219,418 |
| Share-based compensation | 91,006 | 72,850 |
| Changes in operating assets and liabilities: | | |
| Decrease in restricted cash | 10,009 | 9,392 |
| Increase in accounts receivable | (107,969) | (197,139) |
| Decrease in other current assets | 43,017 | 62,314 |
| Increase in inventory | (181,319) | (125,820) |
| Decrease (increase) in prepaid expenses and other current assets | 6,608 | (65,538) |
| (Decrease) increase in accounts payable | (858,954) | 495,891 |
| Increase in income tax payable | 936,269 | — |
| Increase in accrued expenses | 141,841 | 23,037 |
| Increase in deferred revenue | 152,938 | 65,227 |
| Decrease in jackpot liabilities | (15,069) | (6,296) |
| Decrease in deferred rent | (3,555) | (957) |
| Net cash provided by operating activities | 3,321,274 | 2,301,674 |
| Cash flows from investing activities: | | |
| Acquisition of property and equipment | (43,345) | (44,980) |
| Cash flows from financing activities: | | |
| Proceeds received from long-term debt | 932,126 | — |
| Principal payments on capital lease obligations | (51,698) | (49,186) |
| Principal payments on long-term debt | (2,873,437) | (2,662,699) |
| Net cash used in financing activities | (1,993,009) | (2,711,885) |
| Effect of exchange rate changes on cash | (31,886) | (1,962) |
| Net increase (decrease) in cash and cash equivalents | 1,253,034 | (457,153) |
| Cash and cash equivalents – beginning of period | 570,623 | 560,184 |
| Cash and cash equivalents – end of period | \$1,823,657 | \$103,031 |
| Supplemental cash flow information: | | |

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| | | |
|---|-----------|-----------|
| Cash paid for interest | \$753,250 | \$800,830 |
| Inventory transferred to leased assets | \$108,577 | \$39,896 |
| Cash paid for income taxes | \$35,000 | \$— |
| Supplemental non-cash financing activities information: | | |
| Effect of exchange rate on long-term debt payable in foreign currency | \$336,485 | \$119,414 |
| Issuance of warrants in conjunction with term loan | \$809,631 | \$— |
| Points paid on term loan | \$262,500 | \$— |

The accompanying notes are an integral part of the financial statements.

GALAXY GAMING, INC.

NOTES TO FINANCIAL STATEMENTS

(Unaudited)

NOTE 1. DESCRIPTION OF BUSINESS

Unless the context indicates otherwise, references to “Galaxy Gaming, Inc.,” “we,” “us,” “our,” or the “Company,” refer to Galaxy Gaming, Inc., a Nevada corporation. “GGLLC” refers to Galaxy Gaming, LLC, a Nevada limited liability company that was a predecessor of the Company’s business, but is not directly associated with Galaxy Gaming, Inc.

We are an established global gaming company specializing in the design, development, manufacturing, marketing and acquisition of proprietary casino table games and associated technology, platforms and systems for the casino gaming industry. We are a leading supplier of gaming entertainment products worldwide and provide a diverse offering of quality products and services at competitive prices, designed to enhance the player experience.

Casinos use our proprietary products to enhance their gaming floor operations and improve their profitability, productivity and security, as well as offer popular cutting-edge gaming entertainment content and technology to their players. We market our products to land-based, riverboat and cruise ship and internet gaming companies. The game concepts and the intellectual property associated with these games are typically protected by patents, trademarks and/or copyrights. We market our products primarily via our internal sales force to casinos throughout North America, the Caribbean, the British Isles, Europe, and Africa and to cruise ships and internet gaming sites worldwide.

NOTE 2. SIGNIFICANT ACCOUNTING POLICIES

This summary of our significant accounting policies is presented to assist in understanding our financial statements. The financial statements and notes are representations of our management team, who are responsible for their integrity and objectivity.

Basis of presentation. As permitted by the rules and regulations of the Securities and Exchange Commission (“SEC”), certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America (“U.S. GAAP”) have been condensed or omitted pursuant to those rules and regulations. The operating results for interim periods are not necessarily indicative of results that may be expected for any other interim period or for the full year.

In the opinion of management, the accompanying unaudited interim financial statements contain all necessary adjustments, consisting only of those of a recurring nature, and disclosures to present fairly the Company’s financial position and the results of its operations and cash flows for the periods presented. These unaudited interim condensed financial statements should be read in conjunction with the financial statements and the related notes thereto included in the Company’s Form 10-K for the fiscal year ended December 31, 2015, filed with the SEC on March 30, 2016.

Basis of accounting. The financial statements have been prepared on the accrual basis of accounting in conformity with U.S. GAAP. Revenues are recognized as income when earned and expenses are recognized when they are incurred. We do not have significant categories of cost as our income is recurring with high margins. Expenses such as wages, consulting expenses, legal, regulatory and professional fees and rent are recorded when the expense is incurred.

Cash and cash equivalents. We consider cash on hand, cash in banks, certificates of deposit, and other short-term securities with maturities of three months or less when purchased, as cash and cash equivalents. Our bank accounts are deposited in insured institutions. The funds are insured up to \$250,000 per account. To date, we have not experienced uninsured losses.

Restricted cash. We are required by gaming regulation to maintain sufficient reserves in restricted accounts to be used for the purpose of funding payments to winners of our jackpots offered. Compliance with restricted cash requirements for jackpot funding is reported to gaming authorities in various jurisdictions.

Inventory. Inventory consists of ancillary products such as signs, layouts, and bases for the various games and electronic devices and components. Inventory value (Note 3) is determined by the average cost method and management maintains inventory levels based on historical and industry trends. We regularly assess inventory quantities for excess and obsolescence primarily based on forecasted product demand.

Products leased and held for lease. We develop products intended primarily to be leased by casinos, which are stated at cost, net of depreciation (Note 5). Depreciation on leased products is calculated using the straight-line method over a three-year period

Property and equipment. Property and equipment (Note 4) are being depreciated over their estimated useful lives of 3 to 5 years, using the straight-line method.

Goodwill. Goodwill was created as a result of an acquisition in October 2011 (discussed in more detail in Note 9). Goodwill is assessed for impairment at least annually and if found to be impaired, its carrying amount will be reduced and an impairment loss will be recognized.

Other intangible assets. Our finite-lived intangible assets (Note 6) are being amortized using the straight-line method over the following estimated economic lives:

| | |
|----------------------|------------------|
| Licensing agreements | 60 months |
| Patents | 87 - 132 months |
| Trademarks | 144 - 360 months |
| Client relationships | 264 months |

Intangible assets are analyzed for potential impairment whenever events or changes in circumstances indicate the carrying value may not be recoverable.

Impairment of long-lived assets. We continually monitor events and changes in circumstances that could indicate carrying amounts of long-lived assets may not be recoverable. When such events or changes in circumstances are present, we assess the recoverability of long-lived assets by determining whether the carrying value of such assets will be recovered through undiscounted expected future cash flows. If the total of the future cash flows is less than the carrying amount of those assets, we recognize an impairment loss based on the excess of the carrying amount over the fair value of the assets. Assets to be disposed of are reported at the lower of the carrying amount or the fair value less costs to sell.

Leases. We recognize rent expense for operating leases (Note 10) on a straight-line basis (including the effect of reduced or free rent and rent escalations) over the applicable lease term. The difference between the cash paid to the landlord and the amount recognized as rent expense on a straight-line basis is recorded as deferred rent. The landlord of our corporate headquarters financed leasehold improvements in the amount of \$150,000. These improvements have been recorded as a capital lease and amortized over the life of the lease.

Revenue recognition. Revenue is primarily derived from the licensing of our products and intellectual property. Consistent with our strategy, revenue is generated from negotiated month-to-month recurring licensing fees or the performance of our products, or both. We also, occasionally, receive a one-time sale of certain products and/or reimbursement of our manufactured equipment.

Substantially all of our revenue is recognized when it is earned. Depending upon the product and negotiated terms, our clients may be invoiced monthly in advance, monthly in arrears or quarterly in arrears for the licensing of our products. If billed in advance, the advance billings are recorded as deferred revenue until earned. If billed in arrears, we recognize the corresponding preceding period's revenue upon invoicing at the subsequent date. Generally, we begin earning revenue with the installation or "go live" date of the associated product in our clients' establishment. The monthly recurring invoices are based on executed agreements with each client.

Additionally, clients may be invoiced for product sales at the time of shipment or delivery of the product. Revenue from the sale of our associated products is recognized when the following criteria are met:

- (1) Persuasive evidence of an arrangement between us and our client exists;
- (2) Shipment has occurred;
- (3) The price is fixed and/or determinable; and
- (4) Collectability is reasonably assured or probable.

We do not segregate the portion of revenue between manufactured equipment and any software or electronic devices needed to use the equipment when the system is provided, nor do we market the software separately from the equipment.

Costs of ancillary products and assembled components. Ancillary products include paytables (display of payouts), bases, layouts, signage and other items as they relate to support specific proprietary games in connection with the licensing of our games. Assembled components represent the cost of the equipment, devices and incorporated software used to support the Bonus Jackpot System and SpectrumVision.

Research and development. We incur research and development (“R&D”) costs to develop our new and next-generation products. Our products reach commercial feasibility shortly before the products are released and therefore R&D costs are expensed as incurred. Employee-related costs associated with product development are included in R&D costs.

Foreign currency translation. For non-US functional accounts, assets and liabilities are translated at exchange rates in effect at the balance sheet date, and income and expense accounts at the average exchange rates for the year. Resulting currency translation adjustments are recorded as a separate component of shareholders’ equity. We record foreign currency transactions at the exchange rate prevailing at the date of the transaction with resultant gains and losses being included in results of operations. Realized foreign currency transaction gains and losses have not been significant for any period presented.

Income taxes. In the ordinary course of business, there are transactions and calculations where the ultimate tax outcome is uncertain. We recognize the tax benefit from an uncertain tax position if we believe it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. Judgment is required in determining the provision for incomes taxes and related accruals, deferred tax assets and liabilities. Additionally, our tax returns for tax years 2013 and thereafter remain open for examination by various tax authorities.

Net income per share. Basic net income per share is calculated by dividing net income by the weighted-average number of common shares issued and outstanding during the year. Diluted net income per share is similar to basic, except that the weighted-average number of shares outstanding is increased by the potentially dilutive effect of outstanding stock options and warrants, if applicable, during the year, using the treasury stock method.

Share-based compensation. We recognize compensation expense for all share-based awards made to employees, directors and independent contractors. The fair value of share based awards (Note 11) is estimated at the grant date using the Black-Scholes option-pricing model and the portion that is ultimately expected to vest is recognized as compensation cost over the requisite service period. We have elected to recognize compensation expense for all options with graded vesting on a straight-line basis over the vesting period of the entire option. The determination of fair value using the Black-Scholes pricing model is affected by our stock price as well as assumptions regarding a number of complex and subjective variables, including expected stock price volatility, risk-free interest rate, expected dividends and projected employee stock option exercise behaviors. We estimate volatility based on historical volatility of our common stock, and estimate the expected term based on several criteria, including the vesting period of the grant and the term of the award. We estimate employee stock option exercise behavior based on actual historical exercise activity and assumptions regarding future exercise activity of unexercised, outstanding options.

Share based compensation is recognized only for those awards that are ultimately expected to vest, and we have applied or estimated forfeiture rate to unvested awards for purposes of calculating compensation costs. These estimates will be revised in future periods if actual forfeitures differ from the estimates. Changes in forfeiture estimates impact compensation cost in the period in which the change in estimate occurs.

Warrant accounting. We account for common stock warrants pursuant to the applicable guidance on accounting for derivative financial instruments indexed to, and potentially settled in, a company’s own stock, on the understanding that in compliance with applicable securities laws, registered warrants require the issuance of unregistered securities upon exercise. We classify warrants on the balance sheet as a long-term liability, which is revalued at each balance sheet date subsequent to the initial issuance. Determining the appropriate fair-value model and calculating the fair value of warrants requires considerable judgment, including estimating stock price volatility and expected warrant life. We develop our estimates based on historical data. A small change in the estimates used may have a relatively large change in the estimated valuation. We use the Black-Scholes pricing model to value the registered warrants. Changes in the fair market value of the warrants are reflected in the statement of operations as “Change in the fair value

of warrant liability.” No warrants have been exercised as of September 30, 2016.

Use of estimates and assumptions. We are required to make estimates, judgments and assumptions that we believe are reasonable based on our historical experience, contract terms, observance of known trends in our company and the industry as a whole, and information available from other outside sources. Our estimates affect reported amounts for assets, liabilities, revenues, expenses and related disclosures. Actual results may differ from initial estimates.

Reclassifications. Certain accounts and financial statement captions in the prior periods have been reclassified to conform to the current period financial statement presentations.

New accounting standards not yet adopted

Revenue Recognition. In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09 (Topic 606), Revenue from Contracts with Customers, which is a comprehensive new revenue recognition standard that will supersede virtually all existing revenue guidance, including industry-specific guidance. Under the new standard,

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revenue will be recognized when control of the promised goods or services is transferred to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods and services. The standard creates a five-step model that will generally require companies to use more judgment and make more estimates than under current guidance when considering the terms of contracts along with all relevant facts and circumstances. These include the identification of customer contracts and separating performance obligations, the determination of transaction price that potentially includes an estimate of variable consideration, allocating the transaction price to each separate performance obligation, and recognizing revenue in line with the pattern of transfer.

In August 2015, the FASB issued ASU No. 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which defers the effective date of ASU 2014-09 by one year to now be effective for fiscal years, and interim reporting periods within those years, beginning after December 15, 2017. Early adoption of the standard is permitted but not before the original effective date of December 15, 2016. The ASU may be adopted using a full retrospective approach or reporting the cumulative effect as of the date of adoption. We are currently evaluating the impact of adopting this guidance.

Inventory. In July 2015, the FASB issued ASU No. 2015-11, Inventory: Simplifying the Measurement of Inventory. ASU 2015-11 changes the criteria for measuring inventory within the scope of the ASU. Inventory will now be measured at the lower of cost and net realizable value, while the concept of market value will be eliminated. The ASU defines net realizable value as the estimated selling process in the ordinary course of business, less reasonably predictable costs of completion, disposal and transportation. ASU 2015-11 is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years, with earlier adoption permitted. The prospective adoption of the ASU is required and we are currently evaluating the impact of adopting this guidance.

Deferred Taxes. In November 2015, the FASB issued ASU No. 2015-17, Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes, which eliminates the requirement to present deferred tax liabilities and assets as current and non-current in a classified balance sheet. Instead, all deferred tax assets and liabilities will be required to be presented as non-current. The ASU is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. The amendments in this guidance may be applied prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented with earlier application permitted for financial statements that have not been issued. This ASU is not expected to have a material impact on our financial statements.

Leases. In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). The amended guidance is intended to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The adoption of this guidance is expected to result in a significant portion of our operating leases being recognized on our Balance Sheets. The guidance requires lessees and lessors to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years with earlier adoption permitted. We are currently evaluating the impact of adopting this guidance.

NOTE 3. INVENTORY

Inventory consisted of the following at:

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| | September 30, | December 31, |
|-----------------------------------|------------------|--------------|
| | 2016 | 2015 |
| Raw materials and component parts | \$ 320,868 | \$ 231,709 |
| Finished goods | 168,151 | 170,528 |
| Work-in-process | 25,423 | 39,463 |
| | 514,442 | 441,700 |
| Less: inventory reserve | (30,000) | (30,000) |
| | \$ 484,442 | \$ 411,700 |

NOTE 4. PROPERTY AND EQUIPMENT

Property and equipment, substantially all of which collateralizes long-term obligations (Notes 8 and 9), consisted of the following at:

| | September 30, | December 31, |
|--------------------------------|------------------|--------------|
| | 2016 | 2015 |
| Furniture and fixtures | \$238,273 | \$ 211,411 |
| Leasehold improvements | 156,843 | 156,843 |
| Automotive vehicles | 94,087 | 94,087 |
| Computer equipment | 96,956 | 89,203 |
| Office equipment | 37,871 | 29,140 |
| | 624,030 | 580,684 |
| Less: accumulated depreciation | (379,134) | (281,807) |
| | \$244,896 | \$ 298,877 |

As of September 30, 2016, property and equipment includes \$243,970 of assets acquired under capital leases (Note 8). Accumulated depreciation of assets under capital leases totaled \$148,500 as of September 30, 2016.

NOTE 5. PRODUCTS LEASED AND HELD FOR LEASE

Products leased and held for lease consisted of the following at:

| | September 30, | December 31, |
|--------------------------------|------------------|--------------|
| | 2016 | 2015 |
| Enhanced table systems | \$397,261 | \$ 288,683 |
| Less: accumulated depreciation | (192,794) | (154,198) |
| | \$204,467 | \$ 134,485 |

NOTE 6. GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill and finite-lived intangible assets consisted of the following at:

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| | September 30, | December 31, |
|---------------------------------|---------------|---------------|
| | 2016 | 2015 |
| Goodwill | \$ 1,091,000 | \$ 1,091,000 |
| Finite-lived intangible assets: | | |
| Patents | 13,615,967 | 13,615,967 |
| Customer relationships | 3,400,000 | 3,400,000 |
| Trademarks | 2,740,000 | 2,740,000 |
| Non-compete agreements | 660,000 | 660,000 |
| Licensing agreements | 35,000 | 35,000 |
| | 20,450,967 | 20,450,967 |
| Less: accumulated amortization | (8,306,269) | (7,189,331) |
| | 12,144,698 | 13,261,636 |
| | \$ 13,235,698 | \$ 14,352,636 |

NOTE 7. ACCRUED EXPENSES

Accrued expenses, consisted of the following at:

| | September 30, | December 31, |
|----------------------------|-------------------|-------------------|
| | 2016 | 2015 |
| Royalties | \$ 33,157 | \$ 259,193 |
| TableMAX reimbursement | 392,358 | 136,785 |
| Salaries and payroll taxes | 275,015 | 95,115 |
| Trade show expenses | 85,275 | 78,549 |
| Vacation | 85,834 | 62,546 |
| Professional fees | 69,286 | 154,888 |
| Commissions | 33,282 | 22,056 |
| Accrued interest | 2,627 | 14,832 |
| | \$ 976,834 | \$ 823,964 |

NOTE 8. CAPITAL LEASE OBLIGATIONS

Capital lease obligations consisted of the following at:

| | September 30, | December 31, |
|---|------------------|------------------|
| | 2016 | 2015 |
| Capital lease obligation – leasehold improvements | \$ 85,506 | \$ 107,365 |
| Capital lease obligation – office furniture | — | 29,839 |
| | 85,506 | 137,204 |
| Less: Current portion | (30,608) | (59,196) |
| | \$ 54,898 | \$ 78,008 |

Future annual payments for capital leases obligations are as follows for the years ending September 30:

| | Total |
|------|-----------|
| 2017 | \$ 34,545 |
| 2018 | 34,545 |
| 2019 | 23,030 |
| 2020 | — |

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| | |
|------------------------------------|----------|
| Total minimum lease payments | \$92,120 |
| Less: amount representing interest | (6,614) |
| | \$85,506 |

NOTE 9. LONG-TERM DEBT

Long-term debt consisted of the following at:

| | September 30, | December 31, |
|---------------------------------|------------------|--------------|
| | 2016 | 2015 |
| Term loan | \$10,500,000 | \$— |
| Note payable, unrelated party | — | 11,577,858 |
| Notes payable, related party | 527,102 | 1,079,083 |
| Equipment notes payable | 58,402 | 70,664 |
| | 11,085,504 | 12,727,605 |
| Less: | | |
| Unamortized debt issuance costs | (369,236) | — |
| Warrants issued | (809,632) | — |
| Debt discount | — | (643,314) |
| | 9,906,636 | 12,084,291 |
| Less: Current portion | (878,401) | (4,648,120) |
| | \$9,028,235 | \$7,436,171 |

Term loan credit facility. In August 2016, we entered into a term loan agreement for an aggregate principal amount of \$10,500,000 (the "Term Loan"). Proceeds of the Term Loan were primarily used to prepay in full the outstanding notes payable to unrelated parties. The remainder of the proceeds from the Term Loan will be used for general corporate purposes and working capital needs. The Term Loan is secured by a senior lien on the Company's assets. In conjunction with the Term Loan, we issued the lenders a six-year warrant to purchase 1,965,780 shares of the Company's common stock (the "Warrants") (Note 13).

Under the Term Loan, the Company is subject to quarterly financial covenants that, among other things, limit our annual capital expenditures (as defined in the Term Loan agreement), and require us to maintain a specified leverage ratio and minimum EBITDA amounts, each of which are defined in the Term Loan agreement. We are not aware of any noncompliance with the financial covenants of the Term Loan Agreement.

During the initial twelve-month period of the Term Loan, the outstanding principal will accrue interest at the rate of 14.0% per annum. Thereafter, the outstanding principal will accrue interest at the lesser of 14.0% per annum or 12.5% per annum for any quarterly period in which the Company achieves a specified leverage ratio.

The Term Loan requires quarterly interest-only payments through December 31, 2016 after which the Company is required to make quarterly principal payments of \$262,500 plus accrued interest. The remaining principal and any unpaid interest will be payable in full on August 29, 2021. Voluntary prepayments of the Term Loan, in full or in part,

are permitted after the first anniversary of the Term Loan, subject to certain premiums. The Term Loan also requires certain mandatory prepayments in the amount of 100% of the proceeds from certain asset dispositions (other than in the ordinary course of business) and certain other extraordinary events, and 25% of the proceeds from the sale and issuance of capital stock.

Note payable, unrelated party. In connection with an asset acquisition in October 2011, we executed a promissory note payable for \$12.2 million, and another promissory note payable for £6.4 million GBP (\$10.0 million USD). The notes were recorded net of a debt discount of \$1,530,000. The effective interest rate of the notes was 6% and 7% during 2015 and 2016, respectively. These notes were repaid in full in connection with the Term Loan agreement executed in August 2016. Concurrently with the repayment of the note obligation payable in GBP, \$239,598 of previously unrecognized gains on foreign exchange translations related to the GBP note payable were reclassified out of accumulated other comprehensive income and factored into the calculation of loss on debt extinguishment.

Notes payable, related party. In connection with an asset purchase agreement executed in December 2007, we executed a note payable due to an entity owned and controlled by our Chief Executive Officer ("CEO"). This note requires annual principal and interest payments of \$109,908, at a fixed interest rate of 7.3% through December 2018, at which time there is a balloon payment due of \$354,480.

In October 2015, our CEO loaned the Company \$500,000 for working capital purposes, in exchange for a promissory note. In April 2016, pursuant to the terms of the agreement, we paid the CEO \$535,000 in full satisfaction of the balance due, relieving us of any further payments or obligations under this arrangement.

As of September 30, 2016, maturities of our long-term debt obligations are as follows:

| Twelve months ending | |
|---------------------------------|-------------|
| September 30, | Total |
| 2017 | \$878,401 |
| 2018 | 1,147,294 |
| 2019 | 1,442,486 |
| 2020 | 1,054,823 |
| 2021 | 6,562,500 |
| Total notes payable | 11,085,504 |
| Less: | |
| Unamortized debt issuance costs | (369,236) |
| Warrants issued | (809,632) |
| Notes payable, net | \$9,906,636 |

NOTE 10. COMMITMENTS AND CONTINGENCIES

Concentration of risk. We are exposed to risks associated with clients who represent a significant portion of total revenues. For the nine months ended September 30, 2016 and 2015, respectively, we had the following client revenue concentrations:

| | 2016 | 2015 |
|-------------------------|---------|---------|
| Location | Revenue | Revenue |
| Client A North America | 13.6% | 14.8% |
| Client B North America | 6.9% | 5.5% |
| Client C North America | 6.2% | 6.8% |
| Client D North America | 5.7% | 3.5% |
| Client E United Kingdom | 5.3% | 6.7% |

We are also exposed to risks associated with the expiration of our patents. Domestic and international patents for two of our products expired in June 2015. The patents accounted for approximately \$4,299,637 or 47% of our revenue for the nine months ended September 30, 2016 and \$4,283,055 or 53% of revenue for the nine months ended September 30, 2015.

Operating lease. In February 2014, we entered into a lease (the “Spencer Lease”) for a new corporate office with an unrelated third party. The 5-year Spencer Lease is for a building approximately 24,000 square feet in size, located in Las Vegas, Nevada.

The initial term of the Spencer Lease commenced on April 1, 2014. We paid approximately \$153,000 in annual base rent in the first year, which increases by approximately 4% each year. We are also obligated to pay real estate taxes and other building operating costs. Subject to certain conditions, we have certain rights under the Spencer Lease, including rights of first offer to purchase the premises if the landlord elects to sell. We also have an option to extend the term of the Spencer Lease for two consecutive terms of three years each, at the then current fair market value rental rate determined in accordance with the terms of the Spencer Lease.

In connection with the commencement of the Spencer Lease, the landlord agreed to finance tenant improvements (“TI Allowance”) of \$150,000. The base rent is increased by an amount sufficient to fully amortize the TI Allowance through the Spencer Lease term upon equal monthly payments of principal and interest, with interest imputed on the outstanding principal balance at the rate of 5.5% per annum. The TI Allowance has been classified as a capital lease on the balance sheet.

Total rent expense was \$165,856 and \$171,840 for the nine months ended September 30, 2016 and 2015, respectively.

Future minimum lease payments are as follows:

| Twelve Months Ending | Annual |
|----------------------|------------|
| September 30, | Obligation |
| 2017 | \$ 229,236 |
| 2018 | 237,972 |
| 2019 | 184,794 |
| 2020 | 1,401 |
| 2021 | — |
| | \$ 653,403 |

Legal proceedings. In the ordinary course of conducting our business, we are, from time to time, involved in various legal proceedings, administrative proceedings, regulatory government investigations and other matters, including those in which we are a plaintiff, that are complex in nature and have outcomes that are difficult to predict. In accordance with U.S. GAAP, we record accruals for such contingencies to the extent that we conclude that it is probable that a liability will be incurred and the amount of the related loss can be reasonably estimated. Our assessment of each matter may change based on future unexpected events. An unexpected adverse judgment in any pending litigation could cause a material impact on our business operations, intellectual property, results of operations or financial position. Unless otherwise expressly stated, we believe costs associated with litigation will not have a material impact on our financial position or liquidity, but may be material to the results of operations in any given period. We assume no obligation to update the status of pending litigation, except as may be required by applicable law, statute or regulation. For a complete description of the facts and circumstances surrounding material litigation to which we are a party, see Note 12 in Item 8. "Financial Statements and Supplementary Data" included in our annual report on Form 10-K for the year ended December 31, 2015. Except as discussed in the following paragraph, there are no material updates to matters previously reported on Form 10-K for the year ended December 31, 2015.

On July 11, 2016, we entered into a settlement agreement (the "Settlement Agreement") with Red Card Gaming, Inc. ("RCG"), and AGS, LLC ("AGS") for purposes of resolving all disputes between the parties. Pursuant to the Settlement Agreement, among other things, RCG, AGS and the Company agreed to a mutual release of all claims and counter-claims. RCG and AGS also agreed to terminate all of their rights and obligations related to the APA, and AGS agreed to pay us the sum of \$350,000 and agreed to the injunctive terms of the Final Award. Furthermore, we agreed to dismiss the complaint they filed in November 2014 against In Bet Gaming, Inc. and In Bet, LLC (collectively "In Bet"), alleging that In Bet's In-Between side bet game infringed on one of our patents. AGS became involved in an Inter-Parties Review subsequent to November 2014, concerning the patent at issue because AGS had title and interest in the game In-Between. As a result of the Settlement Agreement, we recognized settlement income of \$697,214, calculated as follows:

| Settlement | Amount |
|-------------------|------------|
| Income | |
| Release of | \$ 347,214 |
| accrued royalties | |

| | |
|--------------|------------|
| owed to AGS | |
| Payment from | |
| AGS | 350,000 |
| | \$ 697,214 |

NOTE 11. STOCKHOLDERS' EQUITY

In April 2015, one of our Directors, was granted 75,000 shares of our restricted common stock as condition of his Board of Directors Director Service Agreement. The fair market value of the grant was \$22,500, which was determined using our closing stock price as April 1, 2015, the date of the grant. The restricted stock grant vested immediately.

In November 2015, our CFO, was granted 150,000 shares of our restricted common stock as condition of his Employment Agreement. The fair market value of the grant was \$30,000, which was determined using our closing stock price at November 14, 2015, the date of the grant. Beginning June 30, 2016, the restricted stock will vest at six-month intervals through December 31, 2018.

As a condition of his 2015 employment agreement, our CFO can elect to use up to 50% of his annual bonus to purchase shares of the Company's common stock at a 50% discount. The purchase price is determined by using the average closing price of the prior 10 business days discounted by 50%. On February 28, 2016, our CFO made the election to utilize \$9,000 of his annual 2015 bonus to purchase 100,000 shares of common stock at the market price of \$0.18 (effective price of \$0.09 after discount). The shares vested immediately.

NOTE 12. INCOME TAXES

Our forecasted effective tax rate at September 30, 2016 is 40.8%, a 6.8% decrease from the 47.6% effective tax rate recorded at September 30, 2015. After a discrete benefit of \$65,078, the effective tax rate for the nine months ended September 30, 2016 was 38.2%. The discrete tax benefit was primarily due to changes in positions taken for uncertain tax positions.

NOTE 13. STOCK WARRANTS, OPTIONS AND GRANTS

Stock options. For the nine months ended September 30, 2016 and 2015, we issued 427,500 and 412,500 stock options, respectively. Stock options issued to members of our Board of Directors were 225,000 and 200,000 for the nine months ended September 30, 2016 and 2015, respectively. Stock options issued to independent contractors were 112,500 for each of the nine month periods ended September 30, 2016 and 2015, respectively.

During the nine months ended September 30, 2016, we issued 90,000 stock options to two employees, with a vesting period of three years. The strike price was equal to the stock price at the date of the grant. During the nine months ended September 30, 2015, we issued 100,000 stock options to an employee, with a vesting period of three years. The strike price was equal to the stock price at the date of the grant.

The value of all stock options granted for the nine months ended September 30, 2016 and 2015 was determined to be \$85,606 and \$52,600, respectively, using the Black-Scholes option pricing model with the following assumptions:

| | Options Issued Nine Months Ended September 30, 2016 | Options Issued Nine Months Ended September 30, 2015 |
|-------------------------|---|---|
| Dividend yield | 0% | 0% |
| Expected volatility | 89% - 90% | 84% - 85% |
| Risk free interest rate | 1.01% - 1.22% | 1.37% - 1.63% |
| Expected life (years) | 5.00 | 5.00 |

A summary of stock option activity is as follows:

| | Common stock options | Weighted-average exercise price |
|----------------------------------|-------------------------|------------------------------------|
| Outstanding – January 1, 2015 | 381,250 | \$ 0.36 |
| Issued | 675,000 | 0.23 |
| Exercised | — | — |
| Expired | — | — |
| Outstanding – December 31, 2015 | 1,056,250 | \$ 0.28 |
| Issued | 427,500 | 0.33 |
| Exercised | — | — |
| Expired | — | — |
| Outstanding – September 30, 2016 | 1,483,750 | \$ 0.29 |
| Exercisable – September 30, 2016 | 1,143,750 | \$ 0.30 |

Share based compensation. The cost of all stock options issued has been classified as share based compensation for the nine months ended September 30, 2016 and 2015, respectively. Total share based compensation was \$91,006 and \$72,850 for the nine months ended September 30, 2016 and 2015, respectively.

Warrants. On August 29, 2016, in connection with the Term Loan agreement, the Company entered into a Warrant Agreement (the "Warrant Agreement") with the lenders pursuant to which the Company issued warrants to purchase 1,965,780 shares of common stock at an initial exercise price of \$0.30 per share (the "Warrants"). The number of shares of common stock issuable upon exercise of the Warrants, and/or the exercise price of such shares, is subject to standard anti-dilution adjustments in the event of stock splits, reorganizations, stock dividends, and similar events. As of the date of the Warrant Agreement, the shares of common stock issuable upon a full exercise of the Warrants would represent 5.0% of the total issued and outstanding shares of the Company's common stock. The lenders were also granted the right, but not the obligation, to purchase up to 5.0% of the total number of new securities that the Company may, from time to time, sell and issue.

The Warrants expire on August 29, 2022, and may not be exercised prior to the earliest of (a) the fifth anniversary of the Loan Agreement, (b) the date on which the obligations described in the Loan Agreement are repaid in full, or (c) the date on which the Lender declares all or any portion of the outstanding amount of the Term Loan to be due and payable under the terms of the Loan Agreement (collectively, the "Trigger Date"). Exercise of the Warrants requires a sixty (60) day prior written notice, during which time the Company may exercise its Call Right described below.

The Warrant Agreement includes a call right (the "Call Right") whereby the Company can purchase the Warrants for a fixed sum of \$1,333,333 upon providing the Warrant holders with a thirty (30) day prior written notice. Furthermore, the Warrant Agreement also includes a put right (the "Put Right") whereby the Lenders may require the Company to purchase from the Lenders all or any portion of the Warrants at a purchase price equal to the lesser of (a) the fair market value of the underlying shares of common stock as of the date of exercise of the Put Right, or (b) \$1,333,333. The Put Right may not be exercised prior to the Trigger Date (as defined above), and the Put Right expires on August 29, 2022.

A summary of warrant activity is as follows:

| | Common stock warrants | Weighted-average exercise price |
|----------------------------------|--------------------------|------------------------------------|
| Outstanding – December 31, 2015 | — | — |
| Issued | 1,965,780 | 0.30 |
| Exercised | — | — |
| Expired | — | — |
| Outstanding – September 30, 2016 | 1,965,780 | \$ 0.30 |
| Exercisable – September 30, 2016 | — | \$ — |

NOTE 14. SUBSEQUENT EVENTS

In accordance with ASC 855-10, we have evaluated all events and transactions that occurred subsequent to September 30, 2016 through the date these financial statements were issued, and we did not identify any additional material subsequent events, the effects of which would require additional disclosure or adjustment to these financial statements.

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

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report contains statements that do not relate to historical or current facts, but are "forward looking" statements. These statements relate to analyses and other information based on forecasts of future results and estimates of amounts not yet determinable. These statements may also relate to future events or trends, our future prospects and proposed new products, services, developments, or business strategies, among other things. These statements can generally (although not always) be identified by their use of terms and phrases such as anticipate, appear, believe, could, would, estimate, expect, indicate, intent, may, plan, predict, project, pursue, will, continue and other similar terms and phrases, as well as the use of the future tense.

Actual results could differ materially from those expressed or implied in our forward looking statements. Our future financial condition and results of operations, as well as any forward looking statements, are subject to change and to inherent known and unknown risks and uncertainties. You should not assume at any point in the future that the forward looking statements in this report are still valid. We do not intend, and undertake no obligation, to update our forward looking statements to reflect future events or circumstances.

OVERVIEW

We develop, acquire, manufacture and market technology and entertainment-based products for the gaming industry for placement on the casino floor. Our products primarily relate to licensed casino operators' table games activities and focus on either increasing their profitability, productivity and security or expanding their gaming entertainment offerings in the form of proprietary table games or electronically enhanced table game platforms. Our products are offered in highly regulated markets throughout the world. Our products are assembled or manufactured at our headquarters in Las Vegas, Nevada, and are outsourced for certain sub-assemblies in the United States.

Additional information regarding our products and product categories may be found in Note 1 "Description of Business" in Item 1 "Financial Statements" included in this Form 10-Q and on our web site, www.galaxygaming.com. Information found on the web site should not be considered part of this report.

Strategy. Our long-term business strategy is designed to capitalize on the opportunities we perceive within the gaming industry. We are an experienced developer and provider of proprietary table games and advanced electronic table game platforms. Throughout our history, we have been focused on creating and expanding our base of recurring revenues that we earn on a monthly basis. Our plan is to continue to increase the recurring revenues we receive by employing the following strategies:

1. Expand our inventory of products and technologies to attain a fully comprehensive portfolio; and
2. Increase our per unit price point by leveraging our Enhanced Table Systems.

Expand our inventory of products and technologies to attain a fully comprehensive portfolio. Historically, only one company in the table game industry, Scientific Games dba Bally Technologies dba Shuffle Master Gaming has had the ability to offer casinos nearly all of the table game products they require. Their unique ability to offer numerous products both in terms of game content and what they term as "utility" products (e.g. card shufflers, smart dealing shoes, baccarat displays, etc.), has stifled competition from other companies, including us, who are disadvantaged without a complete product line offering. Our strategy is to be an alternative for casino operators by offering a complete and comprehensive portfolio of games, products, systems, technologies and methodologies for casino table games. If we achieve this objective, we intend to offer complete turn-key systems rather than compete solely as a purveyor of individual products only. We intend to continuously develop and/or seek to acquire new proprietary table games to

complement our existing offerings and to extend our penetration of proprietary table games on the casino floor. We expect to accomplish this strategic shift through internal development of products as well as continued acquisitions from others.

We anticipate the continued acquisition and/or development of additional new proprietary table games and associated intellectual property, which when combined with our existing portfolio, will give us the complete inventory of proprietary games to offer casinos a complete solution, thereby increasing our competitiveness in the marketplace.

Increase our per unit price point by leveraging our Enhanced Table Systems. Our Enhanced Table Systems permit us the opportunity to significantly increase the amount of recurring revenue we receive from each table game placement. Accordingly, our goal is to concentrate on installing new game placement using one or more of our Enhanced Table Systems and to convert our existing Proprietary Table Game placements that currently do not incorporate our Enhanced Table Systems. We have modified most of our Premium Table Games and many of our Side Bets to benefit from the economics this new system affords us. In the future, we intend to be able to offer this platform for all games.

Sources of revenue. We derive recurring revenues from the licensing of our products and intellectual property. Consistent with our strategy, these revenues are generated from negotiated recurring licensing fee agreements, which typically are month-to-month in nature. We also receive revenues in the form of one-time sales of certain products and/or reimbursement of our manufactured equipment.

Financing. Additional funding may be necessary to facilitate our current aggressive growth plans and acquisition strategy, as well as the investments in our infrastructure. If we determine that additional funding is required and we are unsuccessful in raising capital, we will still pursue acquisitions and growth; however, our acquisition opportunities could be limited and our growth strategy could be negatively impacted.

Expected changes in number of employees, plant and equipment. As we continue to grow, we anticipate the purchasing of inventory and equipment and possibly the leasing of additional space to accommodate research, development, manufacturing and assembly operations. We will also evaluate the necessary increases to our employee base over the course of the year.

Results of operations for the three months ended September 30, 2016. For the three months ended September 30, 2016, our continuing operations generated gross revenues of \$3,191,969 compared to gross revenues of \$2,754,848 for the previous year's comparable quarter, representing an increase of \$437,121, or 15.9%. This increase was primarily attributable to an increase in our overall billable unit count and our continued focus on premium games, which command a higher price point than side bets. Selling, general and administrative expenses for the quarter ended September 30, 2016, were \$1,576,480 compared to \$1,736,024 for the previous year's third quarter, representing a decrease of \$159,544, or 9.2%. The significant year-over-year changes in selling, general and administrative expenses were comprised of the following categories:

| | Three months ended | |
|-----------------------------|--------------------|-----------|
| | September 30, | |
| | 2016 | 2015 |
| Compensation | \$577,828 | \$428,342 |
| Legal and professional fees | \$152,821 | \$519,095 |

Employee compensation expenses increased as we are making investments in personnel as the company grows as well as increased commissions from greater sales throughout 2016. Legal and professional fees have decreased as ongoing legal proceedings have subsided.

Research and development expenses for the three months ended September 30, 2016 were \$89,513 compared to \$101,822 for the previous year's comparable period, representing a decrease of \$12,309, or 12.1%. This decrease is

primarily due to less costs surrounding the development of SpectrumVision.

Results of operations for the nine months ended September 30, 2016. For the nine months ended September 30, 2016, our continuing operations generated gross revenues of \$9,240,240 compared to gross revenues of \$8,021,542 for the previous year's comparable period, representing an increase of \$1,218,698 or 15.2%. This increase was primarily attributable to an increase in our overall billable unit count and our continued focus on premium games, which command a higher price point than side bets. Selling, general and administrative expenses for the nine months ended September 30, 2016, were \$4,850,785 compared to \$4,995,984 for the previous year's period, representing a decrease of \$145,199, or 2.9%. The year-over-year changes in selling, general and administrative was comprised of the following categories:

| | Nine months ended | |
|-----------------------------|-------------------|-------------|
| | September 30, | |
| | 2016 | 2015 |
| Compensation | \$1,632,953 | \$1,304,295 |
| Legal and professional fees | \$1,024,710 | \$1,433,173 |

Employee compensation expenses increased as we are making investments in personnel as the company grows as well as increased commissions from greater sales throughout 2016. Legal and professional fees have decreased as ongoing legal proceedings have subsided.

Research and development expenses for the nine months ended September 30, 2016 were \$270,734 compared to \$371,251, representing a decrease of \$100,517, or 27.1%. This decrease is primarily due to less costs surrounding the development of SpectrumVision.

Liquidity and capital resources. As of September 30, 2016 we had total current assets of \$4,433,197 and total assets of \$18,418,176. This compares to \$3,060,695 and \$17,971,048, respectively as of December 31, 2015. The increase in current assets as of September 30, 2016 was primarily impacted by an increase in cash and cash equivalents, as well as an increase in inventories. Cash increased significantly due to the effects of the August 2016 refinancing transaction. Our total current liabilities as of September 30, 2016 were \$4,606,229 versus \$7,954,017 as of December 31, 2015. This decrease was primarily driven by the decrease in current portions of long-term debt, an effect of the August 2016 refinancing transaction. Our business model continues to be highly profitable and we have several options to ensure we are able to meet our short-term and long-term obligations.

We have undertaken certain growth initiatives to expand our recurring revenue base. As such we have made investments in personnel, inventory and research related to the development of our enhanced table systems. Additionally, we increased our sales and marketing budget and spent monies on regulatory efforts for the purpose of expanding our distribution network. We are also subject to several regulatory investigations and proceedings which may result in significant future legal and regulatory expenses. A significant increase in such expenses may require us to postpone growth initiatives or investments in personnel, inventory and research and development of our products. It is our intention to continue such initiatives and investments. However, to the extent we are not able to achieve our growth objectives or raise additional capital, we will need to evaluate the reduction of operating expenses.

At September 30, 2016, other than the commitment from the major shareholder of TMAX to provide a line of credit specific to acquiring inventory for the TMAX system, we do not have any available third-party lines or letters of credit. Furthermore, we do not have any written or oral commitments from officers or shareholders to provide us with loans or advances to support our operations or fund potential acquisitions.

The primary components of our operating cash flow for the nine months ended September 30, 2016, were non-cash items of \$2,555,860, net income of \$1,577,867, increases in accounts receivable of \$107,969, inventory of \$181,319 and accrued expenses of \$141,841 and decreases in restricted cash of \$10,009 and accounts payables of \$858,954 for a total operating activities impact of an increase of \$3,321,274 in cash and cash equivalents.

Cash flows used in investing activities for the nine months ended September 30, 2016 were \$43,345, due to the acquisition of property and equipment. Cash used in financing activities during the nine months ended September 30, 2016 was \$1,993,009, which was comprised of principal payments towards long-term debt and capital leases, as well as principal received from long-term debt.

We incur unrealized gains and losses related to foreign currency translation adjustments, which is recorded as other comprehensive income or loss. In prior periods, we generated other comprehensive income, net of tax, related to the unrealized translation adjustment on the note payable due Prime Table Games – UK, which was due in British Sterling currency. The remaining translation adjustments relate to insignificant amounts in accounts receivable, accounts

payable and accrued expenses recorded in foreign currencies. For the period ended September 30, 2016, we reclassified \$239,598 out of accumulated other comprehensive income as part of the recognition of the August 2016 refinance transaction. This amount offset the non-cash loss on extinguishment of debt. So as long as we have balance sheet items recorded in foreign currencies, we may be subject to fluctuations against the U.S. Dollar. Additionally, as transactions are settled, the foreign currency translations are realized and recorded as selling, general and administrative expenses on the statement of operations. Such realized translation adjustments are not material for the nine months ended September 30, 2016.

We intend to fund our continuing operations through increased sales. Additionally the issuance of debt or equity financing arrangements may be required to fund expenditures or other cash requirements. Despite this funding, there is no assurance that we will be successful in raising additional funding, if necessary. If we are not able to secure additional funding, the implementation of our business plan could be impaired. There can be no assurance that such additional financing will be available to us on acceptable terms or at all. In addition, we may incur higher capital expenditures in the future to expand our operations. We may from time to time acquire products and businesses complementary to our business. We may also incur significant expenses when applying for new licenses or in complying with current jurisdictional requirements. As a public entity, we may issue shares of our common stock and preferred stock in private or public offerings to obtain financing, capital or to acquire other businesses that can improve our performance and growth. To the extent that we seek to acquire other businesses in exchange for our common stock, fluctuations in our stock price could have a material adverse effect on our ability to complete acquisitions.

Critical accounting policies. In December 2001, the SEC requested that all registrants list their most “critical accounting policies” in the Management Discussion and Analysis. The SEC indicated that a “critical accounting policy” is one which is both important to the portrayal of a company’s financial condition and results, and requires management’s most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Currently, we do not believe that we have any accounting policies that fit this definition.

Recently issued accounting pronouncements. We do not expect the adoption of recently issued accounting pronouncements to have a significant impact on our results of operations, financial position or cash flow.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

A smaller reporting company is not required to provide the information required by this Item.

ITEM 4. CONTROLS AND PROCEDURES

We carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) as of the end of the period covered by this Quarterly Report. This evaluation was carried out under the supervision and with the participation of our Chief Executive Officer and our Chief Financial Officer. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of September 30, 2016 our disclosure controls and procedures were effective.

Disclosure controls and procedures are controls and other procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Exchange Act are recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

No change in our internal control over financial reporting occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Limitations on the effectiveness of internal controls. Our management does not expect that our disclosure controls and procedures or our internal control over financial reporting will necessarily prevent all fraud and material error. Our disclosure controls and procedures are designed to provide reasonable assurance of achieving our objectives and our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective at that reasonable assurance level. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake.

Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the internal control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate.

PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

In the ordinary course of conducting our business, we are, from time to time, involved in various legal proceedings, administrative proceedings, regulatory government investigations and other matters, including those in which we are a plaintiff, that are complex in nature and have outcomes that are difficult to predict. In accordance with topic ASC Topic 450, we record accruals for such contingencies to the extent that we conclude that it is probable that a liability will be incurred and the amount of the related loss can be reasonably estimated. Our assessment of each matter may change based on future unexpected events. An unexpected adverse judgment in any pending litigation could cause a material impact on our business operations, intellectual property, results of operations or financial position. Unless otherwise expressly stated, we believe costs associated with litigation will not have a material impact on our financial position or liquidity, but may be material to the results of operations in any given period. We assume no obligation to update the status of pending litigation, except as may be required by applicable law, statute or regulation. For a complete description of the facts and circumstances surrounding material litigation to which we are a party, see Note 12 in Item 8. "Financial Statements and Supplementary Data" included in our annual report on Form 10-K for the year ended December 31, 2015. There are no material updates to matters previously reported on Form 10-K for the year ended December 31, 2015, except:

As discussed in our previous filings, we were served in December 2014 with a complaint by Red Card Gaming, Inc. ("RCG"), and AGS, LLC ("AGS"), regarding an asset purchase agreement ("APA") executed between Galaxy and RCG in September 2012. The complaint filed in the United States District Court for the District of Nevada (the "District Court"), alleged fraud, breach of contract, and trademark infringement, among other allegations. We filed counterclaims against RCG and AGS alleging, among other things, fraud on the trademark office and in the marketplace, misappropriation of our trade secrets, breach of contract, infringement of our trademark and interference with customer relationships. We subsequently filed a demand for arbitration which was required pursuant to terms of the APA. The complaint in the District Court case was stayed pending outcome from the arbitration hearings and both proceedings are collectively referred to as the "Nevada Litigation."

In February 2016, we received notice the arbitration panel (the "Panel") had issued an interim award (the "Interim Award") which resulted in, among other things, our retention of all rights and privileges in the ownership of the product and trademark High Card Flush, and an injunction prohibiting AGS and RCG from selling the High Card Flush game and using the trademark. In March 2016, the Panel issued a recovery order ("Recovery Order") and determined that Galaxy was due 70% of its reasonable attorney fees. Additional briefing on the matter, relating to questions about the nature and amount of attorneys' fees incurred was requested and provided.

On May 16, 2016, the arbitration panel issued a final award (the "Final Award") incorporating the Interim Award and awarding us our attorneys' fees and costs.

On July 11, 2016, we entered into a settlement agreement (the "Settlement Agreement") with RCG and AGS for purposes of resolving the Nevada Litigation as well as the "In Bet Litigation" further referenced below. Pursuant to the Settlement Agreement, among other things, RCG, AGS and us agreed to a mutual release of all claims and counter-claims. RCG and AGS also agreed to terminate all of their rights and obligations related to the APA, and AGS

agreed to pay us the sum of \$350,000 and agreed to the injunctive terms of the Final Award. Furthermore, we agreed to dismiss the complaint we filed in November 2014 against In Bet Gaming, Inc. and In Bet, LLC (collectively "In Bet"), alleging that In Bet's In-Between side bet game infringed one of our patents. AGS became involved in an Inter-Partes Review subsequent to November 2014 concerning the patent at issue because AGS had title and interest in the game In-Between.

ITEM 5. OTHER INFORMATION

None.

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ITEM 6. EXHIBITS

| Exhibit Number | Description of Exhibit |
|----------------|--|
| 31.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002* |
| 101 | Financials in XBRL format |

* In accordance with Item 601(b)(32)(ii) of Regulation S-K, this exhibit shall not be deemed “filed” for the purposes of Section 18 of the Securities and Exchange Act of 1934 or otherwise subject to the liability of that section, nor shall it be deemed incorporated by reference in any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.

SIGNATURES

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

Galaxy Gaming, Inc.

Date: November 14, 2016

By: /s/ ROBERT B. SAUCIER
Robert B. Saucier
Chief Executive Officer (Principal Executive Officer)

Galaxy Gaming, Inc.

Date: November 14, 2016

By: /s/ GARY A. VECCHIARELLI
Gary A. Vecchiarelli
Chief Financial Officer (Principal Accounting Officer)