

SURGE COMPONENTS INC  
Form 10-Q  
October 12, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For The Quarterly Period Ended August 31, 2012

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

COMMISSION FILE NUMBER 000-27688

SURGE COMPONENTS, INC.

(Exact name of registrant as specified in its charter)

Nevada  
(State or other jurisdiction of incorporation or organization)

11-2602030  
(I.R.S. Employer Identification No.)

95 East Jefryn Blvd., Deer Park, New York  
(Address of principal executive offices)

11729  
(Zip code)

Issuer's telephone number: (631) 595-1818

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or 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. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

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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

As of October 12, 2012, there were 9,060,012 outstanding shares of the Registrant's Common Stock, \$.001 par value.

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SURGE COMPONENTS, INC

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## PART I Financial Information

## ITEM 1. FINANCIAL STATEMENTS.

## SURGE COMPONENTS, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

|   | August 31,<br>2012<br>(unaudited) | November<br>30,<br>2011 |
|---|-----------------------------------|-------------------------|
| <b>ASSETS</b>   |                                   |                         |
| Current assets:   |                                   |                         |
| Cash  | \$ 3,234,472                      | \$ 1,905,455            |
| Accounts receivable - net of allowance for<br>doubtful accounts of \$34,676 and \$29,676          | 4,124,917                         | 4,149,068               |
| Inventory, net  | 2,809,982                         | 2,802,327               |
| Prepaid expenses and income taxes   | 100,264                           | 130,436                 |
| Deferred income taxes   | 255,878                           | 293,783                 |
| <b>Total current assets</b>   | <b>10,525,513</b>                 | <b>9,281,069</b>        |
| Fixed assets – net of accumulated depreciation and amortization of \$2,110,872 and<br>\$2,069,538 | 88,054                            | 118,049                 |
| Deferred income taxes   | 1,023,513                         | 1,175,133               |
| Other assets  | 8,020                             | 6,376                   |
| <b>Total assets</b>   | <b>\$ 11,645,100</b>              | <b>\$ 10,580,627</b>    |

See notes to consolidated financial statements

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## SURGE COMPONENTS, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

|   | August 31,<br>2012<br>(unaudited) | November<br>30,<br>2011 |
|---|-----------------------------------|-------------------------|
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                                   |                         |
| Current liabilities:  |                                   |                         |
| Loan payable  | \$ -                              | \$ -                    |
| Accounts payable  | 2,405,946                         | 2,019,980               |
| Accrued expenses and taxes  | 671,469                           | 669,949                 |
| Accrued salaries  | 391,037                           | 517,172                 |
| <b>Total current liabilities</b>  | <b>3,468,452</b>                  | <b>3,207,101</b>        |
| Deferred rent   | 25,503                            | 16,743                  |
| <b>Total liabilities</b>  | <b>3,493,955</b>                  | <b>3,223,844</b>        |
| Commitments and contingencies   |                                   |                         |
| Shareholders' equity  |                                   |                         |
| Preferred stock - \$.001 par value stock, 5,000,000 shares authorized:  |                                   |                         |
| Series A – 260,000 shares authorized, none outstanding.   |                                   |                         |
| Series B – 200,000 shares authorized, none outstanding, non-voting, convertible, redeemable.  |                                   |                         |
| Series C – 100,000 shares authorized, 23,700 and 23,700 shares issued and outstanding, redeemable, convertible, and a liquidation preference of \$5 per share | 24                                | 24                      |
| Common stock - \$.001 par value stock, 75,000,000 shares authorized, 9,060,012 and 9,035,012 shares issued and outstanding                                    | 9,060                             | 9,035                   |
| Additional paid-in capital  | 23,027,033                        | 22,995,384              |
| Accumulated deficit   | (14,884,972)                      | (15,647,660)            |
| <b>Total shareholders' equity</b>   | <b>8,151,145</b>                  | <b>7,356,783</b>        |
| <b>Total liabilities and shareholders' equity</b>   | <b>\$ 11,645,100</b>              | <b>\$ 10,580,627</b>    |

See notes to consolidated financial statements.

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## SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Statements of Income  
(Unaudited)

|   | Nine Months Ended<br>August 31, |               | Three Months Ended<br>August 31, |              |
|---|---------------------------------|---------------|----------------------------------|--------------|
|   | 2012                            | 2011          | 2012                             | 2011         |
| Net sales   | \$ 16,891,754                   | \$ 17,336,082 | \$ 6,059,072                     | \$ 6,318,925 |
| Cost of goods sold                                    | 11,930,233                      | 11,989,346    | 4,326,069                        | 4,361,529    |
| Gross profit  | 4,961,521                       | 5,346,736     | 1,733,003                        | 1,957,396    |
| Operating expenses:                                   |                                 |               |                                  |              |
| Selling and shipping expenses                         | 1,598,747                       | 1,327,022     | 555,417                          | 485,044      |
| General and administrative expenses                   | 2,335,915                       | 2,341,282     | 743,288                          | 763,596      |
| Depreciation and amortization                         | 41,334                          | 66,877        | 13,996                           | 22,404       |
| Total operating expenses                              | 3,975,996                       | 3,735,181     | 1,312,701                        | 1,271,044    |
| Income before other income (expense) and income taxes | 985,525                         | 1,611,555     | 420,302                          | 686,352      |
| Other income(expense):                                |                                 |               |                                  |              |
| Interest expense                                      | -                               | (11,920)      | -                                | (830)        |
| Investment income                                     | 1,777                           | 1,693         | 734                              | 392          |
| Other income(expense)                                 | 1,777                           | (10,227)      | 734                              | (438)        |
| Income before income taxes                            | 987,302                         | 1,601,328     | 421,036                          | 685,914      |
| Income taxes  | 212,764                         | 74,265        | 10,289                           | 5,818        |
| Net Income  | 774,538                         | 1,527,063     | 410,747                          | 680,096      |
| Dividends on preferred stock                          | 11,850                          | 14,100        | 5,925                            | 5,925        |
| Net income available to common shareholders           | \$ 762,688                      | \$ 1,512,963  | \$ 404,822                       | \$ 674,171   |

## Net income per share available to common shareholders:

|         |        |        |        |        |
|---------|--------|--------|--------|--------|
| Basic   | \$ .08 | \$ .17 | \$ .04 | \$ .07 |
| Diluted | \$ .08 | \$ .16 | \$ .04 | \$ .07 |

## Weighted Shares Outstanding:

|         |           |           |           |           |
|---------|-----------|-----------|-----------|-----------|
| Basic   | 9,044,285 | 8,992,311 | 9,060,012 | 9,035,012 |
| Diluted | 9,673,922 | 9,536,004 | 9,689,649 | 9,578,705 |

See notes to consolidated financial statements.

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## SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows  
(unaudited)

Nine Months Ended  
August 31,    August 31,  
2012            2011

## CASH FLOWS FROM OPERATING ACTIVITIES:

|  |            |              |
|--|------------|--------------|
| Net income   | \$ 774,538 | \$ 1,527,063 |
| Adjustments to reconcile net income<br>to net cash provided by operating activities: |            |              |
| Allowance for doubtful accounts  | 5,000      | -            |
| Depreciation and amortization  | 41,334     | 66,877       |
| Stock compensation expense   | 25,424     | 77,850       |
| Deferred income taxes  | 189,525    | --           |

## CHANGES IN OPERATING ASSETS AND LIABILITIES:

|                            |           |           |
|----------------------------|-----------|-----------|
| Accounts receivable        | 19,151    | (282,560) |
| Inventory                  | (7,655)   | (599,678) |
| Prepaid expenses and taxes | 30,172    | (18,546)  |
| Other assets               | (1,644)   | 239,336   |
| Accounts payable           | 385,966   | 173,223   |
| Deferred rent              | 8,760     | 11,097    |
| Accrued expenses           | (136,465) | (400,588) |

|  |           |         |
|--|-----------|---------|
| NET CASH FLOWS FROM OPERATING ACTIVITIES | 1,334,106 | 794,074 |
|--|-----------|---------|

## CASH FLOWS FROM INVESTING ACTIVITIES:

|   |          |          |
|---|----------|----------|
| Acquisition of fixed assets                 | (11,339) | (13,663) |
| NET CASH FLOWS USED IN INVESTING ACTIVITIES | (11,339) | (13,663) |

See notes to consolidated financial statements.

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## SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Statements Of Cash Flows  
(Continued)  
(unaudited)

|   | Nine Months Ended   |                     |
|---|---------------------|---------------------|
|   | August 31,<br>2012  | August 31,<br>2011  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>              |                     |                     |
| Proceeds from exercising stock options                    | 6,250               | -                   |
| <b>NET CASH FLOWS PROVIDED BY IN FINANCING ACTIVITIES</b> | <b>6,250</b>        | <b>-</b>            |
| <b>NET CHANGE IN CASH</b>                                 | <b>1,329,017</b>    | <b>780,411</b>      |
| <b>CASH AT BEGINNING OF PERIOD</b>                        | <b>1,905,455</b>    | <b>883,331</b>      |
| <b>CASH AT END OF PERIOD</b>                              | <b>\$ 3,234,472</b> | <b>\$ 1,663,742</b> |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>  |                     |                     |
| Income taxes paid   | \$ 47,745           | \$ 74,265           |
| Interest paid   | \$ -                | \$ 46,340           |
| <b>NONCASH INVESTING AND FINANCING ACTIVITIES:</b>        |                     |                     |
| Accrued dividends on preferred stock                      | \$ 11,850           | \$ 14,100           |

See notes to consolidated financial statements.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE A – ORGANIZATION, DESCRIPTION OF COMPANY'S BUSINESS AND BASIS OF PRESENTATION

Surge Components, Inc. (“Surge”) was incorporated in the State of New York and commenced operations on November 24, 1981 as an importer of electronic products, primarily capacitors and discrete semi-conductors selling to customers located principally throughout North America. On June 24, 1988, Surge formed Challenge/Surge Inc. (“Challenge”), a wholly-owned subsidiary to engage in the sale of electronic component products and sounding devices from established brand manufacturers to customers located principally throughout North America.

In May 2002, Surge and an officer of Surge founded and became sole owners of Surge Components, Limited (“Surge Limited”), a Hong Kong corporation. Under current Hong Kong law, Surge Limited is required to have at least two shareholders. Surge owns 999 shares of the outstanding common stock and the officer of Surge owns 1 share of the outstanding common stock. The officer of Surge has assigned his rights regarding his 1 share to Surge. Surge Limited started doing business in July 2002. Surge Limited operations have been consolidated with the Company. Surge Limited is responsible for the sale of Surge’s products to customers located in Asia.

On August 31, 2010, the Company changed its corporate domicile by merging into a newly-formed corporation, Surge Components, Inc. (Nevada), which was formed in the State of Nevada for that purpose. Surge Components Inc. is the surviving entity. The number of common stock shares authorized for issuance was increased to 75,000,000 shares.

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

[1] Principles of Consolidation:

The consolidated financial statements include the accounts of Surge, Challenge, and Surge Limited (collectively the “Company”). All material intercompany balances and transactions have been eliminated in consolidation.

The accompanying interim consolidated financial statements have been prepared, without audit, in accordance with the instructions to Form 10-Q for interim financial reporting pursuant to the rules and regulations of the Securities and Exchange Commission.

The results and trends in these interim consolidated financial statements for the nine months ended August 31, 2012 and August 31, 2011 may not be representative of those for the full fiscal year or any future periods.

(2) Accounts Receivable:

Trade accounts receivable are recorded at the net invoice value and are not interest bearing. The Company considers receivables past due based on the payment terms. The Company reviews its exposure to amounts receivable and reserves specific amounts if collectability is no longer reasonably assured. The Company also reserves a percentage of its trade receivable balance based on collection history and current economic trends that might impact the level of future credit losses. The Company re-evaluates such reserves on a regular basis and adjusts its reserves as needed. Based on the Company’s operating history and customer base, bad debts to date have not been material.

(3) Revenue Recognition:

Revenue is recognized for products sold by the Company when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed and determinable, collectability is reasonably assured and title and risk of loss have been transferred to the customer. This occurs when product is shipped from the Company's warehouse.

For direct shipments, revenue is recognized when product is shipped from the Company's supplier. The Company has a long term supply agreement with one of our suppliers. The Company purchases the merchandise from the supplier and has the supplier directly ship to the customer through a freight forwarder. Title passes to customer upon the merchandise being received by a freight forwarder. Direct shipments were approximately \$2,550,000 and \$2,885,000 for the nine months ended August 31, 2012 and August 31, 2011 respectively.

The Company also acts as a sales agent to certain customers in North America for one of its suppliers. The Company reports these commissions as revenues in the period earned. Commission revenue totaled \$215,644 and \$257,482 for the nine months ended August 31, 2012 and August 31, 2011 respectively.

The Company performs ongoing credit evaluations of its customers and maintains reserves for potential credit losses.

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## SURGE COMPONENTS, INC. AND SUBSIDIARIES

## Notes to Consolidated Financial Statements

## NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

## (3) Revenue Recognition (continued):

The Company and its subsidiaries currently have agreements with several distributors. Some of these agreements allow for the return of up to 10% of certain product sales for the previous 6 month period. The Company does not recognize this portion of the revenues, or the related costs of the sale, until the right of return has expired. There are no provisions for the granting of price concessions in any of the agreements. Revenues under these distribution agreements were approximately \$2,830,000 and \$3,435,000 for the nine months ended August 31, 2012 and August 31, 2011 respectively.

## (4) Inventories:

Inventories, which consist solely of products held for resale, are stated at the lower of cost (first-in, first-out method) or market. Products are included in inventory when the Company obtains title and risk of loss on the products, primarily when shipped from the supplier. Inventory in transit principally from foreign suppliers at August 31, 2012 approximated \$930,000. The Company, at August 31, 2012, has a reserve against slow moving and obsolete inventory of \$911,353. From time to time the Company's products are subject to legislation from various authorities on environmental matters.

## (5) Depreciation and Amortization:

Fixed assets are recorded at cost. Depreciation is generally calculated on a straight line method and amortization of leasehold improvements is provided for on the straight-line method over the estimated useful lives of the various assets as follows:

|                                   |   |
|-----------------------------------|---|
| Furniture, fixtures and equipment | 5 - 7 years   |
| Computer equipment                | 5 years   |
| Leasehold Improvements            | Estimated useful life or lease term, whichever is shorter |

Maintenance and repairs are expensed as incurred while renewals and betterments are capitalized.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(6) Concentration of Credit Risk:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of accounts receivable. The Company maintains substantially all of its cash balances in two financial institutions. At August 31, 2012 and November 30, 2011, the Company's uninsured cash balances totaled approximately \$1,698,387 and \$586,000, respectively.

(7) Income Taxes:

The Company's deferred income taxes arise primarily from the differences in the recording of net operating losses, allowances for bad debts, inventory reserves and depreciation expense for financial reporting and income tax purposes. A valuation allowance is provided when it has been determined to be more likely than not that the likelihood of the realization of deferred tax assets will not be realized. See Note G.

The Company follows the provisions of the Accounting Standards Codification topic, ASC 740, "Income Taxes" (ASC 740). There have been no unrecognized tax benefits and, accordingly, there has been no effect on the Company's financial condition or results of operations as a result of ASC 740.

The Company files income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. The Company is no longer subject to U.S. federal tax examinations for years before fiscal years ending November 30, 2008, and state tax examinations for years before fiscal years ending November 30, 2007. Management does not believe there will be any material changes in our unrecognized tax positions over the next twelve months.

The Company's policy is to recognize interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense. As of the date of adoption of ASC 740, there was no accrued interest or penalties associated with any unrecognized tax benefits, nor was any interest expense recognized during the nine months ended August 31, 2012 and August 31, 2011.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(8) Cash Equivalents:

The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents.

(9) Use of Estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

(10) Marketing and promotional costs:

Marketing and promotional costs are expensed as incurred and have not been material to date. The Company has contractual arrangements with several of its distributors which provide for cooperative advertising rights to the distributor as a percentage of sales. Cooperative advertising is reflected as a reduction in revenues and has not been material to date.

(11) Fair Value of Financial Instruments:

The carrying amount of cash balances, accounts receivable, accounts payable and accrued expenses approximate their fair value based on the nature of those items. Estimated fair values of financial instruments are determined using available market information and appropriate valuation methodologies. Considerable judgment is required to interpret the market data used to develop the estimates of fair value, and accordingly, the estimates are not necessarily indicative of the amounts that could be realized in a current market exchange.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE B – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

(12) Shipping Costs

The Company classifies shipping costs as a component of selling expenses. Shipping costs totaled \$10,468 and \$9,778 for the nine months ended August 31, 2012 and August 31, 2011 respectively.

(13) Earnings Per Share

Basic earnings per share includes no dilution and is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding for the period. The difference between reported basic and diluted weighted-average common shares results from the assumption that all dilutive stock options and convertible preferred stock exercised into common stock. Total potentially dilutive shares excluded from diluted weighted shares outstanding at August 31, 2012 and 2011 totaled 316,363 and 378,307, respectively.

(14) Stock Based Compensation to Employees

The Company accounts for its stock-based compensation for employees in accordance with Accounting Standards Codification (“ASC”) 718. The Company recognizes in the statement of operations the grant-date fair value of stock options and other equity-based compensation issued to employees and non-employees over the related vesting period.

Stock Based Compensation to Other than Employees

The Company accounts for equity instruments issued in exchange for the receipt of goods or services from other than employees in accordance with ASC 718. Costs are measured at the estimated fair market value of the consideration received or the estimated fair value of the equity instruments issued, whichever is more reliably determinable. The value of equity instruments issued for consideration other than employee services is determined on the earlier of a performance commitment or completion of performance by the provider of goods or services. In the case of equity instruments issued to consultants, the fair value of the equity instrument is recognized over the term of the consulting agreement.

(15) Recent Accounting Standards:

**Comprehensive Income** — In June 2011, the Financial Accounting Standards Board (“FASB”) issued new guidance on the presentation of comprehensive income. Specifically, the new guidance allows an entity to present components of net income and other comprehensive income in one continuous statement, referred to as the statement of comprehensive income, or in two separate, but consecutive statements. The new guidance eliminates the current option to report other comprehensive income and its components in the statement of changes in equity. While the new guidance changes the presentation of comprehensive income, there are no changes to the components that are recognized in net income or other comprehensive income under current accounting guidance. This new guidance is effective for fiscal years and interim periods beginning after December 15, 2011. We do not believe our adoption of the new guidance in the first quarter of fiscal 2013 will have an impact on our consolidated financial position, results of operations or cash flows.

**Fair Value Measurement** — In April 2011, the FASB issued new guidance to achieve common fair value measurement and disclosure requirements between GAAP and International Financial Reporting Standards. This new guidance



amends current fair value measurement and disclosure guidance to include increased transparency around valuation inputs and investment categorization. This new guidance is effective for fiscal years and interim periods beginning after December 15, 2011. We do not believe our adoption of the new guidance in the first quarter of fiscal 2013 will have an impact on our consolidated financial position, results of operations or cash flows.

(16) Reclassifications:

Certain amounts included in 2011 financial statements have been reclassified to conform to the 2012 presentation.

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## SURGE COMPONENTS, INC. AND SUBSIDIARIES

## Notes to Consolidated Financial Statements

## NOTE C - FIXED ASSETS

Fixed assets consist of the following:

|                               | August 31,<br>2012 | November<br>30,<br>2011 |
|-------------------------------|--------------------|-------------------------|
| Furniture and Fixtures        | \$ 321,099         | \$ 350,563              |
| Leasehold Improvements        | 909,014            | 906,449                 |
| Computer Equipment            | 968,813            | 930,575                 |
| Less-Accumulated Depreciation | (2,110,872)        | (2,069,538)             |
| Net Fixed Assets              | \$ 88,054          | \$ 118,049              |

Depreciation and amortization expense for the nine months ended August 31, 2012 and August 31, 2011 was \$41,334 and \$66,877, respectively.

## NOTE D - ACCRUED EXPENSES

Accrued expenses consist of the following:

|                           | August 31,<br>2012 | November<br>30,<br>2011 |
|---------------------------|--------------------|-------------------------|
| Commissions               | \$ 287,413         | \$ 211,789              |
| Preferred Stock Dividends | 176,857            | 165,007                 |
| Interest                  | 102,399            | 102,399                 |
| Other accrued expenses    | 104,800            | 190,754                 |
|                           | \$ 671,469         | \$ 669,949              |

In March 2000, the Company completed a \$7,000,000 private placement. The entire note balance was converted into common stock in July 2001 pursuant to the automatic conversion provisions of the notes. The interest accrued on the notes required approval by the holder in order to convert to common stock. The accrued interest in the Company's disclosures relate to the portion of the interest which was not converted. No additional interest accrues on these amounts and none of this interest was repaid during any of the periods presented.

## NOTE E - RETIREMENT PLAN

In June 1997, the Company adopted a qualified 401(k) retirement plan for all full-time employees who are twenty-one years of age and have completed twelve months of service. The plan allows total employee contributions of up to fifteen percent (15%) of the eligible employee's salary through salary reduction. The Company makes a matching contribution of twenty percent (20%) of each employee's contribution for each dollar of employee deferral up to five percent (5%) of the employee's salary. Net assets for the plan, as estimated by Union Central, Inc., which maintains

the plan's records, were approximately \$770,000 at November 30, 2011. Pension expense for the nine months ended August 31, 2012 and August 31, 2011 was \$2,766 and \$4,033, respectively.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE F – SHAREHOLDERS' EQUITY

[1] Preferred Stock:

In February 1996, the Company amended its Certificate of Incorporation to authorize the issuance of 1,000,000 shares of preferred stock in one or more series. In August 2010, the number of preferred shares authorized for issuance was increased to 5,000,000 shares.

In January 2000, the Company authorized 260,000 shares of preferred stock as Non-Voting Redeemable Convertible Series A Preferred Stock ("Series A Preferred"). None of the Series A preferred stock is outstanding as of August 31, 2012.

In November 2000, the Company authorized 200,000 shares of preferred stock as Voting Redeemable Convertible Series B Preferred Stock ("Series B Preferred"). None of the Series B Preferred Stock is outstanding as of August 31, 2012.

In November 2000, the Company authorized 100,000 shares of preferred stock as Non-Voting Redeemable Convertible Series C Preferred Stock ("Series C Preferred"). Each share of Series C Preferred is automatically convertible into 10 shares of the Company's Common Stock upon shareholder approval. If the Series C Preferred were converted into common stock on or before April 15, 2001, these shares were entitled to cumulative dividends at the rate of \$.50 per share per annum commencing April 15, 2001 payable on June 30 and December 31 of each year. In November 2000, 70,000 shares of the Series C Preferred were issued in payment of financial consulting services to its investment banker and a shareholder of the Company. In April 2001, 8,000 shares of the Series C Preferred were repurchased and cancelled. Dividends aggregating \$176,857 have not been declared or paid for the semiannual periods ended December 31, 2001 through the semiannual payment due June 30, 2012. The Company has accrued these dividends.

In April 2002, in connection with a Mutual Release, Settlement, Standstill and Non-Disparagement Agreement and among other provisions, certain investors transferred back to the Company 252,000 shares of common stock, 19,300 shares of Series C preferred stock, and certain warrants, in exchange for \$225,000. These repurchased shares were cancelled.

In February 2006, the Company settled with a shareholder to repurchase 10,000 shares of Series C Preferred plus accrued dividends for \$50,000.

Pursuant to exchange agreements dated as of March 14, 2011, 9,000 shares of Series C Preferred were returned to the Company for cancellation in exchange for 112,500 shares of common stock.

At August 31, 2012 there are 23,700 shares of Series C Preferred issued and outstanding.



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## SURGE COMPONENTS, INC. AND SUBSIDIARIES

## Notes to Consolidated Financial Statements

## NOTE F – SHAREHOLDERS’ EQUITY (Continued)

## [2] 2010 Incentive Stock Plan

In March 2010, the Company adopted, and in April 2010 the shareholders ratified, the 2010 Incentive Stock Plan (“Stock Plan”). The plan provides for the grant of options to officers, employees or consultants to the Company to purchase an aggregate of 1,500,000 common shares.

Stock option incentive plan activity for the nine months ended August 31, 2012 is summarized as follows:

|  | Shares    | Weighted<br>Average<br>Exercise<br>Price |
|--|-----------|--|
| Options outstanding December 1, 2011                   | 685,000   | \$0.25                                   |
| Options issued in nine months ended August 31, 2012    | 50,000    | \$0.51                                   |
| Options exercised in nine months ended August 31, 2012 | (25,000 ) | \$0.25                                   |
| Options cancelled in nine months ended August 31, 2012 | (1,000 )  | \$1.15                                   |
| Options outstanding at August 31, 2012                 | 709,000   | \$0.30                                   |
| Options exercisable at August 31, 2012                 | 619,667   | \$0.30                                   |

## Stock Compensation

The fair values of stock options are estimated at the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions during 2010: expected volatility of 60% (based on stock volatility of public company industry peers); average risk-free interest rate of 2.31% (the five year treasury note rate on the date of the grant); initial expected life of 5 years (based on the term of the options); no expected dividend yield; and amortized over the vesting period for a year.

On February 25, 2011, the Company granted stock options to employees to purchase 85,000 shares of the Company’s common stock at an exercise price of \$1.15, the value of the common stock on the date of the grant. These options vest over a three year period and expire in ten years. The fair values of these stock options are estimated at the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions: expected volatility of 60% (based on stock volatility of public company industry peers); average risk-free interest rate of 3.42% (the ten year treasury note rate on the date of the grant); initial expected life of 10 years (based on the term of the options); no expected dividend yield; and amortized over the vesting period.

In July 2012, the Company granted a stock option to one non-officer director to purchase 50,000 shares of common stock at an exercise price of \$0.51, the market price of the common stock on the date of the grant. This option vested immediately and expires in five years. The fair value of this stock options is estimated at the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions: expected volatility of 35% (based on stock volatility of public company industry peers); average risk-free interest rate of 0.67% (the five year treasury note rate on the date of the grant); initial expected life of 5 years (based on the term of the options) and no

expected dividend yield.

The weighted average grant date fair value of the stock options granted during the year ended November 30, 2011 was \$0.82. During the nine months ended August 31, 2012, the Company recorded stock based compensation totaling \$17,433 as a result of these stock option grants.

The intrinsic value of the exercisable options at August 31, 2012 totaled \$57,500. At August 31, 2012 the weighted average remaining life of the stock options is 3.60 years. At August 31, 2012, there was \$34,861 of total unrecognized compensation cost related to the stock options granted under the plan. This cost is expected to be recognized over a weighted average period of .875 years.

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## SURGE COMPONENTS, INC. AND SUBSIDIARIES

## Notes to Consolidated Financial Statements

## NOTE F – SHAREHOLDERS’ EQUITY (Continued)

## [3] Authorized Repurchase:

In November 2002, the Board of Directors authorized the repurchase of up to 1,000,000 Common Shares at a price between \$.04 and \$.045. The Company has not repurchased any shares to date pursuant to such authority

## [4] Compensation of Directors

In May 2010, the Company issued 12,000 shares of its common stock to each non-officer director as compensation for services on the Board of Directors. These shares were valued at \$0.18 per share, the closing price of the common stock on the over-the-counter market. Starting April 1, 2012, the amount directors each receive for their services on the Board of Directors was increased from \$200 a month to \$2,000 a month. In May 2010, options were granted to each non-officer director to purchase 25,000 shares of common stock at an exercise price of \$0.25. In July 2012, a stock option was granted to one non-officer director to purchase 50,000 shares of common stock at an exercise price of \$0.51. (See Note F[2] for disclosure on the valuation and terms of these options). In May 2012, one non-officer director exercised an option and acquired 25,000 shares of common stock for \$6,250.

## NOTE G – INCOME TAXES

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes using the enacted tax rates in effect in the years in which the differences are expected to reverse.

The Company’s deferred income taxes are comprised of the following:

|                           | August 31,<br>2012 | November<br>30,<br>2011 |
|---------------------------|--------------------|-------------------------|
| Deferred Tax Assets       |                    |                         |
| Net operating loss        | \$ 5,247,001       | \$ 5,345,554            |
| Allowance for bad debts   | 11,853             | 7,793                   |
| Inventory                 | 442,366            | 498,220                 |
| Deferred Rent             | 10,186             | 985                     |
| Depreciation              | 187,389            | 183,646                 |
| Total deferred tax assets | 5,898,795          | 6,036,198               |
| Valuation allowance       | (4,619,404)        | (4,567,282)             |
| Deferred Tax Assets       | \$ 1,279,391       | \$ 1,468,916            |

The valuation allowance for the deferred tax assets relates principally to the uncertainty of the utilization of deferred tax assets and was calculated in accordance with the provisions of ASC 740, which requires that a valuation allowance be established or maintained when it is “more likely than not” that all or a portion of deferred tax assets will not be realized. This valuation is based on management estimates of future taxable income. Although the degree of variability inherent in the estimates of future taxable income is significant and subject to change in the near term,



management believes, that the estimate is adequate. The estimated valuation allowance is continually reviewed and as adjustments to the allowance become necessary, such adjustments are reflected in the current operations.

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## SURGE COMPONENTS, INC. AND SUBSIDIARIES

## Notes to Consolidated Financial Statements

## NOTE G – INCOME TAXES (CONTINUED)

The valuation allowance increased by approximately \$52,000 during the nine months ended August 31, 2012. This change in the valuation allowance is based on management estimates of future taxable income. The degree of variability inherent in the estimates of future taxable income is significant and subject to change in the near term. The Company reviews its estimates of future taxable income in each reporting period and adjustments to the valuation allowance are reflected in the current operations.

The Company's income tax expense consists of the following:

|                            | Nine Months Ended  |                    |
|----------------------------|--------------------|--------------------|
|                            | August 31,<br>2012 | August 31,<br>2011 |
| Current:                   |                    |                    |
| Federal                    | \$ 193,860         | \$ 38,790          |
| States                     | 18,904             | 35,475             |
|                            | 212,764            | 74,265             |
| Deferred:                  |                    |                    |
| Federal                    | -                  | --                 |
| States                     | -                  | --                 |
|                            | -                  | --                 |
| Provision for income taxes | \$ 212,764         | \$ 74,265          |

The Company files a consolidated income tax return with its wholly-owned subsidiaries and has net operating loss carryforwards of approximately \$13,000,000 for federal and state purposes, which expire through 2020. A reconciliation of the difference between the expected income tax rate using the statutory federal tax rate and the Company's effective rate is as follows:

|                                       | Nine Months Ended  |       |
|---------------------------------------|--------------------|-------|
|                                       | August 31,<br>2012 | 2011  |
| U.S Federal Income tax statutory rate | 34%                | 34%   |
| Valuation allowance                   | (14)%              | (34)% |
| State income taxes                    | 2%                 | 5%    |
| Other                                 | -                  | -     |
| Effective tax rate                    | 22%                | 5%    |



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## SURGE COMPONENTS, INC. AND SUBSIDIARIES

## Notes to Consolidated Financial Statements

## NOTE H- RENTAL COMMITMENTS

The Company leases its office and warehouse space through 2020 from a corporation that is controlled by officers/shareholders of the Company ("Related Company"). Annual minimum rental payments to the Related Company approximated \$156,000 for the Fiscal 2011, and increase at the rate of three per cent per annum throughout the lease term.

Pursuant to the lease, rent expense charged to operations differs from rent paid because of scheduled rent increases. Accordingly, the Company has recorded deferred rent. Rent expense is calculated by allocating to rental payments, including those attributable to scheduled rent increases, on a straight line basis, over the lease term.

In June 2012, the Company renewed a lease to rent office space in Hong Kong for one year. Annual minimum rental payments are approximately \$23,000.

The future minimum rental commitments at November 30, 2011:

| Year Ending<br>November 30, |              |
|-----------------------------|--------------|
| 2012                        | 182,641      |
| 2013                        | 174,163      |
| 2014                        | 165,878      |
| 2015                        | 169,195      |
| 2016                        | 172,579      |
| 2017 & thereafter           | 693,878      |
|                             | \$ 1,558,334 |

Net rental expense for the nine months ended August 31, 2012 and August 31, 2011 were \$184,628 and \$184,763 respectively, of which \$167,344 was paid to the Related Company.

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## SURGE COMPONENTS, INC. AND SUBSIDIARIES

## Notes to Consolidated Financial Statements

## NOTE I – EMPLOYMENT AND OTHER AGREEMENTS

The Company has employment agreements, with terms through July 30, 2013 (renewable on each July 30th for an additional one year period) with two officers of the Company, which provides each with a base salary of \$225,000, subject to certain increases as defined, per annum, plus fringe benefits and bonuses. The Compensation Committee of the Company's Board of Directors determines the bonuses. Bonuses have been accrued to the two officers through August 31, 2012 totaling \$200,000. The agreements also contain provisions prohibiting the officers from engaging in activities which are competitive with those of the Company during employment and for one year following termination. The agreements further provide that in the event of a change of control, as defined, or a change in ownership of at least 25% of the issued and outstanding stock of the Company, and such issuance was not approved by either officer, or if they are not elected to the Board of Directors of the Company and/or are not elected as an officer of the Company, then the non-approving officer may elect to terminate his employment agreement. If either officer elects to terminate the agreement, he will receive 2.99 times his annual compensation (or such other amount then permitted under the Internal Revenue Code without an excess penalty), in addition to the remainder of his compensation under his existing employment contract. In addition, if the Company makes or receives a "firm commitment" for a public offering of Common Shares, each officer will receive a warrant to purchase, at a nominal value, up to 9.5% of the Company's common stock, provided they do not voluntarily terminate employment.

## NOTE J– MAJOR CUSTOMERS

The Company had one customer who accounted for 10% of net sales for the nine months ended August 31, 2012 and two customers who accounted for 10% and 12% of net sales for the nine months ended August 31, 2011. The Company had one customer who accounted for 20% and 22% of accounts receivable at August 31, 2012 and November 30, 2011, respectively.

## NOTE K- MAJOR SUPPLIERS

During the nine months ended August 31, 2012 and August 31, 2011 there was one foreign supplier accounting for 42% and 44% of total inventory purchased.

The Company purchases a significant portion of its products overseas. For the nine months ended August 31, 2012, the Company purchased 46% from Taiwan, 19% from Hong Kong, 23% from elsewhere in Asia and less than 1% overseas outside of Asia.

## NOTE L - EXPORT SALES

The Company's export sales approximated:

|        | Nine Months Ended<br>August 31, |           |
|--------|---------------------------------|-----------|
|        | 2012                            | 2011      |
| Canada | 2,041,882                       | 2,240,202 |
| China  | 3,178,617                       | 3,160,164 |

|                       |           |           |
|-----------------------|-----------|-----------|
| Other Asian Countries | 1,079,456 | 1,688,897 |
| Europe                | 138,276   | 106,779   |

Revenues are attributed to countries based on location of customer.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE M – LINE OF CREDIT

In June 2011, the Company replaced its existing credit line with a line of credit with a new bank totaling \$1,000,000. Borrowings under the line accrue interest at 2.56% over the LIBOR rate. While the credit line was to expire in September 2012, the bank agreed to extend the credit line until March 2013. The Company plans to renew the credit line by March 2013. The line is collateralized by all the Company's assets and includes working capital and tangible net worth covenants. At August 31, 2012, the Company was in compliance with the financial covenants. As of August 31, 2012, the outstanding balance on the line of credit was zero.

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

This report contains forward-looking statements. All statements other than statements of historical facts contained herein, including statements regarding our future results of operations and financial position, business strategy and plans and objectives of management for future operations, are forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements.

In some cases, forward-looking statements can be identified by terms such as "may," "will," "should," "expects," "plans," "anticipates," "could," "intends," "target," "projects," "contemplates," "believes," "estimates," "predicts," "potential" or "continue" or the negative of these terms or other similar words. These statements are only predictions. We have based these forward-looking statements largely on our current expectations and projections about future events and financial trends that we believe may affect our business, financial condition and results of operations. We discuss many of the risks in greater detail under the heading "Risk Factors" in our Annual Report on Form 10-K. These forward-looking statements represent our estimates and assumptions only as of the date of the filing of this report. Except as required by law, we assume no obligation to update any forward-looking statements after the date of the filing of this report.

Overview

We are a supplier of electronic products and components. These products include capacitors, which are electrical energy storage devices, and discrete components, such as semiconductor rectifiers, transistors and diodes, which are single function low power semiconductor products that are packaged alone as compared to integrated circuits such as microprocessors. The products that we sell are typically utilized in the electronic circuitry of diverse products, including, but not limited to, automobiles, cellular telephones, computers, consumer electronics, garage door openers, household appliances, power supplies and security equipment. We sell our products to both original equipment manufacturers, commonly referred to as OEMs, who incorporate them into their products, and to distributors who resell these products within their customer base. The products that we sell are manufactured predominantly in Asia by approximately sixteen independent manufacturers. We have a long-term supply agreement with only one of our suppliers. We act as the exclusive sales agent utilizing independent sales representative organizations in North America to sell and market the products for one such manufacturer pursuant to a written agreement. When we act as a sales agent, the supplier who sold the product to the customer that we introduced to such supplier will pay us a commission. The amount of the commission is determined on a sale by sale basis depending on the profit margin of the product. Such commissions have not been material to date. The Company anticipates that this direct business will increase and so will commissions to the Company.

Challenge engages in the sale of electronic components business, including audible components. We have been able to increase the types of products that we sell because some of our suppliers introduced new products, and we also located other products from new suppliers. As a result we are continually trying to add to the types of products that we sell. In 2002 we started to import products similar to our parent company Surge, and sold these under the Challenge name. It started with a line of transducers, then we added battery snaps, and coin cell holders. Since 2002, we have increased our imported private label Challenge branded product mix to include buzzers, speakers, microphones, resonators, filters, and discriminators. We now also work with our suppliers to have our suppliers customize many of the products we sell for many customers through the customers' own designs and those that we work with our suppliers to have our suppliers redesign for them at our suppliers' factories. We have an experienced design engineer on our staff, who works with our suppliers on such redesigns. We continue to expand the line of products we sell and we now



are selling alarms and chimes. We sell these products through independent representatives that earn a 5-6% commission rate on the gross sale of the products we sell. We also are working with local, regional, and national distributors to sell these products to local accounts in every state. We do not have contractual authority from our manufactures to modify any of the products that we distribute.

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In 2002, the Company opened a Hong Kong office and hired direct sales people in order to effectively handle the transfer business from United States customers purchasing and manufacturing in Asia after designing the products in the United States of America. This office has strengthened its global capabilities and service to its customer base in Asia.

The electronic components industry has changed, from one of strong demand to now one of moderate demand. As management previously stated, the strong demand of 2011 has leveled off to a moderate demand for components in 2012. We believe the move from strong demand to moderate demand is a result of the easing of post tsunami/earthquake conditions in Japan. We believe that once the suppliers in Japan were back to full production, customers' demand for product was less urgent. We also attribute softening demand to economic problems in Europe, which have a trickle down effect globally. As a result of decreased business volumes overall, we expect that some of the Company's customers, especially those whose business includes the European market, will experience reduced demand for components.

In order for us to grow, we will depend on, among other things, the continued growth of the electronics and semiconductor industries, our ability to withstand intense price competition, our ability to obtain new clients, our ability to retain sales and other personnel in order to expand our marketing capabilities, our ability to secure adequate sources of products, which are in demand on commercially reasonable terms, our success in managing growth, including monitoring an expanded level of operations and controlling costs, and the availability of adequate financing.

### Critical Accounting Policies

#### Accounts Receivable:

The allowance for doubtful accounts is based on the Company's assessment of the collectability of specific customer accounts and an assessment of international, political and economic risk as well as the aging of the accounts receivable. If there is a change in actual defaults from the Company's historical experience, the Company's estimates of recoverability of amounts due could be affected and the Company would adjust the allowance accordingly.

#### Revenue Recognition:

Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the price is fixed and determinable, collectability is reasonably assured and title and risk of loss have been transferred to the customer. This occurs when product is shipped from the Company's warehouse. For direct shipments, revenue is recognized when product is shipped from the Company's supplier. The Company acts as a sales agent for certain customers for one of its suppliers. The Company reports these commissions as revenues in the period earned.

The Company performs ongoing credit evaluations of its customers and maintains reserves for potential credit losses.

#### Inventory Valuation

Inventories are recorded at the lower of cost or market. Write-downs of inventories to market value are based on stock rotation, historical sales requirements and obsolescence as well as in the changes in the backlog. Reserves required for obsolescence were not material in any of the periods in the financial statements presented. A significant portion (approximately \$500,000) of the total amount of the reserves relate to a product line for which demand dropped significantly as a result of a change in an environmental law several years ago. If market conditions are less favorable than those projected by management, additional write-downs of inventories could be required. For example,

each additional 1% of obsolete inventory would reduce operating income by approximately \$37,000.

The Company does not have price protection agreements with any of its vendors and assumes the risk of changes in the prices of its products. The Company does not believe there to be a significant risk with regards to the lack of price protection agreements as many of its inventory items are purchased to fulfill purchase orders received.

#### Income Taxes

We have made a number of estimates and assumptions relating to the reporting of a deferred income tax asset to prepare our financial statements in accordance with generally accepted accounting principles. These estimates have a significant impact on our valuation allowance relating to deferred income taxes. Our estimates could materially impact the financial statements.

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Results of Operations

Comparison of nine and three months ended August 31, 2012 and August 31, 2011

Consolidated net sales for the nine months ended August 31, 2012 decreased by \$444,328 or 3%, to \$16,891,754 as compared to net sales of \$17,336,082 for the nine months ended August 31, 2011. We largely attribute the decrease to a decline in business with certain customers due to these customers having excess inventory as a result of not meeting their forecasts and over-ordering in prior periods. At this time we do not expect additional declines in sales as a result of these excess inventories. Certain of our customers are currently experiencing declines in their business or are transitioning to new designs, which also attributed to the decrease in our sales. A small portion of the decrease can also be attributed to the decrease in commission income. Consolidated net sales for the three months ended August 31 2012 decreased by \$289,853 or 4% to \$6,059,072 as compared to net sales of \$6,318,925 for the three months ended August 31, 2011.

Our gross profit for the nine months ended August 31, 2012 decreased by \$385,215, or 7%, as compared to the nine months ended August 31, 2011. The decrease in gross profit was partially due to the decrease in net sales. Gross margin as a percentage of net sales decreased to 29.4% for the nine months ended August 31, 2012 compared to 30.8% for the nine months ended August 31, 2011. Our gross profit for the three months ended August 31, 2012 decreased by \$224,393 or 11% as compared to the three months ended August 31, 2011. Our gross profit as a percentage of net sales for the three months ended August 31, 2012 decreased to 28.6% compared to 31% for the three months ended August 31, 2011. We attribute the decrease in gross margin as a percentage of net sales to our rising costs, primarily costs of materials. As our factories have passed cost increases on to us, we have only been able to pass the same on to some customers but not all. Management also attributes some of the reduction in gross profit to the fact that our major supplier is no longer giving us a volume discount on products bought. Also, the concentration of business with one main distributor has shifted to lower profit margin items compared to the nine months ended August 31, 2011 which comprised mainly of higher profit margin items.

Selling and shipping expenses for the nine months ended August 31, 2012 was \$1,598,747, an increase of \$271,725, or 20%, as compared to \$1,327,022 for the nine months ended August 31, 2011. Selling and shipping expenses for the three months ended August 31, 2012 was \$555,417, an increase of \$70,373 or 15% as compared to \$485,044 for the three months ended August 31, 2011. Specifically the increase is due to additional salesmen salaries, commission expense and other selling expenses, such as travel and freight out expense.

General and administrative expenses for the nine months ended August 31, 2012 was \$2,335,915, a decrease of \$5,367, or less than 1%, as compared to \$2,341,282 for the nine months ended August 31, 2011. General and administrative expenses for the three months ended August 31, 2012 was \$743,288, a decrease of \$20,308 or 3% as compared to \$763,596 for the three months ended August 31, 2011. The decrease is primarily attributed to the reduction in officer bonuses this quarter and partially offset by the increase in directors fees that took effect in March 2012.

Investment income for the nine months ended August 31, 2012 was \$1,777 compared to \$1,693 for the nine months ended August 31, 2011. We attribute the decrease of \$84, or 5%, to lower interest rates in our money market accounts during the nine months ended August 31, 2012. Investment income for the three months ended August 31, 2012 was \$734 an increase of \$342 or 87% as compared to \$392 for the three months ended August 31, 2011. We attribute the increase to additional cash being placed in the money market account during the three months ended August 31, 2012.

Interest expense for the nine months ended August 31, 2012 was \$0, compared to \$11,920 for the nine months ended August 31, 2012. Interest expense for the three months ended August 31, 2012 was \$0 compared to \$830 for the three

months ended August 31, 2011. We attribute the decrease to the decrease in borrowing from our lender. The Company did not have any borrowings in the nine months ended August 31, 2012.

Income tax expense for the nine months ended August 31, 2012 was \$212,764, compared to \$74,265 in expense for the nine months ended August 31, 2011. Income tax expense for the three months ended August 31, 2012 was \$10,289 compared to \$5,818 for the three months ended August 31, 2011. The difference is a result of an increase in federal corporate taxes incurred due to net operating loss limitations with the IRS tax code and management's reevaluating their estimate on the deferred income tax valuation to reflect a less than full valuation allowance. Due to the Company sustaining profits for the last few years, management has determined that it is more likely than not that the Company will realize a portion of the deferred tax assets. This change in the valuation allowance is based on management estimates of future taxable income. The degree of variability inherent in the estimates of future taxable income is significant and subject to change in the near term. The Company reviews its estimates of future taxable income in each reporting period and adjustments to the valuation allowance are reflected in the current operations.

As a result of the foregoing, net income for the nine months ended August 31, 2012 was \$774,538, compared to the net income of \$1,527,063 for the nine months ended August 31, 2011. As a result of the foregoing, net income for the three months ended August 31, 2012 was \$410,747 as compared to \$680,096 for the three months ended August 31, 2011.

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## Liquidity and Capital Resources

As of August 31, 2012, we had cash of \$3,234,472, and working capital of \$7,057,061. We believe that our working capital levels and available financing are adequate to meet our operating requirements during the next twelve months.

During the nine months ended August 31, 2012, we had net cash flow from operating activities of \$1,334,106, as compared to net cash flow from operating activities of \$794,074 for the nine months ended August 31, 2011. The increase in cash flow from operating activities resulted from an increase in accounts payable and inventory and deferred income taxes and partially offset by a decrease in income, in accounts receivable, and other assets.

We had net cash flow used in investing activities of \$11,339 for the nine months ended August 31, 2012, as compared to net cash flow used in investing activities of \$13,663 for the nine months ended August 31, 2011. The Company invested relatively the same amount of money into new computers for both years.

We had net cash flows provided by financing activities of \$6,250 for the nine months ended August 31, 2012, as compared to net cash flow used in or provided by financing activities of \$0 for the nine months ended August 31, 2011. The increase in cash flow from financing activities resulted from a non-executive board member exercising an option and acquiring 25,000 shares of common stock.

As a result of the foregoing, the Company had a net increase in cash of \$1,329,017 for the nine months ended August 31, 2012, as compared to a net increase in cash of \$780,411 for the nine months ended August 31, 2011.

We are currently developing a strategic plan for our future, which will include a plan for the use of a portion of our cash. We expect to complete development of this strategic plan by the end of the year.

In June 2011, the Company replaced its existing credit line with a line of credit with a new bank totaling \$1,000,000. Borrowings under the line accrue interest at 2.56% over the LIBOR rate. While the credit line was to expire in September 2012 the bank agreed to extend the credit line until March 2013. The Company plans to renew the credit line by March 2013.. The line is collateralized by all the Company's assets and includes working capital and tangible net worth covenants. At August 31, 2012 the Company was in compliance with the financial covenants and had no borrowings on the credit line.

The table below sets forth our contractual obligations, including long-term debt, operating leases and other long-term obligations, as of August 31, 2012:

| Contractual Obligations  | Total               | Payments due      |                   |                   |                        |
|--------------------------|---------------------|-------------------|-------------------|-------------------|------------------------|
|                          |                     | 0 – 12<br>Months  | 13 – 36<br>Months | 37 – 60<br>Months | More than<br>60 Months |
| Long-term debt           | \$ -                | \$ --             | \$ --             | \$ --             | \$ --                  |
| Operating leases         | 1,558,334           | 182,641           | 340,041           | 341,774           | 693,878                |
| Employment agreements    | 412,500             | 412,500           | --                | --                | --                     |
| <b>Total obligations</b> | <b>\$ 1,970,834</b> | <b>\$ 595,141</b> | <b>\$ 340,041</b> | <b>\$ 341,774</b> | <b>\$ 693,878</b>      |

## Inflation

In the past two fiscal years, inflation has not had a significant impact on our business. However, any significant increase in inflation and interest rates could have a significant effect on the economy in general and, thereby, could affect our future operating results. In addition, the interest on the Company's line of credit is based upon the libor rate. Any significant increase in the libor rate could significantly impact our future operating results.

#### Off Balance Sheet Arrangements

We do not have any off balance sheet arrangements.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Not Applicable.

ITEM 4. CONTROLS AND PROCEDURES.

Evaluation of Disclosure Controls and Procedures

The Company maintains controls and procedures designed to ensure that information required to be disclosed in the reports that it files or submits under the Securities Exchange Act of 1934, as amended (“Exchange Act”), is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission (“Commission”). Ira Levy, the Company’s principal executive officer and principal financial officer has evaluated the effectiveness of the Company’s disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of August 31, 2012 and has concluded that, as of such date, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported with the time periods specified in the Commission's rules and forms.

Changes in Internal Controls

During the three months ended August 31, 2012, there were no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.



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PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

There are no legal proceedings to which the Company or any of its property is the subject.

ITEM 1A. RISK FACTORS.

Not applicable.

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

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

None.

ITEM 4. MINE SAFETY DISCLOSURES.

Not applicable

ITEM 5. OTHER INFORMATION.

None.

ITEM 6. EXHIBITS.

| Exhibit<br>Number | Description |
|-------------------|-------------|
|-------------------|-------------|

|             |   |
|-------------|---|
| <u>31.1</u> | <u>Certification by principal executive officer and principal financial officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u> |
|-------------|---|

|             |   |
|-------------|---|
| <u>32.1</u> | <u>Certification by principal executive officer and principal financial officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u> |
|-------------|---|

|           |                        |
|-----------|------------------------|
| 101.INS * | XBRL Instance Document |
|-----------|------------------------|

|           |   |
|-----------|---|
| 101.SCH * | XBRL Taxonomy Extension Schema Document |
|-----------|---|

|           |   |
|-----------|---|
| 101.CAL * | XBRL Taxonomy Extension Calculation Linkbase Document |
|-----------|---|

|           |  |
|-----------|--|
| 101.DEF * | XBRL Taxonomy Extension Definition Linkbase Document |
|-----------|--|

|           |   |
|-----------|---|
| 101.LAB * | XBRL Taxonomy Extension Label Linkbase Document |
|-----------|---|

101.PRE \* XBRL Taxonomy Extension Presentation Linkbase Document

\* XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

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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.

SURGE COMPONENTS, INC.

Date: October 12, 2012

By: /s/ Ira Levy  
Name: Ira Levy  
Title: Chief Executive Officer (Principal  
Executive Officer, Principal Financial  
Officer and Principal Accounting Officer)