

SURGE COMPONENTS INC  
Form 10-Q  
July 15, 2013

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 May 31, 2013

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 July 15, 2013, there were 9,060,012 outstanding shares of the Registrant's Common Stock, \$.001 par value.

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## PART I Financial Information

## ITEM 1. FINANCIAL STATEMENTS.

## SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Balance Sheets  
(unaudited)

|   | May 31,<br>2013 | November<br>30,<br>2012 |
|---|-----------------|-------------------------|
| ASSETS  |                 |                         |
| Current assets:   |                 |                         |
| Cash  | \$ 3,875,872    | \$ 3,443,964            |
| Accounts receivable - net of allowance for<br>doubtful accounts of \$43,117 and \$34,676          | 4,351,429       | 3,962,034               |
| Inventory, net  | 3,602,729       | 2,788,958               |
| Prepaid expenses and income taxes   | 175,331         | 106,364                 |
| Deferred income taxes   | 311,089         | 315,197                 |
| Total current assets  | 12,316,450      | 10,616,517              |
| Fixed assets – net of accumulated depreciation and amortization of \$2,150,832 and<br>\$2,126,238 | 76,020          | 80,629                  |
| Deferred income taxes   | 1,244,355       | 1,260,788               |
| Other assets  | 15,369          | 7,370                   |
| Total assets  | \$ 13,652,194   | \$ 11,965,304           |

See notes to consolidated financial statements

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## SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Balance Sheets (unaudited)  
(Continued)

|   | May 31,<br>2013      | November<br>30,<br>2012 |
|---|----------------------|-------------------------|
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |                      |                         |
| Current liabilities:  |                      |                         |
| Accounts payable  | 3,217,542            | 1,921,631               |
| Accrued expenses and taxes  | 592,798              | 600,903                 |
| Accrued salaries  | 262,802              | 475,184                 |
| <b>Total current liabilities</b>  | <b>4,073,142</b>     | <b>2,997,718</b>        |
| Deferred rent   | 32,144               | 27,893                  |
| <b>Total liabilities</b>  | <b>4,105,286</b>     | <b>3,025,611</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, non-voting, convertible, redeemable.  |                      |                         |
| Series B – 200,000 shares authorized, none outstanding, 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 9,060,012 shares issued and outstanding                                    | 9,060                | 9,060                   |
| Additional paid-in capital  | 23,114,466           | 23,082,844              |
| Accumulated deficit   | (13,576,642)         | (14,152,235)            |
| <b>Total shareholders' equity</b>   | <b>9,546,908</b>     | <b>8,939,693</b>        |
| <b>Total liabilities and shareholders' equity</b>   | <b>\$ 13,652,194</b> | <b>\$ 11,965,304</b>    |

See notes to consolidated financial statements.

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## SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Statements of Operations  
(Unaudited)

|  | Six Months Ended May 31, |               | Three Months Ended May 31, |              |
|--|--------------------------|---------------|----------------------------|--------------|
|  | 2013                     | 2012          | 2013                       | 2012         |
| Net sales  | \$ 11,077,572            | \$ 10,832,682 | \$ 5,891,089               | \$ 5,603,262 |
| Cost of goods sold                                     | 7,856,995                | 7,604,164     | 4,223,752                  | 3,919,709    |
| Gross profit   | 3,220,577                | 3,228,518     | 1,667,337                  | 1,683,553    |
| Operating expenses:                                    |                          |               |                            |              |
| Selling and shipping expenses                          | 1,000,819                | 1,044,299     | 507,853                    | 513,629      |
| General and administrative expenses                    | 1,569,275                | 1,591,658     | 790,803                    | 760,868      |
| Depreciation and amortization                          | 24,594                   | 27,338        | 13,235                     | 13,793       |
| Total operating expenses                               | 2,594,688                | 2,663,295     | 1,311,891                  | 1,288,290    |
| Income before other income (expense) and income taxes  | 625,889                  | 565,223       | 355,446                    | 395,263      |
| Other income(expense):                                 |                          |               |                            |              |
| Interest expense                                       | -                        | -             | -                          | -            |
| Investment income                                      | 2,403                    | 1,043         | 1,614                      | 729          |
| Other income(expense)                                  | 2,403                    | 1,043         | 1,614                      | 729          |
| Income before income taxes                             | 628,292                  | 566,266       | 357,060                    | 395,992      |
| Income taxes   | 46,774                   | 202,475       | 34,892                     | 165,015      |
| Net income   | 581,518                  | 363,791       | 322,168                    | 230,977      |
| Dividends on preferred stock                           | 5,925                    | 5,925         | -                          | -            |
| Net income available to common shareholders            | \$ 575,593               | \$ 357,866    | \$ 322,168                 | \$ 230,977   |
| Net income per share available to common shareholders: |                          |               |                            |              |
| Basic  | \$ .06                   | \$ .04        | \$ .04                     | \$ .03       |
| Diluted  | \$ .06                   | \$ .04        | \$ .03                     | \$ .02       |
| Weighted Shares Outstanding:                           |                          |               |                            |              |
| Basic  | 9,060,012                | 9,036,378     | 9,060,012                  | 9,037,729    |
| Diluted  | 9,667,192                | 9,658,954     | 9,667,192                  | 9,660,305    |

See notes to consolidated financial statements.

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## SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows  
(unaudited)

|   | Six Months Ended |                  |
|---|------------------|------------------|
|   | May 31,<br>2013  | May 31,<br>2012  |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                  |                  |
| Net income  | \$ 581,518       | \$ 363,791       |
| Adjustments to reconcile net income<br>to net cash provided by operating<br>activities: |                  |                  |
| Depreciation and amortization   | 24,594           | 27,338           |
| Stock compensation expense  | 11,622           | 11,622           |
| Deferred income taxes   | 20,541           | 189,525          |
| Allowance for doubtful accounts   | 8,441            | 5,000            |
| <b>CHANGES IN OPERATING ASSETS AND LIABILITIES:</b>                                     |                  |                  |
| Accounts receivable   | (397,836)        | 479,615          |
| Inventory   | (813,771)        | (259,460)        |
| Prepaid expenses and income taxes   | (48,967)         | 16,171           |
| Other assets  | (7,999)          | 153              |
| Accounts payable  | 1,295,911        | 521,847          |
| Deferred rent   | 4,251            | 5,840            |
| Accrued expenses  | (226,412)        | (32,312)         |
| <b>NET CASH FLOWS FROM OPERATING ACTIVITIES</b>   | <b>451,893</b>   | <b>1,329,130</b> |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                  |                  |
| Acquisition of fixed assets   | (19,985)         | (9,157)          |
| <b>NET CASH FLOWS USED IN INVESTING ACTIVITIES</b>                                      | <b>(19,985)</b>  | <b>(9,157)</b>   |



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## SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Statements Of Cash Flows  
(Continued)  
(unaudited)

| Six Months Ended |         |
|------------------|---------|
| May 31,          | May 31, |
| 2013             | 2012    |

## CASH FLOWS FROM FINANCING ACTIVITIES:

|   |                     |                     |
|---|---------------------|---------------------|
| Proceeds from exercising stock options                    | -                   | 6,250               |
| <b>NET CASH FLOWS PROVIDED BY IN FINANCING ACTIVITIES</b> | <b>-</b>            | <b>6,250</b>        |
| <b>NET CHANGE IN CASH</b>                                 | <b>431,908</b>      | <b>1,326,223</b>    |
| <b>CASH AT BEGINNING OF PERIOD</b>                        | <b>3,443,964</b>    | <b>1,905,455</b>    |
| <b>CASH AT END OF PERIOD</b>                              | <b>\$ 3,875,872</b> | <b>\$ 3,231,678</b> |

## SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:

|                   |           |           |
|-------------------|-----------|-----------|
| Income taxes paid | \$ 12,128 | \$ 37,745 |
| Interest paid     | \$ -      | \$ 13,179 |

## NONCASH INVESTING AND FINANCING ACTIVITIES:

|                                      |          |          |
|--------------------------------------|----------|----------|
| Accrued dividends on preferred stock | \$ 5,925 | \$ 5,925 |
|--------------------------------------|----------|----------|

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 six months ended May 31, 2013 and May 31, 2012 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 \$932,000 and \$1,422,000 for the six months ended May 31, 2013 and May 31, 2012 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 \$354,721 and \$205,964 for the six months ended May 31, 2013 and May 31, 2012 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 \$1,234,000 and \$2,119,000 for the six months ended May 31, 2013 and May 31, 2012 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 May 31, 2013 approximated \$1,435,000. The Company, at May 31, 2013, has a reserve against slow moving and obsolete inventory of \$559,458. 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 a limited number of financial institutions. At May 31, 2013 and November 30, 2012, the Company's uninsured cash balances totaled approximately \$2,222,249 and \$1,341,304, 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, 2009, and state tax examinations for years before fiscal years ending November 30, 2008. 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 six months ended May 31, 2013 and May 31, 2012.

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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 \$9,639 and \$7,809 for the six months ended May 31, 2013 and May 31, 2012 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 May 31, 2013 and May 31, 2012 totaled 332,820 and 273,424, 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. The adoption of the new guidance in the first quarter of fiscal 2013 had no 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. The adoption of the new guidance in the first quarter of fiscal 2013 had no impact on our consolidated financial position, results of operations or cash flows.

(16) Reclassifications:

Certain amounts included in 2012 financial statements have been reclassified to conform to the 2013 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:

|                               | May 31,<br>2013 | November<br>30,<br>2012 |
|-------------------------------|-----------------|-------------------------|
| Furniture and Fixtures        | \$ 322,586      | \$ 321,099              |
| Leasehold Improvements        | 924,399         | 909,014                 |
| Computer Equipment            | 979,867         | 976,754                 |
| Less-Accumulated Depreciation | (2,150,832)     | (2,126,238)             |
| Net Fixed Assets              | \$ 76,020       | \$ 80,629               |

Depreciation and amortization expense for the six months ended May 31, 2013 and May 31, 2012 was \$24,594 and \$27,338, respectively.

## NOTE D - ACCRUED EXPENSES

Accrued expenses consist of the following:

|                           | May 31,<br>2013 | November<br>30,<br>2012 |
|---------------------------|-----------------|-------------------------|
| Commissions               | \$ 218,601      | \$ 238,003              |
| Preferred Stock Dividends | 182,782         | 176,857                 |
| Interest                  | 102,399         | 102,399                 |
| Other accrued expenses    | 89,016          | 83,644                  |
|                           | \$ 592,798      | \$ 600,903              |

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 \$898,000 at November 30, 2012. Pension expense for the six months ended May 31, 2013 and May 31, 2012 was \$3,633 and \$1,197, 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 May 31, 2013.

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 May 31, 2013.

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 our 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 \$182,782 have not been declared or paid for the semiannual periods ended December 31, 2001 through the semiannual payment due December 31, 2012. The Company has accrued these dividends.

In April 2002, in connection with a Mutual Release, Settlement, Standstill and Non-Disparagement Agreement 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 May 31, 2013 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, directors or consultants to the Company to purchase an aggregate of 1,500,000 common shares.

Stock option incentive plan activity for the six months ended May 31, 2013 is summarized as follows:

|   | Shares   | Weighted<br>Average<br>Exercise<br>Price |
|---|----------|--|
| Options outstanding December 1, 2011                  | 685,000  | \$ 0.25                                  |
| Options issued in the year ended November 30, 2012    | 50,000   | \$ 0.51                                  |
| Options exercised in the year ended November 30, 2012 | (25,000) | \$ 0.25                                  |
| Options cancelled in the year ended November 30, 2012 | (7,000)  | \$ 1.15                                  |
| Options outstanding at May 31, 2013                   | 703,000  | \$ 0.29                                  |
| Options exercisable at May 31, 2013                   | 677,000  | \$ 0.34                                  |

## Stock Compensation

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 option 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, 2012 was \$0.82. During the six months ended May 31, 2013, the Company recorded stock based compensation totaling \$11,622

as a result of these stock option grants.

The intrinsic value of the exercisable options at May 31, 2013 totaled \$237,500. At May 31, 2013 the weighted average remaining life of the stock options is 2.84 years. At May 31, 2013, there was \$17,428 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 .499 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:

|                           | May 31,<br>2013 | November<br>30,<br>2012 |
|---------------------------|-----------------|-------------------------|
| Deferred Tax Assets       |                 |                         |
| Net operating loss        | \$ 4,372,555    | \$ 4,606,652            |
| Allowance for bad debts   | 17,221          | 11,853                  |
| Inventory                 | 303,328         | 311,730                 |
| Deferred Rent             | 12,838          | 10,186                  |
| Depreciation              | 183,379         | 187,302                 |
| Total deferred tax assets | 4,889,321       | 5,127,723               |
| Valuation allowance       | (3,333,877)     | (3,551,738)             |
| Deferred Tax Assets       | \$ 1,555,444    | \$ 1,575,985            |

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 decreased by approximately \$218,000 during the six months ended May 31, 2013. 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:

|                            | Six Months Ended |                 |
|----------------------------|------------------|-----------------|
|                            | May 31,<br>2013  | May 31,<br>2012 |
| Current:                   |                  |                 |
| Federal                    | \$ 20,538        | \$ 6,702        |
| States                     | 5,695            | 6,248           |
|                            | 26,233           | 12,950          |
| Deferred:                  |                  |                 |
| Federal                    | 16,638           | 146,818         |
| States                     | 3,903            | 42,707          |
|                            | 20,541           | 189,525         |
| Provision for income taxes | \$ 46,774        | \$ 202,475      |

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:

|                                       | Six Months ended |                 |
|---------------------------------------|------------------|-----------------|
|                                       | May 31,<br>2013  | May 31,<br>2012 |
| U.S Federal Income tax statutory rate | 34%              | 34%             |
| Valuation allowance                   | (29)%            | (0)%            |
| State income taxes                    | 2%               | 2%              |
| Other                                 | -                | -               |
| Effective tax rate                    | 7%               | 36%             |





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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 \$160,000 for the Fiscal 2012, 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 May 2013, the Company entered into a lease to rent office space and a warehouse in Hong Kong for two years. Annual minimum rental payments for this space are approximately \$51,200.

The Company's future minimum rental commitments at May 31, 2013 are as follows:

| Twelve<br>Months<br>Ended<br>May 31, |    |           |
|--------------------------------------|----|-----------|
| 2014                                 | \$ | 213,124   |
| 2015                                 | \$ | 218,762   |
| 2016                                 | \$ | 175,151   |
| 2017                                 | \$ | 174,299   |
| 2018                                 | \$ | 177,785   |
| 2019 &<br>thereafter                 | \$ | 428,370   |
|                                      | \$ | 1,387,491 |

Net rental expense for the six months ended May 31, 2013 and May 31, 2012 were \$150,230 and \$129,595 respectively, of which \$134,441 and \$112,240 respectively, 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 May 31, 2013 totaling \$100,000. 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 11% of net sales for the six months ended May 31, 2013 and 10% of net sales for the six months ended May 31, 2012. The Company had one customer who accounted for 20% and 19% of accounts receivable at May 31, 2013 and November 30, 2012, respectively.

## NOTE K- MAJOR SUPPLIERS

During the six months ended May 31, 2013 and May 31, 2012 there was one foreign supplier accounting for 52% and 27% of total inventory purchased.

The Company purchases substantially all of its products overseas. For the six months ended May 31, 2013, the Company purchased 60% of its products from Taiwan, 13% from Hong Kong, 21% from elsewhere in Asia and less than 1% overseas outside of Asia. The Company purchases the balance of its products in the United States.

## NOTE L - EXPORT SALES

The Company’s export sales approximated:

|                       | Six Months Ended |                 |
|-----------------------|------------------|-----------------|
|                       | May 31,<br>2013  | May 31,<br>2012 |
| Canada                | 887,036          | 1,328,258       |
| China                 | 2,114,106        | 1,999,646       |
| Other Asian Countries | 375,639          | 705,717         |
| Europe                | 621,949          | 67,434          |

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 accrued interest at 2.56% over the LIBOR rate. The line was collateralized by all the Company's assets and included working capital and tangible net worth covenants. The credit line expired in March 2013. The Company did not renew the credit line since it does not believe that such additional funds are required at this time.

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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. Also, 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

The Company operates with two sales groups, Surge Components ("Surge") and Challenge Electronics ("Challenge"). Surge is a supplier of electronic products and components. These products include capacitors, which are electrical energy storage devices, and discrete semiconductor components, such as 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 sold by Surge are typically utilized in the electronic circuitry of diverse products, including, but not limited to, automobiles, audio products, temperature control products, lighting products, energy related products, computer related products, various types of consumer products, garage door openers, household appliances, power supplies and security equipment. These products are sold to both original equipment manufacturers, commonly referred to as OEMs, who incorporate them into their products, and to distributors of the lines of products we sell, who resell these products within their customer base. These products are manufactured predominantly in Asia by approximately sixteen independent manufacturers. We act as the master distribution 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. Commission revenue totaled \$354,721 and \$205,964 for the six months ended May 31, 2013 and May 31, 2012 respectively.

Challenge engages in the sale of electronic components, including audible components, alarms, chimes and battery related products. Challenge has increased the types of products it sells because some of its suppliers introduced new products, and it has also sourced other products from new suppliers. As a result, we are continually trying expand our product line. In 2002 we started to import products 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 product mix to include buzzers, speakers, microphones, resonators, filters, and discriminators. Our suppliers customize many of the products we sell for many customers based on the customers' own designs and those our suppliers redesign for them at our suppliers' factories. We have an experienced design engineer on our staff with thirty years of experience who works with our suppliers on such redesigns. We continue to expand the product mix we sell. We sell these products through independent representatives that earn a 5-6% commission rate on the gross sale of the

products we sell in their area. We also are working with local, regional, and national distributors to sell these products to local accounts in every state.

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The Company has a Hong Kong office to effectively handle the transfer business from United States customers purchasing and manufacturing in Asia after designing the products in the United States. This office has strengthened the Company's global capabilities and service to its customer base.

The electronic components industry has changed, from one of strong demand to now one of moderate demand. Management expects 2013 to continue with the moderate demand for components from 2012. Due to this worldwide reduction in demand, the Company could feel the effects of potentially reduced demand for its products.

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 customers, 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 from our factory to our customer, revenue is recognized when product is shipped from the Company's supplier. The Company acts as a sales agent for certain customers buying direct from 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. 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 \$36,000.

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.

#### Results of Operations

Comparison of six and three months ended May 31, 2013 and May 31, 2012

Consolidated net sales for the six months ended May 31, 2013 increased by \$244,890 or 2%, to \$11,077,572 as compared to net sales of \$10,832,682 for the six months ended May 31, 2012. Consolidated net sales for the three months ended May 31 2013 increased by \$287,827 or 5% to \$5,891,089 as compared to net sales of \$5,603,262 for the three months ended May 31, 2012.

We largely attribute the increase to increased business with new customers as well as increased business from existing customers, offset by decreases in sales by two of the Company's distributors.

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Our gross profit for the six months ended May 31, 2013 was \$3,220,577, a decrease of \$7,941, or less than 1%, as compared to \$3,228,518 for the six months ended May 31, 2012. Gross margin as a percentage of net sales decreased to 29.1% for the six months ended May 31, 2013 compared to 29.8% for the six months ended May 31, 2012. Our gross profit for the three months ended May 31, 2013 was \$1,667,337, a decrease of \$16,216 or 1%, as compared to \$1,683,553 for the three months ended May 31, 2012. Our gross profit as a percentage of net sales for the three months ended May 31, 2013 decreased to 28.3% compared to 30.0% for the three months ended May 31, 2012. The Company attributes this decrease in profit margin to two main distributors having shifted to lower profit margin items compared to the six months ended May 31, 2012, which comprised of more higher profit margin items.

Selling and shipping expenses for the six months ended May 31, 2013 was \$1,000,819, a decrease of \$43,480, or 4%, as compared to \$1,044,299 for the six months ended May 31, 2012. Selling and shipping expenses for the three months ended May 31, 2013 was \$507,853, a decrease of \$5,776 or 1% as compared to \$513,629 for the three months ended May 31, 2012. The decrease was due to a decrease in commission expenses and auto expenses offset by the Company hiring an additional salesperson and increased travel and freight expenses.

General and administrative expenses for the six months ended May 31, 2013 was \$1,569,275, a decrease of \$22,383, or 1%, as compared to \$1,591,658 for the six months ended May 31, 2012. The decrease is due to the reduction in officer bonus accrual, office and computer expenses and expenses from the Company's 30th Anniversary party in 2012 and partially offset by the increase in rent, salaries and an increase in directors fees that took effect in April 2012. General and administrative expenses for the three months ended May 31, 2013 was \$790,803, an increase of \$29,935 or 4% as compared to \$760,868 for the three months ended May 31, 2012. The increase is due to the hiring of additional employees and increased costs of insurance, an increase in allowance for doubtful accounts as well as increases in professional fees and directors fees as partially offset by the reduction in officers bonus accrual, as well as decreases in office and computer expenses.

Depreciation expense for the six months ended May 31, 2013 was \$24,594, a decrease of \$2,744 or 10%, as compared to \$27,338 for the six months ended May 31, 2012. Depreciation expense for the three months ended May 31, 2013 was \$13,235, a decrease of \$558 or 4%, as compared to \$13,793 for the three months ended May 31, 2012. The decrease is due to assets becoming fully depreciated and less fixed assets being purchased in the six months ended May 31, 2013.

Income tax expense for the six months ended May 31, 2013 was \$46,774, a decrease of \$155,701, or 77% as compared to \$202,475 for the six months ended May 31, 2012. Income tax expense for the three months ended May 31, 2013 was \$34,892, a decrease of \$130,123 or 79% as compared to \$165,015 for the three months ended May 31, 2012. The decrease is a result of management's revised estimate of future taxable income and the related impact on the reported deferred tax. As a result, there was a decrease of \$20,541 in the deferred tax asset during the six months ended May 31, 2013. The Company reviews 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 six months ended May 31, 2013 was \$581,518, compared to the net income of \$363,791 for the six months ended May 31, 2012. As a result of the foregoing, net income for the three months ended May 31, 2013 was \$322,168 as compared to \$230,977 for the three months ended May 31, 2012.

## Liquidity and Capital Resources

As of May 31, 2013 we had cash of \$3,875,872, and working capital of \$8,243,308. We believe that our working capital levels are adequate to meet our operating requirements during the next twelve months.

During the six months ended May 31, 2013, we had net cash flow from operating activities of \$451,893, as compared to net cash flow from operating activities of \$1,329,130 for the six months ended May 31, 2012. The decrease in cash flow from operating activities resulted from an increase in inventory, increase in backorders, increase in buffer stock held for certain customers and accounts receivable as partially offset by an increase in net income, and an increase in accounts payable

We had net cash flow used in investing activities of \$19,985 for the six months ended May 31, 2013, as compared to net cash flow used in investing activities of \$9,157 for the six months ended May 31, 2012. The Company purchased new equipment and furniture for their new offices in Hong Kong during the six months ended May 31, 2013.

We had net cash flows provided by financing activities of \$0 for the six months ended May 31, 2013, as compared to net cash flow used in or provided by financing activities of \$6,250 for the six months ended May 31, 2012. 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 during the six months ended May 31, 2012.

As a result of the foregoing, the Company had a net increase in cash of \$431,908 for the six months ended May 31, 2013, as compared to a net increase in cash of \$1,326,223 for the six months ended May 31, 2012.

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In June 2011, the Company replaced its existing credit line with a line of credit with JP Morgan Chase Bank totaling \$1,000,000. Borrowings under the line accrued interest at 2.56% over the LIBOR rate. The line was collateralized by all the Company's assets and included working capital and tangible net worth covenants. The credit line expired in March 2013. The Company did not renew the credit line since it does not believe such additional funds are required at this time.

The Company intends to maintain its current cash along with cash generated from operations to fund its current operations and to execute its plans, which may include potential merger and acquisition activities and investments to expand the Company's core businesses.

The table below sets forth our contractual obligations, including long-term debt, operating leases and other long-term obligations, as of May 31, 2013.

| 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         | \$ 1,387,491        | 213,124           | 393,913           | 352,084           | 428,370                |
| Employment agreements    | \$ 75,000           | 75,000            | --                | --                | --                     |
| <b>Total obligations</b> | <b>\$ 1,462,491</b> | <b>\$ 288,124</b> | <b>\$ 393,913</b> | <b>\$ 352,084</b> | <b>\$ 428,370</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.

## Off Balance Sheet Arrangements

We do not have any off balance sheet arrangements.

## 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 May 31, 2013 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 six months ended May 31, 2013, 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 Number | Description   |
|----------------|---|
| <u>10.1</u>    | <u>Rental Agreement with Adcock Investment Company Limited dated May 5, 2013</u>  |
| <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: July 15, 2013

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