SURGE COMPONENTS INC
Form 10-Q
April 12, 2013

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For The Quarterly Period Ended February 28, 2013

o 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 x No o

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 x No o

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 o Accelerated filer o

Non-accelerated filer o Smaller reporting company x

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

As of April 11, 2013, 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

(unaudited)

	February 28, 2013	November 30, 2012
ASSETS		
Current assets:		
Cash	$ 3,449,654	$ 3,443,964
Accounts receivable - net of allowance for doubtful accounts of $34,676 and $34,676	3,910,936	3,962,034
Inventory, net	2,753,394	2,788,958
Prepaid expenses and income taxes	81,145	106,364
Deferred income taxes	315,197	315,197
Total current assets	10,510,326	10,616,517
Fixed assets – net of accumulated depreciation and amortization of $2,137,597 and $2,126,238	70,491	80,629
Deferred income taxes	1,260,788	1,260,788
Other assets	6,831	7,370
Total assets	$ 11,848,436	$ 11,965,304

See notes to consolidated financial statements

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Balance Sheets (unaudited)
(Continued)

	February 28, 2013	November 30, 2012
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Loan payable	$ -	$ -
Accounts payable	1,713,562	1,921,631
Accrued expenses and taxes	602,493	600,903
Accrued salaries	303,435	475,184
Total current liabilities	2,619,490	2,997,718
Deferred rent	30,019	27,893
Total liabilities	2,649,509	3,025,611
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	23,088,655	23,082,844
Accumulated deficit	(13,898,812)	(14,152,235)
Total shareholders' equity	9,198,927	8,939,693
Total liabilities and shareholders' equity	$ 11,848,436	$ 11,965,304

See notes to consolidated financial statements.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Statements of Income

(unaudited)

	Three Months Ended February 28, 2013	February 29, 2012
Net sales	$ 5,186,483	$ 5,229,420
Cost of goods sold	3,633,244	3,684,455
Gross profit	1,553,239	1,544,965
Operating expenses:		
Selling and shipping	492,966	530,670
General and administrative	778,472	830,790
Depreciation expense	11,359	13,545
Total operating expenses	1,282,797	1,375,005
Income before other income (expense) and income taxes	270,442	169,960
Other income (expense):		
Investment income	788	314
Interest expense	-	-
Other income (expenses)	788	314
Income before income taxes	271,230	170,274
Income taxes	11,882	37,460
Net income	$ 259,348	$ 132,814
Dividends on preferred stock	5,925	5,925
Net income available to common shareholders	$ 253,423	$ 126,889
Net income per share available to common shareholders:		
Basic	$ .03	$ .01
Diluted	$ .03	$ .01
Weighted Shares Outstanding:		

Basic	9,060,012	9,035,012
Diluted	9,667,910	9,682,588

See notes to consolidated financial statements.

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(unaudited)

	Three Months Ended February 28, 2013	February 29, 2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 259,348	$ 132,814
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	11,359	13,545
Stock compensation expense	5,811	5,811
Deferred income taxes	-	24,795
CHANGES IN OPERATING ASSETS AND LIABILITIES:		
Accounts receivable	51,098	548,109
Inventory	35,564	678,398
Prepaid expenses and income taxes	25,219	(38,716)
Other assets	539	153
Accounts payable	(208,069)	(353,051)
Deferred rent	2,126	2,920
Accrued expenses	(176,084)	(118,523)
NET CASH FLOWS FROM OPERATING ACTIVITIES	6,911	896,255
CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of fixed assets	(1,221)	(6,685)
NET CASH FLOWS USED IN INVESTING ACTIVITIES	(1,221)	(6,685)

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SURGE COMPONENTS, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows
(CONTINUED)

(unaudited)

	Three Months Ended February 28, 2013	Three Months Ended February 29, 2012
NET CASH FLOWS USED IN FINANCING ACTIVITIES	-	-
NET CHANGE IN CASH	5,690	889,570
CASH AT BEGINNING OF YEAR	3,443,964	1,905,455
CASH AT END OF YEAR	$ 3,449,654	$ 2,795,025
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Income taxes paid	$ 24,243	$ 30,000
Interest paid	$ -	$ 7,129
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 three months ended February 28, 2013 and February 29, 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 $493,000 and $862,000 for the three months ended February 28, 2013 and February 29, 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 $347,775 and $74,152 for the three months ended February 28, 2013 and February 29, 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 $654,000 and $1,281,000 for the three months ended February 28, 2013 and February 29, 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 February 28, 2013 approximated $772,000. The Company, at February 28, 2013, has a reserve against slow moving and obsolete inventory of $580,496. 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 February 28, 2013 and November 30, 2012, the Company's uninsured cash balances totaled approximately $2,731,383 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 three months ended February 28, 2013 and February 29, 2012.

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 $5,080 and $5,219 for the three months ended February 28, 2013 and February 29, 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 February 28, 2013 and February 29, 2012 totaled 332,102 and 274,424, 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:

	February 28, 2013	November 30, 2012
Furniture and Fixtures	$ 321,099	$ 321,099
Leasehold Improvements	909,014	909,014
Computer Equipment	977,975	976,754
Less-Accumulated Depreciation	(2,137,597)	(2,126,238)
Net Fixed Assets	$ 70,491	$ 80,629

Depreciation and amortization expense for the three months ended February 28, 2013 and February 29, 2012 was $11,359 and $13,545, respectively.

NOTE D - ACCRUED EXPENSES

Accrued expenses consist of the following:

	February 28, 2013	November 30, 2012
Commissions	$ 230,324	$ 238,003
Preferred Stock Dividends	182,782	176,857
Interest	102,399	102,399
Other accrued expenses	86,988	83,644
	$ 602,493	$ 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 three months ended February 28, 2013 and February 29, 2012 was $7,708 and $1,954, 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 February 28, 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 February 28, 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 February 28, 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 three months ended February 28, 2013 is summarized as follows:

	Shares		Weighted Average Exercise 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 February 28, 2013	703,000	$	0.29
Options exercisable at February 28, 2013	617,667	$	0.29

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 three months ended February 28, 2013, the Company recorded stock based compensation totaling $5,811 as a result of these stock option grants.

The intrinsic value of the exercisable options at February 28, 2013 totaled $115,000. At February 28, 2013 the weighted average remaining life of the stock options is 3.09 years. At February 28, 2013, there was $23,239 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 .749 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:

	February 28, 2013	November 30, 2012
Deferred Tax Assets		
Net operating loss	$ 4,501,230	$ 4,606,652
Allowance for bad debts	11,853	11,853
Inventory	301,453	311,730
Deferred Rent	11,989	10,186
Depreciation	184,103	187,302
Total deferred tax assets	5,010,628	5,127,723
Valuation allowance	(3,434,643)	(3,551,738)
Deferred Tax Assets	$ 1,575,985	$ 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 $117,000 during the three months ended February 28, 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:

	Three Months Ended February 28, 2013	Three Months Ended February 29, 2012
Current:		
Federal	$ -	$ 4,335
States	11,882	8,330
	11,882	12,665
Deferred:		
Federal	-	21,206
States	-	3,589
	-	24,795
Provision for income taxes	$ 11,882	$ 37,460

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:

	Three Months ended February 28, 2013	Three Months ended February 29, 2012
U.S Federal Income tax statutory rate	34%	34%
Valuation allowance	(39)%	(30)%
State income taxes	5%	5%
Other	4	13%
Effective tax rate	4 %	22%

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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 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 February 28, 2013:

Twelve MonthsEnded February 28,		
2014	$	174,163
2015	$	165,878
2016	$	169,195
2017	$	172,579
2018	$	176,323
2019 & thereafter	$	462,278
	$	1,320,416

Net rental expense for the three months ended February 28, 2013 and February 29, 2012 were $82,384 and $66,039 respectively, of which $74,490 and $57,362 respectively, was incurred to the Related Company.

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 February 28, 2013 totaling $50,000. 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 three months ended February 28, 2013 and 16% of net sales for the three months ended February 29, 2012. The Company had one customer who accounted for 18% and 19% of accounts receivable at February 28, 2013 and November 30, 2012, respectively.

NOTE K- MAJOR SUPPLIERS

During the three months ended February 28, 2013 and February 29, 2012 there was one foreign supplier accounting for 47% and 46% of total inventory purchased.

The Company purchases a significant portion of its products overseas. For the three months ended February 28, 2013 and February 29, 2012, the Company purchased 55% from Taiwan, 11% from Hong Kong, 22% from elsewhere in Asia and less than 1% overseas outside of Asia.

NOTE L - EXPORT SALES

The Company's export sales approximated:

	Three Months Ended	
	February 28, 2013	February 29, 2012
Canada	498,205	615,626
China	1,015,929	869,224
Other Asian Countries	160,133	358,990

Europe	253,528	33,361

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 credit line expired in March 2013. The Company has no plans to renew the credit line. The line was collateralized by all the Company's assets and included working capital and tangible net worth covenants. At February 28, 2013, the Company was in compliance with the financial covenants. As of February 28, 2013, 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. 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

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. The products that we sell 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. The products that we sell are manufactured predominantly in Asia by approximately sixteen independent manufacturers. 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. Commission revenue totaled $347,775 and $74,152 for the three months ended February 28, 2013 and February 29, 2012 respectively.

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 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 with thirty years of experience who works with our suppliers on such redesigns. We continue to expand the line of products we sell, we now are selling alarms and chimes. We sell these products through independent representatives that make 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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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 its 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 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. 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 $28,000.

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 three months ended February 29, 2013 and February 29, 2012

Consolidated net sales for the three months ended February 28, 2013 decreased by $42,937 or 1%, to $5,186,483 as compared to net sales of $5,229,420 for the three months ended February 29, 2012. The Company maintained substantially the same sales levels as the three months ended February 29, 2012.

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Our gross profit for the three months ended February 28, 2013 increased by $8,274 to $1,553,239, or less than 1%, as compared to $1,544,965 for the three months ended February 29, 2012. Gross margin as a percentage of net sales increased to 29.9% for the three months ended February 28, 2013 compared to 29.5% for the three months ended February 29, 2012. The Company continues to pass on increased purchased costs on certain products to customers, as well as selling more higher-margin products.

Selling and shipping expenses for the three months ended February 28, 2013 was $492,966, a decrease of $37,704, or 7%, as compared to $530,670 for the three months ended February 29, 2012. The decrease was due to a decrease in commission expenses, shipping expenses and travel related expenses.

General and administrative expenses for the three months ended February 28, 2013 was $778,472, a decrease of $52,318, or 6%, as compared to $830,790 for the three months ended February 29, 2012. The decrease is due to the reduction in officer bonus accrual, professional fees, expenses from the Company's 30th Anniversary party in 2012, and payroll taxes and partially offset by the increase in rent, salaries and an increase in directors fees that took effect in April 2012.

Depreciation expense for the three months ended February 28, 2013 was $11,359, a decrease of $2,186 or 16%, as compared to $13,545 for the three months ended February 29, 2012. The decrease is due to assets becoming fully depreciated and less fixed assets being purchased in the three months ended February 28, 2013.

Income tax expense for the three months ended February 28, 2013 was $11,882, compared to $37,460 for the three months ended February 29, 2012. The decrease of $25,578, or 68%, 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 no change to the deferred tax asset during the three months ended February 28, 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 three months ended February 28, 2013 was $259,348 compared to the net income of $132,814 for the three months ended February 29, 2012.

Liquidity and Capital Resources

As of February 28, 2013 we had cash of $3,449,654, and working capital of $7,890,836. We believe that our working capital levels and available financing are adequate to meet our operating requirements during the next twelve months.

During the three months ended February 28, 2013, we had net cash flow from operating activities of $6,911, as compared to net cash flow from operating activities of $896,255 for the three months ended February 29, 2012. The decrease in cash flow from operating activities as compared to the three month period ended February 29, 2012 resulted from a decrease in accounts payable and accrued expenses as partially offset by a decrease in accounts receivable, inventory and prepaid expenses.

We had net cash flow used in investing activities of $1,221 for the three months ended February 28, 2013, as compared to net cash flow used in investing activities of $6,685 for the three months ended February 29, 2012. The Company invested less money in new fixed assets for the three months ended February 28, 2013.

As a result of the foregoing, the Company had a net increase in cash of $5,690 for the three months ended February 28, 2013, as compared to a net increase in cash of $889,570 for the three months ended February 29, 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 credit line expired in March 2013. The Company has no plans to renew the credit line. The line was collateralized by all the Company’s assets and included working capital and tangible net worth covenants. At February 28, 2013, the Company was in compliance with the financial covenants. At February 28, 2013, the Company had no borrowings on the credit line.

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 February 28, 2013.

		Payments due			
Contractual Obligations	Total	0 – 12 Months	13 – 36 Months	37 – 60 Months	More than 60 Months
Long-term debt	$-	$--	$--	$--	$--
Operating leases	$1,320,416	174,163	335,073	348,902	462,278
Employment agreements	$187,500	187,500	--	--	--
Total obligations	$1,507,916	$361,663	$335,073	$348,902	$462,278

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.

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 February 28, 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 three months ended February 28, 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
31.1	Certification by principal executive officer and principal financial officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification by principal executive officer and principal financial officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
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: April 12, 2013	By:	/s/ Ira Levy Name: Ira Levy Title: Chief Executive Officer (Principal Executive Officer, Principal Financial Officer and Principal Accounting Officer)