

SURGE COMPONENTS INC  
Form 10-Q  
April 14, 2015

**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 February 28, 2015**

**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

11-2602030

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(State or other jurisdiction of incorporation or organization) (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

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 April 14, 2015, there were 9,218,815 outstanding shares of the Registrant's Common Stock, \$.001 par value.

**SURGE COMPONENTS, INC**

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**PART I Financial Information****ITEM 1. FINANCIAL STATEMENTS.**

## SURGE COMPONENTS, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

ASSETS	February 28, 2015 (unaudited)	November 30, 2014
Current assets:		
Cash	\$6,306,264	\$6,174,561
Accounts receivable - net of allowance for doubtful accounts of \$102,207 and \$93,765	4,216,765	4,433,994
Inventory, net	2,972,003	3,258,156
Prepaid expenses and income taxes	174,124	233,275
Deferred income taxes	369,549	295,873
Total current assets	14,038,705	14,395,859
Fixed assets – net of accumulated depreciation and amortization of \$2,122,940 and \$2,114,416	109,289	84,966
Deferred income taxes	739,097	887,620
Other assets	12,242	11,652
Total assets	\$14,899,333	\$15,380,097

See notes to consolidated financial statements



## SURGE COMPONENTS, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

(Continued)

	February 28, 2015 (Unaudited)	November 30, 2014
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$2,803,226	\$3,288,798
Accrued expenses and taxes	634,508	785,002
Accrued salaries	408,078	556,805
Total current liabilities	3,845,812	4,630,605
Deferred rent	41,052	40,564
Total liabilities	3,886,864	4,671,169
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, 21,700 and 21,700 shares issued and outstanding, redeemable, convertible, and a liquidation preference of \$5 per share	22	22
Common stock - \$.001 par value stock, 75,000,000 shares authorized, 9,218,815 and 9,080,012 shares issued and outstanding	9,219	9,080
Additional paid-in capital	23,300,917	23,192,407
Accumulated deficit	(12,297,689)	(12,492,581)
Total shareholders' equity	11,012,469	10,708,928
Total liabilities and shareholders' equity	\$14,899,333	\$15,380,097

See notes to consolidated financial statements.



## SURGE COMPONENTS, INC. AND SUBSIDIARIES

## Consolidated Statements of Operations (Unaudited)

	Three Months Ended February 28, 2015	
	2015	2014
Net sales	\$6,959,625	\$6,221,708
Cost of goods sold	5,114,665	4,516,683
Gross profit	1,844,960	1,705,025
Operating expenses:		
Selling and shipping expenses	549,562	524,874
General and administrative expenses	1,004,730	880,112
Depreciation and amortization	8,523	9,671
Total operating expenses	1,562,815	1,414,657
Income before other income (expense) and income taxes	282,145	290,368
Other income:		
Investment income	1,997	689
Other income	1,997	689
Income before income taxes	284,142	291,057
Income taxes	83,825	105,167
Net income	\$200,317	\$185,890
Dividends on preferred stock	5,425	5,925
Net income available to common shareholders	\$194,892	\$179,965
Net income per share available to common shareholders:		

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Basic	\$ .02	\$ .02
Diluted	\$ .02	\$ .02

Weighted Shares Outstanding:

Basic	9,218,815	9,060,012
Diluted	9,744,341	9,719,066

See notes to consolidated financial statements.

## SURGE COMPONENTS, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows (Unaudited)

	Three Months Ended February 28,	
	2015	2014
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$200,317	\$185,890
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	8,523	9,671
Stock compensation expense	-	5,811
Deferred income taxes	74,847	91,038
Allowance for doubtful accounts	8,442	8,441
<b>CHANGES IN OPERATING ASSETS AND LIABILITIES:</b>		
Accounts receivable	208,787	893,080
Inventory	286,153	477,059
Prepaid expenses and income taxes	59,151	20,543
Other assets	(590 )	-
Accounts payable	(485,571)	(837,222)
Deferred rent	488	1,315
Accrued expenses	(202,247)	(126,823)
<b>NET CASH FLOWS PROVIDED BY OPERATING ACTIVITIES</b>	<b>158,300</b>	<b>728,803</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Acquisition of fixed assets	(32,847 )	(7,607 )
<b>NET CASH FLOWS USED IN INVESTING ACTIVITIES</b>	<b>(32,847 )</b>	<b>(7,607 )</b>

## SURGE COMPONENTS, INC. AND SUBSIDIARIES

## Consolidated Statements Of Cash Flows (Unaudited)

(Continued)

	Three Months Ended February 28,	
	2015	2014
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from exercising stock options	\$6,250	\$-
<b>NET CASH FLOWS PROVIDED BY FINANCING ACTIVITIES</b>	<b>6,250</b>	<b>-</b>
<b>NET CHANGE IN CASH</b>	<b>131,703</b>	<b>721,196</b>
<b>CASH AT BEGINNING OF PERIOD</b>	<b>6,174,561</b>	<b>4,288,090</b>
<b>CASH AT END OF PERIOD</b>	<b>\$6,306,264</b>	<b>\$5,009,286</b>
 <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>		
Income taxes paid	\$8,978	\$43,151
Interest paid	\$-	\$-
 <b>NONCASH INVESTING AND FINANCING ACTIVITIES:</b>		
Accrued dividends on preferred stock	\$5,425	\$5,925
Payment of accrued interest through issuance of common stock:	\$102,399	\$-

See notes to consolidated financial statements.



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, 2015 and February 28, 2014 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 accounts 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 the customer upon the merchandise being received by a freight forwarder. Direct shipments were approximately \$535,000 and \$995,000 for the three months ended February 28, 2015 and February 28, 2014 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 \$60,814 and \$107,745 for the three months ended February 28, 2015 and February 28, 2014 respectively.

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





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. There are no provisions for the granting of price concessions in any of the agreements. Revenues under these distribution agreements were approximately \$2,442,000 and \$1,515,000 for the three months ended February 28, 2015 and February 28, 2014 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, 2015 approximated \$1,319,000. The Company, at February 28, 2015, had a reserve against slow moving and obsolete inventory of \$313,000. 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.

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 February 28, 2015 and November 30, 2014, the Company's uninsured cash balances totaled approximately \$3,375,905 and \$2,994,000, respectively.

(7) Income Taxes:

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

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

The Company files income tax returns in the U.S. federal jurisdiction and various state and foreign jurisdictions. The Company is no longer subject to U.S. federal tax examinations for years before fiscal years ending November 30, 2010, and state tax examinations for years before fiscal years ending November 30, 2009. 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, 2015 and February 28, 2014.

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.

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 \$2,293 and \$1,926 for the three months ended February 28, 2015 and February 28, 2014 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, 2015 and February 28, 2014 totaled 524,875 and 455,946, respectively.

(14) Stock Based Compensation

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.



SURGE COMPONENTS, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE C - FIXED ASSETS

Fixed assets consist of the following:

	February 28, 2015	November 30, 2014
Furniture and Fixtures	\$322,586	\$322,586
Leasehold Improvements	944,362	940,204
Computer Equipment	965,281	936,592
Less-Accumulated Depreciation	(2,122,940)	(2,114,416)
Net Fixed Assets	\$109,289	\$84,966

Depreciation and amortization expense for the three months ended February 28, 2015 and February 28, 2014 was \$8,523 and \$9,671, respectively.

NOTE D - ACCRUED EXPENSES

Accrued expenses consist of the following:

	February 28, 2015	November 30, 2014
Commissions	\$249,838	\$263,796

Preferred Stock Dividends	205,982	200,557
Interest	-	102,399
Other accrued expenses	178,688	218,250
	\$634,508	\$785,002

In March 2000, the Company completed a \$7,000,000 private placement of convertible notes. The face value of the notes was converted into common stock in July 2001 pursuant to the automatic conversion provisions of the notes. However, approval by holders of the notes was required to convert the interest accrued on the notes to common stock. The accrued interest set forth in the Company's financial statements relates to the portion of the accrued interest for which note holder approval was not obtained and therefore not converted into common stock. No additional interest accrues on these amounts and none of the accrued interest was repaid during any of the periods presented. In February 2015, the Company issued 113,803 shares of common stock to the holders of the notes in payment of the accrued interest at a conversion rate of \$0.90 per share.

#### 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 \$1,054,000 at November 30, 2014. Pension expense for the three months ended February 28, 2015 and February 28, 2014 was \$1,330 and \$8,129, respectively.

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, 2015.

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, 2015.

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 \$205,982 have not been declared or paid for the semiannual periods ended December 31, 2001 through the semiannual payment due December 31, 2014. 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.

In October 2014, 2,000 shares of Series C Preferred were converted into 20,000 shares of common stock.

At February 28, 2015 there are 21,700 shares of Series C Preferred issued and outstanding.

## 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 Stock 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 Plan activity for the three months ended February 28, 2015 is summarized as follows:

	Shares	Weighted Average Exercise Price
Options outstanding December 1, 2014	986,438	\$ 0.50
Options issued in the three months ended February 28, 2015	-	\$ -
Options exercised in the three months ended February 28, 2015	25,000	\$ 0.25
Options cancelled in the three months ended February 28, 2015	-	\$ -
Options outstanding at February 28, 2015	961,438	\$ 0.50
Options exercisable at February 28, 2015	961,438	\$ .050

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 per share, the value of the common stock on the date of the grant. These options vest over a three year period and expires ten years from the grant date. 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 per share, the market price of the common stock on the date of the grant. This option vested immediately and expires five years from the grant date. 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.

In November 2013, the Company granted a stock option to (a) one employee-director and all non-employee directors to purchase 25,000 shares of common stock, and (b) one employee-director to purchase 50,000 shares of common stock at an exercise price of \$0.82 per share, the market price of the common stock on the date of the grant. These options vested immediately and expire five years from the grant date. The fair value of these stock options is estimated at the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions: expected volatility of 18% (based on the Company's historical stock volatility); average risk-free interest rate of 1.36% (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.

In April 2014, the Company granted a stock option to (a) one employee-director to purchase 62,500 shares of common stock, and (b) one employee-director to purchase 45,938 shares of common stock, at an exercise price of \$.80 per share, the market price of the common stock on the date of the grant. These options vest immediately and expire five years from the grant date. The fair value 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 20% (based on the Company's historical stock volatility); average risk-free interest rate of 1.65% (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 intrinsic value of the exercisable options at February 28, 2015 totaled \$401,844. At February 28, 2015 the weighted average remaining life of the stock options is 1.35 years. At February 28, 2015, there was no unrecognized compensation cost related to the stock options granted under the Stock Plan.

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 per share. 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. In November 2013, each non-officer director was granted an option to purchase 25,000 shares of common stock at an exercise price of \$0.82 per share. Starting December 1, 2013 the compensation for each non-officer director was increased to \$2,500 per month (and \$3,500 per month for a non-officer director that serves as the chairman of more than two committees of the Board of Directors). In February 2015, 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, 2015	November 30, 2014
Deferred Tax Assets		
Net operating loss	\$4,292,237	\$4,366,694
Allowance for bad debts	31,811	29,317
Inventory	120,202	120,219
Deferred Rent	16,421	16,201
Depreciation	169,287	170,131
Total deferred tax assets	4,629,958	4,702,562
Valuation allowance	(3,521,312)	(3,519,069)
 Deferred Tax Assets	 \$1,108,646	 \$1,183,493

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. The valuation allowance increased by approximately \$2,200 during the three months ended February 28, 2015. 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.



## SURGE COMPONENTS, INC. AND SUBSIDIARIES

## Notes to Consolidated Financial Statements

NOTE G – INCOME TAXES (CONTINUED)

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

	Three Months Ended	
	February 28, 2015	February 28, 2014
Current:		
Federal	\$4,627	\$6,403
States	4,351	7,726
	8,978	14,129
Deferred:		
Federal	59,129	71,920
States	15,718	19,118
	74,847	91,038
Provision for income taxes	\$83,825	\$105,167

The Company files a consolidated income tax return with its wholly-owned subsidiaries and has net operating loss carryforwards of approximately \$11,000,000 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,	February 28,

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	2015		2014	
U.S Federal Income tax statutory rate	34	%	34	%
Valuation allowance	(16	)%	(3	)%
State income taxes	6	%	5	%
Other	-		-	
Effective tax rate	24	%	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 \$169,000 for the year ended November 30, 2014, 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 February 28, 2015 are as follows:

Twelve Months Ended February 28,	
2016	\$ 173,439
2017	\$ 176,908
2018	\$ 180,446
2019	\$ 184,055
2020	\$ 108,608
2021 & thereafter	\$-
	\$823,456

Net rental expense for the three months ended February 28, 2015 and February 28, 2014 were \$75,627 and \$78,459 respectively, of which \$62,331 and \$64,337 respectively, was paid 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, 2015 (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. A bonus pool has been accrued for the two officers through February 28, 2015 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 23% of net sales for the three months ended February 28, 2015 and two customers who accounted for 14% and 10% of net sales for the three months ended February 28, 2014. The Company had one customer who accounted for 11% of accounts receivable at February 28, 2015 and another customer who accounted for 11% of accounts receivable at November 30, 2014.

NOTE K- MAJOR SUPPLIERS

During the three months ended February 28, 2015 and February 28, 2014 there was one foreign supplier who accounted for 50% and 42% of total inventory purchased.

The Company purchases substantially all of its products overseas. For the three months ended February 28, 2015, the Company purchased 61% of its products from Taiwan, 9% from Hong Kong, 25% 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 were as follows:

	Three Months Ended	
	February 28, 2015	February 28, 2014
Canada	613,790	591,433
China	1,099,755	1,165,097
Other Asian Countries	227,727	218,314
South America	83,096	134,116
Europe	273,779	223,018

Revenues are attributed to countries based on location of customer.

## **ITEM MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS 2. 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, our supplier who sold the product to the customer that we introduced to our supplier pays 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 \$60,814 and \$107,745 for the three months ended February 28, 2015 and February 28, 2014 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 to 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, and 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 and are also are working with local, regional, and national distributors to sell these products to local accounts in every state.



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 reduced demand. This reduced demand can be attributed to a slowdown in global growth as well as a slowdown in the forecast of retail sales in North America. Management expects 2015 to continue with the reduced demand for components and significant pricing pressures that it experienced in 2014. Due to this worldwide reduction in demand, the Company could feel the effects of potentially reduced demand and reduced margins 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 and attract 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.

## **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 suppliers 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 \$30,000.

Because of the experience of the Company's management, including Ira Levy and Steven Lubman, the Company believes that it knows the best prices to buy the products it sells and as a result the Company generally waives rights to manufacturers' inventory protection agreements (including price protection and inventory return rights), and thereby bears the risk of increases in the prices charged by manufacturers and decreases in the prices of products held in the Company's inventory or covered by purchase commitments. If prices of components which the Company holds in inventory decline, or if new technology is developed that displaces products that the Company sells, the business could be materially adversely affected. While the Company has experienced little impact from customer design changes and slowdown, this can potentially increase due to general economic conditions and customer-specific business conditions. If the Company's customers experience these changes, the business could be adversely affected.

### *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**

Consolidated net sales for the three months ended February 28, 2015 increased by \$737,917 or 11.9%, to \$6,959,625 as compared to net sales of \$6,221,708 for the three months ended February 28, 2014. We attribute the increase in net sales to an increase in business with new customers as well as new business with existing customers.



Our gross profit for the three months ended February 28, 2015 increased by \$139,935 to \$1,844,960, or 8.2%, as compared to \$1,705,025 for the three months ended February 28, 2014. Gross margin as a percentage of net sales decreased to 26.5% for the three months ended February 28, 2015 compared to 27.4% for the three months ended February 28, 2014. The Company attributes the increase in gross profit to the increase in sales volume offset by the decrease in profit margin percentage to certain customers having a high volume of sales for products with a lower gross profit margin in the three months ended February 28, 2015 as compared to the three months ended February 28, 2014. Profit margins have decreased as a result of certain of our customers, who are some of the biggest buyers of components, demanding the lowest prices for our products. Some of them further demand periodic price reductions on a quarterly or six month basis, as opposed to annual fixed pricing. We work with electronic manufacturing service subcontractor customers who manufacture products for other customers who do not have their own manufacturing operations. The Company has agreements with these subcontractor customers to provide periodic cost reductions through rebates in the amount of 5%. This reduction only affects future shipments of our products, and does not affect such customers' existing orders. This obligation can have a negative impact on our profit margins since it reduces the amount of commissions we can earn. Even though this rebate can impact the Company's gross profit margin, these subcontractor customers represent very significant potential growth for the Company, because they help the Company become an approved supplier at the customers they manufacture for, and they purchase our components for these customers. It would be very difficult for the Company to achieve business at these customers without the help of the subcontractor customers.

Selling and shipping expenses for the three months ended February 28, 2015 was \$549,562, an increase of \$24,688, or 4.7%, as compared to \$524,874 for the three months ended February 28, 2014. Specifically the increase is due to increases in salaries for our salespersons, advertising, travel expenses, freight and catalog expenses as partially offset by decreases in commission expenses, auto and entertainment expenses.

General and administrative expenses for the three months ended February 28, 2015 was \$1,004,730, an increase of \$124,618, or 14.2%, as compared to \$880,112 for the three months ended February 28, 2014. The increase is due to the hiring of additional employees and increased costs of both health and general insurance, officers' salaries and warehouse expenses, an increase in professional fees, and public company expenses and as partially offset by decreases in rent, office and computer and consulting expenses.

Depreciation expense for the three months ended February 28, 2015 was \$8,523, a decrease of \$1,148 or 11.9%, as compared to \$9,671 for the three months ended February 28, 2014. The decrease is due to assets becoming fully depreciated during the fiscal year ended November 30, 2014.

Investment income for the three months ended February 28, 2015 was \$1,997, compared to \$689 for the three months ended February 28, 2014. We attribute the increase of \$1,308, or 189.8%, to additional cash being placed in several money market accounts during the fiscal year ended November 30, 2014.

Income taxes for the three months ended February 28, 2015 was \$83,825, a decrease of 21,342 or 20.3% as compared to a tax expense of \$105,167 for the three months ended February 28, 2014. The decrease is a result of management's revised estimate of future taxable income and the related impact on the reported deferred tax. This change in the valuation allowance is based on management's estimates of future taxable income. The degree of variability inherent in the estimates of future taxable income is significant and subject to change in the near term. The Company reviews its estimates of future taxable income in each reporting period and adjustments to the valuation allowance are reflected in the current operations.

As a result of the foregoing, net income for the three months ended February 28, 2015 was \$200,317, compared to net income of \$185,890 for the three months ended February 28, 2014.

### **Liquidity and Capital Resources**

As of February 28, 2015 we had cash of \$6,306,264, and working capital of \$10,192,893. We believe that our working capital levels are adequate to meet our operating requirements during the next twelve months.

During the three months ended February 28, 2015, we had net cash flow from operating activities of \$158,300, as compared to net cash flow from operating activities of \$728,803 for the three months ended February 28, 2014. The decrease in cash flow from operating activities resulted from a decrease in accounts receivable, inventory, prepaid expenses and accrued expenses and accounts payable.

We had net cash flow used in investing activities of \$(32,847) for the three months ended February 28, 2015, as compared to net cash flow used in investing activities of \$(7,607) for the three months ended February 28, 2014. We attribute the increase to the Company purchasing new equipment during the three months ended February 28, 2015.

We had net cash flow provided by financing activities of \$6,250 for the three months ended February 28, 2015, as compared to net cash flow provided by financing activities of \$0 for the three months ended February 28, 2014. We attribute the increase to a non-executive board member exercising an option and acquiring 25,000 shares of common stock.

As a result of the foregoing, the Company had a net increase in cash of \$131,703 for the three months ended February 28, 2015, as compared to a net increase in cash of \$721,196 for the three months ended February 28, 2014.

We will continue to evaluate opportunities to use any excess cash generated by our operations, including investing in acquisitions, expanding our business and repurchasing our common stock if permitted by our governing documents and existing contracts while maintaining sufficient liquidity to support our operational needs and fund future strategic growth opportunities.

The table below sets forth our contractual obligations, including operating leases and other long-term obligations, as of February 28, 2015:

Contractual Obligations	Total	Payments due			
		0 – 12 Months	13 – 36 Months	37 – 60 Months	More than 60 Months
Long-term debt	\$-	\$--	\$--	\$--	\$--
Operating leases	\$823,456	173,439	357,354	292,663	--
Employment agreements	\$208,333	208,333	--	--	--
Total obligations	\$1,031,789	\$381,772	\$357,354	\$292,663	\$--

## 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 February 28, 2015 and has concluded that, as of such date, our disclosure controls and procedures were effective.

#### **Changes in Internal Controls**

During the three months ended February 28, 2015, 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.

## **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.**

In February 2015, the Company issued 113,803 shares of common stock to the holders of the Company's convertible promissory notes in payment of the aggregate accrued interest on the notes in the amount of \$102,399. The notes were originally offered and sold solely to accredited investors pursuant to a private placement exemption under Section 4(a)(2) of the Securities Act of 1933, as amended, and Regulation D/Rule 506 thereunder.

#### **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**