

SURG II INC  
Form 10QSB  
November 07, 2002

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

**FORM 10-QSB**

(Mark One)

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

For the quarterly period ended September 30, 2002

TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT.

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-16686

**SURG II, INC.**

(Name of small business issuer as specified in its charter)

**Minnesota**  
(State or other jurisdiction of  
incorporation of organization)

**58-1486040**  
(I.R.S. Employer  
Identification Number)

**800 Nicollet Mall, Suite 2690, Minneapolis MN 55402**  
(Address of principal executive offices)

**(612) 333-0614**  
(Issuer's telephone number)

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter periods 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

4,348,720 shares of Common Stock, \$.01 par value, were outstanding at  
November 1, 2002

Transitional Small Business Disclosure Format. YES NO

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Certification Pursuant to 18 U.S.C. Section 1350

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## ITEM 1. FINANCIAL STATEMENTS

**SURG II, INC.  
BALANCE SHEETS**

	September 30, 2002 (unaudited)	December 31, 2001 (audited)
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash	\$ 3,198,681	\$ 8,150
Accounts receivable, less allowance for doubtful accounts of \$4,200 as of December 31, 2001		44,734
Inventory		124,712
Prepaid expenses	13,500	12,243
	<u>3,212,181</u>	<u>189,839</u>
<b>Furniture and Equipment</b> , at cost		353,917
Less accumulated depreciation and amortization		338,003
		<u>15,914</u>
<b>Other Assets</b>		
Patents and trademarks, net of accumulated amortization of \$19,020 as of December 31, 2001		3,627
		<u>3,627</u>
<b>Total assets</b>	<u>\$ 3,212,181</u>	<u>\$ 209,380</u>
<b>LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)</b>		
<b>Current Liabilities</b>		
Current maturities of capital lease obligation	\$	\$ 5,000
Notes payable to officers and directors		8,474
Other notes payable		61,646
Accounts payable	40,573	119,210
Accrued expenses		56,401
	<u>40,573</u>	<u>250,731</u>
<b>Total current liabilities</b>	<u>40,573</u>	<u>250,731</u>
<b>Capital Lease Obligation, Less Current Maturities</b>		<u>5,507</u>
<b>Stockholders Equity (Deficit)</b>		
Series A preferred stock, 1,600,000 shares authorized; \$400,000 liquidation preference, 1,600,000 shares issued and outstanding as of December 31, 2001		400,000
Common stock, \$.01 par value; 5,000,000 shares authorized; 4,348,720 and 186,177 issued and outstanding as of September 30, 2002 and December 31,	43,487	1,862

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2001, respectively		
Additional paid-in capital	8,212,779	4,604,404
Accumulated deficit	(5,084,658)	(5,053,124)
	<u>                    </u>	<u>                    </u>
Total stockholders' equity (deficit)	3,171,608	(46,858)
	<u>                    </u>	<u>                    </u>
Total liabilities and stockholders' equity (deficit)	\$ 3,212,181	\$ 209,380
	<u>                    </u>	<u>                    </u>

See Notes to Financial Statements

**Table of Contents****SURG II, INC.  
STATEMENTS OF OPERATIONS (UNAUDITED)**

	Three Months Ended		Nine Months Ended	
	September 30 2002	September 30 2001	September 30 2002	September 30 2001
<b>Net Sales</b>	\$	\$ 121,156	\$ 33,133	\$ 347,256
<b>Cost of Goods Sold</b>		108,926	31,524	274,558
Gross profit		12,230	1,609	72,698
<b>Operating Expenses</b>				
Research and development		3,224	1,026	10,185
Sales and marketing		8,534	2,977	25,849
General and administrative	23,507	34,737	115,073	150,008
Total operating expenses	23,507	46,495	119,076	186,042
Operating loss	(23,507)	(34,265)	(117,467)	(113,344)
<b>Other Income (Expense)</b>				
Net gain on sale of net assets			62,125	
Interest income	17,419	11	23,490	37
Interest expense		(1,199)	(210)	(3,709)
Other		39	528	730
Net loss	\$ (6,088)	\$ (35,414)	\$ (31,534)	\$ (116,286)
Basic and diluted loss per common share	\$ (0.00)	\$ (0.19)	\$ (0.02)	\$ (0.62)
Weighted average common shares outstanding-basic and diluted	4,014,969	186,177	1,922,532	186,177

See Notes to Financial Statements

**Table of Contents****SURG II, INC.  
STATEMENTS OF CASH FLOWS (UNAUDITED)**

	Nine Months Ended	
	September 30, 2002	September 30, 2001
<b>Cash Flows from Operating Activities</b>		
Net loss	\$ (31,534)	\$ (116,286)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Net gain on sale of net assets	(62,125)	
Depreciation and amortization		4,360
Amortization of prepaid consulting expenses		38,636
Non-cash compensation	10,000	
Changes in assets and liabilities, net of effect of sale of net assets:		
Accounts receivable	6,267	(34,757)
Inventory	6,474	71,023
Prepaid expenses	(1,257)	(1,149)
Accounts payable and accrued expenses	(56,400)	20,563
Net cash used in operating activities	<u>(128,575)</u>	<u>(17,610)</u>
<b>Cash Flows from Investing Activities</b>		
Net proceeds from sale of net assets	149,226	
<b>Cash Flows from Financing Activities</b>		
Net proceeds from sale of common stock	3,240,000	
Payments on notes payable	(70,120)	(5,546)
Payments on capital lease obligation		(3,401)
Net cash provided by (used in) financing activities	<u>3,169,880</u>	<u>(8,947)</u>
Increase (decrease) in cash	3,190,531	(26,557)
<b>Cash:</b>		
Beginning	8,150	33,924
Ending	<u>\$ 3,198,681</u>	<u>\$ 7,367</u>
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash payments for interest	\$ 6,105	\$ 7,011
<b>Supplemental Disclosures of Non-cash Investing and Financing Activities</b>		
Conversion of preferred stock to common stock	\$ 400,000	\$

See Notes to Financial Statements



**Table of Contents****SURG II, INC.****NOTES TO FINANCIAL STATEMENTS (unaudited)****Note 1. Financial Statements:**

The accompanying unaudited financial statements of Surg II, Inc. (the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions to Form 10-QSB. Accordingly they do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America. In the opinion of management all adjustments, consisting of normal recurring items, necessary for a fair presentation have been included. Operating results for the three and nine months ended September 30, 2002 are not necessarily indicative of the results that may be expected for the year ending December 31, 2002. These financial statements should be read in conjunction with the financial statements and footnotes thereto included in the Company's Annual Report on Form 10-KSB for the year ended December 31, 2001.

**Note 2. Sale of Net Operating Assets:**

On January 22, 2002, pursuant to an agreement, the Company closed on the sale of substantially all of its net operating assets. The sale resulted in gross proceeds of \$200,000 and a gain of approximately \$9,000 after considering total transaction costs of \$104,000 including \$55,000 that were incurred and expensed in 2001. After the sale the Company has no sources of revenue as the net operating assets sold represent substantially all of its operations. The Company anticipates utilizing its remaining capital structure to attract a business opportunity with potential value to shareholders, see Note 3. However, there can be no assurance that a business combination or similar transaction will occur. The Company currently has no continuing operations.

A summary of the asset sale is as follows:

Proceeds	\$ 200,000
Transaction costs	104,000
	<hr/>
Net proceeds	\$ 96,000
Less net book value of assets sold	(87,102)
	<hr/>
Gain	\$ 8,898
	<hr/>

The actual gain recorded in the statements of operations for the nine months ended September 30, 2002 was approximately \$62,000 as \$55,000 of the total transaction costs of \$104,000 were incurred and expensed in 2001. The net proceeds of approximately \$150,000 reflected in the accompanying September 30, 2002 statement of cash flows is comprised of the gross proceeds received of \$200,000 less the transaction costs incurred and expensed in 2002 of approximately \$50,000.

A summary of the assets sold and liabilities assumed is as follows:

Accounts receivable	\$ 38,467
Inventories	118,238
Other assets	3,627
Furniture and equipment	15,914
Long-term debt	(10,506)
Accounts payable	(78,638)
	<hr/>
Net assets sold	\$ 87,102
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Because the Company sold all of its net operating assets, on a pro forma basis there would have been no sales in any period presented, assuming the transaction had been effective January 1, 2001.

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**Note 3. Sale of Capital Stock to Entrx Corporation (formerly Metalclad Corporation):**

On May 30, 2002, Entrx Corporation ( Entrx ) acquired 3,625,000 shares of common stock, constituting approximately 90% of the outstanding shares of the Company for \$3,000,000 invested into the Company.

On September 25, 2002, Entrx acquired an additional 357,142 shares of common stock for \$300,000 invested into the Company.

**Note 4. Reverse Stock Split**

On September 23, 2002, the Company's Board of Directors approved a reverse stock split of the Company's common stock at a ratio of one-for-40 and a change in the par value from none to \$.01 per share. The reverse split and change in par value became effective with respect to shareholders of record at the close of business on October 4, 2002. In lieu of fractional shares, shareholders will receive a cash payment. Stockholders equity has been restated to give retroactive recognition of the reverse split and change in par value for all periods presented by reclassifying to additional paid-in capital the amount in excess of the par value of the outstanding shares. All references to common share and per common share amounts for all periods presented have been retroactively restated to reflect this reverse split.

**Note 5. Net Loss Per Share:**

The loss per share amounts for the three and nine months ended September 30, 2002 and September 30, 2001 were computed by dividing the net loss by the weighted average shares outstanding during the applicable period. Dilutive common equivalent shares have not been included in the computation of diluted loss per share because their inclusion would be antidilutive. Anti-dilutive common equivalent shares issuable based on future exercise of stock warrants could potentially dilute basic and diluted earnings per share in subsequent periods.

All stock warrants were anti-dilutive as of September 30, 2002 and 2001.

**Note 6. Subsequent Event:**

On October 18, 2002, Entrx paid a dividend to its shareholders of record as of October 11, 2002 of one share of Surg II's \$.01 par value common stock for each 2 shares of Entrx common stock held.

**ITEM 2. Management's Discussion and Analysis of Financial Condition or Plan of Operation**

All statements, other than statements of historical fact, included in this Form 10-QSB, including without limitation the statements under Management's Discussion and Analysis of Financial Condition and Results of Operations are, or may be deemed to be, forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934. Such forward-looking statements involve assumptions, known and unknown risks, uncertainties, and other factors which may cause the actual results, performance or achievements of Surg II, Inc. to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements contained in this Form 10-QSB. Such potential risks and uncertainties include, without limitation, the ability of the Company to acquire a business enterprise and other risk factors detailed herein and in other of the Company's filings with the Securities and Exchange Commission. The forward-looking statements are made as of the date of this Form 10-QSB and the Company assumes no obligation to update the forward-looking statements or to update the reasons actual results could differ from those projected in such forward-looking statements. Therefore, readers are cautioned not to place undue reliance on these forward-looking statements.

**Results of Operations Three and Nine Months Ended September 30, 2002 and 2001**

**Overview:** On January 22, 2002, pursuant to an agreement and shareholder approval, the Company closed on the sale of substantially all of its net operating assets. The sale resulted in a gain of approximately \$9,000 with gross cash proceeds of

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\$200,000. See Note 2 to the financial statements for further information. After the sale the Company has no sources of revenue as the net operating assets sold represented substantially all of its operations. On May 30, 2002, Entrx Corporation ( Entrx ), an unrelated company, acquired 3,625,000 shares of common stock, constituting approximately 90% of the outstanding shares of the Company for \$3,000,000 invested into the Company, and on September 25, 2002 acquired an additional 357,142 share for \$300,000 invested into the Company.

**Sales.** There were no sales for the three months ended September 30, 2002 compared with sales of \$121,000 for the comparable period in 2001. Sales for the nine months ended September 30, 2002 were \$33,000, compared to \$347,000 for the same period in 2001, a decrease of approximately 90%. These decreases were primarily related to the sale of net assets, as sales activity ceased after January 22, 2002.

**Cost of Goods Sold and Gross Profit.** Due to the sale of the net assets, there was no cost of goods sold for the three months ended September 30, 2002 and cost of goods sold was \$32,000 for the nine months ended September 30, 2002. For the three and nine months ended September 30, 2001 cost of goods sold was \$109,000 and \$275,000, respectively. Gross profit expressed as a percentage of sales was approximately 10% for the three months ended September 30, 2001 and was 5% for the nine months ended September 30, 2002 compared to 21% for the same period in 2001. The decreases were due primarily to less sales volume in 2002 over which to spread certain fixed manufacturing costs.

**Operating Expenses.** Operating expenses decreased from \$46,000 for the three-month period ended September 30, 2001 to \$24,000 for the three-month period ended September 30, 2002, a 49% decrease. For the nine months ended September 30, 2002, operating expenses were \$119,000 compared to \$186,000 for the nine months ended September 30, 2001, a 36% decrease. The decreases were primarily the result of the sale of net assets, as operating activities ceased after January 22, 2002.

**Interest Income and Expense.** Net interest income for the three and nine months ended September 30, 2002 was \$17,000 and \$23,000, respectively, as compared to net interest expense of \$1,000 and \$4,000 for the three and nine months ended September 30, 2001, respectively. The increase in net interest income is primarily the result of higher cash balances due to the sale of common stock to Entrx Corporation.

**Net Loss.** As a result of the above factors, the Company experienced a net loss of \$6,000, or \$0.00 per share, and \$32,000, or \$0.02 per share, for the three and nine months ended September 30, 2002, respectively, compared with a net loss of \$35,000, or \$0.19 per share, and \$116,000, or \$0.62 per share, for the three and nine months ended September 30, 2001.

**Liquidity and Capital Resources:**

The Company is seeking to acquire a business which the Company believes would be expected to have potential for growth. The Company has been seeking such businesses, and has been negotiating with various parties for such an acquisition. The Company will continue to engage in such negotiations, and will publicly announce any definitive agreement entered into for the acquisition of any new business shortly after reaching such an agreement.

As of September 30, 2002, the Company had working capital of \$3,172,000 compared to a working capital deficit of \$61,000 as of December 31, 2001. The increase in working capital was primarily the result of the net proceeds from the sale of common stock to Entrx Corporation.

For the nine month period ended September 30, 2002, the net cash used in operating activities was \$129,000 compared with net cash used in operating activities of \$18,000 for the nine months ended September 30, 2001. The negative cash flows from operating activities were primarily the result of funding operating losses. In addition, during the nine months ended September 30, 2002, the Company used cash to decrease accounts payable and accrued expenses. These uses were partially offset by non-cash compensation expense and decreases in accounts receivable and inventory. During the nine months ended September 30, 2001, in addition to the use of cash to fund operating losses an increase in accounts receivable also used cash. These uses were partially offset by a decrease in inventory, an increase in accounts payable and accrued expenses and non-cash expenses for amortization of prepaid consulting.

Net proceeds from investing activities provided \$149,000 of cash for the nine months ended September 30, 2002 due to the net proceeds received from the net asset sale.

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Financing activities provided \$3,170,000 of cash for the nine months ended September 30, 2002 and used \$9,000 of cash for the nine months ended September 30, 2001. Net proceeds from the sale of common stock, offset by payments on notes payable, was the source of the financing funds provided in 2002. For the nine months ended September 30, 2001 payments on notes payable used \$6,000 of cash and payments on the capital lease obligation used \$3,000 of cash.

As discussed above, the Company anticipates utilizing its remaining capital structure to attract a business opportunity that will maximize potential value to shareholders. However, there can be no assurance that a business combination or similar transaction will occur. The Company currently has no continuing operations. Management believes that its cash should be sufficient to satisfy its cash requirements for the next twelve months.

### **Critical Accounting Policies**

Our significant accounting policies are described in Note 1 to the financial statements included in our annual report for the year ended December 31, 2001. The accounting policies used in preparing our interim 2002 condensed financial statements are the same as those described in our annual report.

### **Recently Issued Accounting Pronouncements**

In October 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 147, Acquisitions of Certain Financial Institutions. SFAS No. 147 is effective October 1, 2002. The Company believes the adoption of SFAS No. 147 will not have a material effect on the Company's financial position or results of operations.

## **PART II. OTHER INFORMATION**

### **Item 1. Legal Proceedings**

None

### **Item 2. Changes in Securities and Use of Proceeds**

On September 25, 2002, Entrx acquired an additional 357,142 shares of common stock for \$300,000 invested into the Company.

On October 4, 2002, the Company reverse split its no par value common stock one share for each forty shares held. At the same time, the Company changed the par value of its common stock from none to \$.01 per share.

### **Item 3. Defaults Upon Senior Securities**

Not Applicable

### **Item 4. Submission of Matters to a Vote of Security Holders**

None

### **Item 5. Other Information**

None



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**Item 6. Exhibits and Reports on Form 8-K**

a) Exhibits

99.1 Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

99.2 Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

b) Reports on Form 8-K

On July 16, 2002 the Company filed a Form 8-K disclosing that it had engaged Virchow, Krause & Company, LLP to audit its financial statements for the year ending December 31, 2002.

**SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

**SURG II, INC**

Date:

November 7,

2002 /s/

Kenneth W.

Brimmer

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By:

Kenneth W.

Brimmer

President and

Chief

Executive

Officer Date:

November 7,

2002 /s/

Brian D.

Niebur

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By: Brian

D. Niebur

Chief

Financial

Officer

(Principal

Accounting

Officer)

**CERTIFICATIONS**

I, Kenneth W. Brimmer, certify that:

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1. I have reviewed this quarterly report on 10-QSB of Surg II, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the Evaluation Date) and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):



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- a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 7, 2002

/s/ Kenneth W. Brimmer

By: Kenneth W. Brimmer  
President and Chief Executive Officer

I, Brian D. Niebur, certify that:

1. I have reviewed this quarterly report on 10-QSB of Surg II, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date") and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: November 7, 2002

/s/ Brian D. Niebur

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By: Brian D. Niebur  
Chief Financial Officer