

Surna Inc.  
Form 10-Q  
August 14, 2012

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**FORM 10-Q**

QUARTERLY REPORT UNDER TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934 for the quarterly period ended JUNE 30, 2012

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

**Commission File Number: 333-164578**

**SURNA INC.**

*(Exact name of registrant as specified in its charter)*

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

**27-3911608**  
*(I.R.S. Employer Identification No.)*

**1103 United Success Commercial Centre**

**508 Jaffe Road, Causeway Bay**

**N/A**

**Hong Kong**

*(Address of principal executive offices)*

*(ZIP Code)*

**+852.3721.3668**

*(Registrant's telephone number, including area code)*

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 (§232.405 of this chapter) during the preceding 12 months (or for 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. (Check one):

Large Accelerated Filer  Accelerated Filer  Non-accelerated Filer  Smaller Reporting Company

*(Do not check if a smaller reporting company)*

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). **YES**  **NO**

At August 14 2012, 99,375,000 shares of the registrant's common stock were outstanding.

SURNA INC.

**Quarterly Report on Form 10-Q**

*For the Quarter ended 30 June, 2012*

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## AVAILABLE INFORMATION

Surna Inc. files annual, quarterly and current reports and other information with the Securities and Exchange Commission (the "SEC"). You may read and copy any document we file with the SEC at the SEC's public reference room at 100 F Street, NE, Washington, DC 20549. Please call the SEC at 1-800-SEC-0330 for information on the public reference room. The SEC maintains an internet site that contains annual, quarterly and current reports, proxy and information statements and other information that issuers (including Morgan Stanley) file electronically with the SEC. Surna's electronic SEC filings are available to the public at the SEC's internet site, [www.sec.gov](http://www.sec.gov).

Surna's internet site is [surna.com](http://surna.com). You can access the Company's Investor Relations webpage at [invest.surna.com](http://invest.surna.com) and Corporate Governance webpage at [governance.surna.com](http://governance.surna.com). Surna posts the following on its Corporate Governance webpage:

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Code of Ethics

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Charter for our Audit Committee

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Charter for our Disclosure Committee

Surna's Code of Ethics applies to all directors, officers and employees, including its Chief Executive Officer, its Chief Financial Officer and its Controller and Principal Accounting Officer. Surna will post any amendments to the Code of Ethics on its internet site. The information on Surna's internet site is not incorporated by reference into this report.

## CERTAIN CONVENTIONS

Except where the context otherwise requires and for purposes of this quarterly report only:

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China or PRC refers to the People's Republic of China, and excludes Hong Kong, Macau and Taiwan;

we, us, our company and our refer to Surna Inc., and, unless the context requires otherwise, its wholly-owned subsidiaries, including Surna Media Inc., a British Virgin Islands company, Surna Hongkong Limited, a Hong Kong company, and Flying Cloud Information Technology Co. Ltd., a PRC company.

## **FORWARD-LOOKING INFORMATION**

This quarterly report contains statements of a forward-looking nature. 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 those expressed or implied by the forward-looking statements. These statements are made under the safe harbor provisions of the U.S. Private Securities Litigation Reform Act of 1995. You can identify these forward-looking statements by terminology such as may, will, expects, anticipates, future, intend, plan, estimate, is/are likely to or other similar expressions. The accuracy of these statements may be impacted by a number of risks and uncertainties that could cause actual results to differ materially from those projected or anticipated. Such risks and uncertainties include, but are not limited to, the following:

We have limited financial resources and accordingly may not be able to continue to operate as a going concern unless we obtain additional financing;

Our lack of resources may make it difficult or impossible to stabilize and strengthen our position as an online game developer in China;

We may not be successful in our efforts to develop and launch additional online games;



·  
Our various initiatives to implement our business strategies may not prove successful despite the costs incurred to pursue them;

·  
Our competitors have significantly more resources than we do, and as a result we might not be able to compete successfully;

·  
The regulatory environment in China and other countries relating to the Internet and Internet content providers, including online game developers and operators, may hinder or impair our ability to conduct our online gaming business as we intend; and

These risks are not exhaustive. We operate in an emerging and evolving environment. New risk factors emerge from time to time and it is impossible for our management to predict all risk factors, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results of this annual report to differ materially from those contained in any forward-looking statement.

We would like to caution you not to place undue reliance on forward-looking statements and you should read these statements in conjunction with the risk factors disclosed under Item 1A. Risk Factors of our last annual report. We do not undertake any obligation to update or revise the forward-looking statements except as required under applicable law.





## PART I - FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS.

## Surna Inc.

## Consolidated Balance Sheets

(Unaudited)

	June 30, 2012		December 31, 2011
<b>ASSETS</b>			
Current Assets			
Cash	\$ 1,175	\$	2,798
Account receivable	47,619		4,527
Prepaid expenses	1,418		1,793
Total Current Assets	50,212		9,118
Equipment, net of accumulated depreciation of \$16,666 and \$10,000, respectively	23,334		30,000
<b>TOTAL ASSETS</b>	<b>\$ 73,546</b>	<b>\$</b>	<b>39,118</b>
<b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>			
CURRENT LIABILITIES			
Accounts Payable	\$ 0	\$	2,954
Accrued liabilities	50,900		20,691
Amounts due to related parties	2,073,249		1,685,363
Total Current Liabilities	2,124,149		1,709,008
<b>TOTAL LIABILITIES</b>	<b>2,124,149</b>		<b>1,709,008</b>
<b>STOCKHOLDERS DEFICIT</b>			
Preferred stock, \$0.00001 par value; 150,000,000 shares authorized; 0 shares issued and outstanding			994
Common stock, \$0.00001 par value; 350,000,000 shares authorized; 99,375,000 shares issued and outstanding	994		994
Paid in capital	148,507		148,507
Accumulated other comprehensive income	(1,994)		(4,304)
Accumulated deficit	(2,198,110)		(1,815,087)
Total Stockholders' Deficit	(2,050,603)		(1,669,890)

<b>TOTAL LIABILITIES AND STOCKHOLDERS DEFICIT</b>	\$	73,546	\$	39,118
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See accompanying notes to the unaudited consolidated financial statements

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## Surna Inc.

## Consolidated Statement of Operations and Comprehensive Income

(Unaudited)

	3 months ended June 30, 2012	3 months ended June 30, 2011	6 months ended June 30, 2012	6 months ended June 30, 2011	1 month ended Dec. 31, 2011
<b>Revenue</b>	\$ 0	\$ 0	\$ 47,831	\$ -	\$ 335
<b>Operating Expenses</b>					
Salaries	154,264	130,448	297,595	193,448	50,496
Compensation expenses	-	769,231	-	769,231	0
Product development cost	11,839	76,453	29,272	76,453	13,256
General and					
Administrative expenses	66,608	59,639	115,594	88,314	20,759
<b>Loss from operations</b>	(232,711)	(1,035,771)	(394,630)	(1,127,446)	(84,176)
Loss on extinguishment of debt	-	(10,000)	-	(10,000)	-
<b>Loss from continuing operations</b>	(232,711)	(1,045,771)	(394,630)	(1,137,446)	(84,176)
Income (loss) from discontinued operations	(0)	0	11,607	0	(1,894)
<b>Net loss</b>	(232,711)	(1,045,771)	(383,023)	(1,137,446)	(86,070)
Foreign currency translation gain (loss)	2,360	(1,157)	2,310	(1,157)	(2,934)
Comprehensive Loss, net of tax	\$ (230,351)	\$ (1,046,928)	\$ (380,713)	\$ (1,138,603)	\$ (89,004)
Net loss per share, basic and diluted:					
Net loss from continuing operations	(0.00)	(0.01)	(0.00)	(0.01)	(0.00)
Discontinued operations, net of tax	-	-	-	-	-
Total net loss per share	(0.00)	(0.01)	(0.00)	(0.01)	(0.00)
Weighted average number of common shares outstanding, basic and diluted	99,375,000	99,196,978	99,375,000	99,186,050	99,375,000

See accompanying notes to the unaudited consolidated financial statements



## Surna Inc.

## Consolidated Statement of Cash Flows

(Unaudited)

	<b>6 months ended June 30, 2012</b>		<b>6 months ended June 30, 2011</b>		<b>1 month ended Dec. 31, 2011</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>					
Net loss	\$ (383,023)	\$	(1,137,446)	\$	(86,070)
Income (loss) from continuing operations	11,607		-		(1,894)
Net loss from continuing operations	(394,630)		(1,137,446)		(84,176)
Adjustments to reconcile net loss from continuing operations to net cash:					
Loss on extinguishment of debt			10,000		
Depreciation expense	6,666		3,333		1,111
Adjustments to reconcile net loss to cash					
from (used by) operating activities:					
Changes in operating assets and liabilities:					
Accounts receivable	(46,346)		-		(335)
Prepaid expenses	375		346		(565)
Accrued liabilities	30,209		3,716		(4,233)
Net cash from (used by) continuing operation	(403,726)		(1,120,051)		(88,198)
Net cash flow from (used by) discontinued operation	2		-		(118)
Net cash from (used by) operating activities	(403,724)		(1,120,051)		(88,316)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>					
Advances from related party	399,846		1,086,336		90,466
Capital contribution	-		425		-
Net cash from financing activities	399,846		1,086,761		90,466
Effect of disposal of discontinued operation	(55)		-		
Effect of exchange rate changes on cash	2,310		(1,157)		(2,934)
Net decrease in cash	(1,623)		(34,447)		(784)
Cash, beginning of period	2,798		70,938		3,582
Cash, end of period	\$ 1,175	\$	36,491	\$	2,798
<b>Non-Cash Transaction</b>					
Stock issued for settlement of debt	\$ -	\$	40,000	\$	-

See accompanying notes to the unaudited consolidated financial statements

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**Surna Inc.**

Notes to Consolidated Financial Statements (Unaudited)

**NOTE 1 - BASIS OF PRESENTATION AND INTERIM UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

The unaudited consolidated financial statements for the three-month periods ended June 30, 2012 and 2011 and for the transition one-month period ended December 31, 2011 have been prepared in accordance with accounting principles generally accepted in the United States of America and the rules of the Securities and Exchange Commission and do not conform in all respects to the disclosure and information that is required for annual consolidated financial statements. These interim consolidated financial statements should be read in conjunction with the most recent 10-K form of the Company filed on March 13, 2012.

In opinion of management, all adjustments, all of which are of a normal recurring nature, considered necessary for fair statement have been included in these interim consolidated financial statements.

Most accounting policies and methods followed in preparing these unaudited consolidated financial statements are those used by Surna Inc (the Company ) as described in Note 1 of the notes to consolidated financial statements included in the Annual Report on Form 10-K.

*Revenue Recognition*

The Company provided software development services related to online games in current fiscal year. Based on ASC 985-605-25-3 Software Not Requiring Significant Production, Modification, or Customization , revenue is recognized when persuasive evidence of an arrangement exists, delivery of services has occurred, the service fee is fixed or determinable and the collectability is reasonably assured.

**NOTE 2 - GOING CONCERN**

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. The Company currently has working capital deficit, no sources of recurring revenue and has generated cumulative net losses of \$2,198,110 during the period from inception through June 30, 2012.



In the course of its development activities, the Company has sustained and continues to sustain losses. The Company cannot predict if and when the Company will generate profits. The Company expects to finance its operations primarily through debt or equity financing.

These conditions raise substantial doubt about the Company's ability to continue as a going concern. The Company's continuation as a going concern is dependent on its ability to meet its obligations, to obtain additional financing as may be required until such time as it can generate sources of recurring revenues and to ultimately attain profitability. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

**NOTE 3 - CHANGE IN FISCAL YEAR-END**

On March 19, 2012, we changed our fiscal year end from November 30 to December 31 of each year. With the change effective this 2012 fiscal year, which will now end December 31, 2012, there is a one fiscal month transition period covering the fiscal month of December 2011. This Form 10-Q covers the transition period, in addition to the six months ended June 30, 2012 and 2011. Notice of the Company's election of a change in fiscal year was made on Form 8-K, which was filed on March 20, 2012.

**NOTE 4 - DISCONTINUED OPERATIONS**

On March 27, 2012, Surna Inc sold Surna Networks Inc, and Surna Networks Limited to Chan Kam Ming for a total sales price of US\$1. Surna Inc assumed liabilities of Surna Networks Inc and Surna Networks Limited of US\$9,286. Surna Networks Inc was incorporated on July 19, 2011 and Surna Networks Ltd was incorporated on August 2, 2011.

The results of discontinued operations of Surna Network Inc and Surna Network Ltd for the one month ended December 31, 2011 and the six months ended June 30, 2012 are summarized as below:

	Surna Networks Inc (USD)		Surna Networks Limited (USD)	
	1 Month Ended	6 Months Ended	1 Month Ended	6 Months Ended
	12/31/11	6/30/12	12/31/11	6/30/12
Revenue	-	-	2,485	44,433
Cost of Revenue	-	-	(1,898)	(31,323)
Salaries	-	-	(1,564)	-
Product Development Costs	-	-	-	-
General & Administrative	-	-	(917)	(1,503)
Net Income (Loss)	-	-	(1,894)	11,607

**NOTE 5 - SIGNIFICANT CONCENTRATIONS, RISKS AND UNCERTAINTIES**

The majority of the Company's operations are carried out in the PRC. Accordingly, the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environments in the PRC, and by the general state of the PRC's economy.

The Company's operations in the PRC are subject to specific considerations and significant risks not typically associated with companies in the North America and Western Europe. These include risks associated with, among others, the political, economic and legal environments and foreign currency exchange. The Company's results may be adversely affected by changes in governmental policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation, among other things.

**NOTE 6 - RELATED PARTY TRANSACTIONS**

As of June 30, 2012 and December 31, 2011, the Company had a balance due to related parties of \$2,073,249 and \$1,685,363, respectively. This balance is from various advances from the Company's directors and which are non-interest bearing, unsecured and due on demand.

**NOTE 7 - REVERSAL OF PRIOR RESTATEMENT**

On September 1, 2011, we acquired Surna Media Inc. for 20,000,000 common shares, an acquisition that included a partially-developed game acquired by that company as of May 1, 2011. In the Annual Report on Form 10-K filed on March 13, 2012 we had reported this acquisition as accounted for as an entity under common control. In the Quarterly Report on Form 10-Q for the fiscal first quarter filed on May 21, 2012, we incorrectly amended the accounting for the acquisition to purchase method. Following the submission of last quarterly report, we did further examination of the ownership structure of Surna Media Inc. Based on ASC 805-50-25 Business Combinations - Transactions Between Entities Under Common Control, we concluded the acquisition should be accounted as an entity under common control, as it had originally been in the last Annual Report. Adjustments to paid in capital and the deficit accumulated during the development stage as presented in the previous Quarterly Report have both been reversed to take into account this reversion to the initial treatment.

**NOTE 8 - SERVICE AGREEMENT**

During March, 2012, the Company entered into an agent agreement with Jurun Information Technology (Shanghai) Co. Ltd. ( Jurun ), and Jurun entered into a technical service agreement with Kunlun Wanwei Information Technology Company Ltd ( Kunlun ). Under the agreements, the Company provided the license of the online game to Jurun and on the same date the license was transferred from Jurun to Kunlun for a period of five years. The Company will receive upfront fees of RMB 1 million payable in the following installments: 1) 30% after the first closed-beta testing; 2) 50% after the second closed-beta testing and 3) 20% after the first open-beta testing. In addition, the Company will receive 20% of game-related revenue from Kunlun during the agreement term. All amounts due from Kunlun will be transferred to Jurun and Jurun will return 100% of the fees back to the Company.

The Company was notified that the first closed-beta testing was reached in late March 2012. Therefore, the Company recognized the first 30% of the RMB 1 million fee as revenue in the first quarter 2012 in accordance with ASC 985-605-25-3 Software Not Requiring Significant Production, Modification, or Customization. The Company was notified in June 2012 that the second closed-beta testing was satisfactorily completed, but no payments have been received for either the first or second testing. Hence, no additional revenue has been recognized pending receipt of payment.

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

You should read the following discussion and analysis of our financial condition and results of operations together with the information in our consolidated financial statements (unaudited) for the current period and our consolidated annual audited financial statements for the last fiscal year as filed on Form 10-K, and the notes thereto and other financial information incorporated by reference. Some of the information contained in this discussion and analysis includes forward-looking statements that involve risks and uncertainties. You should review the Risk Factors section of our last annual report for a discussion of important factors that could cause actual results to differ materially from the results described in or implied by the forward-looking statements contained in the following discussion and analysis.

### **Liquidity and Capital resources**

We are a start-up company and have not yet generated significant revenues from our business operations. Our auditors have issued a going concern opinion; this means that our auditors believe there is substantial doubt that we can continue as an on-going business for the next twelve months unless we obtain additional capital. Accordingly, we must raise cash from sources other than operations. Our only other source of funds at this time is further investment in our company by existing shareholders or others. If we need additional funds and cannot raise them, we will either have to suspend operations until we raise sufficient capital, or cease operations entirely.

Since inception, we have sold 75,000,000 shares of common stock to 7bridge Capital Management Limited for \$15,000. From September through November in the fiscal year 2011, the company placed 4,175,000 shares to 51 individuals at \$0.02 per shares and raised \$83,500 excluding expenses.

We issued 79,175,000 shares of common stock, 75,000,000 shares pursuant to the exemption from registration contained in Regulation S of the Securities Act of 1933 and 4,175,000 shares pursuant to our public offering. Both were accounted for as sales of common stock. On May 16, 2011 we declared a stock dividend of 4 new shares for each 1 share held, with a record date of May 18, 2011. On May 18, 2011 our Board of Directors approved an increase in authorized capital from 100,000,000 common shares to 350,000,000 common shares.

There is limited historical financial information about us upon which to base an evaluation of our performance. We are in a start-up stage of operations and have not generated significant revenues and are subject to risks inherent in the establishment of a new business enterprise, including limited capital resources. We have no assurance that future financing will be available to us on acceptable terms. If financing is not available on satisfactory terms, we may be unable to continue, develop or expand our operations. Equity financing could result in additional dilution to existing shareholders.

As of December 31, 2011, our total assets were \$39,118 and our total liabilities were \$1,709,008.

As of June 30, 2012, our total assets were \$73,546 and our total liabilities were \$2,124,149.

### **Results of Operations**

During the six months ended June 30, 2012, we generated approximately \$50,000 of revenue. To meet our initial need for cash, we raised money from our public offering. Our only other source for cash at this time is investments by others in our company, and if we can not rely on loans from our officers, shareholders or others in order for us to maintain our operations we may need to find alternative sources, like a second public offering or a private placement of securities. At present, if we cannot generate sufficient revenues to continue operations or if we do not secure any additional funding we may either have to suspend operations until we do raise funds, or cease operations entirely.

*Sale of a subsidiary and change in operating segments*

Previously Surna Inc. had two direct operating subsidiaries: Surna Media Inc. ( Surna Media ) and Surna Networks, Inc. ( Surna Networks ). Surna Media 's principal business is the development of web and mobile games and social networks. Surna Network 's principal business is telecommunications services, IT support services and open-source software development.

Surna Networks had been established to develop and provide a range of information technology and network services for potential customers, including game companies inside and outside of the PRC, but its business had focused solely on wholesale carrier services utilizing VoIP telecommunications, which is also referred to as International Simple Resale ( ISR ). Results of the ISR business were disappointing, and we did not foresee it being self-supporting or profitable without further significant investment. Upon further review we determined that it is not relevant to our core business or future plans, and that the best strategy was the sale or winding-up of this business line. On 27 March 2012 we entered into an agreement for the sale of all of the issued and outstanding shares of Surna Networks. The Board of Directors determined that there was no intrinsic value in the current operations of Surna Networks, and therefore accepted an offer to purchase the company for the par value of the issued shares of US\$1.00.

With the sale of Surna Networks we now operate in only one distinct segment, that being Surna Media 's online and mobile games and social networks development business.

*Strategy*

We intend to engage in the further development of our online games that can be played through a browser or on a mobile device. According to reports from the China Internet Network Information Center ( CNNIC ) of the Chinese Academy of Sciences, the number of users for networked games in China in 2011 was 120 million, 66.32 million of whom were paying users (the report can be accessed through [cgic.com.cn](http://cgic.com.cn) - in Chinese).

CNNIC estimated that revenues in 2011 in the PRC from browser games - that is, games accessed through a web browser and excluding those that require downloaded software - exceeded RMB 5.54 billion (approximately US\$ 880 million), and forecast a compound annual growth rate (CAGR) for 2012 to 2016 of 18.6%. Revenues for mobile games in 2011 were estimated at RMB 1.7 billion (approximately US\$ 270 million), with a CAGR 34.6% expected for 2012 to 2016.

To-date, our development efforts have focused to a large extent on games that are not targeted at the traditional customers for these products, which are typically teenage and young-adult males. We believe that the super-deformed



cartoon style (known as SD ) employed in our online game *Demon Immortal* is likely to appeal to female and younger users. In addition to *Demon Immortal*, we are currently developing other game products:

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*Hamsterland*, a social network and online game designed for young children and pre-teens with characters from a children s animated series.

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*Serica*, an ARPG online game based on a Chinese fantasy theme and featuring realistic-style graphics and martial-art fighting.

.  
A *Hamsterland* game for the iPhone mobile platform.

.  
*Qia Ke Zhong Shi*, an ARPG game incorporating influences from kung-fu novels and which will be targeted at a more general audience.

.  
*Ori-Princess*, a game incorporating ARPG and strategy elements with characters from a popular Chinese animated television series, targeted primarily for teenaged girls and young women.

The development of *Hamsterland* has been contracted to Flying Cloud by Shuren Limited, a BVI corporation ( Shuren ), which is owned and controlled by Lim Clarke & Co Limited, a BVI corporation controlled by our Directors and which is the majority shareholder of Surna Inc ( Lim Clarke ). Shuren holds a license to utilize the hamster cartoon characters for online games, mobile games and social networks. Development work on *Hamsterland* is on-going, but its release will be coordinated with the launch of the TV series, the schedule for which has not yet been finalized. It is intended that the iPhone version of the *Hamsterland* game will be released at the same time.

All of these games are expected to be free-to-play for the user, with revenue being generated through the purchase by the player of in-game items and upgrades. Depending on the negotiated commercial terms, game publishers would normally undertake to support marketing and other operating costs, and the game developer would receive a revenue and/or profit share from them. There are currently no contractual arrangements in place for *Hamsterland*, and while it is not certain that we will be able to secure any on acceptable commercial terms, we expect the experience and connections of our PRC personnel in the industry will be able to secure licensing of these in greater China and Asia-Pacific region. If we cannot secure any such contractual arrangements, we will not be able to derive any significant revenues from these games.

#### *Licensing for Serica*

Publishing rights for the Simplified Chinese, Traditional Chinese and Korean versions of the game have been licensed to Beijing Kunlun World Wide Technology Share Co., Ltd., an enterprise organized under the laws of the PRC ( Kunlun ). On 19 March 2012, our subsidiary corporation in the PRC, Flying Cloud Information Technology Co. Ltd. ( Flying Cloud ) entered into a Technical Services agreement (the Technical Services Contract ) with Jurun Information Technology (Shanghai) Co. Ltd. ( Jurun ), in a transaction that is effectively a licensing of the Simplified Chinese version of the game. As the copyright ownership of online games that are to be distributed in the PRC is restricted to domestic PRC entities (that is, a natural person who is a citizen or corporations that are not foreign-invested), commercial distribution of any products that are the copyright of Flying Cloud, as a foreign-owned entity, would not be possible. Accordingly, the copyright, for the PRC only, for *Serica* is held in-trust for Flying Cloud by Jurun as a domestic PRC company. Jurun is incorporated in Pudong, Shanghai and its equity interest is owned by two PRC citizens, who hold the company in-trust for a British Virgin Islands ( BVI ) corporation, Evident Games Limited ( Evident ), through a series of contractual arrangements that make Jurun a Variable Interest Entity ( VIE ) of Evident. Evident is in turn 52% owned and controlled by Lim Clarke.

An exclusive, global license to publish the Simplified Chinese version of the game has been granted by Jurun to Kunlun for a term of 5 years from date of the commencement of commercial operations. The terms of the Technical Services Contract between Jurun and Flying Cloud mirror the terms of Jurun's licensing agreement with Kunlun, and provide for Flying Cloud to receive the full economic benefit of the licensing of the Simplified Chinese version of the game. Under the terms of the contract for development work that was undertaken on the game, 20% of the income derived from the game by Surna is due to YouQu Interactive (Beijing) Technology Co. Ltd., a company controlled by Yeah YE, a consultant to Flying Cloud. *Serica* completed two beta-tests in March and May 2012.

*Game engines*

The 2.5D ARPG games (except *Serica*) use our *Tempest* game and client engines. Game engines are a core software component for online games running on the web server, and provide the main processing functions for the computation and display of on-screen action. Our *Tempest* game engine is written in the C++ programming language and its features include load balancing, module message distribution, attributes server, particle effects and real-time data backup. The client engine features centralized management and monitoring, map editors, dynamic map loading and rendering and custom attributes. *Serica* utilizes an engine we refer to as *Tempest A (MudRV)* that was developed by YouQu, and for which we have been granted a license for its use in the game. An updated *Tempest 2* engine is in development which will include support for new block-inclined isometric geometry and extra effects editors.

## Target Markets

We plan to develop further games and social communities for children, pre-teens and teens, female players and young-adults over the next two years. These will include online and mobile games and we intend, whenever possible, to work with the producers of animated TV-series and movies in the PRC on licensing and product tie-ins. At present we have limited financial resources and this may restrict or render ineffective the marketing and advertising program that we will need to undertake, which may materially effect our operations. Our primary target for online gaming customers are children and young adults, female game players, students and office workers. As game developers we intend to reach the end-user through the licensing of our products to independent publishers, however we may at some point choose to supplement there efforts with online advertising, including display ads, paid search ads, and social media marketing campaigns.

## Factors affecting results of our operations in China

The majority of our operations are carried out in the PRC and the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environments, and by the general state of the PRC's economy and of the online games industry there. For example, we benefit from the overall economic growth in China in the past several years, which has resulted in increases in disposable income and discretionary consumer spending; the increasing use of the Internet; the growing popularity of online games in comparison with other forms of entertainment; and favorable demographic trends. Our results of operations may be adversely affected by an economic slowdown in China and other countries and regions where our games are operated, or the arrival of additional competition in the markets where we operate. They may be adversely affected by changes in governmental policies with respect to laws and regulations, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation, among other things. Regulation imposed by the government of China and other countries on the online game industries may also have significant impact on our results of operations in the future.

Our operating results are more directly affected by company-specific factors including the following:

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- our cost of developing and marketing online games;
- .
- the speed at which we develop and launch new online games and related in-game items;
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- the popularity of our games and in-game items compared with those of our competitors;

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the amount of our licensing revenues inside of China; and

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the success of investments and merger and acquisition activities.

Our future growth will depend significantly upon our ability to continually and successfully develop and market additional online games that are attractive to players and to increase the monetization of our existing and future games in China.

## **Taxation**

### *Nevada*

Surna Inc. and Surna Networks, Inc. are each required to pay an annual fee to the Nevada Secretary of State of \$165.00. Nevada has no corporate income taxes. Although the majority of our operations are outside the United States, we may be subject to federal or other U.S. taxation in the future.

### *British Virgin Islands*

Surna Media is incorporated in the BVI. Under current laws, it is not subject to income or capital gains tax. In addition, payment of dividends to its shareholder, Surna Inc., is not subject to withholding tax.

*Hong Kong*

Our subsidiary in Hong Kong is subject to a profit tax at the rate of 16.5% on assessable profit determined under relevant Hong Kong tax regulations.

According to the *Mainland and Hong Kong Special Administrative Region Arrangement on the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, or the Tax Agreement, dividends paid by a foreign-invested enterprise in mainland China to its corporate shareholder in Hong Kong will be subject to withholding tax at a maximum rate of 5.0%, provided however that such Hong Kong company directly owns at least 25.0% of the equity interest in the mainland foreign-invested enterprise. However, under the new *Enterprise Income Tax Law* ( EIT ) and its implementation rules, as well as *Circular No. 601* issued by SAT in October 2009 (or Circular 601), dividends from our PRC subsidiary paid to us through Surna HK may be subject to withholding tax at a rate of 10.0% if Surna HK is not considered to be the beneficial owner of the dividends distributed by a resident enterprise of the PRC.

Surna HK currently holds all the equity interest in our PRC operating company Flying Cloud. To the extent that Surna HK is considered a non-resident enterprise of the PRC under the Tax Agreement, dividends paid by Flying Cloud may be subject to a maximum withholding tax rate of 10.0%. Dividends paid by Surna HK to its shareholder will not be subject to any Hong Kong withholding tax.

*China - PRC Enterprise Income Tax*

Prior to January 1, 2008, companies established in China were generally subject to state and local EIT at statutory rates of 30% and 3% respectively. On March 16, 2007, the National People's Congress of China enacted a new regulation, the PRC *Enterprise Income Tax Law*, which took effect beginning January 1, 2008. On December 6, 2007, the State Council also adopted the *Implementing Rules for the Enterprise Income Tax Law*, or the Implementing Rules, which also took effect beginning January 1, 2008. Under the PRC EIT Law, foreign invested enterprises (or FIEs ), and Chinese domestic companies are subject to EIT at a uniform rate of 25%. On February 22, 2008, the Ministry of Finance and the State Administration of Taxation, or the SAT, promulgated the *Notice on Several Preferential Policies in Respect of Enterprise Income Tax* (or Notice No. 1 2008 ), reiterating the policy that a software enterprise newly established within China may, upon determination, be exempted from income taxes for its first two profit-making years and shall be subject to the income tax at half the standard rate for the next three years.

Qualification as a software enterprise is however subject to an annual assessment by the relevant government authorities in China. We may be classified as a resident enterprise for PRC enterprise income tax purposes, which could result in our global income becoming subject to 25% PRC enterprise income tax. Under the PRC EIT Law and the Implementing Rules, dividends generated from the business of our PRC subsidiary and payable to us may be

subject to a withholding tax rate of 10% if we are considered a non-resident enterprise incorporated outside of the PRC unless there is an applicable tax treaty with China that provides for a different withholding arrangement and we are deemed to be entitled to such favorable treatment. If we were to be classified as a resident enterprise for PRC enterprise income tax purposes, this would result in our global income becoming subject to 25% PRC enterprise income tax.

## **Foreign currency and foreign currency translation**

Foreign currency may have a major impact on our financial results. The functional currency of the Company is the United States Dollars ( USD ). The functional currency of the Company's operating subsidiary, Surna HK, is the Hong Kong Dollar ( HKD ). The functional currency of the Surna HK's operating subsidiary in PRC, Flying Cloud, is the Renminbi ( RMB ), the PRC's currency. Monetary assets and liabilities denominated in currencies other than the functional currency are translated into the functional currency at rates of exchange prevailing at the balance sheet dates. Transactions denominated in currencies other than the functional currency are translated into the functional currency at the exchange rates prevailing at the dates of the transaction. Exchange gains or losses arising from foreign currency transactions are included in the determination of net income (loss) for the respective periods.

For financial reporting purposes, the consolidated financial statements of the Company are translated into the Company's reporting currency, United States Dollars ( USD ). Balance sheet accounts are translated using the closing exchange rate in effect at the balance sheet date and income and expense accounts are translated using the average exchange rate prevailing during the reporting period.

Adjustments resulting from the translation, if any, are included in accumulated other comprehensive income (loss) in stockholders' equity.

### **Six Months Ended June 30, 2012 and June 30, 2011**

Our revenues from Continuing Operation for the six-month period ended June 30, 2012 were \$47,831 which was from our online games. The net loss from continuing operations for the six-month period ended June 30, 2012 was \$394,630 of which includes \$297,595 for Salaries, \$29,272 for Product development cost and \$115,594 for general and administration expense. We earned no revenue for the six-month period ended June 30, 2011. We had a loss from operation for the six-month period ended June 30, 2011 of \$1,127,446 of which includes \$193,448 for Salaries, \$769,231 for Compensation expenses, \$76,453 for Product development costs and \$88,314 for general and administration expenses. The decrease in net loss for 2012 compared with the same period in 2011 was due to a decrease in Compensation expenses.

### **Three Months Ended June 30, 2012 and June 30, 2011**

We earned no revenue for the three-month period ended June 30, 2012 and 2011. The net loss from continuing operations for the three-month period ended June 30, 2012 was \$232,711 of which includes \$154,264 for Salaries, \$11,839 for Product development cost and \$66,608 for general and administration expense. We had a loss from



operation for the three-month period ended June 30, 2011 of \$1,035,771 of which includes \$130,448 for Salaries, \$769,231 for Compensation expenses, \$76,453 for Product development costs and \$59,639 for general and administration expenses. The decrease in net loss for 2012 compared with the same period in 2011 was due to a decrease in Compensation expenses.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

We are a smaller reporting company as defined by Rule 12b-2 of the Exchange Act and are not required to provide the information under this item.

#### **ITEM 4. CONTROLS AND PROCEDURES.**

Under the supervision and with the participation of our management, including the Principal Executive Officer and Principal Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as required by Exchange Act Rule 13a-15(b) as of the end of the period covered by this report. Based on that evaluation, the Principal Executive Officer and Principal Financial Officer have concluded that these disclosure controls and procedures are not effective because of the identification of material weaknesses in our internal control over financial reporting which are identified below, which we view as an integral part of our disclosure controls and procedures.

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The Company lacks proper segregation of duties. We believe that the lack of proper segregation of duties is due to our limited resources.

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The Company does not have a comprehensive and formalized accounting and procedures manual.

Our management does not expect that our disclosure controls and internal controls will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by individual acts or collusion between two or more people, or by management or board override of the control.

The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.



**PART II - OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS.**

We are not presently a party to any litigation.

**ITEM 1A. RISK FACTORS.**

We are a smaller reporting company as defined by Rule 12b-2 of the Securities Exchange Act of 1934 and are not required to provide the information under this item..

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

None.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES.**

None.

**ITEM 4. MINE SAFETY DISCLOSURES.**

None.

**ITEM 5. OTHER INFORMATION.**

None.

**ITEM 6. EXHIBITS.**

Incorporated by reference to the Exhibit index attached hereto.

**SIGNATURES**

Pursuant to the requirements of the Securities Act of 1933, the registrant certifies that it has reasonable grounds to believe that it meets all of the requirements for filing of this Form 10-Q and has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on this 14<sup>th</sup> day of August, 2012.

**SURNA INC.**

(the Registrant )

BY: /s/ Richard Clarke

Richard Clarke

President (Principal Executive Officer), Secretary and a member of the Board of Directors

BY: /s/ Walter Lee

Walter Hon-Chiu Lee

Chief Financial Officer (Principal Financial Officer, Principal Accounting Officer), Treasurer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following person on behalf of the Registrant and in the capacities.

Signature	Title	Date
<u>/s/ Richard Clarke</u> Richard Clarke	President (Principal Executive Officer), Secretary and a member of the Board of Directors	August 14, 2012
<u>/s/ Cherry Lim</u> Cherry Ping-Wai Lim	Member of the Board of Directors	August 14, 2012



**EXHIBIT INDEX**

Exhibit	Document Description	Incorporated by reference			Filed herein
		Form	Date	Number	
3.1	Articles of Incorporation	S-1	1/28/10	3.1	
3.2	Bylaws	S-1	1/28/10	3.2	
3.3	Amended Articles of Incorporation	8K	6/16/11	3.3	
4.1	Specimen Stock Certificate	S-1	1/28/10	4.1	
10.1	Asset purchase agreement with Kopere Limited	8-K	4/28/11	10.1	
10.2	Debt conversion agreement with Kopere Limited	8-K	6/23/11	10.1	
10.3	Share exchange agreement for Surna Media Inc.	8-K	11/8/11	10.1	
10.4	Technical Services Agreement with Jurun Information Technology (Shanghai) Co. Ltd.	10-Q	5/21/12	10.4	
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.				X
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.				X
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.				X
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.				X



