

SURREY BANCORP
Form 10-Q
November 12, 2010
Table of Contents

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

FORM 10-Q

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

for the quarterly period ended September 30, 2010

.. **TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT OF 1934**

For the transition period from _____ to _____

COMMISSION FILE NO. 000-50313

SURREY BANCORP

(Exact name of registrant as specified in its charter)

Edgar Filing: SURREY BANCORP - Form 10-Q

North Carolina
(State or other jurisdiction of

59-3772016
(IRS Employer

incorporation or organization)

Identification No.)

145 North Renfro Street, Mount Airy, NC 27030

(Address of principal executive offices)

(336) 783-3900

(Registrant's telephone number)

Check whether the registrant: (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 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 for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by checkmark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition 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

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

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practical date:

On November 8, 2010 there were 3,206,495 common shares issued and outstanding.

Table of Contents

PART I FINANCIAL INFORMATION

Item 1.	Consolidated Financial Statements	
	<u>Consolidated Balance Sheets September 30, 2010 (Unaudited) and December 31, 2009</u>	3
	<u>Consolidated Statements of Income, Nine Months Ended September 30, 2010 and 2009 (Unaudited)</u>	4
	<u>Consolidated Statements of Income, Three Months Ended September 30, 2010 and 2009 (Unaudited)</u>	5
	<u>Consolidated Statements of Cash Flows, Nine Months Ended September 30, 2010 and 2009 (Unaudited)</u>	6
	<u>Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income Nine Months Ended September 30, 2010 and 2009 (Unaudited)</u>	7
	<u>Notes to Consolidated Financial Statements</u>	8-17
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	18-25
Item 3.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	26
Item 4.	<u>Controls and Procedures</u>	27

PART II OTHER INFORMATION

Item 1.	<u>Legal Proceedings</u>	28
Item 1A.	<u>Risk Factors</u>	28
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	28
Item 3.	<u>Defaults Upon Senior Securities</u>	28
Item 4.	<u>(Removed and Reserved)</u>	28
Item 5.	<u>Other Information</u>	28
Item 6.	<u>Exhibits</u>	28

<u>SIGNATURES</u>	29
--------------------------	----

<u>CERTIFICATIONS</u>	30-32
------------------------------	-------

Table of Contents**Consolidated Balance Sheets***September 30, 2010 (Unaudited) and December 31, 2009 (Audited)*

	September 2010	December 2009
Assets		
Cash and due from banks	\$ 2,290,447	\$ 1,923,621
Interest-bearing deposits with banks	28,592,753	19,067,374
Federal funds sold	454,070	412,947
Investment securities available for sale	1,999,447	2,011,925
Restricted equity securities	976,129	1,047,514
Loans, net of allowance for loan losses of \$5,782,869 at September 30, 2010 and \$4,669,905 at December 31, 2009	173,197,531	180,442,154
Property and equipment, net	4,795,803	4,881,770
Foreclosed assets	296,335	53,336
Accrued income	978,377	1,032,989
Goodwill	120,000	120,000
Bank owned life insurance	3,256,671	3,173,307
Other assets	3,986,426	2,782,845
Total assets	\$ 220,943,989	\$ 216,949,782
Liabilities and Stockholders Equity		
Liabilities		
Deposits:		
Noninterest-bearing	\$ 33,393,016	\$ 24,709,970
Interest-bearing	146,380,287	149,264,588
Total deposits	179,773,303	173,974,558
Short-term debt		3,750,000
Long-term debt	9,450,000	9,200,000
Dividends payable	43,998	44,603
Accrued interest payable	286,726	291,111
Other liabilities	1,994,494	1,264,158
Total liabilities	191,548,521	188,524,430
Commitments and contingencies		
Stockholders equity		
Preferred stock, 1,000,000 shares authorized, 189,356 shares of Series A, issued and outstanding with no par value, 4.5% convertible non-cumulative, perpetual, with a liquidation value of \$14 per share;	2,620,325	2,620,325
2,000 shares of Series B, issued and outstanding with no par value, fixed rate (5%) cumulative perpetual, with a liquidation value of \$1,000 per share, net of accreted discount;	1,929,227	1,903,283
100 shares of Series C, issued and outstanding with no par value, fixed rate (9%) cumulative perpetual, with a liquidation value of \$1,000 per share, net of amortized premium	101,014	103,222

Edgar Filing: SURREY BANCORP - Form 10-Q

Common stock, 10,000,000 shares authorized at no par value; 3,206,495 and 3,198,105 shares issued and outstanding at September 30, 2010 and December 31, 2009, respectively	9,462,653	9,406,429
Retained earnings	15,360,330	14,468,089
Accumulated other comprehensive loss	(78,081)	(75,996)
Total stockholders' equity	29,395,468	28,425,352
Total liabilities and stockholders' equity	\$ 220,943,989	\$ 216,949,782

See Notes to Consolidated Financial Statements

Table of Contents**Consolidated Statements of Income***Nine months ended September 30, 2010 and 2009 (Unaudited)*

	2010	2009
Interest income		
Loans and fees on loans	\$ 8,277,716	\$ 7,988,196
Federal funds sold	594	399
Investment securities, taxable	37,655	54,657
Deposits with banks	20,053	17,587
Total interest income	8,336,018	8,060,839
Interest expense		
Deposits	1,557,497	2,188,643
Federal funds purchased and securities sold under agreements to repurchase		400
Short-term debt	17,720	19,799
Long-term debt	298,394	314,529
Total interest expense	1,873,611	2,523,371
Net interest income	6,462,407	5,537,468
Provision for loan losses	1,840,578	1,014,997
Net interest income after provision for loan losses	4,621,829	4,522,471
Noninterest income		
Service charges on deposit accounts	800,693	851,639
Gain on sale of government guaranteed loans	244,924	
Fees and yield spread premiums on loans delivered to correspondents	91,511	116,960
Other service charges and fees	335,456	285,484
Other operating income	529,071	483,573
Life insurance proceeds		1,000,000
Total noninterest income	2,001,655	2,737,656
Noninterest expense		
Salaries and employee benefits	2,563,874	2,502,541
Occupancy expense	313,507	323,719
Equipment expense	192,050	210,399
Data processing	306,287	283,534
Foreclosed assets, net	23,644	59,667
FDIC insurance premiums	184,271	220,310
Other expense	1,326,747	1,307,604
Total noninterest expense	4,910,380	4,907,774

Edgar Filing: SURREY BANCORP - Form 10-Q

Net income before income taxes	1,713,104	2,352,353
Income tax expense	626,756	422,983
Net income	1,086,348	1,929,370
<i>Preferred stock dividends and accretion of discount</i>	(194,107)	(191,889)
Net income available to common stockholders	\$ 892,241	\$ 1,737,481
<i>Basic earnings per common share</i>	\$ 0.28	\$ 0.54
<i>Diluted earnings per common share</i>	\$ 0.27	\$ 0.51
<i>Basic weighted average common shares outstanding</i>	3,206,341	3,191,040
<i>Diluted weighted average common shares outstanding</i>	3,603,784	3,592,752

See Notes to Consolidated Financial Statements

Table of Contents**Consolidated Statements of Income***Three months ended September 30, 2010 and 2009 (Unaudited)*

	2010	2009
Interest income		
Loans and fees on loans	\$ 2,738,272	\$ 2,733,829
Federal funds sold	190	128
Investment securities, taxable	11,992	16,988
Deposits with banks	8,342	5,225
Total interest income	2,758,796	2,756,170
Interest expense		
Deposits	515,211	658,619
Short-term debt		6,200
Long-term debt	94,931	100,832
Total interest expense	610,142	765,651
Net interest income	2,148,654	1,990,519
Provision for loan losses	636,736	261,001
Net interest income after provision for loan losses	1,511,918	1,729,518
Noninterest income		
Service charges on deposit accounts	268,216	311,605
Fees and yield spread premiums on loans delivered to correspondents	41,774	28,090
Other service charges and fees	112,407	98,657
Other operating income	159,609	152,731
Total noninterest income	582,006	591,083
Noninterest expense		
Salaries and employee benefits	840,474	791,648
Occupancy expense	116,277	101,399
Equipment expense	55,667	67,204
Data processing	109,513	93,484
Foreclosed assets, net	7,962	14,758
FDIC insurance premiums	65,990	48,604
Other expense	420,642	410,908
Total noninterest expense	1,616,525	1,528,005
Net income before income taxes	477,399	792,596

Edgar Filing: SURREY BANCORP - Form 10-Q

Income tax expense	171,600	265,045
Net income	305,799	527,551
<i>Preferred stock dividends and accretion of discount</i>	(65,294)	(64,898)
Net income available to common stockholders	\$ 240,505	\$ 462,653
<i>Basic earnings per common share</i>	\$ 0.08	\$ 0.14
<i>Diluted earnings per common share</i>	\$ 0.08	\$ 0.14
<i>Basic weighted average common shares outstanding</i>	3,206,495	3,196,581
<i>Diluted weighted average common shares outstanding</i>	3,601,643	3,602,199
<i>See Notes to Consolidated Financial Statements</i>		

Table of Contents**Consolidated Statements of Cash Flows***Nine months ended September 30, 2010 and 2009 (Unaudited)*

	2010	2009
<i>Cash flows from operating activities</i>		
Net income	\$ 1,086,348	\$ 1,929,370
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	194,072	207,736
Gain on the sale of property and equipment	(400)	(320)
Loss on the sale of foreclosed assets	10,695	30,041
Stock-based compensation, net of tax benefit	21,774	22,526
Provision for loan losses	1,840,578	1,014,997
Deferred income taxes	13,738	(70,020)
Accretion of discount on securities, net of amortization of premiums	1,958	7,843
Increase in cash surrender value of life insurance	(83,364)	(82,793)
Changes in assets and liabilities:		
Accrued income	54,612	99,463
Other assets	(1,216,011)	(573,210)
Accrued interest payable	(4,385)	(168,695)
Other liabilities	730,336	614,415
Net cash provided by operating activities	2,649,951	3,031,353
<i>Cash flows from investing activities</i>		
Net increase in interest-bearing deposits with banks	(9,525,379)	(4,630,007)
Net increase in federal funds sold	(41,123)	(113,000)
Purchases of investment securities	(2,000,000)	(1,499,663)
Maturities of investment securities	2,007,127	2,011,390
Redemption of restricted equity securities	71,385	
Net (increase) decrease in loans	5,082,011	(4,896,453)
Proceeds from the sale of foreclosed assets	68,340	172,936
Proceeds from the sale of property and equipment	400	320
Purchases of property and equipment	(108,105)	(94,358)
Net cash (used in) investing activities	(4,445,344)	(9,048,835)
<i>Cash flows from financing activities</i>		
Net increase in deposits	5,798,745	5,332,077
Net decrease in federal funds purchased and securities sold under agreements to repurchase		(2,144,186)
Net increase (decrease) in short-term debt	(3,750,000)	3,010,000
Increase (decrease) in long-term debt	250,000	(1,500,000)
Dividends paid	(170,976)	(154,543)
Common stock options exercised	34,450	82,322
Proceeds from the issuance of preferred stock, net		1,975,015
Tax benefit related to exercise of non-incentive stock options		19,903
Net cash provided by financing activities	2,162,219	6,620,588

Edgar Filing: SURREY BANCORP - Form 10-Q

Net increase in cash and cash equivalents	366,826	603,106
<i>Cash and cash equivalents, beginning</i>	1,923,621	1,293,770
<i>Cash and cash equivalents, ending</i>	\$ 2,290,447	\$ 1,896,876
 <i>Supplemental disclosures of cash flow information</i>		
Interest paid	\$ 1,877,996	\$ 2,692,066
Taxes paid	\$ 1,246,897	\$ 625,655
Loans transferred to foreclosed properties	\$ 322,034	\$ 233,905

See Notes to Consolidated Financial Statements

Table of Contents**Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income***Nine months ended September 30, 2010 and 2009 (Unaudited)*

	Convertible Preferred Stock Series A		Preferred Stock Series B		Preferred Stock Series C		Common Stock		Retained Earnings	Unrealized Appreciation (Depreciation) on	
	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount		Securities	Total
Balance, January 1, 2009	189,356	\$ 2,620,325		\$		\$	3,167,568	\$ 9,270,253	\$ 12,493,763	\$ (1,338)	\$ 24,383,003
Comprehensive income											
Net income									1,929,370		1,929,370
Net change in unrealized gain on investment securities available for sale, net of income tax of \$8,431										(13,439)	(13,439)
Total comprehensive income											1,915,931
Common stock options exercised							29,013	82,322			82,322
Tax benefit related to exercise of non-qualified stock options								19,903			19,903
Stock-based compensation, net of tax benefit								22,526			15,017
Issue Series B preferred stock to the U.S. Treasury, net of issuance costs			2,000	1,975,015							1,975,015
Issue Series C preferred stock to the U.S. Treasury				(106,000)	100	106,000					
									(89,226)		(59,157)

Edgar Filing: SURREY BANCORP - Form 10-Q

Dividends declared on convertible Series A preferred stock (\$.47 per share)												
Dividends declared and accrued on Series B and Series C preferred stock, net of discount accretion and (premium) amortization				25,362		(2,027)				(102,663)		(52,381)
Balance, September 30, 2009	189,356	\$ 2,620,325	2,000	\$ 1,894,377	100	\$ 103,973	3,196,581	\$ 9,395,004	\$ 14,231,244	\$ (14,777)		\$ 28,230,146
Balance, January 1, 2010	189,356	\$ 2,620,325	2,000	\$ 1,903,283	100	\$ 103,222	3,198,105	\$ 9,406,429	\$ 14,468,089	\$ (75,996)		\$ 28,425,352
Comprehensive income												
Net income									1,086,348			1,086,348
Net change in unrealized gain on investment securities available for sale, net of income tax of \$1,308										(2,085)		(2,085)
Total comprehensive income												1,084,263
Common stock options exercised							8,390	34,450				34,450
Stock-based compensation, net of tax benefit								21,774				21,774
Dividends declared on convertible Series A preferred stock (\$.47 per share)										(89,226)		(89,226)
Dividends declared and accrued on Series B and Series C preferred stock, net of discount accretion and				25,944		(2,208)				(104,881)		(81,145)

(premium)
amortization

Balance, September 30, 2010	189,356	\$ 2,620,325	2,000	\$ 1,929,227	100	\$ 101,014	3,206,495	\$ 9,462,653	\$ 15,360,330	\$ (78,081)	\$ 29,395,468
--	---------	--------------	-------	--------------	-----	------------	-----------	--------------	---------------	-------------	---------------

See Notes to Consolidated Financial Statements

Table of Contents

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and therefore, do not include all disclosures required by generally accepted accounting principles for a complete presentation of financial statements. In the opinion of management, the consolidated financial statements contain all adjustments necessary to present fairly the financial condition of Surrey Bancorp, (the Company), as of September 30, 2010, the results of operations for the nine and three months ended September 30, 2010 and 2009, and its changes in stockholders' equity and comprehensive income and cash flows for the nine months ended September 30, 2010 and 2009. All adjustments are of a normal and recurring nature. The results of operations for the nine months ended September 30, 2010, are not necessarily indicative of the results expected for the full year. These consolidated financial statements should be read in conjunction with the Company's audited financial statements and related disclosures for the year ended December 31, 2009, included in the Company's Form 10-K. The balance sheet at December 31, 2009, has been taken from the audited financial statements at that date.

Organization

Surrey Bancorp (the Company) began operation on May 1, 2003 and was created for the purpose of acquiring all the outstanding shares of common stock of Surrey Bank & Trust. Stockholders of the bank received six shares of Surrey Bancorp common stock for every five shares of Surrey Bank & Trust common stock owned. The Company is subject to regulation by the Federal Reserve.

Surrey Bank & Trust (the Bank) was organized and incorporated under the laws of the State of North Carolina on July 15, 1996 and commenced operations on July 22, 1996. The Bank currently serves Surry County, North Carolina and Patrick County, Virginia and surrounding areas through five banking offices. As a state chartered bank, which is not a member of the Federal Reserve, the Bank is subject to regulation by the State of North Carolina Banking Commission and the Federal Deposit Insurance Corporation.

Surrey Investment Services, Inc., (Subsidiary) was organized and incorporated under the laws of the State of North Carolina on February 10, 1998. The subsidiary provides insurance services through SB&T Insurance and investment advice and brokerage services through U-VEST.

On July 31, 2000, Surrey Bank & Trust formed Freedom Finance, LLC, a subsidiary operation specializing in the purchase of sales finance contracts from local automobile dealers.

The accounting and reporting policies of the Company, the Bank, and its subsidiaries follow generally accepted accounting principles and general practices within the financial services industry. Following is a summary of the more significant policies.

Critical Accounting Policies

The notes to the audited consolidated financial statements for the year ended December 31, 2009 contain a summary of the significant accounting policies. The Company believes our policies with respect to the methodology for the determination of the allowance for loan losses, and asset impairment judgments, including the recoverability of intangible assets involve a higher degree of complexity and require management to make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could cause reported results to differ materially. These critical policies and their application are periodically reviewed with the Audit Committee and our Board of Directors. See our Annual Report for full details on critical accounting policies.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company, the Bank and the subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

Table of Contents

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Business Segments

The Company reports its activities in two business segments. In determining the appropriateness of segment definition, the Company considers the materiality of potential business segments and components of the business about which financial information is available and regularly evaluated relative to resource allocation and performance assessment.

Presentation of Cash Flows

For purposes of reporting cash flows, cash and cash equivalents includes cash and amounts due from depository institutions (including cash items in process of collection). Overnight interest bearing deposits and federal funds sold are shown separately. Federal funds purchased are shown with securities sold under agreements to repurchase.

Investment Securities

Investments classified as available for sale are intended to be held for indefinite periods of time and include those securities that management may employ as part of asset/liability strategy or that may be sold in response to changes in interest rates, prepayments, regulatory capital requirements or similar factors. These securities are carried at fair value and are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments or significant other observable inputs.

Investment securities classified as held to maturity are those debt securities that the Bank has the ability and intent to hold to maturity. Accordingly, these securities are carried at cost adjusted for amortization of premiums and accretion of discount, computed by the interest-method over their contractual lives. At September 30, 2010 and December 31, 2009, the Bank had no investments classified as held to maturity.

Loans Held for Sale

The Bank originates and holds Small Business Administration (SBA) and United States Department of Agriculture (USDA) guaranteed loans in its portfolio in the normal course of business. Occasionally, the Bank sells the guaranteed portions of these loans into the secondary market. The loans are generally variable rate loans, which eliminates the interest rate risk resulting in cost approximating market value. The Bank carries the loans at the lower of cost or market. The Bank recognizes gains on the sale of the guaranteed portion upon the consummation of the transaction. The Bank plans to continue to originate guaranteed loans for sales, however no such loans were funded at September 30, 2010 and December 31, 2009.

Loans Receivable

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding principal amount adjusted for any charge-offs, the allowance for loan losses, and any deferred fees or cost on originated loans and unamortized premiums or discounts on purchased loans.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs. The Bank makes continuous credit reviews of the loan portfolio and considers economic conditions, historical loan loss experience, review of specific problem loans and other factors in determining the adequacy of the allowance balance.

Table of Contents**SURREY BANCORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****NOTE 1. BASIS OF PRESENTATION, CONTINUED*****Loans Receivable, continued***

Activity in the allowance for loan losses for the nine months ended September 30, 2010 and 2009 follows:

	September 30,	
	2010	2009
Balance at beginning of year	\$ 4,669,905	\$ 3,365,370
Add provision charged to expense	1,840,578	1,014,997
Less net charge-offs	(727,614)	(278,497)
	\$ 5,782,869	\$ 4,101,870

Interest on all loans is accrued daily on the outstanding balance. Accrual of interest is discontinued on a loan when management believes, after considering collection efforts and other factors, the borrower's financial condition is such that collection of interest is doubtful.

Recent Accounting Pronouncements

The following is a summary of recent authoritative pronouncements:

In July 2010, the Receivables topic of the ASC was amended to require expanded disclosures related to a company's allowance for credit losses and the credit quality of its financing receivables. The amendments will require the allowance disclosures to be provided on a disaggregated basis. The Company is required to begin to comply with the disclosures in its financial statements for the year ended December 31, 2010.

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which significantly changes the regulation of financial institutions and the financial services industry. The Dodd-Frank Act includes several provisions that will affect how community banks, thrifts, and small bank and thrift holding companies will be regulated in the future. Among other things, these provisions abolish the Office of Thrift Supervision and transfer its functions to the other federal banking agencies, relax rules regarding interstate branching, allow financial institutions to pay interest on business checking accounts, change the scope of federal deposit insurance coverage, and impose new capital requirements on bank and thrift holding companies. The Dodd-Frank Act also establishes the Bureau of Consumer Financial Protection as an independent entity within the Federal Reserve, which will be given the authority to promulgate consumer protection regulations applicable to all entities offering consumer financial services or products, including banks. Additionally, the Dodd-Frank Act includes a series of provisions covering mortgage loan origination standards affecting originator compensation, minimum repayment standards, and pre-payments. Management is actively reviewing the provisions of the Dodd-Frank Act and assessing its probable impact on our business, financial condition, and results of operations.

In August 2010, two updates were issued to amend various SEC rules and schedules pursuant to Release No. 33-9026: Technical Amendments to Rules, Forms, Schedules and Codification of Financial Reporting Policies and based on the issuance of SEC Staff Accounting Bulletin 112. The amendments related primarily to business combinations and removed references to minority interest and added references to controlling and noncontrolling interests(s). The updates were effective upon issuance but had no impact on the Company's financial statements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

Subsequent Events

In accordance with accounting guidance, the Company evaluated events and transactions for potential recognition or disclosure in these financial statements through the date the financial statements were issued.

Table of Contents**SURREY BANCORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****NOTE 2. SECURITIES**

Debt and equity securities have been classified in the balance sheets according to management's intent. The carrying amounts of securities available for sale and their approximate fair values at September 30, 2010 and December 31, 2009 follow:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
September 30, 2010				
Government-sponsored enterprises	\$ 1,500,000	\$ 5,315	\$	\$ 1,505,315
Mortgage-backed securities	76,512	1,870		78,382
Corporate bonds	550,000		134,250	415,750
	\$ 2,126,512	\$ 7,185	\$ 134,250	\$ 1,999,447
December 31, 2009				
Government-sponsored enterprises	\$ 1,501,913	\$ 3,687	\$ 145	\$ 1,505,455
Mortgage-backed securities	83,684	2,036		85,720
Corporate bonds	550,000		129,250	420,750
	\$ 2,135,597	\$ 5,723	\$ 129,395	\$ 2,011,925

Maturities of mortgage-backed securities are stated based on contractual maturities. Actual maturities of these securities may vary as the underlying mortgages are prepaid. The scheduled maturities of securities (all available for sale) at September 30, 2010, were as follows:

	Amortized Cost	Fair Value
Due in one year or less	\$	\$
Due after one year through five years	1,500,000	1,505,315
Due after five years through ten years	610,596	477,726
Due after ten years	15,916	16,406
	\$ 2,126,512	\$ 1,999,447

The following table shows investments' gross unrealized losses and fair value, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, at September 30, 2010 and December 31, 2009. These unrealized losses on investment securities are a result of volatility in interest rates and primarily relate to government-sponsored enterprises and corporate bonds issued by other banks at September 30, 2010 and December 31, 2009.

Less Than 12 Months	12 Months or More	Total
---------------------	-------------------	-------

Edgar Filing: SURREY BANCORP - Form 10-Q

	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2010						
Government-sponsored enterprises	\$	\$	\$	\$	\$	\$
Corporate bonds			415,750	134,250	415,750	134,250
	\$	\$	\$ 415,750	\$ 134,250	\$ 415,750	\$ 134,250
December 31, 2009						
Government-sponsored enterprises	\$ 499,855	\$ 145	\$	\$	\$ 499,855	\$ 145
Corporate bonds			420,750	129,250	420,750	129,250
	\$ 499,855	\$ 145	\$ 420,750	\$ 129,250	\$ 920,605	\$ 129,395

Management considers the nature of the investment, the underlying causes of the decline in market value, the severity and duration of the decline in market value and other evidence, on a security by security basis, in determining if the decline in market value is other than temporary. Management believes all unrealized losses presented in the table above to be temporary in nature.

The Company had no gross realized gains or losses related to securities transactions for the nine and three month periods ended September 30, 2010 and 2009.

Table of Contents

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. EARNINGS PER SHARE

Basic earnings per share for the nine and three months ended September 30, 2010 and 2009 were calculated by dividing net income available to common stockholders by the weighted average number of shares outstanding during the period.

The computation of diluted earnings per share is similar to the computation of basic earnings per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if dilutive potential common shares had been issued. The numerator is adjusted for any changes in income or loss that would result from the assumed conversion of those potential common shares. The potential dilutive shares are represented by common stock options and by the Series A convertible preferred stock each share of which is convertible into 2.0868 shares of common stock.

NOTE 4. COMMITMENTS AND LETTERS OF CREDIT

At September 30, 2010, the Company had commitments to extend credit, including unused lines of credit of approximately \$35,031,000. Letters of credit totaling \$1,452,916 were outstanding.

NOTE 5. FAIR VALUE

The Company utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available for sale, trading securities and derivatives, if present, are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record at fair value other assets on a nonrecurring basis, such as loans held for sale, loans held for investment and certain other assets. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

Fair Value Hierarchy

Under the Fair Value Measurements and Disclosures Topic of FASB ASC, the Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1 Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level 2 Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3 Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

Table of Contents

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5. FAIR VALUE, CONTINUED

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

Investment Securities Available for Sale

Investment securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with the Receivables Topic of FASB ASC. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At September 30, 2010, substantially all of the total impaired loans were evaluated based on the fair value of the collateral. In accordance with the Fair Value and Measurement Topic of the FASB ASC, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3.

Foreclosed Assets

Foreclosed assets are adjusted to fair value upon transfer of the loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value or fair value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3.

Table of Contents**SURREY BANCORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****NOTE 5. FAIR VALUE, CONTINUED***Assets and Liabilities Recorded at Fair Value on a Recurring Basis*

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis.

<i>(in thousands)</i>				
September 30, 2010	Total	Level 1	Level 2	Level 3
Government-sponsored enterprises	\$ 1,505	\$	\$ 1,505	\$
Mortgage-backed securities	78		78	
Corporate bonds	416		416	
Total assets at fair value	\$ 1,999	\$	\$ 1,999	\$
Total liabilities at fair value	\$	\$	\$	\$

<i>(in thousands)</i>				
December 31, 2009	Total	Level 1	Level 2	Level 3
Government-sponsored enterprises	\$ 1,505	\$	\$ 1,505	\$
Mortgage-backed securities	86		86	
Corporate bonds	421		421	
Total assets at fair value	\$ 2,012	\$	\$ 2,012	\$
Total liabilities at fair value	\$	\$	\$	\$

The Company had no Level 3 assets or liabilities measured at fair value on a recurring basis at September 30, 2010 or December 31, 2009.

Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

The Company may be required, from time to time, to measure certain assets or liabilities at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These include assets and liabilities that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. Assets and liabilities measured at fair value on a nonrecurring basis are included in the table below.

<i>(in thousands)</i>				
September 30, 2010	Total	Level 1	Level 2	Level 3
Loans-commercial and industrial	\$ 2,667	\$	\$ 2,667	\$

Edgar Filing: SURREY BANCORP - Form 10-Q

Loans-nonfarm, non-residential	219		219	
Loans- 1- 4 family residential	213		213	
Loans-other	26		26	
Foreclosed assets	296		296	
Total assets at fair value	\$ 3,421	\$	\$ 3,421	\$
Total liabilities at fair value	\$	\$	\$	\$

(in thousands)

December 31, 2009	Total	Level 1	Level 2	Level 3
Loans-commercial and industrial	\$ 2,790	\$	\$ 2,790	\$
Loans-nonfarm, non-residential	652		652	
Loans-other	393		393	
Foreclosed assets	53		53	
Total assets at fair value	\$ 3,888	\$	\$ 3,888	\$
Total liabilities at fair value	\$	\$	\$	\$

The Company had no Level 3 assets or liabilities measured at fair value on a nonrecurring basis at September 30, 2010 or December 31, 2009.

Table of Contents

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5. FAIR VALUE, CONTINUED

Financial Instruments

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Cash and due from banks: The carrying amounts reported in the balance sheet for cash and due from banks approximate their fair values.

Interest-bearing deposits with banks: Fair values for time deposits are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated contractual maturities on such time deposits.

Federal funds sold: Due to the short-term nature of these assets, the carrying value approximates fair value.

Securities: Fair values for securities, excluding restricted equity securities, are based on quoted market prices, where available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions.

Restricted equity securities: The carrying values of restricted equity securities approximate fair values.

Loans: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying amounts. The fair values for other loans are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Loan fair value estimates include judgments regarding future expected loss experience and risk characteristics. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. The carrying amount of accrued interest receivable approximates its fair value.

Bank owned life insurance: The carrying amount reported in the balance sheet approximates the fair value as it represents the cash surrender value of the life insurance.

Deposit liabilities: The fair values disclosed for demand and savings deposits are, by definition, equal to the amount payable on demand at the reporting date. The fair values for certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated contractual maturities on such time deposits. The carrying amount of accrued interest payable approximates fair value.

Short-term debt: The carrying amount of short-term debt approximates their fair values.

Long-term debt: The fair value of long-term debt is estimated using a discounted cash flow calculation that applies interest rates currently available on similar instruments.

Commitments and contingencies: The carrying amount of commitments and contingencies approximate their fair values.

Table of Contents**SURREY BANCORP****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****NOTE 5. FAIR VALUE, CONTINUED***Financial Instruments, continued*

The estimated fair values of the Company's financial instruments are as follows (dollars in thousands):

	September 30, 2010		December 31, 2009	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets				
Cash and due from banks	\$ 2,290	\$ 2,290	\$ 1,924	\$ 1,924
Federal funds sold and interest-bearing deposits with banks	29,047	29,047	19,480	19,480
Securities, available for sale	1,999	1,999	2,012	2,012
Restricted equity securities	976	976	1,048	1,048
Loans, net of allowance	173,197	168,856	180,442	180,354
Bank owned life insurance	3,257	3,257	3,173	3,173
Financial Liabilities				
Deposits	179,774	173,890	173,975	163,638
Long-term and short-term debt	9,450	9,891	12,950	12,953
Commitments and contingencies				

NOTE 6. SEGMENT REPORTING

The Company has two reportable segments, the Bank and Freedom Finance, LLC. The Bank provides mortgage, consumer and commercial loans. Freedom Finance, LLC specializes in the purchase of sales finance contracts from local automobile dealers. Information about reportable segments, and reconciliation of such information to the consolidated financial statements as of and for the nine months ended September 30, 2010 and 2009 is as follows:

	Bank	Freedom Finance, LLC	Intersegment Elimination	Consolidated Totals
September 30, 2010				
Net interest income	\$ 6,321,174	\$ 141,233	\$	\$ 6,462,407
Other income	2,001,389	266		2,001,655
Depreciation and amortization	193,378	694		194,072
Provision for loan losses	1,826,755	13,823		1,840,578
Net income	1,102,213	(15,865)		1,086,348
Assets	221,426,551	1,240,454	(1,723,016)	220,943,989
September 30, 2009				
Net interest income	\$ 5,300,400	\$ 237,068	\$	\$ 5,537,468
Other income	1,736,801	1,000,855		2,737,656
Depreciation and amortization	206,546	1,190		207,736
Provision for loan losses	905,788	109,209		1,014,997

Edgar Filing: SURREY BANCORP - Form 10-Q

Net income	983,682	945,688		1,929,370
Assets	214,504,719	2,412,613	(3,734,552)	213,182,780

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company's reportable segments are strategic business units that offer different products and services. They are managed separately because each segment appeals to different markets and, accordingly, requires different technology and marketing strategies.

Table of Contents

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6. SEGMENT REPORTING, CONTINUED

The Company derives a majority of its revenue from interest income and relies primarily on net interest income to assess the performance of the segments and make decisions about resources to be allocated to the segment. Therefore, the segments are reported using net interest income for the period ended September 30, 2010. The Company does allocate income taxes to the segments. Other income represents noninterest income which is also allocated to the segments. The Company includes the holding company and an insurance and investment agency in its Bank segment above. The Company does not have any single external customer from which it derives 10 percent or more of its revenues and operations in any one geographical area.

NOTE 7. STOCKHOLDERS' EQUITY

On January 9, 2009, the Company issued and sold to the US Department of the Treasury 2,000 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series B, with a liquidation preference of \$1,000 per share and a warrant to purchase 100,001 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series C, with a liquidation preference of \$1,000 per share, at an initial exercise price of \$0.01 per share. The Warrant was immediately exercised. The Series B Preferred Stock pays cumulative dividends at a rate of 5% per annum for the first five years, and 9% per annum thereafter. The Series C Warrant Preferred Stock pays a cumulative dividend of 9%, per annum. Net proceeds from the issuance, after legal fees, amounted to \$1,975,015. Net accretion of discounts over amortization of premiums on the Series B and C Preferred Stock amounted to \$23,736 for the nine months ended September 30, 2010, bringing the total Series B and C Preferred Stock investment to \$2,030,241. Dividends accrued on the Series B and C Preferred Stock at September 30, 2010 totaled \$13,928, which is included in dividends payable with accrued dividends on the Series A Preferred Stock.

On April 28, 2010, the shareholders of the Company approved increasing the number of common shares authorized from 5,000,000 to 10,000,000 and on June 9, 2010, the Articles of Incorporation were amended to reflect this.

Table of Contents

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

Introduction

This discussion, analysis and related financial information are presented to explain the significant factors which affected Surrey Bancorp's financial condition and results of operations for the nine and three months ending September 30, 2010 and 2009. This discussion should be read in conjunction with the financial statements and related notes contained within this report.

Surrey Bancorp (Company) is a North Carolina corporation, located in Mount Airy, North Carolina. The Company was incorporated on February 6, 2003, and began business on May 1, 2003.

Surrey Bank & Trust (Bank) is a North Carolina state chartered bank, located in Mount Airy, North Carolina. The Bank was chartered on July 15, 1996, and began operations on July 22, 1996. The Bank has two operating subsidiaries: Surrey Investment Services, Inc. and Freedom Finance, LLC.

Effective March 5, 1998, the Bank became a member of the Federal Home Loan Bank.

Highlights

Certain information contained in this discussion may include 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, as amended. These forward-looking statements are generally identified by phrases such as the Company expects, the Company believes or words of similar import. Such forward-looking statements involve known and unknown risks including, but not limited to, changes in general economic and business conditions, interest rate fluctuations, competition within and from outside the banking industry, new products and services in the banking industry, risk inherent in making loans such as repayment risks and fluctuating collateral values, problems with technology utilized by the Company, changing trends in customer profiles and changes in laws and regulations applicable to the Company. Although the Company believes that its expectations with respect to the forward-looking statements are based upon reliable assumptions within the bounds of its knowledge of its business and operations, there can be no assurance that actual results, performance or achievements of the Company will not differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements.

Net income available for common stockholders for the three months ended September 30, 2010, was \$240,505 or \$0.08 per diluted share outstanding, compared to a \$462,653 or \$0.14 per diluted share outstanding, for the same period in 2009. Earnings for the three months ended September 30, 2010, are approximately 48% lower than for the same period in 2009. The decrease primarily results from an increase in the provision for loan losses. The provision for loan losses increased from \$261,001 in the third quarter of 2009 to \$636,736 in the third quarter of 2010. The increase in the loan loss provision results from continued weakness in the economy that necessitated an increase in reserves associated with impaired loans. Net interest income increased 7.9% from \$1,990,519 in the third quarter of 2009 to \$2,148,654 in 2010. The lower cost of funds in the third quarter of 2010, compared to 2009 was largely responsible for the margin increase. The cost of funds decreased from 1.69% in the third quarter of 2009 to 1.31% in the third quarter of 2010. Asset yields decreased from 5.45% to 5.28% from 2009 to 2010. However, this decrease was offset by growth in average earning assets. Noninterest income decreased 1.5% in 2010 primarily due to a decrease in revenue from service charges on deposit accounts. Noninterest expenses increased 5.8% from \$1,528,005 in the third quarter of 2009, to \$1,616,525 in 2010. The increase is associated with increases in salaries and employee benefits, data processing cost and FDIC insurance premiums. These cost increases are attributable to growth.

Net income available for common stockholders for the nine months ended September 30, 2010, was \$892,241 or \$0.27 per diluted share outstanding compared to \$1,737,481 or \$0.51 per diluted share outstanding for the same period in 2009. This represents a 48.6% decrease in earnings from the first nine months of 2009 to the same period in 2010. This decrease is attributable to earnings from Freedom Finance, LLC, the Bank's sales finance subsidiary, which recorded tax-exempt life insurance proceeds of \$1,000,000 in the first quarter of 2009. The proceeds were on the life of a former partner of the subsidiary. Excluding the life insurance proceeds, noninterest income increased from \$1,737,656 during the nine month period ended September 30, 2009 to \$2,001,655 or 15.2% in 2010. The increase is primarily due to gains of \$244,924 on the sale of a government guaranteed loan. No such sales were made in 2009.

Table of Contents

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, CONTINUED

Net interest income increased 16.7% from \$5,537,468 in the first nine months of 2009 to \$6,462,407 in 2010.

This increase is due to an improvement in the net interest margin driven by a continuing downward repricing of deposits during 2010. The provision for loan losses increased from \$1,014,997 for the nine month period ended September 30, 2009 to \$1,840,578 in 2010. The significant increase in the reserve was due to the weakening economy and its effects on credit quality and collateral values. This necessitated an increase in reserves associated with impaired loans. Reserves on impaired loans increased from approximately \$2,132,000 at December 31, 2009 to \$3,381,000 at September 30, 2010. The tax-exempt life insurance proceeds reduced the effective income tax rate for the nine months ended September 30, 2009, to 17.98%. The effective income tax rate for the nine months ended September 30, 2010 was 36.59%. Income tax expense increased 48.2% over the 2009 total.

On September 30, 2010, Surrey Bancorp's assets totaled \$220,943,989 compared to \$216,949,782 on December 31, 2009. Net loans were \$173,197,531 compared to \$180,442,154 on December 31, 2009. This decrease was primarily attributable to the sale of the guaranteed portion of a government guaranteed loan amounting to approximately \$4,500,000 and a net increase in the loan loss reserve of approximately \$1,113,000. Loan balances decreased slightly for the nine months ended September 30, 2010, as loan demand decreased.

Total deposits on September 30, 2010, were \$179,773,303 compared to \$173,974,558 at the end of 2009. This increase is primarily attributable to increases in demand deposits and savings deposits, which include money market accounts. Demand deposits increased 20.36% from 2009 totals, while savings deposits increased 11.71%. Certificates of deposit decreased 6.12% from December 31, 2009 totals.

Common stockholders' equity increased by \$946,380 or 3.98% during the nine months ended September 30, 2010. The increase is comprised of net income of \$1,086,348, proceeds from exercised stock options of \$34,450 and other stock based compensation of \$21,774. Decreases included adjustments to Accumulated Other Comprehensive Income of \$2,085 and the payment and accrual of preferred dividends \$194,107. The net increase resulted in a common stock book value of \$7.72 per share, up from \$7.44 on December 31, 2009. The book value per common share is calculated by taking total stockholders' equity, subtracting all preferred equity, and then dividing by the total number of common shares outstanding at the end of the reporting period.

Preferred stockholders' equity increased \$23,736 during the period ended September 30, 2010, as detailed in Note 7 to the financial statements. Combined preferred and common stockholders' equity increased \$970,116, or 3.41% for the nine months ended September 30, 2010.

Financial Condition, Liquidity and Capital Resources

Investments

The Bank maintains a portfolio of securities as part of its asset/liability and liquidity management programs which emphasize effective yields and maturities to match its needs. The composition of the investment portfolio is examined periodically and appropriate realignments are initiated to meet liquidity and interest rate sensitivity needs for the Bank.

Available for sale securities are reported at fair value and consist of bonds, notes, debentures, and certain equity securities not classified as trading securities or as held to maturity securities.

Unrealized holding gains and losses, net of tax, on available for sale securities are reported as a net amount in a separate component of stockholders' equity. Realized gains and losses on the sale of available for sale securities are determined using the specific-identification method. Premiums and discounts are recognized in interest income using the interest method over the period to maturity or to call dates.

Declines in the fair value of individual held to maturity and available for sale securities below cost that are other than temporary are reflected as write-downs of the individual securities to fair value. Related write-downs are included in earnings as realized losses.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, CONTINUED**

Investments in available for sale securities of \$1,999,447 consisted of U.S. Governmental Agency obligations with maturities ranging from 21 to 23 months, corporate bonds with maturities of 7.75 years to 8.0 years, that reprice quarterly, and GNMA adjustable rate mortgage securities, which adjust annually.

Loans

Net loans outstanding on September 30, 2010, were \$173,197,531 compared to \$180,442,154 on December 31, 2009. The Bank maintains a loan portfolio dominated by real estate and commercial loans diversified among various industries. Approximately 71.4% of the Bank's loans as of September 30, 2010, are fixed rate loans with 28.6% floating with the Bank's prime rate or other appropriate internal or external indices.

Deposits

Deposits on September 30, 2010, were \$179,773,303, compared to \$173,974,558 on December 31, 2009. The September total comes from a base of approximately 12,421 accounts compared to 12,176 accounts at December 31, 2009. Interest-bearing accounts represented 81.4% of September 30, 2010 period end deposits versus 85.8% at December 31, 2009.

Short-term Debt

Short-term debt at September 30, 2010 and December 31, 2009 is as follows:

	September 30, 2010	December 31, 2009
Federal Home Loan Bank advances	\$	\$ 3,750,000
Payable under secured borrowing		
	\$	\$ 3,750,000

During the quarter ended June 30, 2010, amounts payable under secured borrowings of \$1,131,300, which represented proceeds from a transaction involving a loan guaranteed by the SBA, were recorded as a sale. The initial transaction met all the criteria to receive sales treatment under ASC 860 except for the lapse of the 90-day warranty period for prepayments. Upon the expiration of the warranty period in June 2010, the transaction was recorded as an asset sale with the securing loan and secured borrowing being removed from the balance sheet and the gain recorded in the income statement. No such transactions occurred during the quarter ended September 30, 2010.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, CONTINUED****Stockholders' Equity**

Surrey Bancorp and Surrey Bank & Trust are subject to various regulatory capital requirements administered by federal banking agencies. The Company and the Bank maintain strong capital positions which exceed all capital adequacy requirements of federal regulatory authorities. The Company's and the Bank's capital ratios are presented in the following table.

	Ratio	Minimum Required For Capital Adequacy Purposes
<i>September 30, 2010:</i>		
Total Capital		
(to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	17.86%	8.0%
Surrey Bank & Trust	17.08%	8.0%
Tier I Capital		
(to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	16.60%	4.0%
Surrey Bank & Trust	15.81%	4.0%
Tier I Capital		
(to Average Assets)		
Surrey Bancorp (Consolidated)	12.69%	4.0%
Surrey Bank & Trust	12.07%	4.0%
<i>December 31, 2009:</i>		
Total Capital		
(to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	17.00%	8.0%
Surrey Bank & Trust	16.12%	8.0%
Tier I Capital		
(to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	15.73%	4.0%
Surrey Bank & Trust	14.86%	4.0%
Tier I Capital		
(to Average Assets)		
Surrey Bancorp (Consolidated)	12.50%	4.0%
Surrey Bank & Trust	11.80%	4.0%

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, CONTINUED****Asset Quality**

The Company actively monitors delinquencies, nonperforming assets and potential problem loans. Unsecured loans that are past due more than 90 days are placed into nonaccrual status. Secured loans reach nonaccrual status when they surpass 120 days past due. When facts and circumstances indicate the borrower has regained the ability to meet the required payments, the loan is returned to accrual status.

Management reviews all criticized loans on a periodic basis for possible charge offs. Any unsecured loans that are 90 plus days past due must be charged off in full. If secured, a reserve equal to the potential loss will be established. Any charge off must be reported to the Board of Directors within 30 days. On a monthly basis, a management report will be provided to the Board of Directors of recovery actions.

The chart below shows the amount of non-performing assets.

Non-Performing Assets to Total Assets:

	September 30, 2010	December 31, 2009
Nonaccrual loans	\$ 4,442,628	\$ 983,043
Loans past due 90 days and still accruing	253,057	2,825
Foreclosed assets	296,335	53,336
Total	\$ 4,992,020	\$ 1,039,204
Total assets	\$ 220,943,989	\$ 216,949,782

Ratio of non-performing assets to total assets	2.26%	0.48%
--	-------	-------

At September 30, 2010, the Bank had loans totaling \$4,442,628 in nonaccrual status. Foreclosed assets at September 30, 2010 primarily include commercial and residential real estate and undeveloped land. Loans that were considered impaired but were still accruing interest at September 30, 2010, including troubled debt restructurings, totaled \$7,155,560. A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due to the contractual terms of the loan agreement. Specific reserves on nonaccrual and impaired loans totaled \$3,380,614 at quarter end, or 29.7% of the balances outstanding. Government loan guarantees associated with these loans amounted to \$4,022,205 at September 30, 2010. Combined specific reserves and guarantees amount to 65.1% of nonaccrual and impaired loans at September 30, 2010.

Impaired loans (including troubled debt restructures) still accruing and nonaccrual loans are summarized below:

	September 30, 2010	December 31, 2009
Construction and development	\$ 56,363	\$ 144,255
1-4 family residential	1,190,083	612,516
Nonfarm, nonresidential	2,618,806	781,797
Commercial and industrial	7,492,271	5,192,563
Consumer	16,330	50,924
Other loans	4,336	1,060
Total impaired and nonaccrual	\$ 11,378,189	\$ 6,783,115

Edgar Filing: SURREY BANCORP - Form 10-Q

Total troubled debt restructures amounted to \$3,784,024 and \$384,584 at September 30, 2010 and December 31, 2009, respectively. These troubled debt restructures are primarily nonfarm, nonresidential loans and commercial and industrial loans.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, CONTINUED**

The loan portfolio is dominated by real estate and commercial loans. The general composition of the loan portfolio is as follows:

	September 30, 2010		December 31, 2009	
Construction and development	\$ 5,790,613	3.24%	\$ 8,044,967	4.35%
1-4 family residential	47,054,360	26.30%	46,355,854	25.05%
Multi-family	1,898,331	1.06%	2,005,142	1.08%
Farmland	2,632,991	1.47%	2,458,748	1.33%
Nonfarm, non-residential	47,351,314	26.47%	51,527,856	27.84%
Total real estate	104,727,609	58.54%	110,392,567	59.65%
Commercial and industrial	67,199,483	37.56%	67,428,438	36.44%
Consumer	6,977,325	3.90%	7,085,464	3.83%
Other loans	6,891	%	155,653	0.08%
Total loans	\$ 178,911,308	100.00%	\$ 185,062,122	100.00%

The concentrations represented above do not, based on management's assessment, expose the Bank to any unusual concentration risk. Based on the Bank's size, the only concentration that is above area peer group analysis is commercial and industrial loans. Management recognizes the inherent risk associated with commercial lending, including whether a borrower's actual results of operations will correspond to those projected by the borrower when the loan was funded; economic factors, such as the number of housing starts and increases in interest rates, etc.; depression of collateral values; and completion of projects within the original cost and time estimates. The Bank mitigates some of that risk by actively seeking government guarantees on these loans. Collectively, the Bank has approximately \$41,876,000 in loans that carry government guarantees. The guaranteed portion of these loans amounts to \$32,931,000 at September 30, 2010. Loan guarantees by loan class are below:

	September 30, 2010	Guaranteed Portion Amount	Percentage
Construction and development	\$ 5,790,613	\$	0.00%
1-4 family residential	47,054,360	1,103,808	2.35%
Multi-family	1,898,331	36,551	1.93%
Farmland	2,632,991	596,137	22.64%
Nonfarm, non-residential	47,351,314	14,263,011	30.12%
Total real estate	104,727,609	15,999,507	15.28%
Commercial and industrial	67,199,483	16,931,514	25.20%
Consumer	6,977,325		0.00%
Other loans	6,891		0.00%
Total loans	\$ 178,911,308	\$ 32,931,021	18.41%

Loans in higher risk categories, such as non-owner occupied nonfarm, non-residential property and commercial real estate construction represent a small segment of our loan portfolio. Commercial construction loans included in construction and development loans amounted to \$2,145,100 at September 30, 2010. Non-owner occupied nonfarm, non-residential properties included in nonfarm, non-residential loans above amounted to \$12,389,052 at September 30, 2010.

Table of Contents**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, CONTINUED**

The consolidated provision for loan losses charged to operations was \$1,840,578 in the first nine months of 2010 compared to \$1,014,997 for the same period in 2009. The provision attributable to the Bank increased from \$905,788 in 2009 to \$1,826,755 in 2010. This increase is primarily attributable to increases in reserves on impaired loans. The increased reserves on impaired loans primarily resulted from the deterioration of the debtors' collateral bases on specific loans during the first nine months of 2010. These collateral bases include inventory and accounts receivable, among other operating assets. Reserves for nonaccrual and impaired loans at September 30, 2010 amounted to \$3,380,614, compared to \$2,132,474 at December 31, 2009. The provision attributable to Freedom Finance, LLC decreased from \$109,209 in 2009 to \$13,823 for the nine months ended September 30, 2010. The decrease in the Freedom Finance, LLC provision was due to a decreasing loan base. Loan balances in the finance subsidiary decreased from \$1,063,311 at December 31, 2009 to \$801,546 at the end of September 2010. The notes to the consolidated financial statements contained within this report provide details of the activity in the allowance for loan losses.

The reserve for loan losses at September 30, 2010 was \$5,782,869 or 3.23% of period end loans. This percentage is derived from total loans. Approximately \$41,876,000 of the total loans outstanding at September 30, 2010 are government guaranteed loans for which the Bank's exposure typically ranges from 10% to 49% of the outstanding balance. When the guaranteed portions of the loans are removed from the equation, the loan loss reserve is approximately 3.95% of outstanding loans.

The level of reserve is established based upon management's evaluation of historical loss data and the effects of certain economic environmental factors on the loan portfolio. The historical loss portion of the reserve is computed using the average loss data from the past three years applied to its corresponding category of loans. However, historical losses only reflect a small portion of the Bank's loan loss reserve. The environmental factors represent risk from external economic influences on the credit quality of the loan portfolio. These factors include the movement of interest rates, unemployment rates, past due and charge off trends, loan grading migrations, movement in collateral values and the Bank's exposure to certain loan concentrations. Positive or negative movements in any of these factors have an effect on the credit quality of the loan portfolio. As a result, management continues to actively monitor the Bank's asset quality affected by these environmental factors. The following table is a summary of loans past due at September 30, 2010 and December 31, 2009.

	September 30, 2010		December 31, 2009	
	30-89 Days	90 Days Plus	30-89 Days	90 Days Plus
Construction and development	\$	\$	\$ 257,318	\$
1-4 family residential	1,051,448	207,341	580,428	
Nonfarm, non-residential	503,497		353,239	
Commercial and industrial	1,037,808	45,109	429,361	
Consumer	61,823	607	106,873	2,825
Other loans			7,243	
	\$ 2,654,576	\$ 253,057	\$ 1,734,462	\$ 2,825
Percentage total loans	1.48%	0.14%	0.94%	0.00%

Past due loans are reviewed weekly and collection efforts assessed to determine potential problems arising in the loan portfolio. Proactive monitoring of past due accounts allows management to anticipate trends within the portfolio and make appropriate adjustments to collection efforts and to the allowance for loan losses. Collectively, past dues increased from December 31, 2009 to September 30, 2010. The largest increases were in 1-4 family loans and commercial and industrial loans. The increases reflect the current economic conditions. Overall, past dues increased approximately 67.0% from the end of 2009 to September 30, 2010.

Management believes that its loan portfolio is diversified so that a downturn in a particular market or industry will not have a significant impact on the loan portfolio or the Bank's financial condition. Management believes that its provision and reserve offer an adequate allowance for loan losses and provide an appropriate reserve for the loan portfolio.

Edgar Filing: SURREY BANCORP - Form 10-Q

The Bank lends primarily in Surry County, North Carolina and Patrick Country, Virginia and surrounding counties.

Table of Contents

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, CONTINUED

Interest Rate Sensitivity and Liquidity

One of the principal duties of the Bank's Asset/Liability Committee is management of interest rate risk. The Bank utilizes quarterly asset/liability reports prepared by a regional correspondent bank to project the impact on net interest income that might occur with hypothetical interest rate changes. The committee monitors and manages asset and liability strategies and pricing.

Another function of the Asset/Liability Committee is maintaining adequate liquidity and planning for future liquidity needs. Having adequate liquidity means the ability to meet current funding needs, including deposit withdrawals and commitments, in an orderly manner without sacrificing earnings. The Bank funds its investing activities, including making loans and purchasing investments, by attracting deposits and utilizing short-term borrowings when necessary.

At September 30, 2010, the liquidity position of the Company was good, in management's opinion with short-term liquid assets of \$31,337,270. Deposit increases and proceeds from the sale of government guaranteed loans primarily accounted for the net increase in liquidity from December 31, 2009 totals. To provide supplemental liquidity, the Bank has seven unsecured lines of credit with correspondent banks totaling \$24,500,000. At September 30, 2010, there were no advances against these lines. Additionally, the Bank has a secured borrowing arrangement with the Federal Home Loan Bank (FHLB). The maximum credit available under this agreement approximates \$16,239,000 of which \$9,450,000 of advances had been taken down at September 30, 2010.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK
Not Applicable as a Smaller Reporting Company.

Table of Contents

ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by the report, an evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures pursuant to Exchange Act Rule 13a-15e. Based on the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the design and operation of these disclosure controls and procedures were effective. There have not been any changes in the Company's internal control over financial reporting that occurred during the Company's last quarter that has materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

Table of Contents

PART II - OTHER INFORMATION

Item 1. Legal Proceedings
None

Item 1A. Risk Factors
Not Applicable as a Smaller Reporting Company.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds
None

Item 3. Defaults Upon Senior Securities
Not Applicable

Item 4. (Removed and Reserved)

Item 5. Other Information
None

Item 6. Exhibits

- 3.1 Articles of Incorporation of Surrey Bancorp (as amended)
- 31.1 Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes Oxley Act
- 31.2 Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act
- 32.1 Certification of PEO/PFO Pursuant to Section 906 of the Sarbanes Oxley Act

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized officers.

Surrey Bancorp

Date: November 12, 2010

/s/ Edward C. Ashby, III
Edward C. Ashby, III
President and Chief Executive Officer
(Principal Executive Officer)

Date: November 12, 2010

/s/ Mark H. Towe
Mark H. Towe
Sr. Vice President and Chief Financial Officer
(Principal Financial Officer)