

SURREY BANCORP  
Form 10QSB  
November 12, 2004  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-QSB**

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

For the quarterly period ended September 30, 2004

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

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

COMMISSION FILE NUMBER 0000-50313

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**SURREY BANCORP**

(Exact name of small business issuer as specified in its charter)

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North Carolina  
(State or other jurisdiction of

59-3772016  
(IRS Employer

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incorporation or organization)

Identification No.)

**145 North Renfro Street, Mount Airy NC 27030**

(Address of principal executive offices)

**(336) 783-3900**

(Issuer's telephone number)

**Not Applicable**

(Former name, former address and former fiscal year, if changed since last report)

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

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

On November 5, 2004, there were 1,199,690 common shares issued and outstanding

Transitional Small Business Disclosure Format (Check one): Yes  No

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| Consolidated Balance Sheets<br>September 30, 2004 and December 31, 2003   | Unaudited             | Audited               |
|---|-----------------------|-----------------------|
|   | September             | December              |
|   | 2004                  | 2003                  |
| <b>Assets</b>   |                       |                       |
| Cash and due from banks   | \$ 2,206,120          | \$ 1,956,473          |
| Interest-bearing deposits with banks  | 17,130,265            | 4,068,017             |
| Federal funds sold  | 400,000               |                       |
| Investment securities available for sale  | 3,220,845             | 5,425,973             |
| Federal Home Loan Bank stock, at cost   | 512,500               | 445,000               |
| Loans, net of allowance of loan losses of \$2,196,447 in 2004 and \$2,109,820 in 2003   | 128,426,132           | 117,362,619           |
| Property and equipment, net   | 4,273,486             | 4,281,770             |
| Accrued income  | 656,043               | 585,608               |
| Goodwill, net of amortization   | 120,000               | 120,000               |
| Other assets  | 1,547,080             | 831,545               |
|   | <u>\$ 158,492,471</u> | <u>\$ 135,077,005</u> |
| <b>Liabilities and Shareholders Equity</b>  |                       |                       |
| <i>Liabilities:</i>   |                       |                       |
| Deposits:   |                       |                       |
| Noninterest-bearing   | \$ 19,510,710         | \$ 16,159,584         |
| Interest-bearing  | 112,342,739           | 95,118,292            |
| Total deposits  | <u>131,853,449</u>    | <u>111,277,876</u>    |
| Federal funds purchased and securities sold under agreements to repurchase  | 897,924               | 3,418,635             |
| Short-term debt   |                       | 1,400,000             |
| Long-term debt  | 9,799,934             | 5,246,080             |
| Dividends payable on preferred stock  | 29,986                | 30,070                |
| Accrued interest payable  | 186,838               | 129,193               |
| Other liabilities   | 1,196,632             | 501,685               |
|   | <u>143,964,763</u>    | <u>122,003,539</u>    |
| Commitments and contingencies   |                       |                       |
| <i>Shareholders equity:</i>   |                       |                       |
| 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 liquidation value of \$14 per share in 2004 and 2003 | 2,620,325             | 2,620,325             |
| Common stock, no par value; 5,000,000 shares authorized; 1,199,182 shares issued in 2004, and 1,170,189 in 2003.  | 7,994,711             | 7,822,387             |
| Retained earnings   | 3,919,711             | 2,627,529             |
| Accumulated other comprehensive income (loss)   | (7,039)               | 3,225                 |
|   | <u>14,527,708</u>     | <u>13,073,466</u>     |
|   | <u>\$ 158,492,471</u> | <u>\$ 135,077,005</u> |

See Notes to Consolidated Financial Statements



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Consolidated Statements of Income Unaudited  
 Nine months ended September 30, 2004 and 2003

|  | Nine months ended |              |
|--|-------------------|--------------|
|  | September 30,     |              |
|  | 2004              | 2003         |
| <b>Interest income:</b>  |                   |              |
| Loans and fees on loans  | \$ 6,032,929      | \$ 5,319,080 |
| Federal funds sold   | 1,065             |              |
| Investment securities, taxable                                 | 61,095            | 63,141       |
| Investment securities, non taxable                             | 456               | 2,041        |
| Deposits with banks  | 78,872            | 23,580       |
|  | 6,174,417         | 5,407,842    |
| <b>Interest expense:</b>                                       |                   |              |
| Deposits   | 1,540,200         | 1,326,670    |
| Federal funds purchased  | 1,697             | 10,717       |
| Securities sold under agreements to repurchase                 | 2,059             | 2,983        |
| Short-term borrowings  | 5,291             | 13,502       |
| Long-term borrowings   | 194,452           | 129,131      |
|  | 1,743,699         | 1,483,003    |
| Net interest income  | 4,430,718         | 3,924,839    |
| <b>Provision for loan losses</b>                               | 208,662           | 181,262      |
| Net interest income after provision for loan losses            | 4,222,056         | 3,743,577    |
| <b>Noninterest income:</b>                                     |                   |              |
| Service charges on deposit accounts                            | 710,074           | 604,877      |
| Gain and fees from the sale of mortgage servicing rights       | 501,610           |              |
| Other service charges and fees                                 | 332,863           | 203,251      |
| Other operating income   | 325,863           | 856,970      |
| Lower of cost or market adjustment on loans available for sale |                   | (321,128)    |
|  | 1,870,410         | 1,343,970    |
| <b>Noninterest expense:</b>                                    |                   |              |
| Salaries and employee benefits                                 | 1,944,380         | 1,685,503    |
| Occupancy expense  | 273,443           | 201,593      |
| Equipment expense  | 303,533           | 300,912      |
| Data processing  | 273,162           | 212,583      |
| Other expense  | 1,044,026         | 978,579      |
|  | 3,838,544         | 3,379,170    |
| Net income before income taxes                                 | 2,253,922         | 1,708,377    |
| <b>Income tax expense</b>                                      | 872,450           | 660,200      |

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|   |                  |                  |
|---|------------------|------------------|
| Net income  | 1,381,472        | 1,048,177        |
| <i>Preferred stock dividend declared</i>                  | (89,290)         | (36,279)         |
| Net income available for common shareholders              | \$ 1,292,182     | \$ 1,011,898     |
| <b><i>Basic earnings per share</i></b>                    | <b>\$ 1.08</b>   | <b>\$ 0.88</b>   |
| <b><i>Diluted earnings per share</i></b>                  | <b>\$ 0.95</b>   | <b>\$ 0.80</b>   |
| <b><i>Basic weighted average shares outstanding</i></b>   | <b>1,191,759</b> | <b>1,152,932</b> |
| <b><i>Diluted weighted average shares outstanding</i></b> | <b>1,457,679</b> | <b>1,310,656</b> |

*See Notes to Consolidated Financial Statements*

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Consolidated Statements of Income  
Three months ended September 30, 2004 and 2003

Unaudited

|  | <b>Three months ended<br/>September 30,</b> |                  |
|--|---|------------------|
|  | <b>2004</b>                                 | <b>2003</b>      |
| <b>Interest income:</b>  |   |                  |
| Loans and fees on loans  | \$ 2,061,279                                | \$ 1,881,775     |
| Federal funds sold   | 1,065                                       |                  |
| Investment securities, taxable                                 | 19,562                                      | 20,504           |
| Investment securities, non taxable                             |   | 679              |
| Deposits with banks  | 49,609                                      | 3,897            |
|  | <u>2,131,515</u>                            | <u>1,906,855</u> |
| <b>Interest expense:</b>                                       |   |                  |
| Deposits   | 564,952                                     | 427,166          |
| Federal funds purchased  |   | 8,519            |
| Securities sold under agreements to repurchase                 | 764   | 767              |
| Short-term borrowings  |   | 4,014            |
| Long-term borrowings   | 81,521                                      | 35,073           |
|  | <u>647,237</u>                              | <u>475,539</u>   |
| Net interest income  | 1,484,278                                   | 1,431,316        |
| <b>Provision for loan losses</b>                               | 82,019                                      | (27,967)         |
| Net interest income after provision for loan losses            | <u>1,402,259</u>                            | <u>1,459,283</u> |
| <b>Noninterest income:</b>                                     |   |                  |
| Service charges on deposit accounts                            | 252,014                                     | 204,635          |
| Other service charges and fees                                 | 111,724                                     | 95,365           |
| Other operating income   | 108,007                                     | 231,146          |
| Lower of cost or market adjustment on loans available for sale |   | (321,128)        |
|  | <u>471,745</u>                              | <u>210,018</u>   |
| <b>Noninterest expense:</b>                                    |   |                  |
| Salaries and employee benefits                                 | 656,182                                     | 627,378          |
| Occupancy expense  | 103,363                                     | 81,010           |
| Equipment expense  | 71,096                                      | 111,787          |
| Data processing  | 93,528                                      | 87,684           |
| Other expense  | 413,494                                     | 343,376          |
|  | <u>1,337,663</u>                            | <u>1,251,235</u> |
| Net income before income taxes                                 | 536,341                                     | 418,066          |
| <b>Income tax expense</b>                                      | 208,250                                     | 161,550          |
| Net income   | <u>328,091</u>                              | <u>256,516</u>   |



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|  |            |            |
|--|------------|------------|
| <i>Preferred stock dividend declared</i>           | (29,986)   | (36,279)   |
| Net income available for common shareholders       | \$ 298,105 | \$ 220,237 |
| <i>Basic earnings per share</i>                    | \$ 0.25    | \$ 0.19    |
| <i>Diluted earnings per share</i>                  | \$ 0.22    | \$ 0.18    |
| <i>Basic weighted average shares outstanding</i>   | 1,197,795  | 1,153,826  |
| <i>Diluted weighted average shares outstanding</i> | 1,469,047  | 1,423,385  |

*See Notes to Consolidated Financial Statements*

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Consolidated Statements of Cash Flows  
 Nine months ended September 30, 2004 and 2003

Unaudited

|   | Nine months ended |              |
|---|-------------------|--------------|
|   | September 30,     |              |
|   | 2004              | 2003         |
| <b><i>Cash flows from operating activities:</i></b>   |                   |              |
| Net income  | \$ 1,381,472      | \$ 1,048,177 |
| Adjustments to reconcile net income to net cash provided (used) by operations:                    |                   |              |
| Depreciation and amortization   | 298,212           | 249,702      |
| Loss on the sale of fixed assets  | 518               |              |
| Provision for loan losses   | 208,662           | 181,262      |
| Accretion of discount on securities, net of amortization of premiums                              | (10,040)          | 17,241       |
| Changes in assets and liabilities:  |                   |              |
| Accrued income  | (70,435)          | (159,781)    |
| Loans held for sale   |                   | (11,201,492) |
| Other assets  | (709,094)         | (823,871)    |
| Accrued interest payable  | 57,645            | 10,552       |
| Other liabilities   | 694,947           | 91,670       |
| Net cash provided (used) by operating activities  | 1,851,887         | (10,586,540) |
| <b><i>Cash flows from investing activities:</i></b>   |                   |              |
| Net decrease (increase) in interest-bearing deposits with banks                                   | (13,062,248)      | 2,235,832    |
| Net increase in federal funds sold  | (400,000)         |              |
| Purchase of investment securities   | (3,991,315)       | (4,456,247)  |
| Sales and maturities of investment securities   | 6,189,778         | 4,598,380    |
| (Purchase) redemption of Federal Home Loan Bank stock   | (67,500)          | (60,000)     |
| Net increase in loans   | (11,272,175)      | (16,475,810) |
| Proceeds from the sale of fixed assets  | 700               |              |
| Purchases of property and equipment   | (291,146)         | (971,550)    |
| Net cash used in investing activities   | (22,893,906)      | (15,129,395) |
| <b><i>Cash flows from financing activities:</i></b>   |                   |              |
| Net increase in deposits  | 20,575,573        | 18,385,219   |
| Net decrease (increase) in fed funds purchased and securities sold under agreements to repurchase | (2,520,711)       | 6,573,756    |
| Net decrease in short-term debt   | (1,400,000)       | (100,000)    |
| Net (decrease) increase in long-term debt   | 4,553,854         | (1,770,662)  |
| Proceeds from the sale of preferred stock   |                   | 2,628,257    |
| Dividends paid on preferred stock   | (89,374)          |              |
| Common stock options exercised  | 172,324           | 57,900       |
| Fractional shares purchased   |                   | (12,051)     |
| Net cash provided by financing activities   | 21,291,666        | 25,762,419   |
| Net increase in cash and cash equivalents   | 249,647           | 46,484       |
| <b><i>Cash and cash equivalents, beginning</i></b>  | 1,956,473         | 1,409,407    |
| <b><i>Cash and cash equivalents, ending</i></b>   | \$ 2,206,120      | \$ 1,455,891 |

|  |              |              |
|--|--------------|--------------|
| <b><i>Supplemental disclosure of cash flow information:</i></b>                  |              |              |
| Interest paid  | \$ 1,686,054 | \$ 1,472,451 |
| Taxes paid   | \$ 766,522   | \$ 1,170,865 |
| <b><i>Supplemental disclosure of Non-cash transactions:</i></b>                  |              |              |
| Non-cash transactions related to acquisition of minority interest in subsidiary: |              |              |
| Cancellation of loan and interest receivable                                     | \$           | \$ 422,984   |
| Cancellation of loans receivable from recourse obligations                       |              | 243,850      |
| Addition to allowance for loan losses  |              | 57,852       |
| Total transaction  | \$           | \$ 724,686   |

*See Notes to Consolidated Financial Statements*

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Consolidated Statements of Changes in Shareholders' Equity  
 Nine months ended September 30, 2004 and 2003

Unaudited

|  | Convertible     |              |              |              |                            | Unrealized        |                              | Total         |
|--|-----------------|--------------|--------------|--------------|----------------------------|-------------------|------------------------------|---------------|
|  | Preferred Stock |              | Common Stock |              |                            | Appreciation      |                              |               |
|  | Shares          | Amount       | Shares       | Amount       | Additional Paid in Capital | Retained Earnings | on Securities (Depreciation) |               |
| Balance January 1, 2003  |                 | \$           | 958,376      | \$ 3,833,504 | \$ 3,879,760               | \$ 1,432,493      | \$ 18,629                    | \$ 9,164,386  |
| <b>Comprehensive income</b>  |                 |              |              |              |                            |                   |                              |               |
| Net income   |                 |              |              |              |                            | 1,048,177         |                              | 1,048,177     |
| Net change in unrealized appreciation on investment securities available for sale, net of income taxes of \$5,280        |                 |              |              |              |                            |                   | (8,417)                      | (8,417)       |
| Total comprehensive income   |                 |              |              |              |                            |                   |                              | 1,039,760     |
| <b>6 for 5 Common stock exchange pursuant to Plan of Reorganization and Share Exchange</b>                               |                 |              | 191,675      | 3,879,760    | (3,879,760)                |                   |                              |               |
| <b>Common stock issued</b>   |                 |              |              |              |                            |                   |                              |               |
| Common stock options exercised   |                 |              | 10,000       | 57,900       |                            |                   |                              | 57,900        |
| Fractional shares purchased  |                 |              | (790)        | (12,051)     |                            |                   |                              | (12,051)      |
| <b>Issuance of convertible preferred stock</b>   | 189,356         | 2,628,257    |              |              |                            |                   |                              | 2,628,257     |
| <b>Dividends declared on convertible preferred stock</b>   |                 |              |              |              |                            | (36,279)          |                              | (36,279)      |
| Balance, September 30, 2003  | 189,356         | \$ 2,628,257 | 1,159,261    | \$ 7,759,113 | \$                         | \$ 2,444,391      | \$ 10,212                    | \$ 12,841,973 |
| Balance January 1, 2004  | 189,356         | 2,620,325    | 1,170,189    | \$ 7,822,387 | \$                         | \$ 2,627,529      | \$ 3,225                     | \$ 13,073,466 |
| <b>Comprehensive income</b>  |                 |              |              |              |                            |                   |                              |               |
| Net income   |                 |              |              |              |                            | 1,381,472         |                              | 1,381,472     |
| Net change in unrealized appreciation on investment securities available for sale, net of income tax benefits of \$6,440 |                 |              |              |              |                            |                   | (10,264)                     | (10,264)      |
| Total comprehensive income   |                 |              |              |              |                            |                   |                              | 1,371,208     |
| <b>Common stock issued</b>   |                 |              |              |              |                            |                   |                              |               |
| Common stock options exercised   |                 |              | 28,993       | 172,324      |                            |                   |                              | 172,324       |
| <b>Dividends declared on convertible preferred stock</b>   |                 |              |              |              |                            | (89,290)          |                              | (89,290)      |

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|                             |         |              |           |              |    |              |            |               |
|-----------------------------|---------|--------------|-----------|--------------|----|--------------|------------|---------------|
| Balance, September 30, 2004 | 189,356 | \$ 2,620,325 | 1,199,182 | \$ 7,994,711 | \$ | \$ 3,919,711 | \$ (7,039) | \$ 14,527,708 |
|-----------------------------|---------|--------------|-----------|--------------|----|--------------|------------|---------------|

*See Notes to Consolidated Financial Statements*

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**SURREY BANCORP**

**NOTES TO FINANCIAL STATEMENTS**

**NOTE 1. BASIS OF PRESENTATION**

The accompanying unaudited financial statements were prepared in accordance with instructions for Form 10-QSB 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 financial statements contain all adjustments necessary to present fairly the financial condition of Surrey Bancorp as of September 30, 2004 and December 31, 2003, the results of operations for the nine and three months ended September 30, 2004 and 2003, and its changes in stockholders' equity and cash flows for the nine months ended September 30, 2004 and 2003. The results of operations for the nine months ended September 30, 2004 are not necessarily indicative of the results expected for the full year. These financial statements should be read in conjunction with the Company's audited financial statements and related disclosures for the year ended December 31, 2003 included in the Company's Form 10-KSB.

**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. Shareholders of the bank received six shares of Surrey Bancorp common stock for every five shares of Surrey Bank & Trust common stock owned.

Surrey Bank & Trust (the Bank) was organized and incorporated under the laws of the State of North Carolina on July 15 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 Friendly Finance, LLC., a subsidiary operation specializing in the purchase of sales finance contracts from local automobile dealers. The Bank originally had a 60% majority interest in the company. On March 1, 2003 the Bank acquired the minority interest in Friendly Finance, LLC in exchange for the satisfaction of other commitments of the holder of the minority interest.

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

**PRINCIPLES OF CONSOLIDATION**

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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.

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### **PRESENTATION OF CASH FLOWS**

For purposes of reporting cash flows, cash and due from banks 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. Cash flows from demand deposits, NOW accounts and savings accounts are reported net since their original maturities are less than three months. Loans and time deposits are reported net per FASB Statement No. 104. Federal Funds purchased are shown separately.

### **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.

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, 2004 and December 31, 2003, the Bank had no investments classified as held to maturity.

### **Loans Held for Sale**

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated market value in the aggregate. Net unrealized losses are recognized through a valuation allowance by charges to income. At September 30, 2004 and December 31, 2003, the Bank had no loans classified as available for sale.

### **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.





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Activity in the allowance for loan losses for the nine months ended September 30, 2004 and 2003 follows:

|  | September 30,       |                     |
|--|---------------------|---------------------|
|  | 2004                | 2003                |
| Balance at beginning of year                                     | \$ 2,109,820        | \$ 1,831,167        |
| Add provision charged to expense                                 | 208,662             | 181,262             |
| Less net charge-offs   | (122,035)           | (64,269)            |
| Allowance applicable to the acquisition of the minority interest |                     | 57,852              |
|  | <u>\$ 2,196,447</u> | <u>\$ 2,006,012</u> |

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, that the borrower's financial condition is such that collection of interest is doubtful.

**Stock-based Compensation**

The Company accounts for its stock-based compensation plans using the accounting prescribed by Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*. The Company is not required to adopt the fair value based recognition provisions prescribed under SFAS No. 123, *Accounting for Stock Based Compensation*, but complies with the disclosure requirements set forth in the Statement (as amended by SFAS No. 148), which include disclosing pro forma net income as if the fair value based method of accounting had been applied.

**NOTE 2. EARNINGS PER SHARE**

Basic earnings per share for the nine and three months ended September 30, 2004 and 2003 were calculated by dividing net income available to common shareholders 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 which is convertible into .8695 shares of common stock.

**NOTE 3. BALANCE SHEETS**

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The balance sheet at December 31, 2003, has been taken from the audited financial statements at that date.

### **NOTE 4. COMMITMENTS AND LETTERS OF CREDIT**

At September 30, 2004, the Company had commitments to extend credit, including unused lines of credit of approximately \$24,833,000. Letters of credit totaling \$1,066,295 were outstanding.

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**NOTE 5. CHANGES IN SHAREHOLDERS EQUITY**

On May 1, 2003, Surrey Bancorp exchanged six shares of its no par value common stock for every five shares of \$4.00 par value common stock of Surrey Bank & Trust. Fractional shares resulting from the transaction were paid in cash.

On June 12, 2003 the Company issued 189,356 shares of Series A, 4.5% Convertible Non-Cumulative Perpetual Preferred Stock at a liquidation value of \$14.00 per share. The issue was a private placement of which the net proceeds amounted to \$2,620,325. The shares are convertible into .8695 shares of common stock.

**NOTE 6. STOCK OPTION PLANS**

The Company has adopted a qualified incentive stock option plan which reserves, as amended, 74,429 shares for purchase by eligible employees. Options granted under this plan vest at the rate of 20% per year, expire not more than ten years from the date of grant, and are exercisable at not less than the fair market value of the stock at the date of the grant.

The Company also adopted a non-qualified stock option plan which reserves, as amended, 101,912 shares for purchase by non-employee directors. Options granted under this plan are exercisable after six months from the date of the grant at not less than the fair market value of the stock at the date of the grant. The life of such options shall not extend more than ten years from the date of the grant.

Information related to pro forma net income for the periods presented is as follows:

|  | <b>September 30,</b> |              |
|--|----------------------|--------------|
|  | <b>2004</b>          | <b>2003</b>  |
| Compensation cost recognized in income for all stock-based compensation awards | \$                   | \$           |
| Pro forma net income available to common shareholders, based on SFAS No. 123   | \$ 1,278,542         | \$ 1,001,233 |
| Pro forma earnings per common share, based on SFAS No. 123                     | \$ 1.07              | \$ 0.87      |
| Pro forma earnings per fully dilutive common share, based on SFAS No. 123      | \$ 0.94              | \$ 0.79      |

**NOTE 7. PURCHASE OF MINORITY INTEREST**

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On March 1, 2003, the Bank acquired the minority interest in Friendly Finance, LLC in a transaction accounted for as a purchase. Purchase consideration (equal to the Bank's recorded minority interest in subsidiary) consisted of cancellation of notes and interest receivable from the minority interest amounting to \$422,984, cancellation of identified recourse obligations of the minority interest to the Bank of \$243,850 and release of the minority interest from any future recourse obligation contingencies to the Bank, valued at \$57,852. The Bank recorded the release of the future recourse obligation amount as an increase in the allowance for loan losses.

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**NOTE 8. SALE OF MORTGAGE SERVICING RIGHTS**

On April 16, 2004, the Company sold its rights to service residential mortgage loans for others to another bank. The fees and gain recognized on the sale of these rights amounted to \$501,610. The sale marked the exit of the Bank from the residential mortgage servicing business.

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**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 months ending September 30, 2004 and 2003. 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 one week later on July 22, 1996.

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

**Highlights**

This Quarterly Report on Form 10-QSB may contain certain forward-looking statements consisting of estimates with respect to the financial condition, results of operations and business of the Company that are subject to various factors which could cause actual results to differ materially from these estimates. These factors include, but are not limited to, general economic conditions, changes in interest rates, deposit flows, loan demand, real estate values, and competition; changes in accounting principles, policies, or guidelines; changes in legislation or regulation; and other economic, competitive, governmental, regulatory, and technological factors affecting the Company's operations, pricing, products, and services.

Net income available for common shareholders for the nine months ended September 30, 2004, was \$1,292,182 or \$.95 per diluted share outstanding compared to a \$1,011,898 or \$.80 per diluted share outstanding for the same period in 2003. Earnings for the period ended September 30, 2004 are approximately 27.7% higher than for the same period in 2003. Loan growth and growth in noninterest income contributed to this increase. Non interest income was bolstered by a one time gain of \$501,610 resulting from the sale of the Company's residential mortgage servicing rights. This sale marked the Company's exit from the residential mortgage servicing business. The Company continues to originate mortgages on a servicing-release basis, collecting origination fees and yield spread premiums.

On September 30, 2004, Surrey Bancorp's assets totaled \$158,492,471 compared to \$135,077,005 on December 31, 2003. Net loans were \$128,426,132 compared to \$117,362,619 on December 31, 2003. This growth was primarily in the commercial loan area which increased 15.3% over December 2003 totals.

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Total deposits on September 30, 2004, were \$131,853,449 compared to \$111,277,876 at the end of 2003. This increase is attributable to an increase in all deposit account categories. Demand deposits increased 21.2% over 2003 totals. Certificates of deposit increased 13.8% over December 31, 2003 totals, while savings deposits increased 34.6%.



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Common shareholders' equity increased by \$1,454,242 or 13.9% during the nine months ended September 30, 2004 resulting in a common stock book value of \$9.93 per share, up from \$8.93 on December 31, 2003.

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.

Bonds, notes, and debentures for which the Bank has the positive intent and ability to hold to maturity are reported at cost, adjusted by premiums and discounts that are recognized in interest income using the interest method over the period to maturity or to call dates. The Bank had no Held to Maturity securities at September 30, 2004 or December 31, 2003.

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 shareholders' 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.

Investments in available for sale securities of \$3,220,845 consisted of U.S. Governmental Agency obligations with maturities ranging from one to twenty months, and GNMA adjustable rate mortgage securities, which adjust annually.

**Loans**

Net loans outstanding on September 30, 2004, were \$128,426,132 compared to \$117,362,619 on December 31, 2003. The Bank maintains a loan portfolio dominated by real estate and commercial loans diversified among various industries. Approximately 45.9% of the Bank's loans as of September 30, 2004 are fixed rate loans with 54.1% floating with the Bank's prime rate or other appropriate internal or external indices.

**Deposits**

Deposits on September 30, 2004, were \$131,853,449, compared to \$111,277,876 on December 31, 2003.

The September total comes from a base of approximately 9,882 accounts compared to 8,840 accounts at December 31, 2003; an 11.8% increase. Interest-bearing accounts represented 85.2% of the 2004 period-end deposits versus 85.5% at December 31, 2003.

**Table of Contents****Shareholders' 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.

|                               | <u>Ratio</u> | <u>Minimum Required<br/>For Capital Adequacy<br/>Purposes</u> |
|-------------------------------|--------------|---|
| September 30, 2004:           |              |   |
| Total Capital                 |              |   |
| (to Risk-Weighted Assets)     |              |   |
| Surrey Bancorp (Consolidated) | 12.43%       | 8.0%  |
| Surrey Bank & Trust           | 10.49%       | 8.0%  |
| Tier I Capital                |              |   |
| (to Risk-Weighted Assets)     |              |   |
| Surrey Bancorp (Consolidated) | 11.17%       | 4.0%  |
| Surrey Bank & Trust           | 9.23%        | 4.0%  |
| Tier I Capital                |              |   |
| (to Average Assets)           |              |   |
| Surrey Bancorp (Consolidated) | 9.71%        | 4.0%  |
| Surrey Bank & Trust           | 8.02%        | 4.0%  |
| December 31, 2003:            |              |   |
| Total Capital                 |              |   |
| (to Risk-Weighted Assets)     |              |   |
| Surrey Bancorp (Consolidated) | 11.52%       | 8.0%  |
| Surrey Bank & Trust           | 10.13%       | 8.0%  |
| Tier I Capital                |              |   |
| (to Risk-Weighted Assets)     |              |   |
| Surrey Bancorp (Consolidated) | 10.26%       | 4.0%  |
| Surrey Bank & Trust           | 8.87%        | 4.0%  |
| Tier I Capital                |              |   |
| (to Average Assets)           |              |   |
| Surrey Bancorp (Consolidated) | 10.50%       | 4.0%  |
| Surrey Bank & Trust           | 8.13%        | 4.0%  |

**Asset Quality**

The notes to the financial statements contained within this report provide details of the activity in the allowance for possible loan losses.

The provision for possible loan losses charge to operations was \$208,662 in the first nine months of 2004 compared to \$181,262 for the same period in 2003. The reserve for loan losses on September 30, 2004 was \$2,196,447 or 1.68% of period end loans. This percentage is derived

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from total loans. Approximately \$22,928,204 of loans at September 30, 2004 are government guaranteed loans which the Bank's exposure ranges from 10% to 50% of the outstanding balance. When the guaranteed portion of the loans are removed from the equation the loan loss reserve is approximately 1.93% of outstanding loans.

Additionally, loan balances in Friendly Finance have reduced by approximately \$791,000 since December 31, 2003 due to a slow down in the used car market and more strict underwriting

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standards. Accordingly, the reserve attributable to this reduction in loans has been recaptured by Friendly Finance, LLC. Through September 30, 2004 reserves in Friendly Finance, LLC have been reduced by \$58,455.

The level of reserve is established based upon management's evaluation of portfolio composition, current and projected national and local economic conditions, and results of independent reviews of the loan portfolio by internal and external examination. Management recognizes the inherent risk associated with commercial and consumer lending, including whether or not 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. As a result, management continues to actively monitor the Bank's asset quality and lending policies. 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 future loan losses and provide a sound reserve for the loan portfolio.

Unsecured loans that are past due more than 90 days are placed into non accrual status. Secured loans reach non accrual 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.

At September 30, 2004, the Bank had loans totaling approximately \$830,127 in nonaccrual status.

## **Interest Rate Sensitivity and Liquidity**

One of the principal duties of the Bank's Asset/Liability Management 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 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, 2004, the liquidity position of the Company was good, with short-term liquid assets of \$19,336,385. Deposit growth was approximately \$9,430,000 greater than the growth in loans in the first nine months of 2004 resulting in a more liquid liquidity position compared to December 31, 2003. To provide supplemental liquidity, the Bank has six lines of credit with correspondent banks totaling \$13,700,000. There were no outstanding advances against these lines at September 30, 2004. Additionally, the Bank has a secured borrowing arrangement with the Federal Home Loan Bank. The maximum credit available under this agreement approximates \$19,372,000 at September 30, 2004. Advances taken down against the Federal Home Loan Bank line amounted to \$9,750,000 at September 30, 2004. In addition, Friendly Finance, LLC has a secured revolving line of credit with another commercial bank in the amount of \$1,200,000. At September 30, 2004 no balance was due on this line.

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**ITEM 3. CONTROLS & 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 reasonable likely to materially affect, internal control over financial reporting.

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**PART II - OTHER INFORMATION**

Item 1. Legal Proceedings

No significant changes in legal proceedings occurred during the quarter.

Item 2. Changes in Securities

None

Item 3. Defaults Upon Senior Securities

Not Applicable

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

None

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K

(a.) Exhibits

31.1 Certification

31.2 Certification

32. Certification

(b.) Reports on 8-K

Incorporated by Reference to 8-Ks filed July 26, 2004

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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, 2004 | /s/ Edward C. Ashby, III<br>Edward C. Ashby, III |
|                         | President and Chief Executive Officer            |
| Date: November 12, 2004 | /s/ Mark H. Towe<br>Mark H. Towe                 |
|                         | Sr. Vice President and Chief Financial Officer   |