SURREY BANCORP
Form 10-Q
November 09, 2012

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, 2012

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

For the transition period from __________ to __________

COMMISSION FILE NO. 000-50313

SURREY BANCORP

(Exact name of registrant as specified in its charter)

North Carolina	**59-3772016**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer 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 x 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 x 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	x

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

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, 2012 there were 3,542,984 common shares issued and outstanding.

PART I FINANCIAL INFORMATION

Consolidated Balance Sheets

September 30, 2012 (Unaudited) and December 31, 2011 (Audited)

	September 2012	December 2011
Assets		
Cash and due from banks	$ 5,536,529	$ 2,269,116
Interest-bearing deposits with banks	18,098,576	30,757,636
Federal funds sold	710,393	709,836
Investment securities available for sale	3,512,197	2,506,426
Restricted equity securities	738,324	809,754
Loans, net of allowance for loan losses of $3,733,177 at September 30, 2012 and $3,880,581 at December 31, 2011	183,238,489	175,446,206
Property and equipment, net	4,546,690	4,569,301
Foreclosed assets	599,877	560,018
Accrued income	1,044,455	962,614
Goodwill	120,000	120,000
Bank owned life insurance	5,255,659	3,389,447
Other assets	2,830,192	2,627,410
Total assets	$ 226,231,381	$ 224,727,764
Liabilities and Stockholders Equity		
Liabilities		
Deposits:		
Noninterest-bearing	$ 40,569,998	$ 30,750,902
Interest-bearing	142,895,915	153,187,474
Total deposits	183,465,913	183,938,376
Long-term debt	7,750,000	8,100,000
Dividends payable	46,106	576,741
Accrued interest payable	221,152	185,362
Other liabilities	2,798,643	1,700,723
Total liabilities	194,281,814	194,501,202
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
181,154 shares of Series D, issued and outstanding with no par value 5.0% convertible non-cumulative, perpetual; with a liquidationvalue of $7.08 per share;	1,248,482	1,248,482
Common stock, 10,000,000 shares authorized at no par value; 3,542,984 and 3,536,724 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively	12,056,178	12,009,588
Retained earnings	16,074,632	14,405,467
Accumulated other comprehensive loss	(50,050)	(57,300)
Total stockholders equity	31,949,567	30,226,562
Total liabilities and stockholders equity	$ 226,231,381	$ 224,727,764

See Notes to Consolidated Financial Statements

Consolidated Statements of Income

Nine months ended September 30, 2012 and 2011 (Unaudited)

	2012	2011
Interest income		
Loans and fees on loans	$ 8,161,796	$ 8,138,762
Federal funds sold	1,168	1,210
Investment securities, taxable	38,935	40,275
Deposits with banks	35,176	11,645
Total interest income	8,237,075	8,191,892
Interest expense		
Deposits	1,049,473	1,368,776
Fed funds purchased	150	
Long-term debt	225,236	264,361
Total interest expense	1,274,859	1,633,137
Net interest income	6,962,216	6,558,755
Provision for loan losses	780,372	67,190
Net interest income after provision for loan losses	6,181,844	6,491,565
Noninterest income		
Service charges on deposit accounts	691,098	767,978
Fees and yield spread premiums on loans delivered to correspondents	103,022	78,865
Other service charges and fees	413,115	372,673
Other operating income	608,033	548,662
Total noninterest income	1,815,268	1,768,178
Noninterest expense		
Salaries and employee benefits	2,674,154	2,624,411
Occupancy expense	331,151	294,493
Equipment expense	184,254	179,090
Data processing	281,290	271,504
Foreclosed assets, net	41,662	140,190
Postage, printing and supplies	148,667	146,904
Professional fees	279,641	267,558
FDIC insurance premiums	110,233	176,286
Litigation settlement		130,000
Other expense	1,080,267	1,075,861
Total noninterest expense	5,131,319	5,306,297
Net income before income taxes	2,865,793	2,953,446
Income tax expense	1,059,312	1,128,365
Net income	1,806,481	1,825,081
Preferred stock dividends	(137,316)	(137,190)

Net income available to common stockholders	$ 1,669,165	$ 1,687,891
Basic earnings per common share	$ 0.47	$ 0.48
Diluted earnings per common share	$ 0.43	$ 0.44
Basic weighted average common shares outstanding	3,540,220	3,532,680
Diluted weighted average common shares outstanding	4,174,155	4,166,615

See Notes to Consolidated Financial Statements

Consolidated Statements of Income

Three months ended September 30, 2012 and 2011 (Unaudited)

	2012	2011
Interest income		
Loans and fees on loans	$ 2,726,346	$ 2,762,166
Federal funds sold	389	415
Investment securities, taxable	12,517	13,917
Deposits with banks	11,370	3,641
Total interest income	2,750,622	2,780,139
Interest expense		
Deposits	329,792	435,353
Long-term debt	73,382	81,461
Total interest expense	403,174	516,814
Net interest income	2,347,448	2,263,325
Provision for loan losses	41,384	188,118
Net interest income after provision for loan losses	2,306,064	2,075,207
Noninterest income		
Service charges on deposit accounts	229,368	259,093
Fees and yield spread premiums on loans delivered to correspondents	32,788	25,247
Other service charges and fees	136,411	125,646
Other operating income	184,613	188,683
Total noninterest income	583,180	598,669
Noninterest expense		
Salaries and employee benefits	885,633	862,414
Occupancy expense	105,938	97,313
Equipment expense	66,642	58,593
Data processing	98,871	85,916
Foreclosed assets, net	9,368	(142)
Postage, printing and supplies	51,434	44,150
Professional fees	72,968	77,098
FDIC insurance premiums	25,728	36,709
Litigation settlement		130,000
Other expense	337,885	381,421
Total noninterest expense	1,654,467	1,773,472
Net income before income taxes	1,234,777	900,404
Income tax expense	459,934	338,691
Net income	774,843	561,713
Preferred stock dividends	(46,106)	(46,233)
Net income available to common stockholders	$ 728,737	$ 515,480

Basic earnings per common share	$ 0.21	$ 0.15
Diluted earnings per common share	$ 0.19	$ 0.13
Basic weighted average common shares outstanding	3,542,984	3,536,118
Diluted weighted average common shares outstanding	4,176,919	4,170,053

See Notes to Consolidated Financial Statements

Consolidated Statements of Comprehensive Income

Nine months ended September 30, 2012 and 2011 (Unaudited)

	2012	2011
Net income	$ 1,806,481	$ 1,825,081
Other comprehensive income:		
Unrealized gains arising during the period	11,168	21,974
Tax expense benefits related to unrealized gains	(3,918)	(8,471)
Total other comprehensive income	7,250	13,503
Total comprehensive income	$ 1,813,731	$ 1,838,584

See Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows

Nine months ended September 30, 2012 and 2011 (Unaudited)

	2012	2011
Cash flows from operating activities		
Net income	$ 1,806,481	$ 1,825,081
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	178,088	183,205
Gain on sale of property and equipment	(650)	(760)
(Gain)Loss on the sale of foreclosed assets	(74,806)	50,254
Stock-based compensation, net of tax benefit	16,479	17,155
Provision for loan losses	780,372	67,190
Deferred income taxes	5,308	(6,853)
Accretion of discount on securities, net of amortization of premiums	407	1,526
Increase in cash surrender value of life insurance	(116,212)	(78,475)
Changes in assets and liabilities:		
Accrued income	(81,841)	(88,211)
Other assets	(212,008)	361,314
Accrued interest payable	35,790	21,245
Other liabilities	1,097,920	596,170
Net cash provided by operating activities	3,435,328	2,948,841
Cash flows from investing activities		
Net (increase) decrease in interest-bearing deposits with banks	12,659,060	(10,999,806)
Net decrease in federal funds sold	(557)	(7,525)
Purchases of investment securities	(3,000,481)	(2,002,500)
Sales and maturities of investment securities	2,005,471	1,523,003
Purchase of Bank Owned Life Insurance	(1,750,000)	
Redemption of restricted equity securities	73,600	88,800
Purchase of restricted equity securities	(2,170)	(50)
Net increase in loans	(9,111,060)	(4,634,755)
Proceeds from the sale of foreclosed assets	573,352	463,323
Purchases of property and equipment	(155,477)	(89,720)
Proceeds from the sale of property and equipment	650	760
Net cash provided by (used in) investing activities	1,292,388	(15,658,470)
Cash flows from financing activities		
Net increase (decrease) in deposits	(472,463)	14,339,218
Maturity of long-term debt	(350,000)	(1,350,000)
Dividends paid	(667,951)	(126,472)
Common stock options exercised	30,111	18,825
Net cash provided by (used in) financing activities	(1,460,303)	12,881,571
Net increase in cash and cash equivalents	3,267,413	171,942
Cash and due from banks, beginning	2,269,116	2,398,433
Cash and due from banks, ending	$ 5,536,529	$ 2,570,375
Supplemental disclosures of cash flow information		
Interest paid	$ 1,239,069	$ 1,611,892

Taxes paid	$	500,000	$	626,319
Loans transferred to foreclosed properties	$	538,405	$	245,525

See Notes to Consolidated Financial Statements

Consolidated Statements of Changes in Stockholders Equity

Nine months ended September 30, 2012 and 2011 (Unaudited)

	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance, January 1, 2011	$ 3,868,807	3,206,495	$ 9,464,178	$ 15,380,083	$ (68,913)	$ 28,644,155
Net income				1,825,081		1,825,081
Net change in unrealized gain on investment securities available for sale, net of income tax of $8,471					13,503	13,503
Common stock options exercised		9,269	18,825			18,825
Stock-based compensation, net of tax benefit			17,155			17,155
Dividends declared and accrued on convertible Series A preferred stock ($.47 per share)				(89,225)		(89,225)
Dividends declared and accrued on convertible Series D preferred stock ($.26 per share)				(47,965)		(47,965)
Balance, September 30, 2011	$ 3,868,807	3,215,764	$ 9,500,158	$ 17,067,974	$ (55,410)	$ 30,381,529
Balance, January 1, 2012	$ 3,868,807	3,536,724	$ 12,009,588	$ 14,405,467	$ (57,300)	$ 30,226,562
Net income				1,806,481		1,806,481
Net change in unrealized gain on investment securities available for sale, net of income tax of $3,918					7,250	7,250
Common stock options exercised		6,260	30,111			30,111
Stock-based compensation, net of tax benefit			16,479			16,479
Dividends declared and accrued on convertible Series A preferred stock ($.47 per share)				(89,308)		(89,308)
Dividends declared and accrued on convertible Series D preferred stock ($.26 per share)				(48,008)		(48,008)
Balance, September 30, 2012	$ 3,868,807	3,542,984	$ 12,056,178	$ 16,074,632	$ (50,050)	$ 31,949,567

See Notes to Consolidated Financial Statements

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

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, 2012, the results of operations for the nine and three months ended September 30, 2012 and 2011, and its changes in stockholders equity, comprehensive income and cash flows for the nine months ended September 30, 2012 and 2011. These adjustments are of a normal and recurring nature. The results of operations for the nine months ended September 30, 2012, 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, 2011, included in the Company s Form 10-K. The balance sheet at December 31, 2011, has been taken from the audited financial statements at that date.

Organization

Surrey Bancorp 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 LPL Financial.

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, 2011 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.

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

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, 2012 and December 31, 2011, 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 market risk to the Bank and are therefore carried at cost. 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, 2012 and December 31, 2011.

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.

Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan using the interest method. Discounts and premiums on any purchased residential real estate loans are amortized to income using the interest method over the remaining period to contractual maturity, adjusted for anticipated prepayments. Discounts and premiums on any purchased consumer loans are recognized over the expected lives of the loans using methods that approximate the interest method.

Interest is accrued and credited to income based on the principal amount outstanding. The accrual of interest on impaired loans is discontinued when, in management s opinion, the borrower may be unable to meet payments as they become due. When the interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received. Payments received on nonaccrual loans are first applied to principal and any residual amounts are then applied to interest. When facts and circumstances indicate the borrower has regained the ability to meet the required payments, the loan is returned to accrual status. Past due loans are determined on the basis of contractual terms.

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management s periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower s ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired. For loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-impaired loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management s estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower s prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan s effective interest rate, the loan s obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures.

Recent Accounting Pronouncements

The following is a summary of recent authoritative pronouncements:

In September 2011, the Intangibles topic was amended to permit an entity to consider qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. These amendments were effective for the Company on January 1, 2012.

In April 2011, the criteria used to determine effective control of transferred assets in the Transfers and Servicing topic of the ASC was amended by ASU 2011-03. The requirement for the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms and the collateral maintenance implementation guidance related to that criterion were removed from the assessment of effective control. The other criteria to assess effective control were not changed. The amendments were effective for the Company on January 1, 2012 and had no effect on the financial statements.

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Recent Accounting Pronouncements, continued

ASU 2011-04 was issued in May 2011 to amend the Fair Value Measurement topic of the ASC by clarifying the application of existing fair value measurement and disclosure requirements and by changing particular principles or requirements for measuring fair value or for disclosing information about fair value measurements. The amendments were effective for the Company beginning January 1, 2012 and have been included in Note 8.

The Comprehensive Income topic of the ASC was amended in September 2011. The amendment eliminates the option to present other comprehensive income as a part of the statement of changes in stockholders equity and requires consecutive presentation of the statement of net income and other comprehensive income. The amendments were applicable to the Company on January 1, 2012 and have been applied retrospectively. In December 2011, the topic was further amended to defer the effective date of presenting reclassification adjustments from other comprehensive income to net income on the face of the financial statements. Companies should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect prior to the amendments while FASB redeliberates future requirements.

In July 2012, the Intangibles topic was amended to permit an entity to consider qualitative factors to determine whether it is more likely than not that indefinite-lived intangible assets are impaired. If it is determined to be more likely than not that indefinite-lived intangible assets are impaired, then the entity is required to determine the fair value of the indefinite-lived intangible asset and perform the quantitative impairment test by comparing the fair value with the carrying amount. The amendments are effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. Early adoption is permitted. The amendments are not expected to have a material effect 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

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Non-recognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through the date the financial statements were issued and no subsequent events have occurred requiring accrual or disclosure.

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 amortized costs of securities available for sale and their approximate fair values at September 30, 2012 and December 31, 2011 follow:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
September 30, 2012				
Government-sponsored enterprises	$ 2,500,000	$ 4,570	$ (400)	$ 2,504,170
Mortgage-backed securities	44,315	1,496		45,811
Corporate bonds	550,000		(96,250)	453,750
Equities and mutual funds	499,960	9,293	(787)	508,466
	$ 3,594,275	$ 15,359	$ (97,437)	$ 3,512,197
December 31, 2011				
Government-sponsored enterprises	$ 2,000,374	$ 4,311	$	$ 2,004,685
Mortgage-backed securities	49,298	1,443		50,741
Corporate bonds	550,000		(99,000)	451,000
	$ 2,599,672	$ 5,754	$ (99,000)	$ 2,506,426

At September 30, 2012 and December 31, 2011, substantially all government-sponsored enterprises securities were pledged as collateral on public deposits and for other purposes as required or permitted by law. The mortgage-backed securities were pledged to the Federal Home Loan Bank.

Maturities of mortgage-backed bonds are stated based on contractual maturities. Actual maturities of these bonds may vary as the underlying mortgages are prepaid. The scheduled maturities of securities (all available for sale) at September 30, 2012, were as follows:

	Amortized Cost	Fair Value
Due in one year or less	$	$
Due after one year through five years	2,500,000	2,504,170
Due after five years through ten years	581,134	485,910
Due after ten years	13,181	13,651
	$ 3,094,315	$ 3,003,731

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, 2012 and December 31, 2011. These unrealized losses on investment securities are a result of volatility in interest rates and primarily relate to corporate bonds issued by other banks at September 30, 2012 and December 31, 2011.

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2012						
Government-sponsored enterprises	$ 499,600	$ (400)	$	$	$ 499,600	$ (400)
Corporate bonds			453,750	(96,250)	453,750	(96,250)
Equities and mutual funds	51,022	(787)			51,022	(787)
	$ 550,622	$ (1,187)	$ 453,750	$ (96,250)	$ 1,004,372	(97,437)
December 31, 2011						
Corporate bonds	$	$	$ 451,000	$ (99,000)	$ 451,000	$ (99,000)
	$	$	$ 451,000	$ (99,000)	$ 451,000	$ (99,000)

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SECURITIES, CONTINUED

Management considers the nature of the investment, the underlying causes of the decline in the market value and the severity and duration of the decline in market value in determining if impairment is other than temporary. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Based upon this evaluation, there are two securities in the portfolio with unrealized losses for a period greater than 12 months. We have analyzed each individual security for Other Than Temporary Impairment (OTTI) purposes by reviewing delinquencies, loan-to-value ratios, and credit quality and concluded that all unrealized losses presented in the tables above are not related to an issuer s financial condition but are due to changes in the level of interest rates and no declines are deemed to be other than temporary in nature.

The Company had no gross realized gains or losses from the sales of investment securities for the nine and three month periods ended September 30, 2012 and 2011.

NOTE 3. EARNINGS PER SHARE

Basic earnings per share for the nine and three months ended September 30, 2012 and 2011 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 and D convertible preferred stock. Each share of the Series A preferred is convertible into 2.2955 shares of common stock. Each share of Series D preferred is convertible into 1.10 shares of common stock.

NOTE 4. COMMITMENTS AND LETTERS OF CREDIT

At September 30, 2012, the Company had commitments to extend credit, including unused lines of credit of approximately $34,690,000 and letters of credit outstanding of $2,023,331.

NOTE 5. LOANS

The major components of loans in the balance sheets at September 30, 2012 and December 31, 2011 are below.

	2012	2011
Commercial	$ 84,317,344	$ 73,756,422
Real estate:		
Construction and land development	5,585,372	6,213,443
Residential, 1-4 families	36,853,785	39,499,189
Residential, 5 or more families	1,730,308	2,214,365
Farmland	2,398,007	2,722,872
Nonfarm, nonresidential	48,853,854	47,867,333
Agricultural	17,517	29,493
Consumer, net of discounts of $19,845 in 2012 and $21,742 in 2011	7,090,254	7,041,846
Other	37,976	
	186,884,417	179,344,963
Deferred loan origination costs, net of (fees)	87,249	(18,176)

	186,971,666	179,326,787
Allowance for loan losses	(3,733,177)	(3,880,581)
	$ 183,238,489	$ 175,446,206

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5. LOANS, CONTINUED

Residential, 1-4 family loans pledged as collateral against FHLB advances approximated $18,888,000 and $19,112,000 at September 30, 2012 and December 31, 2011, respectively.

NOTE 6. ALLOWANCE FOR LOAN LOSSES

The activity of the allowance for loan losses by loan components during the nine months ending September 30, 2012 and 2011 was as follows:

	Construction & Development	1-4 Family Residential	Nonfarm, Nonresidential	Commercial & Industrial	Consumer	Other	Total
September 30, 2012							
Allowance for credit losses:							
Beginning balance	$ 103,200	$ 836,860	$ 865,854	$ 1,808,260	$ 210,807	$ 55,600	$ 3,880,581
Charge-offs	(7,286)	(271,224)	(21,831)	(710,645)	(151,102)		(1,162,088)
Recoveries	250	752	83,968	132,949	16,393		234,312
Provision	8,105	142,712	(5,404)	513,462	133,797	(12,300)	780,372
Ending balance	$ 104,269	$ 709,100	$ 922,587	$ 1,744,026	$ 209,895	$ 43,300	$ 3,733,177
Ending balance: individually evaluated for impairment	$ 3,869	$	$ 339,087	$ 185,726	$	$	$ 528,682
Ending balance: collectively evaluated for impairment	$ 100,400	$ 709,100	$ 583,500	$ 1,558,300	$ 209,895	$ 43,300	$ 3,204,495
Ending balance: loans acquired with deteriorated credit quality	$	$	$	$	$	$	$
Loans Receivable:							
Ending balance	$ 5,585,372	$ 36,853,785	$ 48,853,854	$ 84,317,344	$ 7,090,254	$ 4,183,808	$ 186,884,417
Ending balance: individually evaluated for impairment	$ 88,429	$ 290,489	$ 3,235,812	$ 2,457,177	$	$ 207,179	$ 6,279,086
Ending balance: collectively evaluated for impairment	$ 5,496,943	$ 36,563,296	$ 45,618,042	$ 81,860,167	$ 7,090,254	$ 3,976,629	$ 180,605,331
Ending balance: loans acquired with deteriorated credit quality	$	$	$	$	$	$	$
September 30, 2011							
Allowance for credit losses:							
Beginning balance	$ 118,797	$ 1,696,068	$ 1,199,292	$ 3,411,403	$ 205,662	$ 52,700	$ 6,683,922

Charge-offs	(27,468)	(1,113,243)	(203,418)	(1,007,729)	(45,010)		(2,396,868)
Recoveries	996	56,241	108,114	83,804	24,833		273,988
Provision	3,621	185,093	(233,826)	77,669	29,233	5,400	67,190
Ending balance	$ 95,946	$ 824,159	$ 870,162	$ 2,565,147	$ 214,718	$ 58,100	$ 4,628,232
Ending balance: individually evaluated for impairment	$ 146	$ 156,159	$ 277,262	$ 1,447,747	$	$	$ 1,881,314
Ending balance: collectively evaluated for impairment	$ 95,800	$ 668,000	$ 592,900	$ 1,117,400	$ 214,718	$ 58,100	$ 2,746,918
Ending balance: loans acquired with deteriorated credit quality	$	$	$	$	$	$	$
Loans Receivable:							
Ending balance	$ 5,253,339	$ 41,806,459	$ 49,721,494	$ 71,722,630	$ 7,013,836	$ 5,205,852	$ 180,723,610
Ending balance: individually evaluated for impairment	$ 93,385	$ 949,971	$ 4,054,573	$ 6,338,214	$ 5,475	$	$ 11,441,618
Ending balance: collectively evaluated for impairment	$ 5,159,954	$ 40,856,488	$ 45,666,921	$ 65,384,416	$ 7,008,361	$ 5,205,852	$ 169,281,992
Ending balance: loans acquired with deteriorated credit quality	$	$	$	$	$	$	$

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6. ALLOWANCE FOR LOAN LOSSES, CONTINUED

The following table presents impaired loans individually evaluated by class of loan as of September 30, 2012 and December 31, 2011 and the recognized interest income per the related period:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
September 30, 2012					
With no related allowance recorded:					
Construction and development	$ 74,534	$ 74,534	$	$ 75,212	$ 500
1-4 family residential	290,489	290,489		294,580	
Nonfarm, nonresidential	1,413,150	1,413,151		1,433,767	47,087
Commercial and industrial	1,455,374	1,724,439		1,434,658	52,490
Consumer					
Other loans	207,179	207,179			
	3,440,726	3,709,792		3,238,217	100,077
With an allowance recorded:					
Construction and development	$ 13,895	$ 13,895	$ 3,869	$ 14,408	$
1-4 family residential					
Nonfarm, nonresidential	1,822,662	1,844,492	339,087	1,828,907	
Commercial and industrial	1,001,803	1,001,803	185,726	1,009,959	17,364
Consumer					
Other loans				209,432	6,659
	2,838,360	2,860,190	528,682	3,062,706	24,023
Combined:					
Construction and development	$ 88,429	$ 88,429	$ 3,869	$ 89,620	$ 500
1-4 family residential	290,489	290,489		294,580	
Nonfarm, nonresidential	3,235,812	3,257,643	339,087	3,262,674	47,087
Commercial and industrial	2,457,177	2,726,242	185,726	2,444,617	69,854
Consumer					
Other loans	207,179	207,179		209,432	6,659
	$ 6,279,086	$ 6,569,982	$ 528,682	$ 6,300,923	$ 124,100
December 31, 2011					
With no related allowance recorded:					
Construction and development	$ 92,504	$ 92,504	$	$ 92,504	$ 4,398
1-4 family residential	469,514	502,598		504,456	20,970
Nonfarm, nonresidential	1,548,288	1,711,019		1,720,582	90,633
Commercial and industrial	1,526,985	1,701,473		1,679,148	99,979
Consumer	10,452	10,452		6,753	6,738
Other loans					

	3,647,743	4,018,046		4,003,443	222,718
With an allowance recorded:					
Construction and development	$	$	$	$	$
1-4 family residential	235,812	235,812	83,460	236,822	13,693
Nonfarm, nonresidential	2,079,602	2,079,602	280,454	2,079,917	109,936
Commercial and industrial	1,633,189	1,633,189	449,260	1,843,975	97,007
Consumer					
Other loans					
	3,948,603	3,948,603	813,174	4,160,714	220,636
Combined:					
Construction and development	$ 92,504	$ 92,504	$	$ 92,504	$ 4,398
1-4 family residential	705,326	738,410	83,460	741,278	34,663
Nonfarm, nonresidential	3,627,890	3,790,621	280,454	3,800,499	200,569
Commercial and industrial	3,160,174	3,334,662	449,260	3,523,123	196,986
Consumer	10,452	10,452		6,753	6,738
Other loans					
	$ 7,596,346	$ 7,966,649	$ 813,174	$ 8,164,157	$ 443,354

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6. ALLOWANCE FOR LOAN LOSSES, CONTINUED

The following presents by class, an aging analysis of the recorded investment in loans.

	30-59 Days Past Due	60-89 Days Past Due	90 Days Plus Past Due	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
September 30, 2012							
Construction and development	$ 434,894	$	$	$ 434,894	$ 5,150,478	$ 5,585,372	$
1-4 family residential	413,181	369,979	175,374	958,534	35,895,251	36,853,785	
Nonfarm, nonresidential	78,783	1,274,523	121,727	1,475,033	47,378,821	48,853,854	
Commercial and industrial	504,922	705,203	44,234	1,254,359	83,062,985	84,317,344	
Consumer	75,976	7,106	546	83,628	7,006,626	7,090,254	
Other loans		207,179		207,179	3,976,629	4,183,808	
Total	$ 1,507,756	$ 2,563,990	$ 341,881	$ 4,413,627	$ 182,470,790	$ 186,884,417	$
Percentage of total loans	0.81%	1.37%	0.18%	2.36%	97.64%	100.00%	
Non-accruals included above							
Construction and development	$ 74,534	$	$	$ 74,534	$ 13,895	$ 88,429	
1-4 family residential	35,525	87,250	175,374	298,149	140,477	438,626	
Nonfarm, nonresidential		1,087,650	121,727	1,209,377	982,576	2,191,953	
Commercial and industrial		675,453	44,234	719,687	165,224	884,911	
Consumer		2,588	546	3,134	1,979	5,113	
Other loans		207,179		207,179		207,179	
	$ 110,059	$ 2,060,120	$ 341,881	$ 2,512,060	$ 1,304,151	$ 3,816,211	
December 31, 2011							
Construction and development	$ 273,412	$ 23,727	$	$ 297,139	$ 5,916,304	$ 6,213,443	$
1-4 family residential	621,656	77,631	72,774	772,061	38,727,128	39,499,189	
Nonfarm, nonresidential	98,922	119,046		217,968	47,649,365	47,867,333	
Commercial and industrial	764,276	56,117	218,516	1,038,909	72,717,513	73,756,422	44,543
Consumer	170,447	229,368	15,790	415,605	6,626,241	7,041,846	5,338
Other loans					4,966,730	4,966,730	
Total	$ 1,928,713	$ 505,889	$ 307,080	$ 2,741,682	$ 176,603,281	$ 179,344,963	$ 49,881
Percentage of total loans	1.08%	0.28%	0.17%	1.53%	98.47%	100.00%	

Non-accruals included above												
Construction and development	$		$		$		$		$	92,504	$	92,504
1-4 family residential		92,736		217,814		72,774		383,324		322,003		705,327
Nonfarm, nonresidential										2,517,311		2,517,311
Commercial and industrial						173,973		173,973		895,643		1,069,616
Consumer						10,452		10,452				10,452
Other loans												
	$	92,736	$	217,814	$	257,199	$	567,749	$	3,827,461	$	4,395,210

Credit Quality Indicators:

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. Loans classified as substandard or special mention are reviewed quarterly by the Company for further impairment or improvement to determine if appropriately classified. All other loans greater than $500,000, commercial lines greater than $250,000 and personal lines of credit greater than $100,000, and unsecured loans greater than $100,000 are specifically reviewed at least annually to determine the appropriate loan grading. In addition, during the renewal process of any loan, as well as when a loan becomes past due, the Company will evaluate the loan grade.

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6. ALLOWANCE FOR LOAN LOSSES, CONTINUED

Loans excluded from the scope of the annual review process above are generally classified as pass credits until: (a) they become past due; (b) management becomes aware of deterioration in the credit worthiness of the borrower; or (c) the customer contacts the Company for a modification. In these circumstances, the loan is specifically evaluated for potential classification as to special mention, substandard or even charged off. The Company uses the following definitions for risk ratings:

Special Mention. Loans classified as special mention have a potential weakness that deserves management s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution s credit position at some future date.

Substandard. Loans classified as substandard are inadequately protected by the current net worth and payment capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful. Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loans by credit quality indicator are provided in the following table.

	Total	Pass Credits	Special Mention	Substandard	Doubtful
September 30, 2012					
Construction and development	$ 5,585,372	$ 5,496,943	$ 88,429	$	$
1-4 family residential	36,853,785	36,366,077	487,708		
Nonfarm, nonresidential	48,853,854	47,349,952	1,248,173	255,729	
Commercial and industrial	84,317,344	83,153,684	1,163,660		
Consumer	7,090,254	7,081,176	7,691	1,387	
Other loans	4,183,808	3,976,629	207,179		
	$ 186,884,417	$ 183,424,461	$ 3,202,840	$ 257,116	$
	100.0%	98.2%	1.7%	0.1%	0.0%
Guaranteed portion of loans	$ 41,380,165	$ 40,472,990	$ 907,175	$	$

	Total	Pass Credits	Special Mention	Substandard	Doubtful
December 31, 2011					
Construction and development	$ 6,213,443	$ 6,120,939	$ 92,504	$	$
1-4 family residential	39,499,189	38,839,069	660,120		
Nonfarm, nonresidential	47,867,333	46,159,505	1,071,939	635,889	
Commercial and industrial	73,756,422	72,268,150	1,488,272		
Consumer	7,041,846	7,039,155	411	2,280	
Other loans	4,966,730	4,966,730			
	$ 179,344,963	$ 175,393,548	$ 3,313,246	$ 638,169	$

	100.0%	97.8%	1.8%	0.4%	0.0%
Guaranteed portion of loans	$ 38,917,951	$ 38,077,329	$ 840,622	$	$

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7. TROUBLED DEBT RESTRUCTURINGS

For the quarters ended September 30, 2012 and 2011, the following table presents loans modified during the period that were considered to be troubled debt restructurings.

	For the three months ended September 30, 2012			For the nine months ended September 30, 2012		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings						
Construction and development		$	$	1	$ 237,883	$ 237,883
1-4 Family residential				1	113,743	116,438
Nonfarm, nonresidential				1	96,028	96,028
Commercial and industrial				2	343,060	343,060

	For the three months ended September 30, 2011			For the nine months ended September 30, 2011		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings						
Construction and development	1	$ 16,172	$ 16,172	1	$ 16,172	$ 16,172
1-4 Family residential	4	257,298	224,214	1	84,093	84,093
Nonfarm, nonresidential	7	2,201,519	2,038,788	5	1,045,255	1,045,255
Commercial and industrial	11	1,660,797	1,486,309	5	1,197,642	1,197,642

During the nine months ended September 30, 2012, the Bank modified five loans that were considered to be troubled debt restructurings. The terms for these loans were extended. The interest rate was lowered on one loan.

During the nine months ended September 30, 2012, no loans that had previously been restructured were in default.

In the determination of the allowance for loan losses, management considers troubled debt restructurings and subsequent defaults in these restructurings by adjusting the loan grades of such loans, which figure into the environmental factors associated with the allowance. Defaults resulting in charge-offs affect the historical loss experience ratios which are a component of the allowance calculation. Additionally, specific reserves may be established on restructured loans evaluated individually.

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. 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 the 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.

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 the 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, 2012, 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.

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. FAIR VALUE, CONTINUED

Servicing Assets

A valuation of loan servicing rights is performed on an individual basis due to the small number of loans serviced. Loans are evaluated on a discounted earnings basis to determine the present value of future earnings. The present value of the future earnings is the estimated market value for the loan, calculated using consensus assumptions that a first party purchaser would utilize in evaluating a potential acquisition of the servicing. As such, the Company classifies loan servicing rights as 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.

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.

(in thousands)

September 30, 2012	**Total**	**Level 1**	**Level 2**	**Level 3**
Government-sponsored enterprises	$ 2,504	$	$ 2,504	$
Mortgage-backed securities	46		46	
Corporate bonds	454		454	
Equities and mutual funds	508	508		
Servicing assets	90			90
Total assets at fair value	$ 3,602	$ 508	$ 3,004	$ 90
Total liabilities at fair value	$	$	$	$

(in thousands)

December 31, 2011	**Total**	**Level 1**	**Level 2**	**Level 3**
Government-sponsored enterprises	$ 2,004	$	$ 2,004	$
Mortgage-backed securities	51		51	
Corporate bonds	451		451	
Servicing assets	93			93
Total assets at fair value	$ 2,599	$	$ 2,506	$ 93
Total liabilities at fair value	$	$	$	$

For the nine months ended September 30, 2012 and 2011, the changes in Level 3 assets and liabilities measured at fair value on a recurring basis were as follows:

	Level 3	
	2012 Fair Value	**2011 Fair Value**
Balance, January 1	$ 92,682	$ 94,878
Capitalized		
Amortization included in other income	(3,139)	(2,196)
Balance, September 30	$ 89,543	$ 92,682

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. FAIR VALUE, CONTINUED

Changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the three month period ended September 30, 2012 and 2011, was $846 and $769, respectively, which was amortized to other income.

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.

(in thousands)

September 30, 2012	**Total**	**Level 1**	**Level 2**	**Level 3**
Loans-commercial and industrial	$ 816	$	$	$ 816
Loans-nonfarm, non-residential	1,484			1,484
Loans-other	10			10
Foreclosed assets	600			600
Total assets at fair value	$ 2,910	$	$	$ 2,910
Total liabilities at fair value	$	$	$	$

(in thousands)

December 31, 2011	**Total**	**Level 1**	**Level 2**	**Level 3**
Loans-commercial and industrial	$ 1,184	$	$	$ 1,184
Loans-nonfarm, non-residential	1,799			1,799
Loans- 1- 4 family residential	152			152
Loans-other				
Foreclosed assets	560			560
Total assets at fair value	$ 3,695	$	$	$ 3,695
Total liabilities at fair value	$	$	$	$

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

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. FAIR VALUE, CONTINUED

Loans receivable: 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.

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.

Federal funds purchased, securities sold under agreements to repurchase and short-term debt: The carrying amounts of federal funds purchased, securities sold under agreements to repurchase and short-term debt approximate 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.

Other liabilities: For fixed-rate loan commitments, fair value considers the difference between current levels of interest rates and the committed rates. The carrying amounts of other liabilities approximate fair value.

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Company s financial instruments as of September 30, 2012 and December 31, 2011. This table excludes financial instruments for which the carrying amount approximates fair value.

			Fair Value Measurements		
(dollars in thousands)	**Carrying Amount**	**Fair Value**	**Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
September 30, 2012					
Financial Instruments Assets					
Loans	$ 183,240	$ 188,116	$	$	$ 188,116
Financial Instruments Liabilities					
Deposits	183,466	179,389		179,389	
Long-Term Debt	7,750	8,397		8,397	
December 31, 2011					
Financial Instruments Assets					
Loans	$ 175,446	$ 163,835	$	$	$ 163,835
Financial Instruments Liabilities					
Deposits	183,938	174,610		174,610	

Long-Term Debt	8,100	8,704	8,704

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, 2012 and 2011. 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 September 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, 2012, was $728,737 or $0.19 per diluted share outstanding, compared to a $515,480 or $0.13 per diluted share outstanding, for the same period in 2011. Earnings for the three months ended September 30, 2012, are approximately 41.4% higher than for the same period in 2011. The increase results from a reduction in the provision for loan losses. The provision for loan losses decreased from $188,118 in the third quarter of 2011 to a provision of $41,384 in 2012. This decrease is due to a reduction in specific reserves associated with impaired loans during the third quarter of 2012 compared to the same quarter of 2011. Specific reserves on impaired loans decreased from $1,881,314 at September 30, 2011 to $528,682 at September 30, 2012. Much of the decrease is a result of charging off the impaired loans. Charge off of these problem assets resulted in an overall increase in the credit quality of the loan portfolio. At September 30, 2012, the percentage of loans receiving pass credit risk grades was 98.2%, compared to 95.7% at September 30, 2011. Credit quality was further enhanced by an increase in loans carrying government guarantees. At September 30, 2012, the guaranteed portion of loans equaled 22.1% of total loans compared to 20.7% at September 30, 2011. Net interest income increased from $2,263,325 in the third quarter of 2011 to $2,347,448 in 2012. A reduction in the cost of deposits from the third quarter of 2011 to 2012 contributed to the margin improvement. Asset yields increased from 5.09% to 5.32% from 2011 to 2012 due to the change in earning asset mix from lower yielding deposits in other banks to higher yielding loans. The cost of funds continued to decrease from 1.05% in the third quarter of 2011 to 0.85% in the third quarter of 2012. Noninterest income decreased 2.6% in 2012 primarily due to a reduction in service charges on deposit accounts. Noninterest expenses decreased 6.7% from $1,773,472 in the third quarter of 2011, to $1,654,467 in 2012. This decrease is primarily attributable to a $130,000 litigation settlement the Company paid in the third quarter of 2011 compared to no expense in 2012. Salaries and employee benefits increased from $862,414 in 2011 to $885,633 in 2012 primarily due to normal salary adjustments. FDIC insurance premiums dropped due to shrinkage in deposits. The remaining noninterest expenses did not materially change from quarter to quarter collectively amounting to $743,106 in 2012 compared to $744,349 in 2011.

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

Net income available for common stockholders for the nine months ended September 30, 2012, was $1,669,165 or $0.43 per diluted share outstanding compared to $1,687,891 or $0.44 per diluted share outstanding for the same period in 2011. This represents a 1.1% decrease in earnings for the first nine months of 2012 compared to the same period in 2011. This decrease is attributable to an increase in the provision for loan losses, though much of the provision increase was offset by stronger margins and expense reductions. The provision increased from $67,190 in the first nine months of 2011 to a provision of $780,372 during the same period in 2012. The charge off of nonperforming loans and their effect on the historical loss component of the loan loss reserve resulted in the provision increase. Loan charge offs were greater for the first nine months of 2011 than in 2012 but most of the loans charged off in 2011 had specific reserves already established. When these loans were charged off it had minimal effect on the loan loss provision in 2011 since both the loan and the corresponding reserve were removed. However, the historical loss component was enhanced. This increase coupled with a spike in second quarter losses required the 2012 provision to be increased. Net interest income increased from $6,558,755 in the first nine months of 2011 to $6,962,216 in 2012. This increase is due to an increase in average loans as a percentage of total earning assets for the nine month period ended September 30, 2012 versus the same period in 2011. Overall assets yields have increased as a result of this increase in higher yielding average loans. Additionally, corresponding reductions in the cost of funds further increased the margin. The cost of funds decreased from 1.14% in 2011 to 0.90% in 2012. Noninterest income increased 2.7% in 2012 primarily due to an increase in revenues from the Bank s insurance subsidiary. Noninterest expenses decreased 3.3% from $5,306,297 in the nine months ended September 30, 2011, to $5,131,319 for the same period in 2012. Most of the decrease is associated with a reduction in the litigation settlement expense discussed earlier and a decrease in net expenses associated with foreclosed assets. Foreclosed asset expense decreased from $140,190 in first nine months of 2011 to $41,662 in 2012.

On September 30, 2012, Surrey Bancorp s assets totaled $226,231,381 compared to $224,727,764 on December 31, 2011. Net loans were $183,238,489 compared to $175,446,206 on December 31, 2011. This net increase was the result of a $7,644,879 increase in gross loans and a $147,404 reduction in the loan loss reserve. Commercial loans increased 14.3% during the nine month period ended September 30, 2012; however real estate loans decreased over 10.1% reducing the overall increase in gross loans to 4.2%. Interest-bearing deposits with banks decreased from $30,757,636 at December 31, 2011 to $18,098,576 at September 30, 2012, due to the increase in loans, an increase in deposits due from banks of approximately $3,267,000 and a $1,750,000 purchase of bank owned life insurance. The increase in deposits with other banks resulted from changing our correspondent banking relationship for deposit clearings to a correspondent that does not automatically sweep the account to overnight funds.

Total deposits on September 30, 2012, were $183,465,913 compared to $183,938,376 at the end of 2011. This small decrease is attributable to sizable decreases in certificates of deposit and increases in demand deposits and savings deposits. Demand deposits increased 15.2% from 2011 totals, while savings deposits, including money market accounts, increased 8.7%. Certificates of deposit decreased 12.1% from December 31, 2011 totals.

Common stockholders equity increased by $1,723,005, or 6.54%, during the nine months ended September 30, 2012. The increase is comprised of net income of $1,806,481, exercised common stock options of $30,111, other stock based compensation of $16,479 and adjustments to Accumulated Other Comprehensive Income of $7,250. Decreases included the payment and accrual of preferred dividends of $137,316. The net increase resulted in a common stock book value of $7.93 per share, up from $7.45 on December 31, 2011.

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 remained the same during the period ended September 30, 2012. Combined preferred and common stockholders equity increased $1,723,005, or 5.70%, for the nine months ended September 30, 2012.

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

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. The Company invested funds in a brokerage account during the quarter made up of selected equities and mutual funds. The investments were made to increase income in the holding company and improve yields.

Available for sale securities are reported at fair value and consist of bonds, notes, debentures and equity securities and mutual funds 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.

Investments in available for sale securities of $3,512,197 consisted of U.S. Governmental Agency obligations with maturities ranging from 17 to 30 months, corporate bonds with maturities of 5.75 years to 6.0 years, that reprice quarterly, GNMA adjustable rate mortgage securities, which adjust annually, equity securities and mutual funds.

Loans

Net loans outstanding on September 30, 2012, were $183,238,489 compared to $175,446,206 on December 31, 2011. 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, 2012, 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, 2012, were $183,465,913, compared to $183,938,376 on December 31, 2011. The September total consists of a base of approximately 12,285 accounts compared to 12,126 accounts at December 31, 2011. Interest-bearing accounts represent 77.9% of September 30, 2012 period end deposits versus 83.3% at December 31, 2011.

Federal Funds Purchased

The Company had no federal funds purchased at September 30, 2012 or December 31, 2011. Federal funds purchased were not utilized due to the adequate liquidity resulting from the increase in deposits.

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
September 30, 2012:		
Total Capital		
(to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	19.12%	8.0%
Surrey Bank & Trust	18.85%	8.0%
Tier I Capital		
(to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	17.86%	4.0%
Surrey Bank & Trust	17.59%	4.0%
Tier I Capital		
(to Average Assets)		
Surrey Bancorp (Consolidated)	13.81%	4.0%
Surrey Bank & Trust	13.57%	4.0%
December 31, 2011:		
Total Capital		
(to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	18.54%	8.0%
Surrey Bank & Trust	18.53%	8.0%
Tier I Capital		
(to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	17.28%	4.0%
Surrey Bank & Trust	17.26%	4.0%
Tier I Capital		
(to Average Assets)		
Surrey Bancorp (Consolidated)	12.67%	4.0%
Surrey Bank & Trust	12.65%	4.0%

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 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 of recovery actions is provided to the Board of Directors.

Nonperforming assets are detailed below.

	September 30, 2012	December 31, 2011
Nonaccrual loans	$ 3,816,211	$ 4,395,210
Loans past due 90 days and still accruing		49,881
Foreclosed assets	599,877	560,018
Total	$ 4,416,088	$ 5,005,109
Total assets	$ 226,231,381	$ 224,727,764
Ratio of nonperforming assets to total assets	1.95%	2.23%

At September 30, 2012, the Bank had loans totaling $3,816,211 in nonaccrual status. Approximately $1,304,000 of the nonaccrual loans were current at the end of September. The Bank had no loans past due 90 days and still accruing at September 30, 2012. The guaranteed portion of nonaccrual loans at September 30, 2012 is $1,136,138. Foreclosed assets at September 30, 2012 primarily include 1-4 family dwellings. Loans that were considered impaired but were still accruing interest at September 30, 2012, including troubled debt restructurings, totaled $2,616,125. 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 under the contractual terms of the loan agreement. Specific reserves on nonaccrual and impaired loans totaled $528,682 at quarter end, or 8.2% of the balances outstanding.

Nonaccrual and impaired loans still accruing are summarized below:

	September 30, 2012	December 31, 2011
Construction and development	$ 88,429	$ 92,504
1-4 family residential	438,626	705,326
Multi-family	207,179	
Nonfarm, nonresidential	3,235,812	3,627,890
Commercial and industrial	2,457,177	3,160,174
Consumer	5,113	10,452
Total impaired and nonaccrual	$ 6,432,336	$ 7,596,346

At September 30, 2012, consumer loans totaling $153,250 are included above that were not individually evaluated for impairment in the determination of the allowance for loan loss reserve (See Note 6). These loans are primarily home equity loans collateralized by 1-4 family properties which are considered consumer loans. These loans are on nonaccrual status at the end of the quarter and therefore considered impaired.

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, 2012		December 31, 2011	
Construction and development	$ 5,585,372	2.99%	$ 6,213,443	3.46%
1-4 family residential	36,853,785	19.72%	39,499,189	22.02%
Multi-family	1,730,308	0.93%	2,214,365	1.23%
Farmland	2,398,007	1.28%	2,722,872	1.52%
Nonfarm, non-residential	48,853,854	26.15%	47,867,333	26.69%
Total real estate	95,421,326	51.07%	98,517,202	54.92%
Agricultural	17,517	0.01%	29,493	0.02%
Commercial and industrial	84,317,344	45.11%	73,756,422	41.13%
Consumer	7,090,254	3.79%	7,041,846	3.93%
Other	37,976	0.02%		0.00%
Total loans	$ 186,884,417	100.00%	$ 179,344,963	100.00%

The concentrations represented above do not, based on managements assessment, expose the Bank to any unusual concentration risk. Based on the Bank s asset 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 a borrower s actual results of operations not corresponding 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 $51,814,029 in loans that carry government guarantees. The guaranteed portion of these loans amounts to $41,380,165 at September 30, 2012. Loan guarantees by loan class are below:

	September 30, 2012	Guaranteed Portion Amount	Percentage
Construction and development	$ 5,585,372	$	%
1-4 family residential	36,853,785	814,614	2.21%
Multi-family	1,730,308	17,745	1.03%
Farmland	2,398,007	451,116	18.81%
Nonfarm, non-residential	48,853,854	14,176,508	29.02%
Total real estate	95,421,326	15,459,983	16.20%
Agricultural	17,517		%
Commercial and industrial	84,317,344	25,920,182	30.74%
Consumer	7,090,254		%
Other	37,976		%
Total loans	$ 186,884,417	$ 41,380,165	22.14%

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 $2,533,116 at September 30, 2012. Non-owner occupied nonfarm, non-residential properties included in nonfarm, non-residential loans above amounted to $8,965,753 at September 30, 2012.

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

The consolidated provision for loan losses was $780,372 for the first nine months of 2012 compared to $67,190 for the same period in 2011. The charge off of nonperforming loans and their effect on the historical loss component of the loan reserve resulted in the provision increase. Loan charge offs were greater for the first nine months of 2011 than in 2012 but most of the loans charged off in 2011 had specific reserves already established. When these loans were charged off it had minimal effect on the loan loss provision in 2011 since both the loan and the corresponding reserve were removed. However, the historical loss component was enhanced. This increase coupled with unexpected second quarter losses required the current provision to be increased. Reserves for nonaccrual and impaired loans at September 30, 2012 amounted to $528,682, compared to $813,174 at December 31, 2011.

The reserve for loan losses on September 30, 2012, was $3,733,177 or 1.99% of period end loans. This percentage is derived from total loans. Approximately $51,814,000 of total loans outstanding at September 30, 2012, are government guaranteed loans which carry guarantees ranging from 49% to 100% of the outstanding loan balance. When the guaranteed portion of the loans, for which the Bank has no credit exposure, is removed from the equation the loan loss reserve is approximately 2.56% of outstanding loans. At December 31, 2011 the loan loss reserve percentage was 2.16% of total loans and 2.76% of loans net of government guarantees.

The level of reserve is established based upon management s evaluation of historical loss data and the effects of certain environmental factors on the loan portfolio. The historical loss portion of the reserve is computed using the average loss data from the past applied to its corresponding category of loans. However, historical losses only reflect a small portion of the Bank s loan loss reserve, although that portion did increase during the first nine months of 2012 due to the effect of charged off loans. 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, 2012 and December 31, 2011.

	September 30, 2012		December 31, 2011	
	30-89 Days	**90 Days Plus**	**30-89 Days**	**90 Days Plus**
Construction and development	$ 434,894	$	$ 297,139	$
1-4 family residential	783,160	175,374	699,287	72,774
Nonfarm, non-residential	1,353,306	121,727	217,968	
Commercial and industrial	1,210,125	44,234	820,393	218,516
Consumer	83,082	546	399,815	15,790
Other loans	207,179			
	$ 4,071,746	$ 341,881	$ 2,434,602	$ 307,080
Non-accrual loans included above	$ 2,170,179	$ 341,881	$ 310,550	$ 257,199
Guaranteed portion	$ 1,636,951	$ 107,814	$ 422,069	$ 33,407
Ratio to total loans	2.18%	0.18%	1.36%	0.17%
Ratio to total loans, net of guarantees	1.67%	0.16%	1.44%	0.19%

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, 2011 to September 30, 2012. The majority of the increase is in the 30-89 days time frame.

The largest increases were in nonfarm, non-residential loans and commercial loans. The majority of the increase in non-farm, non-residential loans past due at September 30, 2012 consist of three customers amounting to $1,117,705. Those loans carry government guarantees of $653,711. The increase in commercial past dues relate to one of those same customers. The guaranteed portion of commercial loans past due is $852,968. Overall past dues increased approximately 61.0% from the end of 2011 to September 30, 2012. At September 30, 2012, the guaranteed portion of total past due loans equals 39% compared to 17% at December 31, 2011.

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

Management believes that its loan portfolio is sufficiently diversified such 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. The Bank lends primarily in Surry County, North Carolina and Patrick Country, Virginia and surrounding counties.

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, 2012, the liquidity position of the Company was good, in management s opinion, with short-term liquid assets of $24,345,498 compared to $33,736,588 at December 31, 2011. Loan increases of $7,644,879 account for most of the decrease in liquidity. The Bank also increased its investment in Bank Owned Life Insurance (BOLI) by $1,750,000. To provide supplemental liquidity, the Bank has six unsecured lines of credit with correspondent banks totaling $25,500,000. At September 30, 2012, 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 $13,051,000 of which $7,750,000 of advances had been taken down at September 30, 2012.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not Applicable as a Smaller Reporting Company.

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.

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. Mine Safety Disclosures
Not Applicable

Item 5. Other Information
None

Item 6. Exhibits

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

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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 9, 2012

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

Date: November 9, 2012

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