

SURREY BANCORP
Form 10-Q
November 13, 2013

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, 2013

.. 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)

(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 No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by checkmark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company

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

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

On November 8, 2013 there were 3,542,984 common shares issued and outstanding.

PART I FINANCIAL INFORMATION

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Consolidated Balance Sheets*September 30, 2013 (Unaudited) and December 31, 2012 (Audited)*

| | September 2013 | December 2012 |
|---|---------------------------|--------------------------|
| Assets | | |
| Cash and due from banks | \$ 5,007,649 | \$ 5,973,042 |
| Interest-bearing deposits with banks | 35,331,449 | 32,366,318 |
| Federal funds sold | 1,211,320 | 710,588 |
| Investment securities available for sale | 4,528,656 | 3,502,852 |
| Restricted equity securities | 676,739 | 738,324 |
| Loans, net of allowance for loan losses of \$3,299,860 at September 30, 2013 and \$3,403,098 at December 31, 2012 | 178,519,116 | 173,577,565 |
| Property and equipment, net | 4,439,435 | 4,543,738 |
| Foreclosed assets | 88,441 | 491,424 |
| Accrued income | 1,011,371 | 979,098 |
| Goodwill | 120,000 | 120,000 |
| Bank owned life insurance | 5,420,346 | 5,298,354 |
| Other assets | 2,989,334 | 1,611,129 |
| Total assets | \$ 239,343,856 | \$ 229,912,432 |
| Liabilities and Stockholders Equity | | |
| Liabilities | | |
| Deposits: | | |
| Noninterest-bearing | \$ 43,451,729 | \$ 36,979,419 |
| Interest-bearing | 150,243,341 | 150,843,618 |
| Total deposits | 193,695,070 | 187,823,037 |
| Long-term debt | 7,750,000 | 7,750,000 |
| Dividends payable | 46,233 | 46,106 |
| Accrued interest payable | 204,172 | 135,801 |
| Other liabilities | 3,345,311 | 1,920,187 |
| Total liabilities | 205,040,786 | 197,675,131 |
| Commitments and contingencies (Note 4) | | |
| 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, | 2,620,325 | 2,620,325 |

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with a liquidation value of \$14 per share;

| | | |
|--|-----------------------|-----------------------|
| 181,154 shares of Series D, issued and outstanding with no par value 5.0% convertible non-cumulative, perpetual; with a liquidation value 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 shares issued and outstanding at September 30, 2013 and December 31, 2012 | 12,061,153 | 12,061,153 |
| Retained earnings | 18,418,499 | 16,367,187 |
| Accumulated other comprehensive loss | (45,389) | (59,846) |
| Total stockholders' equity | 34,303,070 | 32,237,301 |
| Total liabilities and stockholders' equity | \$ 239,343,856 | \$ 229,912,432 |

See Notes to Consolidated Financial Statements

Consolidated Statements of Income*Nine months ended September 30, 2013 and 2012 (Unaudited)*

| | 2013 | 2012 |
|--|------------------|------------------|
| <i>Interest income</i> | | |
| Loans and fees on loans | \$ 7,795,380 | \$ 8,161,796 |
| Federal funds sold | 1,601 | 1,168 |
| Investment securities, taxable | 40,820 | 38,935 |
| Investment securities, dividends | 9,715 | |
| Deposits with banks | 57,384 | 35,176 |
| Total interest income | 7,904,900 | 8,237,075 |
| <i>Interest expense</i> | | |
| Deposits | 890,412 | 1,049,473 |
| Fed funds purchased | 80 | 150 |
| Short-term debt | 38,543 | |
| Long-term debt | 217,990 | 225,236 |
| Total interest expense | 1,147,025 | 1,274,859 |
| Net interest income | 6,757,875 | 6,962,216 |
| <i>Provision for loan losses</i> | | |
| Net interest income after provision for loan losses | 6,609,762 | 6,181,844 |
| <i>Noninterest income</i> | | |
| Service charges on deposit accounts | 652,230 | 691,098 |
| Gain on sale of government guaranteed loans | 229,130 | |
| Realized gains on the sale of securities | 5,297 | |
| Fees on loans delivered to correspondents | 66,816 | 103,022 |
| Other service charges and fees | 422,731 | 413,115 |
| Other operating income | 691,977 | 608,033 |
| Total noninterest income | 2,068,181 | 1,815,268 |
| <i>Noninterest expense</i> | | |
| Salaries and employee benefits | 2,782,830 | 2,674,154 |
| Occupancy expense | 320,925 | 331,151 |
| Equipment expense | 180,123 | 184,254 |

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| | | |
|--|------------------|------------------|
| Data processing | 312,171 | 281,290 |
| Foreclosed assets, net | 29,200 | 41,662 |
| Postage, printing and supplies | 145,304 | 148,667 |
| Professional fees | 283,744 | 279,641 |
| FDIC insurance premiums | 75,694 | 110,233 |
| Other expense | 1,068,569 | 1,080,267 |
| Total noninterest expense | 5,198,560 | 5,131,319 |
| Net income before income taxes | 3,479,383 | 2,865,793 |
| Income tax expense | 1,290,881 | 1,059,312 |
| Net income | 2,188,502 | 1,806,481 |
| <i>Preferred stock dividends</i> | (137,190) | (137,316) |
| Net income available to common stockholders | \$ 2,051,312 | \$ 1,669,165 |
| <i>Basic earnings per common share</i> | \$ 0.58 | \$ 0.47 |
| <i>Diluted earnings per common share</i> | \$ 0.52 | \$ 0.43 |
| <i>Basic weighted average common shares outstanding</i> | 3,542,984 | 3,540,220 |
| <i>Diluted weighted average common shares outstanding</i> | 4,176,919 | 4,174,155 |
| <i>See Notes to Consolidated Financial Statements</i> | | |

Consolidated Statements of Income*Three months ended September 30, 2013 and 2012 (Unaudited)*

| | 2013 | 2012 |
|---|------------------|------------------|
| <i>Interest income</i> | | |
| Loans and fees on loans | \$ 2,574,613 | \$ 2,726,346 |
| Federal funds sold | 696 | 389 |
| Investment securities, taxable | 14,020 | 12,517 |
| Investment securities, dividends | 3,694 | |
| Deposits with banks | 18,681 | 11,370 |
| Total interest income | 2,611,704 | 2,750,622 |
| <i>Interest expense</i> | | |
| Deposits | 291,280 | 329,792 |
| Long-term debt | 73,472 | 73,382 |
| Total interest expense | 364,752 | 403,174 |
| Net interest income | 2,246,952 | 2,347,448 |
| <i>Provision for loan losses</i> | 12,317 | 41,384 |
| Net interest income after provision for loan losses | 2,234,635 | 2,306,064 |
| <i>Noninterest income</i> | | |
| Service charges on deposit accounts | 215,170 | 229,368 |
| Fees on loans delivered to correspondents | 31,496 | 32,788 |
| Other service charges and fees | 150,787 | 136,411 |
| Other operating income | 215,709 | 184,613 |
| Total noninterest income | 613,162 | 583,180 |
| <i>Noninterest expense</i> | | |
| Salaries and employee benefits | 911,334 | 885,633 |
| Occupancy expense | 102,167 | 105,938 |
| Equipment expense | 59,488 | 66,642 |
| Data processing | 99,878 | 98,871 |
| Foreclosed assets, net | 4,895 | 9,368 |
| Postage, printing and supplies | 46,371 | 51,434 |
| Professional fees | 71,173 | 72,968 |

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| | | |
|--|------------------|------------------|
| FDIC insurance premiums | 28,826 | 25,728 |
| Other expense | 353,845 | 337,885 |
| Total noninterest expense | 1,677,977 | 1,654,467 |
| Net income before income taxes | 1,169,820 | 1,234,777 |
| Income tax expense | 433,937 | 459,934 |
| Net income | 735,883 | 774,843 |
| <i>Preferred stock dividends</i> | (46,233) | (46,106) |
| Net income available to common stockholders | \$ 689,650 | \$ 728,737 |
| <i>Basic earnings per common share</i> | \$ 0.19 | \$ 0.21 |
| <i>Diluted earnings per common share</i> | \$ 0.18 | \$ 0.19 |
| <i>Basic weighted average common shares outstanding</i> | 3,542,984 | 3,542,984 |
| <i>Diluted weighted average common shares outstanding</i> | 4,176,919 | 4,176,919 |
| <i>See Notes to Consolidated Financial Statements</i> | | |

Consolidated Statements of Comprehensive Income*Nine months ended September 30, 2013 and 2012 (Unaudited)*

| | Three Months Ended September, | | Nine Months Ended September 30, | |
|--|--|-------------|--|--------------|
| | 2013 | 2012 | 2013 | 2012 |
| Net income | \$ 735,883 | \$ 774,843 | \$ 2,188,502 | \$ 1,806,481 |
| Other comprehensive income: | | | | |
| Investment securities available-for-sale: | | | | |
| Unrealized holding gains | 22,094 | 18,528 | 27,349 | 11,168 |
| Tax effect | (8,038) | (6,756) | (9,396) | (3,918) |
| Reclassification of gains recognized in net income | | | (5,297) | |
| Tax effect | | | 1,801 | |
| | 14,056 | 11,772 | 14,457 | 7,250 |
| Comprehensive income | \$ 749,939 | \$ 786,615 | \$ 2,199,463 | \$ 1,813,731 |

See Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows*Nine months ended September 30, 2013 and 2012 (Unaudited)*

| | 2013 | 2012 |
|---|--------------|--------------|
| <i>Cash flows from operating activities</i> | | |
| Net income | \$ 2,188,502 | \$ 1,806,481 |
| Adjustments to reconcile net income to net cash provided by operations: | | |
| Depreciation and amortization | 185,873 | 178,088 |
| Gain on sale of property and equipment | (100) | (650) |
| Gain on the sale of government guaranteed loans | (229,130) | |
| Gain on the sale of investments | (5,297) | |
| Gain on the sale of foreclosed assets | (33,520) | (74,806) |
| Stock-based compensation, net of tax benefit | | 16,479 |
| Provision for loan losses | 148,113 | 780,372 |
| Deferred income taxes | 5,673 | 5,308 |
| Accretion of discount on securities, net of amortization of premiums | 31 | 407 |
| Increase in cash surrender value of life insurance | (121,992) | (116,212) |
| Changes in assets and liabilities: | | |
| Accrued income | (32,273) | (81,841) |
| Other assets | (1,391,473) | (212,008) |
| Accrued interest payable | 68,371 | 35,790 |
| Other liabilities | 1,654,254 | 1,097,920 |
| Net cash provided by operating activities | 2,437,032 | 3,435,328 |
| <i>Cash flows from investing activities</i> | | |
| Net (increase) decrease in interest-bearing deposits with banks | (2,965,131) | 12,659,060 |
| Net increase in federal funds sold | (500,732) | (557) |
| Purchases of investment securities | (2,053,314) | (3,000,481) |
| Sales and maturities of investment securities | 1,054,828 | 2,005,471 |
| Purchase of Bank Owned Life Insurance | | (1,750,000) |
| Redemption of restricted equity securities | 61,800 | 73,600 |
| Purchase of restricted equity securities | (215) | (2,170) |
| Net increase in loans | (5,131,864) | (9,111,060) |
| Proceeds from the sale of foreclosed assets | 478,703 | 573,352 |
| Purchases of property and equipment | (81,570) | (155,477) |
| Proceeds from the sale of property and equipment | 100 | 650 |
| Net cash provided by (used in) investing activities | (9,137,395) | 1,292,388 |
| <i>Cash flows from financing activities</i> | | |
| Net increase (decrease) in deposits | 5,872,033 | (472,463) |

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| | | |
|--|--------------|--------------|
| Repayments of long-term debt | | (350,000) |
| Dividends paid | (137,063) | (667,951) |
| Common stock options exercised | | 30,111 |
| Net cash provided by (used in) financing activities | 5,734,970 | (1,460,303) |
| Net increase (decrease) in cash and cash equivalents | (965,393) | 3,267,413 |
| <i>Cash and due from banks, beginning</i> | 5,973,042 | 2,269,116 |
| <i>Cash and due from banks, ending</i> | \$ 5,007,649 | \$ 5,536,529 |
| <i>Supplemental disclosures of cash flow information</i> | | |
| Interest paid | \$ 1,078,654 | \$ 1,239,069 |
| Taxes paid | \$ 1,354,255 | \$ 500,000 |
| <i>Supplemental disclosures of non-cash transactions</i> | | |
| Loans transferred to foreclosed properties | \$ 42,200 | \$ 538,405 |
| Proceeds from the sale of guaranteed loan previously recorded as short term debt | \$ 3,743,820 | \$ |

See Notes to Consolidated Financial Statements

Consolidated Statements of Changes in Stockholders' Equity*Nine months ended September 30, 2013 and 2012 (Unaudited)*

| | Preferred Stock Amount | Common Stock Shares | Common Stock Amount | Retained Earnings | Accumulated Other Comprehensive Loss | Total |
|--|---------------------------------------|--------------------------------|--------------------------------|------------------------------|---|---------------|
| <i>Balance, January 1, 2012</i> | \$ 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 |
| Other comprehensive income | | | | | 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) |
| <i>Balance, September 30, 2012</i> | \$ 3,868,807 | 3,542,984 | \$ 12,056,178 | \$ 16,074,632 | \$ (50,050) | \$ 31,949,567 |
| <i>Balance, January 1, 2013</i> | \$ 3,868,807 | 3,542,984 | \$ 12,061,153 | \$ 16,367,187 | \$ (59,846) | \$ 32,237,301 |
| Net income | | | | 2,188,502 | | 2,188,502 |
| Other comprehensive income | | | | | 14,457 | 14,457 |
| 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) |

| | | | | | | |
|---|--------------|-----------|---------------|---------------|-------------|---------------|
| <i>Balance, September 30, 2013</i> | \$ 3,868,807 | 3,542,984 | \$ 12,061,153 | \$ 18,418,499 | \$ (45,389) | \$ 34,303,070 |
|---|--------------|-----------|---------------|---------------|-------------|---------------|

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, 2013, the results of operations and comprehensive income for the three and nine months ended September 30, 2013 and 2012, and its changes in stockholders' equity and cash flows for the nine months ended September 30, 2013 and 2012. These adjustments are of a normal and recurring nature. The results of operations for the nine months ended September 30, 2013, 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, 2012, included in the Company's Form 10-K. The balance sheet at December 31, 2012, 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, 2012 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 on Form 10-K 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, 2013 and December 31, 2012, 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, 2013 and December 31, 2012.

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 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 were effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012. The amendments did not have a material effect on the Company's financial statements.

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Recent Accounting Pronouncements, continued

The Comprehensive Income topic of the ASC was amended in September 2011. The amendment eliminated the option to present other comprehensive income as a part of the statement of changes in stockholders' equity and required consecutive presentation of the statement of net income and other comprehensive income. The amendments were applicable to the Company 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 while the FASB redeliberated the presentation requirements for the reclassification adjustments. In February 2013, the FASB further amended the Comprehensive Income topic clarifying the conclusions from such redeliberations. Specifically, the amendments do not change the current requirements for reporting net income or other comprehensive income in financial statements. However, the amendments do require an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, in certain circumstances an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income. The amendments were effective for the Company on a prospective basis beginning January 1, 2013. These amendments did not have a material effect on the Company's financial statements.

On April 22, 2013, the FASB issued guidance addressing application of the liquidation basis of accounting. The guidance is intended to clarify when an entity should apply the liquidation basis of accounting. In addition, the guidance provides principles for the recognition and measurement of assets and liabilities and requirements for financial statements prepared using the liquidation basis of accounting. The amendments will be effective for entities that determine liquidation is imminent during annual reporting periods beginning after December 15, 2013, and interim reporting periods therein and those requirements should be applied prospectively from the day that liquidation becomes imminent. Early adoption is permitted. The Company does not expect these amendments to have any effect on its 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, 2013 and December 31, 2012 follow:

| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|----------------------------------|-------------------|---------------------|----------------------|---------------|
| September 30, 2013 | | | | |
| Government-sponsored enterprises | \$ 3,500,000 | \$ 2,900 | \$ 3,895 | \$ 3,499,005 |
| Mortgage-backed securities | 34,067 | 1,077 | | 35,144 |
| Corporate bonds | 550,000 | | 99,000 | 451,000 |
| Equities and mutual funds | 520,180 | 28,869 | 5,542 | 543,507 |
| | \$ 4,604,247 | \$ 32,846 | \$ 108,437 | \$ 4,528,656 |
| December 31, 2012 | | | | |
| Government-sponsored enterprises | \$ 2,500,000 | \$ 4,875 | \$ | \$ 2,504,875 |
| Mortgage-backed securities | 41,659 | 1,316 | | 42,975 |
| Corporate bonds | 550,000 | | 107,250 | 442,750 |
| Equities and mutual funds | 508,836 | 3,416 | | 512,252 |
| | \$ 3,600,495 | \$ 9,607 | \$ 107,250 | \$ 3,502,852 |

At September 30, 2013 and December 31, 2012, 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, 2013, were as follows:

| | Amortized Cost | Fair Value |
|--|-------------------|---------------|
| Due in one year or less | \$ 520,180 | \$ 543,507 |
| Due after one year through five years | 4,057,373 | 3,957,431 |
| Due after five years through ten years | 15,739 | 16,354 |
| Due after ten years | 10,955 | 11,364 |

| | | |
|--|--------------|--------------|
| | \$ 4,604,247 | \$ 4,528,656 |
|--|--------------|--------------|

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, 2013 and December 31, 2012. These unrealized losses on investment securities are a result of volatility in interest rates which relate to government-sponsored enterprises and corporate bonds issued by other banks and market volatility as it relates to equity and mutual fund investments at September 30, 2013 and December 31, 2012.

| | Less Than 12 Months | | 12 Months or More | | Total | |
|----------------------------------|----------------------------|------------------------------|--------------------------|------------------------------|-----------------------|------------------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| <u>September 30, 2013</u> | | | | | | |
| Government-sponsored enterprises | \$ 1,496,105 | \$ 3,895 | \$ | \$ | \$ 1,496,105 | \$ 3,895 |
| Corporate bonds | | | 451,000 | 99,000 | 451,000 | 99,000 |
| Equities and mutual funds | 256,350 | 5,542 | | | 256,350 | 5,542 |
| | \$ 1,752,455 | \$ 9,437 | \$ 451,000 | \$ 99,000 | \$ 2,203,455 | \$ 108,437 |
| <u>December 31, 2012</u> | | | | | | |
| Corporate bonds | \$ | \$ | \$ 442,750 | \$ 107,250 | \$ 442,750 | \$ 107,250 |
| | \$ | \$ | \$ 442,750 | \$ 107,250 | \$ 442,750 | \$ 107,250 |

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 at September 30, 2013, with unrealized losses for a period greater than 12 months. These securities also had unrealized losses for a period greater than 12 months at December 31, 2012. 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 realized gains of \$5,297 from the sales of equity and mutual fund investment securities for the nine month periods ended September 30, 2013. Total proceeds from the sales amounted to \$47,268. There were no such gains in 2012.

NOTE 3. EARNINGS PER SHARE

Basic earnings per share for the nine and three months ended September 30, 2013 and 2012 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, 2013, the Company had commitments to extend credit, including unused lines of credit of approximately \$33,263,000 and letters of credit outstanding of \$1,649,500.

NOTE 5. LOANS

The major components of loans in the balance sheets at September 30, 2013 and December 31, 2012 are below.

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| | 2013 | 2012 |
|--|----------------|----------------|
| Commercial | \$ 67,225,422 | \$ 75,914,072 |
| Real estate: | | |
| Construction and land development | 4,941,654 | 4,873,512 |
| Residential, 1-4 families | 38,040,049 | 36,091,051 |
| Residential, 5 or more families | 1,561,060 | 1,676,449 |
| Farmland | 2,227,847 | 2,284,155 |
| Nonfarm, nonresidential, net of discounts of \$136,784 in 2013 and \$22,001 in 2012 | 61,366,016 | 48,993,867 |
| Agricultural | 109,993 | 147,860 |
| Consumer, net of discounts of \$10,797 in 2013 and \$17,764 in 2012 | 6,071,806 | 6,703,363 |
| Other | 1,789 | 3,000 |
| | 181,545,636 | 176,687,329 |
| Deferred loan origination costs, net of (fees) | 273,340 | 293,334 |
| | 181,818,976 | 176,980,663 |
| Allowance for loan losses | (3,299,860) | (3,403,098) |
| | \$ 178,519,116 | \$ 173,577,565 |

SURREY BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**NOTE 5. LOANS, CONTINUED**

Residential, 1-4 family loans pledged as collateral against FHLB advances approximated \$18,141,000 and \$17,765,000 at September 30, 2013 and December 31, 2012, respectively.

NOTE 6. ALLOWANCE FOR LOAN LOSSES

The activity of the allowance for loan losses by loan components during the nine months ended September 30, 2013 and 2012 was as follows:

| | Construction & Development | 1-4 Family Residential | Nonfarm, Nonresidential | Commercial & Industrial | Consumer | Other | Total |
|--|---|-----------------------------------|------------------------------------|--|-----------------|--------------|--------------|
| <u>September 30, 2013</u> | | | | | | | |
| <i>Allowance for credit losses:</i> | | | | | | | |
| Beginning balance | \$ 86,300 | \$ 668,700 | \$ 801,999 | \$ 1,604,510 | \$ 198,789 | \$ 42,800 | \$ 3,403,098 |
| Charge-offs | | (26,967) | (166,517) | (51,028) | (67,988) | | (312,500) |
| Recoveries | 533 | 402 | 1,357 | 34,719 | 24,138 | | 61,149 |
| Provision | (4,833) | 38,717 | 185,598 | (86,871) | 15,702 | (200) | 148,113 |
| Ending balance | \$ 82,000 | \$ 680,852 | \$ 822,437 | \$ 1,501,330 | \$ 170,641 | \$ 42,600 | \$ 3,299,860 |
| Ending balance: individually evaluated for impairment | \$ | \$ 11,652 | \$ 201,637 | \$ 167,530 | \$ | \$ | \$ 380,819 |
| Ending balance: collectively evaluated for impairment | \$ 82,000 | \$ 669,200 | \$ 620,800 | \$ 1,333,800 | \$ 170,641 | \$ 42,600 | \$ 2,919,041 |

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Ending
balance: loans
acquired with
deteriorated
credit quality \$ \$ \$ \$ \$ \$ \$

**Loans
Receivable:**

Ending
balance \$ 4,941,654 \$ 38,040,049 \$ 61,366,016 \$ 67,225,422 \$ 6,071,806 \$ 3,900,689 \$ 181,545,636

Ending
balance:
individually
evaluated for
impairment \$ 85,562 \$ 330,199 \$ 3,128,863 \$ 2,285,488 \$ \$ \$ 5,830,112

Ending
balance:
collectively
evaluated for
impairment \$ 4,856,092 \$ 37,709,850 \$ 58,237,153 \$ 64,939,934 \$ 6,071,806 \$ 3,900,689 \$ 175,715,524

Ending
balance: loans
acquired with
deteriorated
credit quality \$ \$ \$ \$ \$ \$ \$

**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

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| | | | | | | | |
|---|------------|------------|------------|--------------|------------|-----------|--------------|
| 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 | \$ | \$ | \$ | \$ | \$ | \$ | \$ |
|---|----|----|----|----|----|----|----|

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, 2013 and December 31, 2012 and the recognized interest income per the related period:

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| September 30, 2013 | | | | | |
| With no related allowance recorded: | | | | | |
| Construction and development | \$ 85,562 | \$ 85,562 | \$ | \$ 87,038 | \$ 4,033 |
| 1-4 family residential | 254,777 | 254,777 | | 272,985 | 2,003 |
| Nonfarm, nonresidential | 1,660,595 | 1,742,231 | | 1,830,858 | 41,522 |
| Commercial and industrial | 1,306,985 | 1,481,473 | | 1,340,485 | 50,391 |
| Consumer | | | | | |
| Other loans | | | | | |
| | 3,307,919 | 3,564,043 | | 3,531,366 | 97,949 |
| With an allowance recorded: | | | | | |
| Construction and development | \$ | \$ | \$ | \$ | \$ |
| 1-4 family residential | 75,422 | 75,422 | 11,652 | 79,601 | 1,275 |
| Nonfarm, nonresidential | 1,468,268 | 1,490,099 | 201,637 | 1,536,258 | 11,006 |
| Commercial and industrial | 978,503 | 978,503 | 167,530 | 1,011,624 | 11,601 |
| Consumer | | | | | |
| Other loans | | | | | |
| | 2,522,193 | 2,544,024 | 380,819 | 2,627,483 | 23,882 |
| Combined: | | | | | |
| Construction and development | \$ 85,562 | \$ 85,562 | \$ | \$ 87,038 | \$ 4,033 |
| 1-4 family residential | 330,199 | 330,199 | 11,652 | 352,586 | 3,278 |
| Nonfarm, nonresidential | 3,128,863 | 3,232,330 | 201,637 | 3,367,116 | 52,528 |
| Commercial and industrial | 2,285,488 | 2,459,976 | 167,530 | 2,352,109 | 61,992 |
| Consumer | | | | | |
| Other loans | | | | | |
| | \$ 5,830,112 | \$ 6,108,067 | \$ 380,819 | \$ 6,158,849 | \$ 121,831 |

December 31, 2012

With no related allowance recorded:

| | | | | | |
|------------------------------|-----------|-----------|----|-----------|----------|
| Construction and development | \$ 86,567 | \$ 86,567 | \$ | \$ 87,668 | \$ 4,898 |
| 1-4 family residential | 284,884 | 284,884 | | 287,802 | 19,798 |
| Nonfarm, nonresidential | 1,381,111 | 1,381,111 | | 1,396,123 | 81,741 |
| Commercial and industrial | 1,372,796 | 1,547,284 | | 1,312,662 | 67,194 |
| Consumer | | | | | |
| Other loans | 195,989 | 195,989 | | 199,895 | 18,025 |
| | 3,321,347 | 3,495,835 | | 3,284,150 | 191,656 |

With an allowance recorded:

| | | | | | |
|------------------------------|-----------|-----------|---------|-----------|---------|
| Construction and development | \$ | \$ | \$ | \$ | \$ |
| 1-4 family residential | | | | | |
| Nonfarm, nonresidential | 1,804,769 | 1,826,600 | 319,699 | 1,813,156 | 70,705 |
| Commercial and industrial | 1,000,379 | 1,000,379 | 195,410 | 1,006,640 | 39,320 |
| Consumer | | | | | |
| Other loans | | | | | |
| | 2,805,148 | 2,826,979 | 515,109 | 2,819,796 | 110,025 |

Combined:

| | | | | | |
|------------------------------|--------------|--------------|------------|--------------|------------|
| Construction and development | \$ 86,567 | \$ 86,567 | \$ | \$ 87,668 | \$ 4,898 |
| 1-4 family residential | 284,884 | 284,884 | | 287,802 | 19,798 |
| Nonfarm, nonresidential | 3,185,880 | 3,207,711 | 319,699 | 3,209,279 | 152,446 |
| Commercial and industrial | 2,373,175 | 2,547,663 | 195,410 | 2,319,302 | 106,514 |
| Consumer | | | | | |
| Other loans | 195,989 | 195,989 | | 199,895 | 18,025 |
| | \$ 6,126,495 | \$ 6,322,814 | \$ 515,109 | \$ 6,103,946 | \$ 301,681 |

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, 2013 | | | | | | | |
| Construction and development | \$ 32,174 | \$ | \$ | \$ 32,174 | \$ 4,909,480 | \$ 4,941,654 | \$ |
| 1-4 family residential | 424,565 | 300,806 | | 725,371 | 37,314,678 | 38,040,049 | |
| Nonfarm, nonresidential | 383,177 | 184,056 | 437,363 | 1,004,596 | 60,361,420 | 61,366,016 | |
| Commercial and industrial | 621,797 | 66,285 | 656,607 | 1,344,689 | 65,880,733 | 67,225,422 | |
| Consumer | 102,363 | 54,138 | 3,115 | 159,616 | 5,912,190 | 6,071,806 | 3,115 |
| Other loans | | | | | 3,900,689 | 3,900,689 | |
| Total | \$ 1,564,076 | \$ 605,285 | \$ 1,097,085 | \$ 3,266,446 | \$ 178,279,190 | \$ 181,545,636 | \$ 3,115 |
| Percentage of total loans | 0.86% | 0.33% | 0.61% | 1.80% | 98.20% | 100.00% | |

**Non-accruals
included
above**

| | | | | | | | |
|------------------------------------|---------|--------|---------|---------|-----------|-----------|--|
| Construction and development | \$ | \$ | \$ | \$ | \$ 71,010 | \$ 71,010 | |
| 1-4 family residential | 54,778 | | | 54,778 | 251,538 | 306,316 | |
| Nonfarm, nonresidential | 376,347 | 70,390 | 437,363 | 884,100 | 1,289,593 | 2,173,693 | |

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| | | | | | | | |
|---------------------------|------------|-----------|--------------|--------------|--------------|--------------|--|
| Commercial and industrial | 530,408 | | 656,607 | 1,187,015 | 132,977 | 1,319,992 | |
| Consumer | 1,986 | | | 1,986 | 2,938 | 4,924 | |
| Other loans | | | | | | | |
| | \$ 963,519 | \$ 70,390 | \$ 1,093,970 | \$ 2,127,879 | \$ 1,748,056 | \$ 3,875,935 | |

December 31, 2012

| | | | | | | | |
|------------------------------|--------------|------------|--------------|--------------|----------------|----------------|------------|
| Construction and development | \$ 73,572 | \$ | \$ | \$ 73,572 | \$ 4,799,940 | \$ 4,873,512 | \$ |
| 1-4 family residential | 380,731 | | 324,357 | 705,088 | 35,385,963 | 36,091,051 | 292,583 |
| Nonfarm, nonresidential | 711,408 | 197,479 | 386,160 | 1,295,047 | 47,698,820 | 48,993,867 | |
| Commercial and industrial | 256,672 | 53,391 | 429,226 | 739,289 | 75,174,783 | 75,914,072 | 377,494 |
| Consumer | 172,379 | 28,922 | 13,643 | 214,944 | 6,488,419 | 6,703,363 | 13,643 |
| Other loans | | | | | 4,111,464 | 4,111,464 | |
| Total | \$ 1,594,762 | \$ 279,792 | \$ 1,153,386 | \$ 3,027,940 | \$ 173,659,389 | \$ 176,687,329 | \$ 683,720 |

| | | | | | | | |
|---------------------------|-------|-------|-------|-------|--------|---------|--|
| Percentage of total loans | 0.90% | 0.16% | 0.65% | 1.71% | 98.29% | 100.00% | |
|---------------------------|-------|-------|-------|-------|--------|---------|--|

Non-accruals included above

| | | | | | | | |
|------------------------------|------------|-----------|------------|------------|--------------|--------------|--|
| Construction and development | \$ 73,572 | \$ | \$ | \$ 73,572 | \$ 12,995 | \$ 86,567 | |
| 1-4 family residential | 84,838 | | 31,775 | 116,613 | 359,129 | 475,742 | |
| Nonfarm, nonresidential | | 89,322 | 386,160 | 475,482 | 1,690,633 | 2,166,115 | |
| Commercial and industrial | | | 51,731 | 51,731 | 760,662 | 812,393 | |
| Consumer | 1,612 | | | 1,612 | 2,306 | 3,918 | |
| Other loans | | | | | 195,990 | 195,990 | |
| | \$ 160,022 | \$ 89,322 | \$ 469,666 | \$ 719,010 | \$ 3,021,715 | \$ 3,740,725 | |

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, 2013 | | | | | |
| Construction and development | \$ 4,941,654 | \$ 4,870,644 | \$ 71,010 | \$ | \$ |
| 1-4 family residential | 38,040,049 | 37,732,683 | 307,366 | | |
| Nonfarm, nonresidential | 61,366,016 | 59,047,105 | 2,141,634 | 177,277 | |
| Commercial and industrial | 67,225,422 | 65,970,308 | 1,255,114 | | |
| Consumer | 6,071,806 | 6,071,547 | 259 | | |
| Other loans | 3,900,689 | 3,900,689 | | | |
| | \$ 181,545,636 | \$ 177,592,976 | \$ 3,775,383 | \$ 177,277 | \$ |
| | 100.0% | 97.8% | 2.1% | 0.1% | % |

Guaranteed portion of loans

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| | | | | | |
|------------------------------|---------------|---------------|--------------|-----------|--------|
| Construction and development | \$ 16,268 | 16,268 | \$ | \$ | \$ |
| 1-4 family residential | 707,922 | 662,783 | | 45,139 | |
| Nonfarm, nonresidential | 27,167,833 | 26,250,602 | | 854,665 | 62,566 |
| Commercial and industrial | 16,885,330 | 16,018,413 | | 866,917 | |
| Consumer | | | | | |
| Other loans | 498,984 | 498,984 | | | |
| | \$ 45,276,337 | \$ 43,447,050 | \$ 1,766,721 | \$ 62,566 | \$ |

| | Total | Pass Credits | Special Mention | Substandard | Doubtful |
|------------------------------|----------------|----------------|--------------------|-------------|----------|
| December 31, 2012 | | | | | |
| Construction and development | \$ 4,873,512 | \$ 4,786,945 | \$ 86,567 | \$ | \$ |
| 1-4 family residential | 36,091,051 | 35,755,061 | 335,990 | | |
| Nonfarm, nonresidential | 48,993,867 | 47,500,758 | 1,230,275 | 262,834 | |
| Commercial and industrial | 75,914,072 | 74,878,901 | 1,035,171 | | |
| Consumer | 6,703,363 | 6,696,475 | 6,888 | | |
| Other loans | 4,111,464 | 3,915,474 | 195,990 | | |
| | \$ 176,687,329 | \$ 173,533,614 | \$ 2,890,881 | \$ 262,834 | \$ |
| | 100.0% | 98.2% | 1.6% | 0.2% | % |

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6. ALLOWANCE FOR LOAN LOSSES, CONTINUED

| | Total | Pass Credits | Special Mention | Substandard | Doubtful |
|------------------------------------|---------------|---------------|--------------------|-------------|----------|
| <u>Guaranteed portion of loans</u> | | | | | |
| Construction and development | \$ | \$ | \$ | \$ | \$ |
| 1-4 family residential | 752,677 | 752,677 | | | |
| Nonfarm, nonresidential | 19,855,775 | 19,654,773 | 201,002 | | |
| Commercial and industrial | 22,001,515 | 21,354,422 | 647,093 | | |
| Consumer | | | | | |
| Other loans | 508,363 | 508,363 | | | |
| | \$ 43,118,330 | \$ 42,270,235 | \$ 848,095 | \$ | \$ |

NOTE 7. TROUBLED DEBT RESTRUCTURINGS

For the quarters and nine months ended September 30, 2013 and 2012, the following table presents loans modified during the period that were considered to be troubled debt restructurings.

| | For the three months ended September 30, 2013 | | For the nine months ended September 30, 2013 | |
|-------------------------------------|---|--|---|--|
| | Pre- Modification Number of Contracts | Post- Modification Outstanding Investment | Pre- Modification Number of Contracts | Post- Modification Outstanding Investment |
| <u>Troubled Debt Restructurings</u> | | | | |
| Construction and development | | \$ | | \$ |
| 1-4 Family residential | | | 1 | 54,376 |
| Nonfarm, nonresidential | | | 1 | 145,219 |
| Commercial and industrial | | | | |

| | For the three months ended September 30, 2012 | | For the nine months ended September 30, 2012 | |
|--|---|--|---|--|
| | Pre- Modification Number of Contracts | Post- Modification Outstanding Investment | Pre- Modification Number of Contracts | Post- Modification Outstanding Investment |
| | | | | |

| | Contract Outstanding Recorded Investment | Contract Outstanding Recorded Investment | Contract Outstanding Recorded Investment | Contract Outstanding Recorded Investment |
|------------------------------|---|---|---|---|
| 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 |

During the nine months ended September 30, 2013, 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, 2013, 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, 2013 | Total | Level 1 | Level 2 | Level 3 |
|-----------------------------------|-----------------|----------------|-----------------|----------------|
| Government-sponsored enterprises | \$ 3,499 | \$ | \$ 3,499 | \$ |
| Mortgage-backed securities | 35 | | 35 | |
| Corporate bonds | 451 | | | 451 |
| Equities and mutual funds | 543 | 543 | | |
| Total assets at fair value | \$ 4,528 | \$ 543 | \$ 3,534 | \$ 451 |
| | | | | |
| Total liabilities at fair value | \$ | \$ | \$ | \$ |

(in thousands)

| December 31, 2012 | Total | Level 1 | Level 2 | Level 3 |
|--------------------------|--------------|----------------|----------------|----------------|
|--------------------------|--------------|----------------|----------------|----------------|

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| | | | | |
|-----------------------------------|-----------------|---------------|-----------------|---------------|
| Government-sponsored enterprises | \$ 2,505 | \$ | \$ 2,505 | \$ |
| Mortgage-backed securities | 43 | | 43 | |
| Corporate bonds | 443 | | | 443 |
| Equities and mutual funds | 512 | 512 | | |
| Total assets at fair value | \$ 3,503 | \$ 512 | \$ 2,548 | \$ 443 |
| | | | | |
| Total liabilities at fair value | \$ | \$ | \$ | \$ |

For the nine months ended September 30, 2013 and 2012, the changes in Level 3 assets and liabilities measured at fair value on a recurring basis were as follows:

| <i>(in thousands)</i> | Level 3 | |
|---|---------------|---------------|
| | 2013 | 2012 |
| | Fair Value | Fair Value |
| Corporate Bonds Available for Sale | | |
| Balance, January 1 | \$ 443 | \$ 451 |
| Total unrealized gain (loss) included in income | | |
| Total unrealized gain (loss) included in other comprehensive income | 8 | |
| Balance, September 30 | \$ 451 | \$ 451 |

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. FAIR VALUE, CONTINUED

Changes in Level 3 corporate bond assets measured at fair value on a recurring basis for the three month period ended September 30, 2013 was \$2,750 which was included in other comprehensive income. The change in corporate bond assets for the three month period ended September 30, 2012 was \$5,500.

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)

| | Total | Level 1 | Level 2 | Level 3 |
|---------------------------------|----------|---------|---------|----------|
| September 30, 2013 | | | | |
| Loans-commercial and industrial | \$ 810 | \$ | \$ | \$ 810 |
| Loans-nonfarm, non-residential | 1,267 | | | 1,267 |
| Loans-1-4 family residential | 64 | | | 64 |
| Foreclosed assets | 88 | | | 88 |
| Servicing assets | 263 | | | 263 |
| Total assets at fair value | \$ 2,492 | \$ | \$ | \$ 2,492 |
| Total liabilities at fair value | \$ | \$ | \$ | \$ |

(in thousands)

| | Total | Level 1 | Level 2 | Level 3 |
|---------------------------------|----------|---------|---------|----------|
| December 31, 2012 | | | | |
| Loans-commercial and industrial | \$ 805 | \$ | \$ | \$ 805 |
| Loans-nonfarm, non-residential | 1,485 | | | 1,485 |
| Foreclosed assets | 491 | | | 491 |
| Servicing assets | 63 | | | 63 |
| Total assets at fair value | \$ 2,884 | \$ | \$ | \$ 2,884 |
| 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, 2013 and December 31, 2012. This table excludes financial instruments for which the carrying amount approximates fair value.

| <i>(dollars in thousands)</i> | Carrying Amount | Fair Value | Fair Value Measurements | | |
|-------------------------------|--------------------|------------|--|---|--|
| | | | Quoted Prices in Active Markets for Identical Assets or Liabilities | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |

(Level
1)**September 30, 2013**

| | | | | | |
|-----------------------|-------------|------------|------------|----|------------|
| Financial Instruments | Assets | | | | |
| Loans | | \$ 178,519 | \$ 178,779 | \$ | \$ 178,779 |
| Financial Instruments | Liabilities | | | | |
| Deposits | | 193,695 | 176,159 | | 176,159 |
| Long-Term Debt | | 7,750 | 8,141 | | 8,141 |

December 31, 2012

| | | | | | |
|-----------------------|-------------|------------|------------|----|------------|
| Financial Instruments | Assets | | | | |
| Loans | | \$ 173,578 | \$ 173,813 | \$ | \$ 173,813 |
| Financial Instruments | Liabilities | | | | |
| Deposits | | 187,823 | 180,777 | | 180,777 |
| Long-Term Debt | | 7,750 | 8,291 | | 8,291 |

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 three and nine months ended September 30, 2013 and 2012. This discussion should be read in conjunction with the financial statements and related notes contained within this report.

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

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

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

Highlights

Certain information contained in this discussion may include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are generally identified by phrases such as the Company expects, the Company believes or words of similar import. Such forward-looking statements involve known and unknown risks including, but not limited to, changes in general economic and business conditions, interest rate fluctuations, competition within and from outside the banking industry, new products and services in the banking industry, risk inherent in making loans such as repayment risks and fluctuating collateral values, problems with technology utilized by the Company, changing trends in customer profiles and changes in laws and regulations applicable to the Company. Although the Company believes that its expectations with respect to the forward-looking statements are based upon reliable assumptions within the bounds of its knowledge of its business and operations, there can be no assurance that actual results, performance or achievements of the Company will not differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements.

Net income available for common stockholders for the three months ended September 30, 2013, was \$689,650 or \$0.18 per diluted share outstanding, compared to a \$728,737 or \$0.19 per diluted share outstanding, for the same period in 2012. Earnings for the three months ended September 30, 2013, are approximately 5.4% lower than for the same period in 2012. The decrease results from a reduction in net interest income. Net interest income decreased from \$2,347,448 in the third quarter of 2012 to \$2,246,952 in 2013. Asset yields decreased from 5.32% to 4.73% from 2012 to 2013 partially due to the change in average earning asset mix from higher yielding loans to lower yielding deposits in other banks. Loan yields also decreased from 6.00% in the third quarter of 2012 to 5.61% in the third quarter of 2013. Loan yields fell due to the prolonged low rate environment and competition. A reduction in the cost of deposits from the third quarter of 2012 to 2013 was unable to offset the tightening asset yields. The cost of funds decreased from 0.85% in the third quarter of 2012 to 0.73% in the third quarter of 2013. The provision for loan losses decreased from \$41,384 in the third quarter of 2012 to a provision of \$12,317 in 2013. This decrease is due to a reduction in gross loans in the third quarter of 2013, while gross loans increased in the third quarter of 2012. This reduction offset an increase in charge offs over the third quarter of 2012. Net charge offs were \$143,830 during the three months ended September 2013, compared to \$110,410 in the third quarter of 2012. At September 30, 2013, the percentage of loans receiving pass credit risk grades was 97.8%, compared to 98.2% at December 31, 2012 and at September 30, 2012. Although credit quality decreased over the period credit quality was enhanced by an increase in loans carrying government guarantees. At September 30, 2013, the guaranteed portion of loans equaled 24.9% of total loans

compared to 24.4% December 31, 2012 and 22.1% at September 30, 2012. Noninterest income increased from \$583,180 in the third quarter of 2012 to \$613,162 in 2013. The increase results from revenue growth in the bank's insurance subsidiary. Noninterest expenses increased slightly from \$1,654,467 in the third quarter of 2012, to \$1,677,977 in 2013. Salaries and employee benefits accounted for most of the change increasing from \$885,633 in 2012 to \$911,334 in 2013. This increase was primarily due to normal salary adjustments.

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

On September 30, 2013, Surrey Bancorp's assets totaled \$239,343,856 compared to \$229,912,432 on December 31, 2012. Net loans were \$178,519,116 compared to \$173,577,565 on December 31, 2012. This net increase was the result of a \$4,838,313 increase in gross loans and a \$103,238 net decrease in the loan loss reserve. Commercial loans decreased 11.4% during the nine month period ended September 30, 2013; however, nonfarm nonresidential real estate loans increased over 25.3% resulting in an overall increase in gross loans to 2.7%.

Net income available for common stockholders for the nine months ended September 30, 2013, was \$2,051,312 or \$0.52 per diluted share outstanding compared to \$1,669,165 or \$0.43 per diluted share outstanding for the same period in 2012. This represents a 22.9% increase in earnings for the first nine months of 2013 compared to the same period in 2012. The increase results from a reduction in the provision for loan losses and an increase in noninterest income. The provision for loan losses decreased from \$780,372 in the first nine months of 2012 to \$148,113 for the same period in 2013. This decrease is due to a reduction in net loan charge offs from \$927,776 during the first nine month period of 2012 to \$251,351 in 2013. Noninterest income increased due to a gain on the sale of a government guaranteed loan. The gain of \$229,130 increased noninterest income from \$1,815,268 during the nine months ended September 30, 2012 to \$2,068,181 during the same period in 2013. Net interest income decreased from \$6,962,216 in the first nine months of 2012 to \$6,757,875 in 2013. This decrease is due to a decrease in average loans as a percentage of total earning assets for the nine month period ended September 30, 2013 versus the same period in 2012. Overall assets yields have also decreased as a result of lower yields on loans. Loan yields also decreased from 6.06% in the first nine months of 2012 to 5.73% in 2013. Noninterest expenses increased 1.3% from \$5,131,319 in the nine months ended September 30, 2012, to \$5,198,560 for the same period in 2013. The increase is associated with salaries and employee benefits which increased from \$2,674,154 in first nine months of 2012 to \$2,782,830 in 2013.

Total deposits on September 30, 2013, were \$193,695,070 compared to \$187,823,037 at the end of 2012. This increase is attributable to a sizable increase in noninterest-bearing demand deposits accounts, which increased from \$36,979,419 at December 31, 2012 to \$43,451,729 at September 30, 2013. The bank's large commercial business accounts are primarily responsible for the increase in noninterest-bearing accounts. Overall, noninterest-bearing and interest-bearing demand deposits increased 7.2% from 2012 totals, while savings deposits, including money market accounts, increased 9.5%. Certificates of deposit decreased 2.7% from December 31, 2012 totals.

Common stockholders' equity increased by \$2,065,769, or 6.41%, during the nine months ended September 30, 2013. The increase is comprised of net income of \$2,188,502 and adjustments to Accumulated Other Comprehensive Income of \$14,457. Decreases included the payment and accrual of preferred dividends of \$137,190. The net increase resulted in a common stock book value of \$8.59 per share, up from \$8.01 on December 31, 2012.

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, 2013.

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 also invests funds in a brokerage account 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.

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

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 \$4,528,656 consisted of U.S. Governmental Agency obligations with maturities ranging from 17 to 41 months, corporate bonds with maturities of 4.75 years to 5.00 years, that reprice quarterly, GNMA adjustable rate mortgage securities, which adjust annually, equity securities and mutual funds.

Loans

Net loans outstanding on September 30, 2013, were \$178,519,116 compared to \$173,577,565 on December 31, 2012. The Bank maintains a loan portfolio dominated by real estate and commercial loans diversified among various industries. Approximately 61.7% of the Bank's loans as of September 30, 2013, are fixed rate loans with 38.3% floating with the Bank's prime rate or other appropriate internal or external indices.

Deposits

Deposits on September 30, 2013, were \$193,695,070, compared to \$187,823,037 on December 31, 2012. The September total consists of a base of approximately 12,681 accounts compared to 12,352 accounts at December 31, 2012. Interest-bearing accounts represent 77.8% of September 30, 2013 period end deposits versus 80.3% at December 31, 2012.

Federal Funds Purchased

The Company had no federal funds purchased at September 30, 2013 or December 31, 2012. 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 |
|-----------------------------------|--------------|---|
| <i>September 30, 2013:</i> | | |
| Total Capital | | |
| (to Risk-Weighted Assets) | | |
| Surrey Bancorp (Consolidated) | 21.51% | 8.0% |
| Surrey Bank & Trust | 21.18% | 8.0% |
| Tier I Capital | | |
| (to Risk-Weighted Assets) | | |
| Surrey Bancorp (Consolidated) | 20.25% | 4.0% |
| Surrey Bank & Trust | 19.92% | 4.0% |
| Tier I Capital | | |
| (to Average Assets) | | |
| Surrey Bancorp (Consolidated) | 14.03% | 4.0% |
| Surrey Bank & Trust | 13.79% | 4.0% |
| <i>December 31, 2012:</i> | | |
| Total Capital | | |
| (to Risk-Weighted Assets) | | |
| Surrey Bancorp (Consolidated) | 20.77% | 8.0% |
| Surrey Bank & Trust | 20.49% | 8.0% |
| Tier I Capital | | |
| (to Risk-Weighted Assets) | | |
| Surrey Bancorp (Consolidated) | 19.51% | 4.0% |
| Surrey Bank & Trust | 19.23% | 4.0% |
| Tier I Capital | | |
| (to Average Assets) | | |
| Surrey Bancorp (Consolidated) | 13.49% | 4.0% |
| Surrey Bank & Trust | 13.28% | 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, 2013 | December 31, 2012 |
|---|-----------------------|----------------------|
| Nonaccrual loans | \$ 3,875,935 | \$ 3,740,725 |
| Loans past due 90 days and still accruing | 3,115 | 683,720 |
| Foreclosed assets | 88,441 | 491,424 |
| Total | \$ 3,967,491 | \$ 4,915,869 |
| Total assets | \$ 239,343,856 | \$ 229,912,432 |
| Ratio of nonperforming assets to total assets | 1.66% | 2.14% |

At September 30, 2013, the Bank had loans totaling \$3,875,935 in nonaccrual status. Approximately \$1,748,056 of the nonaccrual loans were current at the end of September. All of the loans past due 90 days and still accruing are less than 120 days past due. All the loans are secured loans. The guaranteed portion of nonaccrual loans at September 30, 2013 is \$1,729,623. Foreclosed assets at September 30, 2013 primarily include 1-4 family dwellings. Loans that were considered impaired but were still accruing interest at September 30, 2013, including troubled debt restructurings, totaled \$1,987,462. 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 \$380,819 at September 30, 2013, or 6.5% of the balances outstanding.

Nonaccrual and impaired loans still accruing are summarized below:

| | September 30, 2013 | December 31, 2012 |
|------------------------------|-----------------------|----------------------|
| Construction and development | \$ 85,562 | \$ 86,567 |

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| | | |
|-------------------------------|--------------|--------------|
| 1-4 family residential | 359,420 | 475,742 |
| Multi-family | | |
| Nonfarm, nonresidential | 3,128,863 | 3,185,880 |
| Commercial and industrial | 2,285,488 | 2,373,175 |
| Consumer | 3,724 | 3,918 |
| Other loans | | 195,990 |
| Total impaired and nonaccrual | \$ 5,863,057 | \$ 6,321,272 |
| Guaranteed portion | \$ 2,430,081 | \$ 2,381,400 |

At September 30, 2013, consumer loans totaling \$32,945 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 September 30, 2013 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, 2013 | | December 31, 2012 | |
|------------------------------|--------------------|---------|-------------------|---------|
| Construction and development | \$ 4,941,654 | 2.72% | \$ 4,873,512 | 2.76% |
| 1-4 family residential | 38,040,049 | 20.95% | 36,091,051 | 20.43% |
| Multi-family | 1,561,060 | 0.86% | 1,676,449 | 0.95% |
| Farmland | 2,227,847 | 1.23% | 2,284,155 | 1.29% |
| Nonfarm, nonresidential | 61,366,016 | 33.81% | 48,993,867 | 27.73% |
| Total real estate | 108,136,626 | 59.57% | 93,919,034 | 53.16% |
| Agricultural | 109,993 | 0.06% | 147,860 | 0.08% |
| Commercial and industrial | 67,225,422 | 37.03% | 75,914,072 | 42.97% |
| Consumer | 6,071,806 | 3.34% | 6,703,363 | 3.79% |
| Other | 1,789 | % | 3,000 | % |
| Total loans | \$ 181,545,636 | 100.00% | \$ 176,687,329 | 100.00% |

The concentrations represented above do not, based on management's assessment, expose the Bank to any unusual concentration risk. Based on the Bank's asset size, the concentrations that are above area peer group analysis are nonfarm nonresidential and commercial and industrial loans. Management recognizes the inherent risk associated with commercial real estate and 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 \$58,542,130 in loans that carry government guarantees. The guaranteed portion of these loans amounts to \$45,276,337 at September 30, 2013. Loan guarantees by loan class are below:

| | September 30, 2013 | Guaranteed Portion | |
|------------------------------|-----------------------|--------------------|------------|
| | | Amount | Percentage |
| Construction and development | \$ 4,941,654 | \$ 16,268 | 0.33% |
| 1-4 family residential | 38,040,049 | 707,922 | 1.86% |
| Multi-family | 1,561,060 | 13,051 | 0.84% |
| Farmland | 2,227,847 | 400,933 | 18.00% |
| Nonfarm, nonresidential | 61,366,016 | 27,167,833 | 44.27% |
| Total real estate | 108,136,626 | 28,306,007 | 26.18% |
| Agricultural | 109,993 | 85,000 | 77.28% |
| Commercial and industrial | 67,225,422 | 16,885,330 | 25.12% |
| Consumer | 6,071,806 | | % |
| Other | 1,789 | | % |

| | | | |
|-------------|----------------|---------------|--------|
| Total loans | \$ 181,545,636 | \$ 45,276,337 | 24.94% |
|-------------|----------------|---------------|--------|

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 \$1,908,181 at September 30, 2013. Non-owner occupied nonfarm, non-residential properties included in nonfarm, non-residential loans above amounted to \$8,088,143 at September 30, 2013.

The consolidated provision for loan losses was \$148,113 for the first nine months of 2013 compared to \$780,372 for the same period in 2012. Significant charge off of nonperforming loans in 2012, in comparison to 2013, resulted in the provision decrease.

The reserve for loan losses on September 30, 2013, was \$3,299,860 or 1.81% of period end loans. This percentage is derived from total loans. Approximately \$58,542,000 of total loans outstanding at September 30, 2013, 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 2.41% of outstanding loans. At December 31, 2012 the loan loss reserve percentage was 1.92% of total loans and 2.54% of loans net of government guarantees.

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

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. That portion did decrease during the first nine months of 2013 due to changes in the loan portfolio. 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, 2013 and December 31, 2012.

| | September 30, 2013 | | December 31, 2012 | |
|---|--------------------|--------------|-------------------|--------------|
| | 30-89 Days | 90 Days Plus | 30-89 Days | 90 Days Plus |
| Construction and development | \$ 32,174 | \$ | \$ 73,572 | \$ |
| 1-4 family residential | 725,371 | | 380,731 | 324,357 |
| Nonfarm, non-residential | 567,233 | 437,363 | 908,887 | 386,160 |
| Commercial and industrial | 688,082 | 656,607 | 310,063 | 429,226 |
| Consumer | 156,501 | 3,115 | 201,301 | 13,643 |
| Other loans | | | | |
| | \$ 2,169,361 | \$ 1,512,852 | \$ 1,874,554 | \$ 1,153,386 |
| Non-accrual loans included above | \$ 1,033,909 | \$ 1,097,085 | \$ 249,344 | \$ 469,666 |
| Guaranteed portion | \$ 422,961 | \$ 784,890 | \$ 467,962 | \$ 339,744 |
| Ratio to total loans | 1.19% | 0.60% | 1.06% | 0.65% |
| Ratio to total loans, net of guarantees | 1.28% | 0.23% | 1.05% | 0.61% |

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 slightly from December 31, 2012 to September 30, 2013. The majority of the increase is in the over 90 day time frame.

Net of loan guarantees, total past dues have decreased from \$2,220,234 at December 31, 2012, to \$2,058,595 at September 30, 2013, or 7.2%. Total past due loans at September 30, 2013 consist of seventy-eight loans with an average balance of \$41,877, compared to seventy-six loans at December 31, 2012, with an average balance of \$39,841. Loans over \$250,000 delinquent at September 30, 2013 and December 31, 2012 amounted to \$977,097 and \$1,219,565, respectively. The September 2013 total consisted of three loans. The December 2012 total included four

loans.

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.

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

Interest Rate Sensitivity and Liquidity

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

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

At September 30, 2013, the liquidity position of the Company was excellent, in management's opinion, with short-term liquid assets of \$46,079,074 compared to \$42,552,800 at December 31, 2012. Deposit growth in excess of gross loan increases account for the increase in liquidity. To provide supplemental liquidity, the Bank has seven unsecured lines of credit with correspondent banks totaling \$35,500,000. At September 30, 2013, 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 \$10,467,000 of which \$7,750,000 of advances had been taken down at September 30, 2013.

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 13, 2013

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

Date: November 13, 2013

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