

SURREY BANCORP
Form 10-Q
August 12, 2016

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

FORM 10-Q

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

for the quarterly period ended June 30, 2016

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

For the transition period from _____ to _____

COMMISSION FILE NO. 000-50313

SURREY BANCORP

(Exact name of registrant as specified in its charter)

North Carolina 59-3772016
(State or other jurisdiction of incorporation or organization) (IRS Employer Identification No.)

145 North Renfro Street, Mount Airy, NC 27030

(Address of principal executive offices)

(336) 783-3900

(Registrant's telephone number)

Check whether the registrant: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes 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

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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 August 12, 2016 there were 3,444,709 common shares issued and outstanding and 104,956 Class A common shares issued and outstanding

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Consolidated Balance Sheets

June 30, 2016 (Unaudited) and December 31, 2015 (Audited)

| | June 2016 | December 2015 |
|---|---------------|------------------|
| Assets | | |
| Cash and due from banks | \$6,716,185 | \$5,874,561 |
| Interest-bearing deposits with banks | 25,992,126 | 32,921,125 |
| Federal funds sold | 1,222,549 | 1,217,801 |
| Investment securities available for sale | 4,319,809 | 5,340,743 |
| Restricted equity securities | 401,829 | 397,599 |
| Loans, net of allowance for loan losses of \$3,846,517 at June 30, 2016 and \$3,626,908 at December 31, 2015 | 207,918,096 | 197,904,895 |
| Property and equipment, net | 5,270,896 | 5,333,066 |
| Foreclosed assets | 202,982 | 384,452 |
| Accrued income | 1,016,293 | 1,084,164 |
| Goodwill | 120,000 | 120,000 |
| Bank owned life insurance | 6,339,377 | 5,125,339 |
| Other assets | 3,130,552 | 2,072,810 |
| Total assets | \$262,650,694 | \$257,776,555 |
| Liabilities and Stockholders' Equity | | |
| Liabilities | | |
| Deposits: | | |
| Noninterest-bearing | \$60,467,106 | \$54,619,375 |
| Interest-bearing | 156,221,927 | 158,068,586 |
| Total deposits | 216,689,033 | 212,687,961 |
| Long-term debt | 1,750,000 | 2,750,000 |
| Dividends payable | 45,730 | 1,004,642 |
| Accrued interest payable | 128,286 | 91,632 |
| Other liabilities | 3,537,887 | 2,571,350 |
| Total liabilities | 222,150,936 | 219,105,585 |
| 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, with a liquidation value of \$14 per share; | 2,620,325 | 2,620,325 |
| 181,154 shares of Series D issued and outstanding with no par value 5.0% convertible non-cumulative, perpetual; with a liquidation value of \$7.08 per share; | 1,248,482 | 1,248,482 |
| Common stock, 9,000,000 shares authorized at no par value; 3,444,709 and 3,549,665 shares issued and outstanding at June 30, 2016 and December 31, 2015, respectively | 10,763,291 | 12,101,480 |
| Common stock, Class A 1,000,000 shares authorized at no par value; 104,956 shares issued and outstanding at June 30, 2016 | 1,313,189 | - |
| Retained earnings | 24,552,405 | 22,727,587 |
| Accumulated other comprehensive loss | 2,066 | (26,904) |

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| | | |
|--|---------------|---------------|
| Total stockholders' equity | 40,499,758 | 38,670,970 |
| Total liabilities and stockholders' equity | \$262,650,694 | \$257,776,555 |

See Notes to Consolidated Financial Statements

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Consolidated Statements of Income

Six months ended June 30, 2016 and 2015 (Unaudited)

| | 2016 | 2015 |
|--|-------------|-------------|
| Interest income | | |
| Loans and fees on loans | \$5,794,040 | \$5,356,148 |
| Federal funds sold | 2,600 | 1,363 |
| Investment securities available for sale, taxable | 44,728 | 34,085 |
| Investment securities available for sale, dividends | 649 | 6,119 |
| Deposits with banks | 55,167 | 47,997 |
| Total interest income | 5,897,184 | 5,445,712 |
| Interest expense | | |
| Deposits | 417,420 | 467,168 |
| Fed funds purchased | 5 | 3 |
| Long-term debt | 39,388 | 118,464 |
| Total interest expense | 456,813 | 585,635 |
| Net interest income | 5,440,371 | 4,860,077 |
| Provision for (recapture of) loan losses | 212,741 | (43,496) |
| Net interest income after provision for (recapture of) loan losses | 5,227,630 | 4,903,573 |
| Noninterest income | | |
| Service charges on deposit accounts | 321,365 | 399,665 |
| Fees on loans delivered to correspondents | 56,202 | 27,808 |
| Other service charges and fees | 375,375 | 359,488 |
| Gain (loss) on the sale of investment securities | (33,127) | 4,376 |
| Income from bank owned life insurance | 94,095 | 73,569 |
| Insurance commissions | 230,877 | 215,315 |
| Brokerage commissions | 36,071 | 102,460 |
| Other operating income | 80,866 | 67,568 |
| Bank-owned life insurance death benefit in excess of CSV | 315,754 | - |
| Total noninterest income | 1,477,478 | 1,250,249 |
| Noninterest expense | | |
| Salaries and employee benefits | 2,213,729 | 1,991,930 |
| Occupancy expense | 255,218 | 228,578 |
| Equipment expense | 137,852 | 127,256 |
| Data processing | 259,583 | 231,208 |
| Foreclosed assets, net | 43,081 | 85,611 |
| Postage, printing and supplies | 85,018 | 106,641 |
| Professional fees | 53,387 | 248,005 |
| FDIC insurance premiums | 62,987 | 56,539 |
| Other expense | 801,031 | 794,282 |
| Total noninterest expense | 3,911,886 | 3,870,050 |
| Net income before income taxes | 2,793,222 | 2,283,772 |
| Income tax expense | 877,447 | 815,402 |
| Net income | 1,915,775 | 1,468,370 |

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| | | |
|--|-------------|-------------|
| Preferred stock dividends | (90,957) | (90,957) |
| Net income available to common stockholders | \$1,824,818 | \$1,377,413 |
| Basic earnings per common share | \$0.51 | \$0.39 |
| Diluted earnings per common share | \$0.46 | \$0.35 |
| Basic weighted average common shares outstanding | 3,549,665 | 3,549,665 |
| Diluted weighted average common shares outstanding | 4,183,600 | 4,187,334 |

See Notes to Consolidated Financial Statements

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Consolidated Statements of Income

Three months ended June 30, 2016 and 2015 (Unaudited)

| | 2016 | 2015 |
|--|-------------|-------------|
| Interest income | | |
| Loans and fees on loans | \$2,920,977 | \$2,676,839 |
| Federal funds sold | 1,334 | 672 |
| Investment securities available for sale, taxable | 21,946 | 17,278 |
| Investment securities available for sale, dividends | - | 3,885 |
| Deposits with banks | 24,311 | 27,160 |
| Total interest income | 2,968,568 | 2,725,834 |
| Interest expense | | |
| Deposits | 205,072 | 230,771 |
| Fed funds purchased | 5 | 3 |
| Long-term debt | 18,521 | 57,759 |
| Total interest expense | 223,598 | 288,533 |
| Net interest income | 2,744,970 | 2,437,301 |
| Provision for loan losses | 136,927 | 70,298 |
| Net interest income after provision for loan losses | 2,608,043 | 2,367,003 |
| Noninterest income | | |
| Service charges on deposit accounts | 160,388 | 208,321 |
| Fees on loans delivered to correspondents | 49,008 | 22,162 |
| Other service charges and fees | 195,190 | 188,295 |
| Income from bank owned life insurance | 48,085 | 36,745 |
| Insurance commissions | 129,966 | 131,538 |
| Brokerage commissions | 21,390 | 23,419 |
| Other operating income | 19,140 | 14,535 |
| Bank-owned life insurance death benefit in excess of CSV | 315,754 | - |
| Total noninterest income | 938,921 | 625,015 |
| Noninterest expense | | |
| Salaries and employee benefits | 1,135,671 | 959,599 |
| Occupancy expense | 126,125 | 119,230 |
| Equipment expense | 69,401 | 64,360 |
| Data processing | 130,007 | 108,202 |
| Foreclosed assets, net | 9,050 | 46,767 |
| Postage, printing and supplies | 41,539 | 65,317 |
| Professional fees | 35,684 | 106,006 |
| FDIC insurance premiums | 30,472 | 32,081 |
| Other expense | 378,348 | 335,820 |
| Total noninterest expense | 1,956,297 | 1,837,382 |
| Net income before income taxes | 1,590,667 | 1,154,636 |
| Income tax expense | 451,846 | 414,700 |
| Net income | 1,138,821 | 739,936 |

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| | | |
|--|-------------|-----------|
| Preferred stock dividends | (45,730) | (45,730) |
| Net income available to common stockholders | \$1,093,091 | \$694,206 |
| Basic earnings per common share | \$0.31 | \$0.20 |
| Diluted earnings per common share | \$0.27 | \$0.18 |
| Basic weighted average common shares outstanding | 3,549,665 | 3,549,665 |
| Diluted weighted average common shares outstanding | 4,183,600 | 4,187,257 |

See Notes to Consolidated Financial Statements

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Consolidated Statements of Comprehensive Income

Three and Six months ended June 30, 2016 and 2015 (Unaudited)

| | Three Months | | Six Months | |
|---|----------------|-----------|----------------|-------------|
| | Ended June 30, | | Ended June 30, | |
| | 2016 | 2015 | 2016 | 2015 |
| Net income | \$1,138,821 | \$739,936 | \$1,915,775 | \$1,468,370 |
| Other comprehensive income (loss): | | | | |
| Investment securities available for sale: | | | | |
| Unrealized holding gains (losses) | 3,716 | (2,615) | 11,172 | 10,211 |
| Tax effect | (1,362) | 338 | (4,066) | (4,464) |
| Reclassification of (gains) losses recognized in net income | - | - | 33,127 | (4,376) |
| Tax effect | - | - | (11,263) | 1,488 |
| | 2,354 | (2,277) | 28,970 | 2,859 |
| Comprehensive income | \$1,141,175 | \$737,659 | \$1,944,745 | \$1,471,229 |

See Notes to Consolidated Financial Statements

Table of ContentsConsolidated Statements of Cash Flows
Six months ended June 30, 2016 and 2015 (Unaudited)

| | 2016 | 2015 |
|---|--------------|--------------|
| Cash flows from operating activities | | |
| Net income | \$ 1,915,775 | \$ 1,468,370 |
| Adjustments to reconcile net income to net cash provided by operations: | | |
| Depreciation and amortization | 148,430 | 134,855 |
| Gain on sale of property and equipment | (10) | (50) |
| (Gain) loss on the sale of securities | 33,127 | (4,376) |
| Loss on the sale of foreclosed assets | 31,103 | 9,620 |
| Provision (recapture) of loan losses | 212,741 | (43,496) |
| Deferred income tax benefit | (3,682) | (630) |
| Accretion of discount on securities, net of amortization of premiums | (1,766) | (304) |
| Increase in cash surrender value of life insurance | (94,095) | (73,569) |
| Bank-owned life insurance death benefit in excess of CSV | (315,754) | (419,150) |
| Changes in assets and liabilities: | | |
| Accrued income | 67,871 | (66,274) |
| Other assets | (1,069,389) | (427,953) |
| Accrued interest payable | 36,654 | 30,255 |
| Other liabilities | 966,537 | 547,397 |
| Net cash provided by operating activities | 1,927,542 | 1,154,695 |
| Cash flows from investing activities | | |
| Net (increase) decrease in interest-bearing deposits with banks | 6,928,999 | 432,980 |
| Net increase in federal funds sold | (4,748) | (2,546) |
| Purchases of investment securities | (1,500,516) | (1,012,202) |
| Maturities of investment securities | 2,003,678 | 1,002,913 |
| Redemption of restricted equity | - | 104,400 |
| Purchase of restricted equity securities | (4,230) | (11,180) |
| Net increase in loans | (10,290,202) | (419,410) |
| Proceeds from the sale of investment securities | 530,710 | 11,135 |
| Proceeds from the sale of foreclosed assets | 214,627 | 207,974 |
| Purchases of property and equipment | (86,260) | (490,093) |
| Purchase of bank owned life insurance | (1,500,000) | - |
| Life insurance proceeds | 695,811 | 1,001,320 |
| Proceeds from the sale of property and equipment | 10 | 50 |
| Net cash provided by (used in) investing activities | (3,012,121) | 825,341 |
| Cash flows from financing activities | | |
| Net increase in deposits | 4,001,072 | 766,488 |
| Maturity of long-term debt | (1,000,000) | (2,000,000) |
| Expenses incurred in recapitalization | (25,000) | - |
| Dividends paid | (1,049,869) | (872,386) |
| Net cash provided by (used in) financing activities | 1,926,203 | (2,105,898) |
| Net increase (decrease) in cash and cash equivalents | 841,624 | (125,862) |
| Cash and due from banks, beginning | 5,874,561 | 6,236,749 |
| Cash and due from banks, ending | \$ 6,716,185 | \$ 6,110,887 |

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| | | |
|---|-------------|-----------|
| Supplemental disclosures of cash flow information | | |
| Interest paid | \$420,159 | \$555,635 |
| Taxes paid | \$1,050,247 | \$828,479 |
| Supplemental disclosures of non-cash transactions | | |
| Loans transferred to foreclosed properties | \$64,260 | \$130,574 |
| Cash dividends declared but not paid | \$45,730 | \$45,730 |
| Reclassification of Class A common stock | \$1,338,189 | \$- |

See Notes to Consolidated Financial Statements

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Table of ContentsConsolidated Statements of Changes in Stockholders' Equity
Six months ended June 30, 2016 and 2015 (Unaudited)

| | Preferred Stock | Common Stock | | Common Stock, Class A | | Retained | Accumulated Other Comprehensive Income (Loss) Total | |
|--|-----------------|--------------|--------------|-----------------------|-------------|--------------|---|--------------|
| | Amount | Shares | Amount | Shares | Amount | Earnings | | |
| Balance, January 1, 2015 | \$3,868,807 | 3,549,665 | \$12,101,480 | - | \$- | \$20,808,309 | \$(7,942) | \$36,770,654 |
| Net income | - | - | - | - | - | 1,468,370 | - | 1,468,370 |
| Other comprehensive income | - | - | - | - | - | - | 2,859 | 2,859 |
| Dividends declared on Series A convertible preferred stock (\$.32 per share) | | | | | | (59,157) | | (59,157) |
| Dividends declared on Series D convertible preferred stock (\$.18 per share) | | | | | | (31,800) | | (31,800) |
| Balance, June 30, 2015 | \$3,868,807 | 3,549,665 | \$12,101,480 | - | \$- | \$22,185,722 | \$(5,083) | \$38,150,926 |
| Balance January 1, 2016 | \$3,868,807 | 3,549,665 | \$12,101,480 | - | \$- | \$22,727,587 | \$(26,904) | \$38,670,970 |
| Net income | | | | | | 1,915,775 | | 1,915,775 |
| Other comprehensive income | | | | | | | 28,970 | 28,970 |
| Reclassification of Class A Common stock | | (104,956) | (1,338,189) | 104,956 | 1,338,189 | | | |
| Expenses associated with reclassification | | | | | | (25,000) | | (25,000) |
| Dividends declared on Series A convertible preferred stock (\$.32 per share) | | | | | | (59,157) | | (59,157) |
| Dividends declared on Series D convertible preferred stock (\$.18 per share) | | | | | | (31,800) | | (31,800) |
| Balance, June 30, 2016 | \$3,868,807 | 3,444,709 | \$10,763,291 | 104,956 | \$1,313,189 | \$24,552,405 | \$2,066 | \$40,499,758 |

See Notes to Consolidated Financial Statements

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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 June 30, 2016, the results of its operations and comprehensive income for the three and six months ended June 30, 2016 and 2015, and its changes in stockholders’ equity and cash flows for the six months ended June 30, 2016 and 2015. These adjustments are of a normal and recurring nature. The results of operations for the six months ended June 30, 2016, 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, 2015, included in the Company’s Form 10-K. The balance sheet at December 31, 2015, 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 (“the Bank”). 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 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, 2015 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.

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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 June 30, 2016 and December 31, 2015, 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. Fixed rate loans are carried at the lower of cost or market. The Bank recognizes gains on the sale of the guaranteed portion upon the consummation of the transaction. The Bank plans to continue to originate guaranteed loans for sales, however no such loans were funded and held for sale at June 30, 2016 and December 31, 2015.

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.

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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 January 2016, the FASB amended the Financial Instruments topic of the Accounting Standards Codification to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The amendments will be effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company will apply the guidance by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values will be applied prospectively to equity investments that exist as of the date of adoption of the

amendments. The Company does not expect these amendments to have a material effect on its financial statements.

In February 2016, the FASB issued new guidance to change accounting for leases and that will generally require most leases to be recognized on the balance sheet. The new lease standard only contains targeted changes to accounting by lessors, however, lessees will be required to recognize most leases in their balance sheets as lease liabilities for lease payments and right-of-use assets representing the lessee's rights to use the underlying assets for the lease terms for lease arrangements longer than 12 months. Under this approach, a lessee will account for most existing capital/finance leases as Type A leases and most existing operating leases as Type B leases. Type A and Type B leases have unique accounting and disclosure requirements. Existing sale-leaseback guidance, including guidance for real estate, will be replaced with a new model applicable to both lessees and lessors. The new guidance will be effective for fiscal years (and interim periods within those fiscal years) beginning after December 15, 2018. Early adoption is permitted for all companies and organizations. Management is currently analyzing the impact of the adoption of this guidance on the Company's financial statements, including assessing changes that might be necessary to information technology systems, processes and internal controls to capture new data and address changes in financial reporting.

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Recent Accounting Pronouncements, continued

In March 2016, the FASB issued guidance to simplify several aspects of the accounting for share-based payment award transactions including the income tax consequences, the classification of awards as either equity or liabilities, and the classification on the statement of cash flows. Additionally, the guidance simplifies two areas specific to entities other than public business entities allowing them apply a practical expedient to estimate the expected term for all awards with performance or service conditions that have certain characteristics and also allowing them to make a one-time election to switch from measuring all liability-classified awards at fair value to measuring them at intrinsic value. The amendments will be effective for the Company for annual periods beginning after December 15, 2016 and interim periods within those annual periods. The Company does not expect these amendments to have a material effect on its financial statements.

In April 2016, the FASB amended the Revenue from Contracts with Customers topic of the Accounting Standards Codification to clarify the implementation guidance on principal versus agent considerations and address how an entity should assess whether it is the principal or the agent in contracts that include three or more parties. The amendments will be effective for the Company for reporting periods beginning after December 15, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

In May 2016, the FASB amended the Revenue from Contracts with Customers topic of the Accounting Standards Codification to clarify guidance related to collectability, noncash consideration, presentation of sales tax, and transition. The amendments will be effective for the Company for reporting periods beginning after December 15, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

In June 2016, the FASB issued guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. The amendments will be effective for the Company for reporting periods beginning after December 15, 2020-public business entities that are not SEC filers; annual periods beginning after December 15, 2020, and interim periods within annual reporting periods beginning after December 15, 2021-all other entities. The Company is currently evaluating the effect that implementation of the new standard will have on its financial position, results of operations, and cash flows

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. Except for the transaction below, management has reviewed events occurring through the date the financial statements were issued and no subsequent events have occurred requiring accrual or disclosure.

Subsequent to June 30, 2016, Freedom Finance, LLC entered into an agreement to sell its outstanding loans receivable, amounting to \$1,057,282, to a third party. The agreement sets a price at 90% of the loan value with other

stipulations regarding past due accounts. The recapture of the reserve associated with these loans will approximate the 10% discount negotiated in the contract. Upon the culmination of the transaction, including the settlement for delinquent accounts the operations of Freedom Finance, LLC will be discontinued.

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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 June 30, 2016 and December 31, 2015 follow:

| | Amortized Cost | Unrealized Gains | Unrealized Losses | Fair Value |
|----------------------------------|-------------------|---------------------|----------------------|---------------|
| <u>June 30, 2016</u> | | | | |
| Government-sponsored enterprises | \$4,000,000 | \$ 2,825 | \$ - | \$4,002,825 |
| Mortgage-backed securities | 16,548 | 436 | - | 16,984 |
| Corporate bonds | 300,000 | - | - | 300,000 |
| | \$4,316,548 | \$ 3,261 | \$ - | \$4,319,809 |
| <u>December 31, 2015</u> | | | | |
| Government-sponsored enterprises | \$4,498,227 | \$ 3,130 | \$ 10,117 | \$4,491,240 |
| Mortgage-backed securities | 20,233 | 446 | - | 20,679 |
| Corporate bonds | 300,000 | - | 300 | 299,700 |
| Equities and mutual funds | 563,321 | 14,644 | 48,841 | 529,124 |
| | \$5,381,781 | \$ 18,220 | \$ 59,258 | \$5,340,743 |

At June 30, 2016 and December 31, 2015, 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 investment in equities and mutual funds by nature have no maturity date and are classified as due in one year or less. The scheduled maturities of securities (all available for sale) at June 30, 2016, were as follows:

| | Amortized Cost | Fair Value |
|--|-------------------|---------------|
| Due in one year or less | \$500,000 | \$500,015 |
| Due after one year through five years | 3,808,872 | 3,811,838 |
| Due after five years through ten years | 805 | 831 |
| Due after ten years | 6,871 | 7,125 |
| | \$4,316,548 | \$4,319,809 |

There were no unrealized investment losses at June 30, 2016. 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 December 31, 2015. 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 December 31, 2015.

| Less Than 12 Months Fair Value | Unrealized Losses | 12 Months or More Fair Value | Unrealized Losses | Total Fair Value | Unrealized Losses |
|--------------------------------------|----------------------|------------------------------------|----------------------|------------------------|----------------------|
|--------------------------------------|----------------------|------------------------------------|----------------------|------------------------|----------------------|

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December 31, 2015

| | | | | | | |
|----------------------------------|-------------|-----------|-----------|-----------|-------------|-----------|
| Government-sponsored enterprises | \$2,488,110 | \$ 10,117 | \$- | \$ - | \$2,488,110 | \$ 10,117 |
| Corporate bonds | - | - | 299,700 | 300 | 299,700 | 300 |
| Equities and mutual funds | 63,865 | 22,785 | 41,140 | 26,056 | 105,005 | 48,841 |
| | \$2,551,975 | \$ 32,902 | \$340,840 | \$ 26,356 | \$2,892,815 | \$ 59,258 |

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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 no securities in the portfolio at June 30, 2016, with unrealized losses

The Company had realized losses of \$33,127 from the sales of equity and mutual fund investment securities for the six month period ended June 30, 2016, and realized gains of \$4,376 from the sales of equity and mutual fund investment securities for the six month periods ended June 30, 2015. Total proceeds from the sales amounted to \$530,710 and \$11,135 in 2016 and 2015, respectively.

NOTE 3. EARNINGS PER COMMON SHARE

Basic earnings per common share for the three months ended June 30, 2016 and 2015 were calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period.

The computation of diluted earnings per common share is similar to the computation of basic earnings per common 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 June 30, 2016, the Company had commitments to extend credit, including unused lines of credit of approximately \$54,082,000 and letters of credit outstanding of \$1,940,837.

NOTE 5. LOANS

The major components of loans in the balance sheets at June 30, 2016 and December 31, 2015 are below.

| | 2016 | 2015 |
|-----------------------------------|--------------|--------------|
| Commercial | \$54,296,937 | \$51,930,870 |
| Real estate: | | |
| Construction and land development | 9,334,109 | 9,669,380 |
| Residential, 1-4 families | 44,070,693 | 43,830,689 |
| Residential, 5 or more families | 1,100,398 | 1,155,535 |
| Farmland | 6,648,149 | 6,043,944 |
| Nonfarm, nonresidential | 90,222,849 | 82,595,636 |
| Agricultural | 1,444,955 | 1,609,150 |

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| | | |
|---|---------------|---------------|
| Consumer, net of discounts of \$19,804 in 2016 and \$11,950 in 2015 | 4,407,255 | 4,532,179 |
| | 211,525,345 | 201,367,383 |
| Deferred loan origination costs, net of (fees) | 239,268 | 164,420 |
| | 211,764,613 | 201,531,803 |
| Allowance for loan losses | (3,846,517) | (3,626,908) |
| | \$207,918,096 | \$197,904,895 |

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5. LOANS, CONTINUED

Residential, 1-4 family loans pledged as collateral against FHLB advances approximated \$12,200,000 and \$12,691,000 at June 30, 2016 and December 31, 2015, respectively.

NOTE 6. ALLOWANCE FOR LOAN LOSSES

The activity of the allowance for loan losses by loan components during the six months ended June 30, 2016 and 2015 was as follows:

| | Construction & Development | 1-4 Family Residential | Nonfarm, Nonresidential | Commercial & Industrial | Consumer | Other | Total |
|---------------------------------------|----------------------------------|---------------------------|----------------------------|-------------------------------|--------------|--------------|----------------|
| <u>June 30, 2016</u> | | | | | | | |
| Allowance for credit losses: | | | | | | | |
| Beginning balance | \$ 150,400 | \$ 790,200 | \$ 1,020,400 | \$ 1,361,814 | \$ 177,894 | \$ 126,200 | \$ 3,626,908 |
| Charge-offs | - | (62,665) | (74,876) | (5,129) | (26,783) | (33,514) | (202,967) |
| Recoveries | - | 7,050 | 6,116 | 187,036 | 4,490 | 4,643 | 209,835 |
| Provision | (3,062) | 86,293 | 288,620 | (225,950) | (76,271) | 143,111 | 212,741 |
| Ending balance | \$ 147,338 | \$ 821,378 | \$ 1,240,260 | \$ 1,317,771 | \$ 79,330 | \$ 240,440 | \$ 3,846,517 |
| Ending balance: | | | | | | | |
| individually evaluated for impairment | \$- | \$- | \$- | \$ 10,625 | \$- | \$- | \$ 10,625 |
| Ending balance: | | | | | | | |
| collectively evaluated for impairment | \$ 147,338 | \$ 821,378 | \$ 1,240,260 | \$ 1,307,146 | \$ 79,330 | \$ 240,440 | \$ 3,835,892 |
| Loans Receivable: | | | | | | | |
| Ending balance | \$ 9,334,109 | \$ 44,070,693 | \$ 90,222,849 | \$ 54,296,937 | \$ 4,407,255 | \$ 9,193,502 | \$ 211,525,345 |
| Ending balance: | | | | | | | |
| individually evaluated for impairment | \$ 9,686 | \$ 1,231,595 | \$ 2,086,625 | \$ 2,081,104 | \$- | \$ 5,543 | \$ 5,414,553 |

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| | | | | | | | |
|---|--------------|---------------|---------------|---------------|--------------|--------------|----------------|
| Ending balance: collectively evaluated for impairment | \$ 9,324,423 | \$ 42,839,098 | \$ 88,136,224 | \$ 52,215,833 | \$ 4,407,255 | \$ 9,187,959 | \$ 206,110,792 |
|---|--------------|---------------|---------------|---------------|--------------|--------------|----------------|

June 30, 2015

| | | | | | | | |
|---|------------|------------|--------------|--------------|------------|-----------|--------------|
| Allowance for credit losses: Beginning balance | \$ 160,100 | \$ 798,199 | \$ 1,067,315 | \$ 1,301,900 | \$ 158,750 | \$ 68,400 | \$ 3,554,664 |
| Charge-offs | - | (119,738) | - | (14,308) | (63,747) | - | (197,793) |
| Recoveries | - | 1,470 | 556 | 355,079 | 16,089 | - | 373,194 |
| Provision | (79,500) | 99,807 | (20,437) | (109,264) | 61,398 | 4,500 | (43,496) |
| Ending balance | \$ 80,600 | \$ 779,738 | \$ 1,047,434 | \$ 1,533,407 | \$ 172,490 | \$ 72,900 | \$ 3,686,569 |

| | | | | | | | |
|---|-----------|------------|------------|--------------|------------|-----------|--------------|
| Ending balance: individually evaluated for impairment | \$ - | \$ 5,538 | \$ 82,334 | \$ 130,207 | \$ - | \$ - | \$ 218,079 |
| Ending balance: collectively evaluated for impairment | \$ 80,600 | \$ 774,200 | \$ 965,100 | \$ 1,403,200 | \$ 172,490 | \$ 72,900 | \$ 3,468,490 |

| | | | | | | | |
|---|--------------|---------------|---------------|---------------|--------------|--------------|----------------|
| Loans Receivable: Ending balance | \$ 5,003,033 | \$ 42,429,891 | \$ 81,471,018 | \$ 54,582,484 | \$ 4,453,977 | \$ 5,556,315 | \$ 193,496,718 |
|---|--------------|---------------|---------------|---------------|--------------|--------------|----------------|

| | | | | | | | |
|---|--------------|---------------|---------------|---------------|--------------|--------------|----------------|
| Ending balance: individually evaluated for impairment | \$ 12,364 | \$ 902,831 | \$ 2,638,166 | \$ 1,001,378 | \$ - | \$ 238,369 | \$ 4,793,108 |
| Ending balance: collectively evaluated for impairment | \$ 4,990,669 | \$ 41,527,060 | \$ 78,832,852 | \$ 53,581,106 | \$ 4,453,977 | \$ 5,317,946 | \$ 188,703,610 |

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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 June 30, 2016 and December 31, 2015 and the recognized interest income per the related period:

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|-------------------------------------|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| <u>June 30, 2016</u> | | | | | |
| With no related allowance recorded: | | | | | |
| Construction and development | \$9,686 | \$9,686 | \$ - | \$10,050 | \$ 425 |
| 1-4 family residential | 1,231,595 | 1,303,749 | - | 1,238,366 | 17,332 |
| Nonfarm, nonresidential | 2,086,625 | 2,086,625 | - | 2,355,586 | 53,280 |
| Commercial and industrial | 2,070,479 | 2,073,174 | - | 2,070,171 | 72,592 |
| Consumer | - | - | - | - | - |
| Other loans | 5,543 | 11,086 | - | 5,543 | - |
| | 5,403,928 | 5,484,320 | - | 5,679,716 | 143,629 |
| With an allowance recorded: | | | | | |
| Construction and development | - | - | - | - | - |
| 1-4 family residential | - | - | - | - | - |
| Nonfarm, nonresidential | - | - | - | - | - |
| Commercial and industrial | 10,625 | 10,625 | 10,625 | 10,654 | 169 |
| Consumer | - | - | - | - | - |
| Other loans | - | - | - | - | - |
| | 10,625 | 10,625 | 10,625 | 10,654 | 169 |
| Combined: | | | | | |
| Construction and development | 9,686 | 9,686 | - | 10,050 | 425 |
| 1-4 family residential | 1,231,595 | 1,303,749 | - | 1,238,366 | 17,332 |
| Nonfarm, nonresidential | 2,086,625 | 2,086,625 | - | 2,355,586 | 53,280 |
| Commercial and industrial | 2,081,104 | 2,083,799 | 10,625 | 2,080,825 | 72,761 |
| Consumer | - | - | - | - | - |
| Other loans | 5,543 | 11,086 | - | 5,543 | - |
| | \$5,414,553 | \$5,494,945 | \$ 10,625 | \$5,690,370 | \$ 143,798 |
| <u>December 31, 2015</u> | | | | | |
| With no related allowance recorded: | | | | | |
| Construction and development | \$11,061 | \$11,061 | \$ - | \$11,408 | \$ 1,005 |
| 1-4 family residential | 966,420 | 975,909 | - | 966,971 | 47,320 |
| Nonfarm, nonresidential | 2,640,143 | 2,640,143 | - | 2,542,346 | 99,820 |
| Commercial and industrial | 1,676,119 | 1,676,119 | - | 1,647,548 | 86,843 |
| Consumer | - | - | - | - | - |
| Other loans | 11,085 | 11,085 | - | 11,085 | 591 |
| | 5,304,828 | 5,314,317 | - | 5,179,358 | 235,579 |

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With an allowance recorded:

| | | | | | |
|------------------------------|---------|---------|--------|---------|--------|
| Construction and development | - | - | - | - | - |
| 1-4 family residential | - | - | - | - | - |
| Nonfarm, nonresidential | - | - | - | - | - |
| Commercial and industrial | 592,557 | 592,557 | 45,014 | 592,557 | 37,304 |
| Consumer | - | - | - | - | - |
| Other loans | - | - | - | - | - |
| | 592,557 | 592,557 | 45,014 | 592,557 | 37,304 |

Combined:

| | | | | | |
|------------------------------|-------------|-------------|-----------|-------------|------------|
| Construction and development | 11,061 | 11,061 | - | 11,408 | 1,005 |
| 1-4 family residential | 966,420 | 975,909 | - | 966,971 | 47,320 |
| Nonfarm, nonresidential | 2,640,143 | 2,640,143 | - | 2,542,346 | 99,820 |
| Commercial and industrial | 2,268,676 | 2,268,676 | 45,014 | 2,240,105 | 124,147 |
| Consumer | - | - | - | - | - |
| Other loans | 11,085 | 11,085 | - | 11,085 | 591 |
| | \$5,897,385 | \$5,906,874 | \$ 45,014 | \$5,771,915 | \$ 272,883 |

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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 |
|------------------------------------|------------------------|------------------------|-----------------------------|-------------------|---------------|-----------------------------------|---|
| <u>June 30, 2016</u> | | | | | | | |
| Construction and development | \$- | \$- | \$- | \$- | \$9,334,109 | \$9,334,109 | \$- |
| 1-4 family residential | 307,109 | 156,742 | 469,481 | 933,332 | 43,137,361 | 44,070,693 | - |
| Nonfarm, nonresidential | 370,626 | - | 157,905 | 528,531 | 89,694,318 | 90,222,849 | - |
| Commercial and industrial | - | - | 130,880 | 130,880 | 54,166,057 | 54,296,937 | 30,809 |
| Consumer | 143,866 | 33,549 | - | 177,415 | 4,229,840 | 4,407,255 | - |
| Other loans | - | - | 5,543 | 5,543 | 9,187,959 | 9,193,502 | - |
| Total | \$821,601 | \$190,291 | \$763,809 | \$1,775,701 | \$209,749,644 | \$211,525,345 | \$30,809 |
| Percentage of total loans | 0.39 | % 0.09 | % 0.36 | % 0.84 | % 99.16 | % 100.00 | % |

Non-accruals
included
above

| | | | | | | |
|------------------------------------|-----------|-----------|-----------|-------------|-----------|-------------|
| Construction and development | \$- | \$- | \$- | \$- | \$- | \$- |
| 1-4 family residential | - | 212,908 | 469,481 | 682,389 | 86,941 | 769,330 |
| Nonfarm, nonresidential | 367,876 | - | 157,905 | 525,781 | 146,261 | 672,042 |
| Commercial and industrial | - | - | 100,071 | 100,071 | - | 100,071 |
| Consumer | - | - | - | - | - | - |
| Other loans | - | - | 5,543 | 5,543 | - | 5,543 |
| | \$367,876 | \$212,908 | \$733,000 | \$1,313,784 | \$233,202 | \$1,546,986 |

December 31,
2015

| | | | | | | | |
|---------------------|-----|-----|-----|-----|-------------|-------------|-----|
| Construction and | \$- | \$- | \$- | \$- | \$9,669,380 | \$9,669,380 | \$- |
|---------------------|-----|-----|-----|-----|-------------|-------------|-----|

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| | | | | | | | | | | | | |
|---------------------------|-------------|-------------|-----------|-------------|---------------|---------------|----------|--|--|--|--|--|
| development | | | | | | | | | | | | |
| 1-4 family residential | 412,158 | 395,682 | 277,572 | 1,085,412 | 42,745,277 | 43,830,689 | - | | | | | |
| Nonfarm, nonresidential | 487,300 | 120,590 | 320,924 | 928,814 | 81,666,822 | 82,595,636 | 3,502 | | | | | |
| Commercial and industrial | 72,259 | 748,958 | 193,165 | 1,014,382 | 50,916,488 | 51,930,870 | 7,866 | | | | | |
| Consumer | 62,137 | 72,140 | 27,242 | 161,519 | 4,370,660 | 4,532,179 | 26,120 | | | | | |
| Other loans | - | 11,085 | - | 11,085 | 8,797,544 | 8,808,629 | - | | | | | |
| Total | \$1,033,854 | \$1,348,455 | \$818,903 | \$3,201,212 | \$198,166,171 | \$201,367,383 | \$37,488 | | | | | |
| Percentage of total loans | 0.51 | % 0.67 | % 0.41 | % 1.59 | % 98.41 | % 100.00 | % | | | | | |

Non-accruals included above

| | | | | | | | |
|------------------------------|----------|----------|-----------|-----------|-----------|-------------|--|
| Construction and development | \$- | \$- | \$- | \$- | \$- | \$- | |
| 1-4 family residential | - | - | 277,572 | 277,572 | 248,468 | 526,040 | |
| Nonfarm, nonresidential | 62,070 | 49,503 | 317,421 | 428,994 | 51,445 | 480,439 | |
| Commercial and industrial | - | - | 185,300 | 185,300 | - | 185,300 | |
| Consumer | - | - | 1,122 | 1,122 | - | 1,122 | |
| Other loans | - | - | - | - | - | - | |
| | \$62,070 | \$49,503 | \$781,415 | \$892,988 | \$299,913 | \$1,192,901 | |

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.

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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 |
|------------------------------|---------------|---------------|--------------------|-------------|----------|
| <u>June 30, 2016</u> | | | | | |
| Construction and development | \$9,334,109 | \$9,334,109 | \$- | \$ - | \$ - |
| 1-4 family residential | 44,070,693 | 43,077,665 | 777,446 | 215,582 | - |
| Nonfarm, nonresidential | 90,222,849 | 88,711,073 | 1,143,900 | 367,876 | - |
| Commercial and industrial | 54,296,937 | 52,229,418 | 2,064,823 | 2,696 | - |
| Consumer | 4,407,255 | 4,397,435 | 9,820 | - | - |
| Other loans | 9,193,502 | 9,187,959 | - | 5,543 | - |
| | \$211,525,345 | \$206,937,659 | \$3,995,989 | \$ 591,697 | \$ - |
| Percentage of total loans | 100.0 | % 97.8 | % 1.9 | % 0.3 | % - % |

Guaranteed portion of loans

| | | | | | |
|------------------------------|--------------|--------------|-----------|------------|------|
| Construction and development | \$86,922 | \$86,922 | \$- | \$ - | \$ - |
| 1-4 family residential | 546,125 | 378,604 | - | 167,521 | - |
| Nonfarm, nonresidential | 36,449,869 | 36,342,990 | 106,879 | - | - |
| Commercial and industrial | 11,311,543 | 10,773,095 | 537,100 | 1,348 | - |
| Consumer | - | - | - | - | - |
| Other loans | 698,732 | 695,961 | - | 2,771 | - |
| | \$49,093,191 | \$48,277,572 | \$643,979 | \$ 171,640 | \$ - |

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| | Total | Pass Credits | Special Mention | Substandard | Doubtful |
|------------------------------|---------------|---------------|--------------------|-------------|----------|
| <u>December 31, 2015</u> | | | | | |
| Construction and development | \$9,669,380 | \$9,669,380 | \$- | \$ - | \$ - |
| 1-4 family residential | 43,830,689 | 43,240,136 | 590,553 | - | - |
| Nonfarm, nonresidential | 82,595,636 | 81,511,272 | 1,084,364 | - | - |
| Commercial and industrial | 51,930,870 | 50,362,579 | 1,568,291 | - | - |
| Consumer | 4,532,179 | 4,525,777 | 6,402 | - | - |
| Other loans | 8,808,629 | 8,797,544 | 11,085 | - | - |
| | \$201,367,383 | \$198,106,688 | \$3,260,695 | \$ - | \$ - |
| | 100.0 | % 98.4 | % 1.6 | % - | % - |

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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 | \$88,754 | \$88,754 | \$- | \$ - | \$ - |
| 1-4 family residential | 642,150 | 433,306 | 208,844 | - | - |
| Nonfarm, nonresidential | 36,610,890 | 36,250,939 | 359,951 | - | - |
| Commercial and industrial | 11,674,243 | 11,555,133 | 119,110 | - | - |
| Consumer | - | - | - | - | - |
| Other loans | 713,210 | 707,667 | 5,543 | - | - |
| | \$49,729,247 | \$49,035,799 | \$693,448 | \$ - | \$ - |

NOTE 7. TROUBLED DEBT RESTRUCTURINGS

For the three and six months ended June 30, 2016, the following table presents loans modified during the period that were considered to be troubled debt restructurings. For the three and six months ended June 30, 2015, no loans were modified that were considered to be troubled debt restructurings.

| | For the three months ended June 30, 2016 | | For the six months ended June 30, 2016 | |
|------------------------------|--|--|--|--|
| | Pre- Modification of Outstanding Recorded Investment | Post- Modification Outstanding Recorded Investment | Pre- Modification of Outstanding Recorded Investment | Post- Modification Outstanding Recorded Investment |
| Troubled Debt Restructurings | | | | |
| Construction and development | - \$ - | \$ - | - \$ - | \$ - |
| 1-4 Family residential | 1 137,472 | 137,472 | 1 137,472 | 137,472 |
| Nonfarm, nonresidential | - - | - | - - | - |
| Commercial and industrial | 2 41,435 | 41,435 | 2 41,435 | 41,435 |

During the three months ended June 30, 2016 and 2015, no loans that had previously been restructured were in default.

During the three months ended June 30, 2016, the Bank modified three loans that were considered to be troubled debt restructurings. The terms for these loans were extended. One loan was renewed while interest was not paid current

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.

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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 June 30, 2016, substantially all of the total impaired loans were evaluated based on the fair value of the collateral and discounted cash flows. 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.

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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)

| June 30, 2016 | Total | Level 1 | Level 2 | Level 3 |
|----------------------------------|---------|------------|------------|------------|
| Government-sponsored enterprises | \$4,003 | \$ - | \$4,003 | \$- |
| Mortgage-backed securities | 17 | - | 17 | - |
| Corporate bonds | 300 | - | - | 300 |
| Total assets at fair value | \$4,320 | \$ - | \$4,020 | \$300 |

(in thousands)

| December 31, 2015 | Total | Level 1 | Level 2 | Level 3 |
|----------------------------------|---------|------------|------------|------------|
| Government-sponsored enterprises | \$4,491 | \$- | \$4,491 | \$- |
| Mortgage-backed securities | 21 | - | 21 | - |
| Corporate bonds | 300 | - | - | 300 |
| Equities and mutual funds | 529 | 529 | - | - |
| Total assets at fair value | \$5,341 | \$529 | \$4,512 | \$300 |

For the six months ended June 30, 2016 and 2015, the changes in Level 3 assets and liabilities measured at fair value on a recurring basis were as follows:

| (in thousands) | Level 3 | |
|----------------|---------|------|
| | 2016 | 2015 |
| | | |

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| | Fair Value | Fair Value |
|---|---------------|---------------|
| Corporate Bonds – Available for Sale | | |
| Balance, January 1 | \$300 | \$255 |
| Total unrealized gain (loss) included in income | - | - |
| Total unrealized gain (loss) included in other comprehensive income | - | 30 |
| Bonds called | - | - |
| Balance, June 30 | \$300 | \$285 |

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. FAIR VALUE, CONTINUED

There was no change in the fair value for the six months period ended June 30, 2016. The change in the fair value of corporate bond assets for the six month period ended June 30, 2015 was \$30,000.

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)

| June 30, 2016 | Total | Level 1 | Level 2 | Level 3 |
|----------------------------|-------|------------|------------|------------|
| Foreclosed assets | \$203 | \$ - | \$ - | \$203 |
| Servicing assets | 335 | - | - | 335 |
| Total assets at fair value | \$538 | \$ - | \$ - | \$538 |

(in thousands)

| December 31, 2015 | Total | Level 1 | Level 2 | Level 3 |
|----------------------------|---------|------------|------------|------------|
| Impaired loans: | | | | |
| Commercial and industrial | \$548 | \$ - | \$ - | \$548 |
| Foreclosed assets | 384 | - | - | 384 |
| Servicing assets | 340 | - | - | 340 |
| Total assets at fair value | \$1,272 | \$ - | \$ - | \$1,272 |

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.

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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 June 30, 2016 and December 31, 2015. This table excludes financial instruments for which the carrying amount approximates fair value.

| (dollars in thousands) | Carrying Amount | Fair Value | Fair Value Measurements | | |
|--------------------------------|-----------------|------------|---|---|---|
| | | | Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| June 30, 2016 | | | | | |
| Financial Instruments – Assets | | | | | |
| Loans, net | \$207,918 | \$214,128 | \$- | \$- | \$ 214,128 |

Financial Instruments-Liabilities

| | | | | | |
|----------------|---------|---------|---|--------|---------|
| Deposits | 216,689 | 209,838 | - | 73,022 | 136,816 |
| Long-Term Debt | 1,750 | 1,750 | - | - | 1,818 |

December 31, 2015

Financial Instruments – Assets

| | | | | | |
|------------|-----------|-----------|---|---|------------|
| Loans, net | \$197,905 | \$203,047 | - | - | \$ 203,047 |
|------------|-----------|-----------|---|---|------------|

Financial Instruments-Liabilities

| | | | | | |
|----------------|---------|---------|---|--------|---------|
| Deposits | 212,688 | 205,778 | - | 74,693 | 131,085 |
| Long-Term Debt | 2,750 | 2,865 | - | - | 2,865 |

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 9. RECLASSIFICATION OF COMMON STOCK

On May 27, 2016, the Company held its Annual Meeting of Shareholders. A proposal to approve an amendment to the Company's Articles of Incorporation was duly approved by the Company's shareholders. Following shareholder approval, the Company filed Articles of Amendment to (i) create a new class of non-voting common stock, no par value per share, designated "Class A Common Stock"; and (ii) effect the "Reclassification" on May 27, 2016 of each share of Common Stock outstanding immediately prior to the reclassification which was owned by a shareholder of record who owned less than 300 shares of Common Stock, as Class A Common Stock, on the basis of one share of Class A Common Stock for each share of Common Stock so reclassified.

As an alternative to receiving shares of Class A Common Stock, shareholders holding less than 300 shares of Common Stock may elect to receive \$12.75 per share for their shares of Common Stock.

Holders of Class A Common Stock will have the right to receive a premium of \$0.03 per share with respect to any dividends paid to holders of Common Stock. Except as to voting rights and the dividend preference, shares of Class A Common Stock have the same preferences, limitations and relative rights as, share ratably with, and are identical in all respects to shares of Common Stock as to all matters.

As a consequence of the Reclassification the Company has fewer than 1,200 shareholders of record and intends to terminate the registration of its Common Stock under the Securities and Exchange Act of 1934, as amended, and become a non-reporting company. If that occurs, the Company will no longer file periodic reports with the Securities and Exchange Commission (the "SEC"), including annual reports on Form 10-K and quarterly reports on Form 10-Q, and it will no longer be subject to the SEC's proxy rules.

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

Introduction

This discussion, analysis and related financial information are presented to explain the significant factors which affected Surrey Bancorp's financial condition and results of operations for the three months ended June 30, 2016 and 2015. 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 June 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 June 30, 2016, was \$1,093,091 or \$0.27 per diluted share outstanding, compared to a \$694,206 or \$0.18 per diluted share outstanding, for the same period in 2015. Earnings for the three months ended June 30, 2016, are approximately 57.5% higher than for the same period in 2015. The increase in earnings results from an increase in net interest income and noninterest income. Net interest income increased from \$2,437,301 in the second quarter of 2015 to \$2,744,970 in 2016. This increase is due to loan growth. Average loans outstanding increased 9.8% from the second quarter of 2015 to 2016, or approximately \$18,741,000. The net interest margin increased from 4.10% to 4.65% from 2015 to 2016 due to a combination of higher assets yields and lower deposit costs. Asset yields increased from 4.59% in 2015 to 5.02% in 2016 primarily from a change in asset mix and a slight uptick in interest rates. Higher yielding loans made up 88.3% of average interest earning assets in the second quarter of 2016 as opposed to 80.2% in the second quarter of 2015. The cost of funds decreased from 0.54% in the second quarter of 2015 to 0.42% in the second quarter of 2016 as non-interest bearing deposits made up a higher percentage of average deposits. The provision for loan losses increased from a provision of \$70,298 in the second quarter of 2015 to a provision of \$136,927 in the second quarter of 2016, a \$66,629 increase. The provision increase is partially due to a decrease in loans carrying government guarantees. The guaranteed portion of loans decreased from \$50,347,995, or 26.02% of gross loans at June 30, 2015 to \$49,093,191, or 23.2% of gross loans at June 30, 2016. Unguaranteed loans represent the majority of the loan growth since June 30,

2015. The increased credit exposure contributed to the increased provision for loan losses.

Noninterest income increased from \$625,015 in the second quarter of 2015 to \$938,921 in 2016. The increase primarily results from the recording of \$315,754 in tax exempt life insurance proceeds during the quarter ended June 30, 2016. Service charges in deposit accounts decreased from \$208,321 in 2015 to \$160,388 due to regulatory changes involving insufficient funds charges. Noninterest expenses increased 6.5% from \$1,837,382 in the second quarter of 2015, to \$1,956,297 in 2016. This increase was primarily due to an increase in salaries and employee benefits, which grew due to the opening of a new branch office and a loan production office in the second half of 2015.

Net income available for common stockholders for the six months ended June 30, 2016, was \$1,824,818 or \$0.46 per diluted share outstanding, compared to a \$1,377,413 or \$0.35 per diluted share outstanding, for the same period in 2015.

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

Earnings for the six months ended June 30, 2016, are approximately 32.5% higher than for the same period in 2015. The increase in earnings results from an increase in net interest income and an increase in noninterest income. Net interest income increased from \$4,860,077 in the first six months of 2015 to \$5,440,371 in 2016. Most of this increase is due to loan growth. Average loans outstanding increased 9.1% from the first six months of 2015 to the same period in 2016, or approximately \$17,420,000. The net interest margin increased from 4.14% to 4.62% from 2015 to 2016 due to higher asset yields and lower deposit costs. Asset yields increased from 4.64% in 2015 to 5.02% in 2016. The cost of funds decreased from 0.55% in the first six months of 2015 to 0.43% in 2016. The provision for loan losses increased from a recapture \$43,496 in the second quarter of 2015 to a provision of \$212,741 in 2016, a \$256,237 increase. The provision increase is partially due to a decrease in loans carrying government guarantees. The guaranteed portion of loans decreased from \$50,347,995, or 26.02% of gross loans at June 30, 2015 to \$49,093,191, or 23.2% of gross loans at June 30, 2016. Unguaranteed loans represent the majority of the loan growth since June 30, 2015. The increased credit exposure contributed to the increased provision for loan losses. Noninterest income increased from \$1,250,249 in the first six months of 2015 to \$1,477,478 in 2016. . The increase results from the recording of tax exempt life insurance proceeds during the six months ended June 30, 2016. Noninterest expenses increased 1.1% from \$3,870,050 in 2015, to \$3,911,886 in 2016. This increase was due increases in salaries and benefits. Salaries and benefits increased 11.1% from 1,991,930 in 2015 to 2,213,729 in 2016 due to expansion. The increase in salaries and benefits was partially offset by the recoupment of certain legal fees associated with the collection of government guaranteed loans. Professional fees decreased from \$248,005 in the first six months of 2015 to \$53,387 during the same period in 2016.

On June 30, 2016, Surrey Bancorp's assets totaled \$262,650,694 compared to \$257,776,555 on December 31, 2015. Net loans were \$207,918,096 compared to \$197,904,895 on December 31, 2015. This net increase was the result of a \$10,157,962 increase in loans, a \$74,848 increase net deferred cost and a \$219,609 net increase in the loan loss reserve. Commercial and nonfarm nonresidential loans account for the increase, with nonfarm, nonresidential loans representing most of the growth. Nonfarm, nonresidential loans increased \$7,627,213 or 9.2% in the first six months of 2016 and commercial loans increased \$2,366,067 or 4.6%. Overall gross loans increased 5.0%

Total deposits on June 30, 2016, were \$216,689,033 compared to \$212,687,961 at the end of 2015. This increase is attributable to an increase in noninterest-bearing demand deposits accounts, which increased from \$54,619,375 at December 31, 2015 to \$60,467,106 at June 30, 2016. Overall, noninterest-bearing and interest-bearing demand deposits increased 0.7% from 2015 totals, while savings deposits, including money market accounts, increased 3.4%. Certificates of deposit decreased 1.3% from December 31, 2015 totals.

Common stockholders' equity increased by \$1,828,788, or 4.73%, during the six months ended June 30, 2016. The increase is comprised of net income of \$1,915,775 and adjustments to other comprehensive income of \$28,970. Decreases included the declaration and accrual of preferred dividends of \$90,957 and the cost of recapitalization of \$25,000. The net increase resulted in a common stock book value of \$10.32 per share, up from \$9.80 on December 31, 2015.

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 June 30, 2016.

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.

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2. OPERATIONS, CONTINUED

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

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

Investments in available for sale securities of \$4,319,809 consisted of Government-sponsored enterprise obligations with maturities ranging from 8 to 38 months, corporate bonds with maturities of 2.25 years, that reprice quarterly, GNMA adjustable rate mortgage securities, which adjust annually.

Loans

Net loans outstanding on June 30, 2016, were \$207,918,096 compared to \$197,904,895 on December 31, 2015. The Bank maintains a loan portfolio dominated by real estate and commercial loans diversified among various industries. Approximately 57.4% of the Bank's loans as of June 30, 2016, are fixed rate loans with 42.6% floating with the Bank's prime rate or other appropriate internal or external indices.

Deposits

Deposits on June 30, 2016, were \$216,689,033, compared to \$212,687,961 on December 31, 2015. The June total consists of a base of approximately 12,957 accounts compared to 12,768 accounts at December 31, 2015. Interest-bearing accounts represent 72.1% of June 30, 2016 period end deposits versus 74.3% at December 31, 2015.

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. Common Equity Tier I Capital "CET1" is a new regulatory ratio resulting from BASEL III. CET1 primarily consist of the Company's and the Bank's common shares, common share surplus, retained earnings and accumulated other comprehensive income. A Capital Conservation Buffer of .625% will increase the minimum CET1 and Total Capital ratios each year through 2019. The Company's and the Bank's capital ratios are presented in the following table.

| | Ratio | Minimum Required For Capital Adequacy Purposes | |
|--|---------|---|---|
| June 30, 2016: | | | |
| Total Capital (to Risk-Weighted Assets) | | | |
| Surrey Bancorp (Consolidated) | 19.81 % | 8.625 | % |
| Surrey Bank & Trust | 19.49 % | 8.625 | % |

| | | | |
|-------------------------------|--------|-------|---|
| Common Equity Tier I Capital | | | |
| (to Risk-Weighted Assets) | | | |
| Surrey Bancorp (Consolidated) | 16.70% | 5.125 | % |
| Surrey Bank & Trust | 18.22% | 5.125 | % |
| Tier I Capital | | | |
| (to Risk-Weighted Assets) | | | |
| Surrey Bancorp (Consolidated) | 18.55% | 6.0 | % |
| Surrey Bank & Trust | 18.22% | 6.0 | % |
| Tier I Capital | | | |
| (to Average Assets) | | | |
| Surrey Bancorp (Consolidated) | 15.12% | 4.0 | % |
| Surrey Bank & Trust | 14.86% | 4.0 | % |

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2. OPERATIONS, CONTINUED

December 31, 2015:

| | | |
|-------------------------------|---------|-------|
| Total Capital | | |
| (to Risk-Weighted Assets) | | |
| Surrey Bancorp (Consolidated) | 20.88 % | 8.0 % |
| Surrey Bank & Trust | 20.52 % | 8.0 % |
| Common Equity Tier I Capital | | |
| (to Risk-Weighted Assets) | | |
| Surrey Bancorp (Consolidated) | 17.56 % | 4.5 % |
| Surrey Bank & Trust | 19.25 % | 4.5 % |
| Tier I Capital | | |
| (to Risk-Weighted Assets) | | |
| Surrey Bancorp (Consolidated) | 19.61 % | 6.0 % |
| Surrey Bank & Trust | 19.25 % | 6.0 % |
| Tier I Capital | | |
| (to Average Assets) | | |
| Surrey Bancorp (Consolidated) | 13.74 % | 4.0 % |
| Surrey Bank & Trust | 13.48 % | 4.0 % |

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.

| | June 30, 2016 | December 31, 2015 |
|---|------------------|----------------------|
| Nonaccrual loans | \$ 1,546,986 | \$ 1,192,901 |
| Loans past due 90 days and still accruing | 30,809 | 37,488 |
| Foreclosed assets | 202,982 | 384,452 |
| Total | \$ 1,780,777 | \$ 1,614,841 |
| Total assets | \$ 262,650,694 | \$ 257,776,555 |
| Ratio of nonperforming assets to total assets | 0.68 | % 0.63 |

At June 30, 2016, the Bank had loans totaling \$1,546,986 in nonaccrual status. Nonaccrual loans totaling \$233,202 were current at the end of June. The guaranteed portion of nonaccrual loans at June 30, 2016 is \$292,315. Foreclosed assets at June 30, 2016 primarily consist of nonresidential properties. Loans that were considered impaired but were still accruing interest at June 30, 2016, including troubled debt restructurings, totaled \$3,867,566. 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. There were no specific reserves on impaired loans at June 30, 2016.

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2. OPERATIONS, CONTINUED

Nonaccrual and impaired loans still accruing are summarized below:

| | June 30, 2016 | December 31, 2015 |
|-------------------------------|------------------|-------------------------|
| Construction and development | \$9,686 | \$11,061 |
| 1-4 family residential | 1,231,595 | 1,149,257 |
| Nonfarm, nonresidential | 2,086,625 | 2,640,143 |
| Commercial and industrial | 2,081,104 | 2,268,676 |
| Consumer | - | 1,122 |
| Other loans | 5,543 | 11,085 |
| Total impaired and nonaccrual | \$5,414,553 | \$6,081,344 |
| Guaranteed portion | \$1,138,762 | \$1,575,318 |

At June 30, 2016, consumer loans totaling \$220,836 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. All of these loans were on nonaccrual at June 30, 2016.

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

| | June 30, 2016 | | December 31, 2015 | |
|------------------------------|---------------|----------|-------------------|----------|
| Construction and development | \$9,334,109 | 4.41 % | \$9,669,380 | 4.80 % |
| 1-4 family residential | 44,070,693 | 20.84 % | 43,830,689 | 21.77 % |
| Multi-family | 1,100,398 | 0.52 % | 1,155,535 | 0.57 % |
| Farmland | 6,648,149 | 3.15 % | 6,043,944 | 3.00 % |
| Nonfarm, nonresidential | 90,222,849 | 42.66 % | 82,595,636 | 41.02 % |
| Total real estate | 151,376,198 | 71.58 % | 143,295,184 | 71.16 % |
| Agricultural | 1,444,955 | 0.68 % | 1,609,150 | 0.80 % |
| Commercial and industrial | 54,296,937 | 25.67 % | 51,930,870 | 25.79 % |
| Consumer | 4,407,255 | 2.08 % | 4,532,179 | 2.25 % |
| Total loans | \$211,525,345 | 100.00 % | \$201,367,383 | 100.00 % |

The concentrations represented above do not, based on managements' assessment, expose the Bank to any unusual concentration risk. Based on the Bank's asset size, the 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 \$61,658,572 in loans that carry government guarantees. The guaranteed portion of these loans amounts to \$49,093,191 at June 30, 2016. Loan guarantees by loan class are below:

| June 30, | Guaranteed Portion |
|----------|--------------------|
|----------|--------------------|

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| | 2016 | Amount | Percentage | |
|------------------------------|---------------|--------------|------------|---|
| Construction and development | \$9,334,109 | \$86,922 | 0.93 | % |
| 1-4 family residential | 44,070,693 | 546,125 | 1.24 | % |
| Multi-family | 1,100,398 | 2,771 | 0.25 | % |
| Farmland | 6,648,149 | 695,961 | 10.47 | % |
| Nonfarm, nonresidential | 90,222,849 | 36,449,869 | 40.40 | % |
| Total real estate | 151,376,198 | 37,781,648 | 24.96 | % |
| Agricultural | 1,444,955 | - | - | % |
| Commercial and industrial | 54,296,937 | 11,311,543 | 20.83 | % |
| Consumer | 4,407,255 | - | - | % |
| Total loans | \$211,525,345 | \$49,093,191 | 23.21 | % |

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2. OPERATIONS, CONTINUED

Loans in higher risk categories, such as non-owner occupied nonfarm, non-residential property and commercial real estate construction represent a smaller segment of our loan portfolio. Commercial construction loans included in construction and development loans amounted to \$7,873,095, or 3.72% of total loans at June 30, 2016. Non-owner occupied nonfarm, non-residential properties included in nonfarm, non-residential loans above amounted to \$22,467,437, or 10.62% of total loans at June 30, 2016.

The reserve for loan losses on June 30, 2016, was \$3,846,517 or 1.82% of period end loans. This percentage is derived from total loans. Approximately \$61,659,000 of total loans outstanding at June 30, 2016, are government guaranteed loans which carry guarantees ranging from 50% 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 2.37% of outstanding loans. At December 31, 2015 the loan loss reserve percentage was 1.80% of total loans and 2.40% of loans net of government guarantees.

The level of reserve is established based upon management's evaluation of historical loss data and the effects of certain environmental factors on the loan portfolio. The historical loss portion of the reserve is computed using the average loss data from the past applied to its corresponding category of loans. However, historical losses only reflect a small portion of the Bank's loan loss reserve. 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 June 30, 2016 and December 31, 2015.

| | June 30, 2016 | | December 31, 2015 | |
|---|---------------|-----------------|-------------------|-----------------|
| | 30-89 Days | 90 Days Plus | 30-89 Days | 90 Days Plus |
| Construction and development | \$- | \$- | \$- | \$- |
| 1-4 family residential | 463,851 | 469,481 | 807,840 | 277,572 |
| Nonfarm, non-residential | 370,626 | 157,905 | 607,890 | 320,924 |
| Commercial and industrial | - | 130,880 | 821,217 | 193,165 |
| Consumer | 177,415 | - | 134,277 | 27,242 |
| Other loans | - | 5,543 | 11,085 | - |
| | \$1,011,892 | \$763,809 | \$2,382,309 | \$818,903 |
| Non-accrual loans included above | \$580,784 | \$733,000 | \$111,573 | \$781,415 |
| Guaranteed portion | \$18,258 | \$271,285 | \$348,362 | \$362,297 |
| Ratio to total loans | 0.48 | % 0.36 | % 1.18 | % 0.41 |
| Ratio to total loans, net of guarantees | 0.61 | % 0.30 | % 1.34 | % 0.30 |

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 decreased from December 31, 2015 to June 30, 2016. The largest decrease is in commercial loans which collectively decreased \$883,501.

Net of loan guarantees, total past dues have decreased from \$2,490,553 at December 31, 2015, to \$1,486,157 at June 30, 2016, or 40.3%. Total past due loans at June 30, 2016 consist of forty-seven loans with an average balance of \$37,781, compared to sixty-nine loans at December 31, 2015, with an average balance of \$46,394. Loans over \$250,000 delinquent at June 30, 2016 and December 31, 2015 amounted to \$367,876 and \$945,434, respectively. The June 2016 and December 2015 totals consist of one and two loans, respectively, one of which are the same. The guaranteed portion December 31, 2015 was \$202,020. None of the loans at June 30, 2016 carried government guarantees.

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 County, Virginia and surrounding counties.

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ITEM MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF
2. 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 June 30, 2016, the liquidity position of the Company was excellent, in management's opinion, with short-term liquid assets of \$33,930,086 compared to \$45,354,230 at December 31, 2015. To provide supplemental liquidity, the Bank has seven unsecured lines of credit with correspondent banks totaling \$35,500,000. At June 30, 2016, 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 \$9,443,000 of which \$1,750,000 had been advanced at June 30, 2016.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Not Applicable as a “Smaller Reporting Company”.

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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.

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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: August 12, 2016 /s/ Edward C. Ashby, III

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

Date: August 12, 2016 /s/ Mark H. Towe

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