

SURREY BANCORP
Form 10-Q
November 14, 2011

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

FORM 10-Q

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

for the quarterly period ended September 30, 2011

.. 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)

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North Carolina
(State or other jurisdiction of

59-3772016
(IRS Employer

incorporation or organization)

Identification No.)

145 North Renfro Street, Mount Airy, NC 27030

(Address of principal executive offices)

(336) 783-3900

(Registrant's telephone number)

Check whether the registrant: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

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

On November 7, 2011 there were 3,215,764 common shares issued and outstanding.

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Consolidated Balance Sheets*September 30, 2011 (Unaudited) and December 31, 2010 (Audited)*

	September 2011	December 2010
Assets		
Cash and due from banks	\$ 2,570,375	\$ 2,398,433
Interest-bearing deposits with banks	33,791,894	22,792,088
Federal funds sold	709,646	702,121
Investment securities available for sale	2,512,078	2,012,132
Restricted equity securities	852,629	941,379
Loans, net of allowance for loan losses of \$4,628,232 at September 30, 2011 and \$6,683,922 at December 31, 2010	176,116,287	171,794,247
Property and equipment, net	4,632,998	4,726,483
Foreclosed assets	182,480	450,532
Accrued income	1,043,727	955,516
Goodwill	120,000	120,000
Bank owned life insurance	3,363,465	3,284,990
Other assets	3,111,630	3,474,563
Total assets	\$ 229,007,209	\$ 213,652,484
Liabilities and Stockholders Equity		
Liabilities		
Deposits:		
Noninterest-bearing	\$ 36,568,922	\$ 27,954,669
Interest-bearing	151,730,369	146,005,404
Total deposits	188,299,291	173,960,073
Long-term debt	8,100,000	9,450,000
Dividends payable	46,233	35,515
Accrued interest payable	249,132	227,887
Other liabilities	1,931,024	1,334,854
Total liabilities	198,625,680	185,008,329
Commitments and contingencies		
Stockholders equity		
Preferred stock, 1,000,000 shares authorized, 189,356 shares of Series A, issued and outstanding with no par value, 4.5% convertible non-cumulative, perpetual, with a liquidation value of \$14 per share;	2,620,325	2,620,325
181,154 shares of Series D, issued and outstanding with no par value 5.0% convertible non-cumulative, perpetual; with a liquidation value of \$7.08 per share;	1,248,482	1,248,482
Common stock, 10,000,000 shares authorized at no par value; 3,215,764 and 3,206,495 shares issued and outstanding at September 30, 2011 and December 31, 2010, respectively	9,500,158	9,464,178
Retained earnings	17,067,974	15,380,083
Accumulated other comprehensive loss	(55,410)	(68,913)
Total stockholders equity	30,381,529	28,644,155
Total liabilities and stockholders equity	\$ 229,007,209	\$ 213,652,484

See Notes to Consolidated Financial Statements

Consolidated Statements of Income*Nine months ended September 30, 2011 and 2010 (Unaudited)*

	2011	2010
<i>Interest income</i>		
Loans and fees on loans	\$ 8,138,762	\$ 8,277,716
Federal funds sold	1,210	594
Investment securities, taxable	40,275	37,655
Deposits with banks	11,645	20,053
Total interest income	8,191,892	8,336,018
<i>Interest expense</i>		
Deposits	1,368,776	1,557,497
Short-term debt		17,720
Long-term debt	264,361	298,394
Total interest expense	1,633,137	1,873,611
Net interest income	6,558,755	6,462,407
<i>Provision for loan losses</i>	67,190	1,840,578
Net interest income after provision for loan losses	6,491,565	4,621,829
<i>Noninterest income</i>		
Service charges on deposit accounts	767,978	800,693
Gain on sale of government guaranteed loans		244,924
Fees and yield spread premiums on loans delivered to correspondents	78,865	91,511
Other service charges and fees	372,673	335,456
Other operating income	548,662	529,071
Total noninterest income	1,768,178	2,001,655
<i>Noninterest expense</i>		
Salaries and employee benefits	2,624,411	2,563,874
Occupancy expense	294,493	313,507
Equipment expense	179,090	192,050
Data processing	271,504	306,287
Foreclosed assets, net	140,190	23,644
Postage, printing and supplies	146,904	159,239
Professional fees	267,558	217,045
FDIC insurance premiums	176,286	184,271
Litigation settlement	130,000	
Other expense	1,075,861	950,463
Total noninterest expense	5,306,297	4,910,380
Net income before income taxes	2,953,446	1,713,104
Income tax expense	1,128,365	626,756

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Net income	1,825,081	1,086,348
<i>Preferred stock dividends and accretion of discount</i>	(137,190)	(194,107)
Net income available to common stockholders	\$ 1,687,891	\$ 892,241
<i>Basic earnings per common share</i>	\$ 0.53	\$ 0.28
<i>Diluted earnings per common share</i>	\$ 0.48	\$ 0.27
<i>Basic weighted average common shares outstanding</i>	3,212,087	3,206,341
<i>Diluted weighted average common shares outstanding</i>	3,788,389	3,603,784
<i>See Notes to Consolidated Financial Statements</i>		

Consolidated Statements of Income*Three months ended September 30, 2011 and 2010 (Unaudited)*

	2011	2010
<i>Interest income</i>		
Loans and fees on loans	\$ 2,762,166	\$ 2,738,272
Federal funds sold	415	190
Investment securities, taxable	13,917	11,992
Deposits with banks	3,641	8,342
Total interest income	2,780,139	2,758,796
<i>Interest expense</i>		
Deposits	435,353	515,211
Short-term debt		
Long-term debt	81,461	94,931
Total interest expense	516,814	610,142
Net interest income	2,263,325	2,148,654
<i>Provision for loan losses</i>	188,118	636,736
Net interest income after provision for loan losses	2,075,207	1,511,918
<i>Noninterest income</i>		
Service charges on deposit accounts	259,093	268,216
Gain on sale of government guaranteed loans		
Fees and yield spread premiums on loans delivered to correspondents	25,247	41,774
Other service charges and fees	125,646	112,407
Other operating income	188,683	159,609
Total noninterest income	598,669	582,006
<i>Noninterest expense</i>		
Salaries and employee benefits	862,414	840,474
Occupancy expense	97,313	116,277
Equipment expense	58,593	55,667
Data processing	85,916	109,513
Foreclosed assets, net	(142)	7,962
Postage, printing and supplies	44,150	48,996
Professional fees	77,098	64,467
FDIC insurance premiums	36,709	65,990
Litigation settlement	130,000	
Other expense	381,421	307,179
Total noninterest expense	1,773,472	1,616,525
Net income before income taxes	900,404	477,399
Income tax expense	338,691	171,600

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Net income	561,713	305,799
<i>Preferred stock dividends and accretion of discount</i>	(46,233)	(65,294)
Net income available to common stockholders	\$ 515,480	\$ 240,505
<i>Basic earnings per common share</i>	\$ 0.16	\$ 0.08
<i>Diluted earnings per common share</i>	\$ 0.15	\$ 0.08
<i>Basic weighted average common shares outstanding</i>	3,215,213	3,206,495
<i>Diluted weighted average common shares outstanding</i>	3,791,515	3,601,643

See Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows*Nine months ended September 30, 2011 and 2010 (Unaudited)*

	2011	2010
<i>Cash flows from operating activities</i>		
Net income	\$ 1,825,081	\$ 1,086,348
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	183,205	194,072
Gain on sale of property and equipment	(760)	(400)
Loss on the sale of foreclosed assets	50,254	10,695
Stock-based compensation, net of tax benefit	17,155	21,774
Provision for loan losses	67,190	1,840,578
Deferred income taxes	(6,853)	13,738
Accretion of discount on securities, net of amortization of premiums	1,526	1,958
Increase in cash surrender value of life insurance	(78,475)	(83,364)
Changes in assets and liabilities:		
Accrued income	(88,211)	54,612
Other assets	361,314	(1,216,011)
Accrued interest payable	21,245	(4,385)
Other liabilities	596,170	730,336
Net cash provided by operating activities	2,948,841	2,649,951
<i>Cash flows from investing activities</i>		
Net increase in interest-bearing deposits with banks	(10,999,806)	(9,525,379)
Net increase in federal funds sold	(7,525)	(41,123)
Purchases of investment securities	(2,002,500)	(2,000,000)
Sales and maturities of investment securities	1,523,003	2,007,127
Redemption of restricted equity securities	88,800	71,385
Purchase of restricted equity securities	(50)	
Net (increase) decrease in loans	(4,634,755)	5,082,011
Proceeds from the sale of foreclosed assets	463,323	68,340
Purchases of property and equipment	(89,720)	(108,105)
Proceeds from the sale of property and equipment	760	400
Net cash (used in) investing activities	(15,658,470)	(4,445,344)
<i>Cash flows from financing activities</i>		
Net increase in deposits	14,339,218	5,798,745
Net decrease in short-term debt		(3,750,000)
Net (decrease) increase in long-term debt	(1,350,000)	250,000
Dividends paid	(126,472)	(170,976)
Common stock options exercised	18,825	34,450
Net cash provided by financing activities	12,881,571	2,162,219
Net increase (decrease) in cash and cash equivalents	171,942	366,826
<i>Cash and due from banks, beginning</i>	2,398,433	1,923,621
<i>Cash and due from banks, ending</i>	\$ 2,570,375	\$ 2,290,447

Supplemental disclosures of cash flow information

Interest paid	\$ 1,611,892	\$ 1,877,996
Taxes paid	\$ 626,319	\$ 1,246,897
Loans transferred to foreclosed properties	\$ 245,525	\$ 322,034

See Notes to Consolidated Financial Statements

Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income*Nine months ended September 30, 2011 and 2010 (Unaudited)*

	<u>Preferred Stock</u>	Common Stock		Retained Earnings	Unrealized Appreciation (Depreciation) on Securities	Total
	<u>Amount</u>	Shares	Amount			
Balance, January 1, 2010	\$ 4,626,830	3,198,105	\$ 9,406,429	\$ 14,468,089	\$ (75,996)	\$ 28,425,352
Comprehensive income						
Net income				1,086,348		1,086,348
Net change in unrealized gain (loss) on investment securities available for sale, net of income tax of \$1,308					(2,085)	(2,085)
Total comprehensive income						1,084,263
Common stock options exercised		8,390	34,450			34,450
Stock-based compensation, net of tax benefit			21,774			21,774
Dividends declared on convertible Series A preferred stock (\$.47 per share)				(89,226)		(89,226)
Dividends declared and accrued on Series B and Series C preferred stock, net of discount accretion and (premium) amortization	25,944			(104,881)		(81,145)
Balance, September 30, 2010	\$ 4,652,774	3,206,495	\$ 9,462,653	\$ 15,360,330	\$ (78,081)	\$ 29,395,468
Balance, January 1, 2011	\$ 3,868,807	3,206,495	\$ 9,464,178	\$ 15,380,083	\$ (68,913)	\$ 28,644,155
Comprehensive income						
Net income				1,825,081		1,825,081
Net change in unrealized gain (loss) on investment securities available for sale, net of income tax of \$8,471					13,503	13,503
Total comprehensive income						1,838,584
Common stock options exercised, net of shares surrendered in cashless exchange		9,269	18,825			18,825
Stock-based compensation, net of tax benefit			17,155			17,155
Dividends declared on Series A convertible preferred stock (\$.47 per share)				(89,225)		(89,225)
Dividends declared on Series D convertible preferred stock (\$.26 per share)				(47,965)		(47,965)
Balance, September 30, 2011	\$ 3,868,807	3,215,764	\$ 9,500,158	\$ 17,067,974	\$ (55,410)	\$ 30,381,529

See Notes to Consolidated Financial Statements

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

NOTE 1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-Q and therefore, do not include all disclosures required by generally accepted accounting principles for a complete presentation of financial statements. In the opinion of management, the consolidated financial statements contain all adjustments necessary to present fairly the financial condition of Surrey Bancorp, (the Company), as of September 30, 2011, the results of operations for the nine and three months ended September 30, 2011 and 2010, and its changes in stockholders' equity and comprehensive income and cash flows for the nine months ended September 30, 2011 and 2010. The results of operations for the nine and three months ended September 30, 2011, 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, 2010, included in the Company's Form 10-K. The balance sheet at December 31, 2010, has been taken from the audited financial statements at that date.

Organization

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

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

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

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

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

Critical Accounting Policies

The notes to the audited consolidated financial statements for the year ended December 31, 2010 contain a summary of the significant accounting policies. The Company believes our policies with respect to the methodology for the determination of the allowance for loan losses, and asset impairment judgments, including the recoverability of intangible assets involve a higher degree of complexity and require management to make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could cause reported results to differ materially. These critical policies and their application are periodically reviewed with the Audit Committee and our Board of Directors. See our Annual Report for full details on critical accounting policies.

Principles of Consolidation

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

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Presentation of Cash Flows

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

Investment Securities

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

Investment securities classified as held to maturity are those debt securities that the Bank has the ability and intent to hold to maturity. Accordingly, these securities are carried at cost adjusted for amortization of premiums and accretion of discount, computed by the interest-method over their contractual lives. At September 30, 2011 and December 31, 2010, the Bank had no investments classified as held to maturity.

Loans Held for Sale

The Bank originates and holds Small Business Administration (SBA) and United States Department of Agriculture (USDA) guaranteed loans in its portfolio in the normal course of business. Occasionally, the Bank sells the guaranteed portions of these loans into the secondary market. The loans are generally variable rate loans, which eliminates the market risk to the Bank and are therefore carried at cost. The Bank recognizes gains on the sale of the guaranteed portion upon the consummation of the transaction. The Bank plans to continue to originate guaranteed loans for sales, however no such loans were funded at September 30, 2011 and December 31, 2010.

Loans Receivable

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

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

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

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Allowance for Loan Losses

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

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

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

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

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

Recent Accounting Pronouncements

The following is a summary of recent authoritative pronouncements:

In July 2010, the Receivables topic of the Accounting Standards Codification (ASC) was amended by Accounting Standards Update (ASU) 2010-20 to require expanded disclosures related to a company's allowance for credit losses and the credit quality of its financing receivables. The amendments require the allowance disclosures to be provided on a disaggregated basis. The Company is required to include these disclosures in its interim and annual financial statements. See Note 6.

Disclosures about Troubled Debt Restructurings (TDRs) required by ASU 2010-20 were deferred by the Financial Accounting Standards Board (FASB) in ASU 2011-01 issued in January 2011. In April 2011 the FASB issued ASU 2011-02 to assist creditors with their determination of when a restructuring is a TDR. The determination is based on whether the restructuring constitutes a concession and whether the debtor is experiencing financial difficulties as both events must be present.

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Recent Accounting Pronouncements, continued

Disclosures related to TDRs under ASU 2010-20 have been presented in Note 7.

In December 2010, the Intangibles topic of the ASC was amended to modify Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. Any resulting goodwill impairment should be recorded as a cumulative-effect adjustment to beginning retained earnings upon adoption. Impairments occurring subsequent to adoption should be included in earnings. The amendment was effective for the Company beginning January 1, 2011.

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

In April 2011, the criteria used to determine effective control of transferred assets in the Transfers and Servicing topic of the ASC was amended by ASU 2011-03. The requirement for the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms and the collateral maintenance implementation guidance related to that criterion were removed from the assessment of effective control. The other criteria to assess effective control were not changed. The amendments are effective for the Company beginning January 1, 2012 but are not expected to have a material effect on the financial statements.

ASU 2011-04 was issued in May 2011 to amend the Fair Value Measurement topic of the ASC by clarifying the application of existing fair value measurement and disclosure requirements and by changing particular principles or requirements for measuring fair value or for disclosing information about fair value measurements. The amendments will be effective for the Company beginning January 1, 2012 but are not expected to have a material effect on the financial statements.

The Comprehensive Income topic of the ASC was amended in June 2011. The amendment eliminates the option to present other comprehensive income as a part of the statement of changes in stockholders' equity. The amendment requires consecutive presentation of the statement of net income and other comprehensive income and requires an entity to present reclassification adjustments from other comprehensive income to net income on the face of the financial statements. The amendments will be applicable to the Company on January 1, 2012 and will be applied retrospectively.

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

Subsequent Events

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

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SECURITIES

Debt and equity securities have been classified in the balance sheets according to management's intent. The amortized costs of securities available for sale and their approximate fair values at September 30, 2011 and December 31, 2010 follow:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
September 30, 2011				
Government-sponsored enterprises	\$ 2,001,016	\$ 8,679	\$	\$ 2,009,695
Mortgage-backed securities	51,232	1,526		52,758
Corporate bonds	550,000		100,375	449,625
	\$ 2,602,248	\$ 10,205	\$ 100,375	\$ 2,512,078
December 31, 2010				
Government-sponsored enterprises	\$ 1,500,000	\$ 1,770	\$	\$ 1,501,770
Mortgage-backed securities	74,278	1,584		75,862
Corporate bonds	550,000		115,500	434,500
	\$ 2,124,278	\$ 3,354	\$ 115,500	\$ 2,012,132

At September 30, 2011 and December 31, 2010, substantially all government-sponsored enterprises securities were pledged as collateral on public deposits and for other purposes as required or permitted by law. The mortgage-backed securities were pledged to the Federal Home Loan Bank.

Maturities of mortgage-backed bonds are stated based on contractual maturities. Actual maturities of these bonds may vary as the underlying mortgages are prepaid. The scheduled maturities of securities (all available for sale) at September 30, 2011, were as follows:

	Amortized Cost	Fair Value
Due in one year or less	\$	\$
Due after one year through five years	2,001,016	2,009,695
Due after five years through ten years	586,895	487,542
Due after ten years	14,337	14,841
	\$ 2,602,248	\$ 2,512,078

The following table shows investments' gross unrealized losses and fair value, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, at September 30, 2011 and December 31, 2010. These unrealized losses on investment securities are a result of volatility in interest rates and primarily relate to corporate bonds issued by other banks at September 30, 2011 and December 31, 2010.

Less Than 12 Months		12 Months or More		Total	
Fair	Unrealized	Fair	Unrealized	Fair	Unrealized

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	Value	Losses	Value	Losses	Value	Losses
<u>September 30, 2011</u>						
Corporate bonds	\$	\$	\$ 449,625	\$ 100,375	\$ 449,625	\$ 100,375
	\$	\$	\$ 449,625	\$ 100,375	\$ 449,625	\$ 100,375
<u>December 31, 2010</u>						
Corporate bonds	\$	\$	\$ 434,500	\$ 115,500	\$ 434,500	\$ 115,500
	\$	\$	\$ 434,500	\$ 115,500	\$ 434,500	\$ 115,500

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SECURITIES, CONTINUED

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

The Company had no gross realized gains or losses from the sales of investment securities for the nine and three month periods ended September 30, 2011 and 2010.

NOTE 3. EARNINGS PER SHARE

Basic earnings per share for the nine and three months ended September 30, 2011 and 2010 were calculated by dividing net income available to common stockholders by the weighted average number of shares outstanding during the period.

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

NOTE 4. COMMITMENTS AND LETTERS OF CREDIT

At September 30, 2011, the Company had commitments to extend credit, including unused lines of credit of approximately \$36,414,000. Letters of credit totaling \$1,349,531 were outstanding.

NOTE 5. LOANS

The major components of loans in the balance sheets at September 30, 2011 and December 31, 2010 are below.

	2011	2010
Commercial	\$ 71,722,630	\$ 66,377,076
Real estate:		
Construction and land development	5,253,339	5,986,045
Residential, 1-4 families	41,806,459	46,356,711
Residential, 5 or more families	2,259,445	1,853,346
Farmland	2,903,144	2,854,481
Nonfarm, nonresidential	49,721,494	48,170,698
Agricultural	43,263	73,852
Consumer, net of discounts of \$21,169 in 2011 and \$14,770 in 2010	7,013,836	6,759,770
	180,723,610	178,431,979
Deferred loan origination costs, net of fees	20,909	46,190

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	180,744,519	178,478,169
Allowance for loan losses	(4,628,232)	(6,683,922)
	\$ 176,116,287	\$ 171,794,247

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5. LOANS, CONTINUED

Residential, 1-4 family loans pledged as collateral against FHLB advances approximated \$20,483,000 and \$25,141,000 at September 30, 2011 and December 31, 2010.

NOTE 6. ALLOWANCE FOR LOAN LOSSES

The activity of the allowance for loan losses by loan components at September 30, 2011 and 2010 was as follows:

	Construction & Development	1-4 Family Residential	Nonfarm, Nonresidential	Commercial & Industrial	Consumer	Other	Total
2011							
<i>Allowance for credit losses:</i>							
Beginning balance	\$ 118,797	\$ 1,696,068	\$ 1,199,292	\$ 3,411,403	\$ 205,662	\$ 52,700	\$ 6,683,922
Charge-offs	(27,468)	(1,113,243)	(203,418)	(1,007,729)	(45,010)		(2,396,868)
Recoveries	996	56,241	108,114	83,804	24,833		273,988
Provision	3,621	185,093	(233,826)	77,669	29,233	5,400	67,190
Ending balance	\$ 95,946	\$ 824,159	\$ 870,162	\$ 2,565,147	\$ 214,718	\$ 58,100	\$ 4,628,232
Ending balance: individually evaluated for impairment	\$ 146	\$ 156,159	\$ 277,262	\$ 1,447,747	\$	\$	\$ 1,881,314
Ending balance: collectively evaluated for impairment	\$ 95,800	\$ 668,000	\$ 592,900	\$ 1,117,400	\$ 214,718	\$ 58,100	\$ 2,746,918
Ending balance: loans acquired with deteriorated credit quality	\$	\$	\$	\$	\$	\$	\$
<i>Loans Receivable:</i>							
Ending balance	\$ 5,253,339	\$ 41,806,459	\$ 49,721,494	\$ 71,722,630	\$ 7,013,836	\$ 5,205,852	\$ 180,723,610
Ending balance: individually evaluated for impairment	\$ 93,385	\$ 949,971	\$ 4,054,573	\$ 6,338,214	\$ 5,475	\$	\$ 11,441,618
Ending balance: collectively evaluated for impairment	\$ 5,159,954	\$ 40,856,488	\$ 45,666,921	\$ 65,384,416	\$ 7,008,361	\$ 5,205,852	\$ 169,281,992
Ending balance: loans acquired with deteriorated credit quality	\$	\$	\$	\$	\$	\$	\$
2010							
<i>Allowance for credit losses:</i>							
Beginning balance	\$ 106,397	\$ 628,963	\$ 696,044	\$ 2,903,267	\$ 281,134	\$ 54,100	\$ 4,669,905

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Charge-offs		(26,748)	(109,948)	(545,752)	(92,774)		(775,222)
Recoveries		950	20,501	368	25,789		47,608
Provision	(25,800)	161,128	100,831	1,573,613	35,606	(4,800)	1,840,578
Ending balance	\$ 80,597	\$ 764,293	\$ 707,428	\$ 3,931,496	\$ 249,755	\$ 49,300	\$ 5,782,869
Ending balance: individually evaluated for impairment	\$ 12,097	\$ 198,093	\$ 120,928	\$ 3,049,496	\$	\$	\$ 3,380,614
Ending balance: collectively evaluated for impairment	\$ 68,500	\$ 566,200	\$ 586,500	\$ 882,000	\$ 249,755	\$ 49,300	\$ 2,402,255
Ending balance: loans acquired with deteriorated credit quality	\$	\$	\$	\$	\$	\$	\$
Loans Receivable:							
Ending balance	\$ 5,790,613	\$ 47,054,360	\$ 47,351,314	\$ 67,199,483	\$ 6,977,325	\$ 4,538,213	\$ 178,911,308
Ending balance: individually evaluated for impairment	\$ 56,363	\$ 703,762	\$ 712,351	\$ 6,104,973	\$ 3,301	\$	\$ 7,580,750
Ending balance: collectively evaluated for impairment	\$ 5,734,250	\$ 46,350,598	\$ 46,638,963	\$ 61,094,510	\$ 6,974,024	\$ 4,538,213	\$ 171,330,558
Ending balance: loans acquired with deteriorated credit quality	\$	\$	\$	\$	\$	\$	\$

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6. ALLOWANCE FOR LOAN LOSSES, CONTINUED

The following table presents impaired loans individually evaluated by class of loan as of September 30, 2011 and December 31, 2010:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
September 30, 2011					
With no related allowance recorded:					
Construction and development	\$ 77,213	\$ 77,213	\$	\$ 78,049	\$
1-4 family residential	387,371	445,185		396,325	3,713
Nonfarm, nonresidential	2,426,530	2,589,261		2,434,737	68,967
Commercial and industrial	2,081,475	2,255,962		2,184,723	77,625
Consumer	5,475	5,475		5,475	
Other loans					
	4,978,064	5,373,096		5,099,309	150,305
With an allowance recorded:					
Construction and development	\$ 16,172	\$ 16,172	\$ 146	\$ 16,453	\$
1-4 family residential	562,600	589,965	156,159	557,367	10,624
Nonfarm, nonresidential	1,628,043	1,628,043	277,262	1,638,660	8,004
Commercial and industrial	4,256,739	4,256,739	1,447,747	4,672,517	106,814
Consumer					
Other loans					
	6,463,554	6,490,919	1,881,314	6,884,997	125,442
Combined:					
Construction and development	\$ 93,385	\$ 93,385	\$ 146	\$ 94,502	\$
1-4 family residential	949,971	1,035,150	156,159	953,692	14,337
Nonfarm, nonresidential	4,054,573	4,217,304	277,262	4,073,397	76,971
Commercial and industrial	6,338,214	6,512,701	1,447,747	6,857,240	184,439
Consumer	5,475	5,475		5,475	
Other loans					
	\$ 11,441,618	\$ 11,864,015	\$ 1,881,314	\$ 11,984,306	\$ 275,747
December 31, 2010					
With no related allowance recorded:					
Construction and development	\$ 97,436	\$ 97,436	\$	\$ 173,163	\$ 5,758
1-4 family residential	931,920	931,920		938,365	55,516
Nonfarm, nonresidential	2,098,860	2,098,860		2,136,591	110,297
Commercial and industrial	2,246,985	2,246,985		2,289,276	123,804
Consumer	10,439	10,439		10,439	
Other loans					
	5,385,640	5,385,640		5,547,834	295,375

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With an allowance recorded:					
Construction and development	\$ 39,267	\$ 39,267	\$ 12,097	\$ 38,893	\$ 1,357
1-4 family residential	1,240,144	1,240,144	1,118,468	1,243,083	39,709
Nonfarm, nonresidential	2,169,536	2,169,536	604,692	2,216,160	126,030
Commercial and industrial	5,803,125	5,803,125	2,334,003	6,076,005	276,677
Consumer					
Other loans					
	9,252,072	9,252,072	4,069,260	9,574,141	443,773
Combined:					
Construction and development	\$ 136,703	\$ 136,703	\$ 12,097	\$ 212,056	\$ 7,115
1-4 family residential	2,172,064	2,172,064	1,118,468	2,181,448	95,225
Nonfarm, nonresidential	4,268,396	4,268,396	604,692	4,352,751	236,327
Commercial and industrial	8,050,110	8,050,110	2,334,003	8,365,281	400,481
Consumer	10,439	10,439		10,439	
Other loans					
	\$ 14,637,712	\$ 14,637,712	\$ 4,069,260	\$ 15,121,975	\$ 739,148

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6. ALLOWANCE FOR LOAN LOSSES, CONTINUED

Nonperforming loans and impaired loans are defined differently. As such, some loans may be included in both categories, whereas other loans may only be included in one category. The following presents by class, an aging analysis of the recorded investment in loans.

	30-89 Days Past Due	90 Days Plus Past Due	Total Past Due	Current	Total	Recorded Investment > 90 Days and Accruing
September 30, 2011						
Construction and development	\$ 36,488	\$	\$ 36,488	\$ 5,216,851	\$ 5,253,339	\$
1-4 family residential	490,283	710,586	1,200,869	40,605,590	41,806,459	263,960
Nonfarm, nonresidential	940,468	686,495	1,626,963	48,094,531	49,721,494	686,495
Commercial and industrial	1,330,747	3,298,976	4,629,723	67,092,907	71,722,630	1,611,684
Consumer	148,817	5,475	154,292	6,859,544	7,013,836	
Other loans				5,205,852	5,205,852	
Total	\$ 2,946,803	\$ 4,701,532	\$ 7,648,335	\$ 173,075,275	\$ 180,723,610	\$ 2,562,139
Non-accruals included above	\$ 126,751	\$ 2,139,393	\$ 2,266,144	\$ 2,262,092	\$ 4,528,236	
December 31, 2010						
Construction and development	\$ 67,993	\$ 39,267	\$ 107,260	\$ 5,878,785	\$ 5,986,045	\$
1-4 family residential	766,017	272,405	1,038,422	45,318,289	46,356,711	
Nonfarm, nonresidential	229,393	220,321	449,714	47,720,984	48,170,698	
Commercial and industrial	567,740	1,351,710	1,919,450	64,457,626	66,377,076	
Consumer	143,832		143,832	6,615,938	6,759,770	
Other loans	3,472		3,472	4,778,207	4,781,679	
Total	\$ 1,778,447	\$ 1,883,703	\$ 3,662,150	\$ 174,769,829	\$ 178,431,979	\$
Non-accruals included above	\$ 369,103	\$ 1,883,703	\$ 2,252,806	\$ 4,109,322	\$ 6,362,128	

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.

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:

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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.

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6. ALLOWANCE FOR LOAN LOSSES, CONTINUED

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

	Total	Pass Credits	Special Mention	Substandard	Doubtful
September 30, 2011					
Construction and development	\$ 5,253,339	\$ 5,159,954	\$ 93,385	\$	\$
1-4 family residential	41,806,459	40,786,605	1,019,854		
Nonfarm, nonresidential	49,721,494	47,459,188	1,889,139	373,167	
Commercial and industrial	71,722,630	67,403,744	4,318,886		
Consumer	7,013,836	7,011,216	94	2,526	
Other loans	5,205,852	5,205,852			
	\$ 180,723,610	\$ 173,026,559	\$ 7,321,358	\$ 375,693	\$
	100.0%	95.7%	4.1%	0.2%	0.0%

Guaranteed portion of loans	\$ 37,399,239	\$ 34,523,956	\$ 2,875,283	\$	\$
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	Total	Pass Credits	Special Mention	Substandard	Doubtful
December 31, 2010					
Construction and development	\$ 5,986,045	\$ 5,779,959	\$ 206,086	\$ -	\$ -
1-4 family residential	46,356,711	43,990,930	1,333,354	65,143	967,284
Nonfarm, nonresidential	48,170,698	45,750,435	2,420,263		
Commercial and industrial	66,377,076	59,501,127	6,094,833		781,116
Consumer	6,759,770	6,743,029	13,864	2,877	
Other loans	4,781,679	4,781,679			
	\$ 178,431,979	\$ 166,547,159	\$ 10,068,400	\$ 68,020	\$ 1,748,400
	100.0%	93.3%	5.7%	0.0%	1.0%

Guaranteed portion of loans	\$ 32,259,668	\$ 29,142,378	\$ 3,117,290	\$	\$
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NOTE 7. TROUBLED DEBT RESTRUCTURINGS

As a result of adopting the amendments in ASU 2011-02, the Bank reassessed all restructurings that occurred on or after the beginning of the fiscal year of adoption (January 1, 2011) to determine whether they are considered troubled debt restructurings (TDRs) under the amended guidance. The Bank identified no TDRs for which the allowance for loan losses had previously been measured under a general allowance methodology.

For the nine months ended
September 30, 2011

For the three months ended
September 30, 2011

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

During the nine months ended September 30, 2011, the Bank modified 23 loans that were considered to be troubled debt restructurings. We extended the terms for 16 of these loans and the interest rate was lowered for four of these loans. Three other loans were demanded due to default.

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7. TROUBLED DEBT RESTRUCTURINGS, CONTINUED

	For the nine months ended September 30, 2011		For the three months ended September 30, 2011	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
Troubled Debt Restructurings				
That Subsequently Defaulted				
During the Period:				
Construction and development		\$		\$
1-4 Family residential	3	193,301	1	84,093
Nonfarm, nonresidential	1	337,084	1	337,084
Commercial and industrial	4	1,176,757	3	1,094,181

During the nine months ended September 30, 2011, eight loans that had previously been restructured, were in default, two of which went into default in the quarter.

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

SURREY BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**NOTE 8. FAIR VALUE**

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

Fair Value Hierarchy

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

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

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

Investment Securities Available for Sale

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

Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with the Receivables Topic of the FASB ASC. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At September 30, 2011 substantially all of the total impaired loans were evaluated based on the fair value of the collateral. In accordance with the Fair Value and Measurement Topic of the FASB ASC, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3.

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. FAIR VALUE, CONTINUED

Servicing Assets

A valuation of loan servicing rights is performed on an individual basis due to the small number of loans serviced. Loans are evaluated on a discounted earnings basis to determine the present value of future earnings. The present value of the future earnings is the estimated market value for the loan, calculated using consensus assumptions that a third party purchaser would utilize in evaluating a potential acquisition of the servicing. As such, the Company classifies loan servicing rights as Level 3.

Foreclosed Assets

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

Assets and Liabilities Recorded at Fair Value on a Recurring Basis

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

*(in thousands)***September 30, 2011**

	Total	Level 1	Level 2	Level 3
Government-sponsored enterprises	\$ 2,010	\$	\$ 2,010	\$
Mortgage-backed securities	53		53	
Corporate bonds	449		449	
Servicing assets	93			93
Total assets at fair value	\$ 2,605	\$	\$ 2,512	\$ 93
Total liabilities at fair value	\$	\$	\$	\$

*(in thousands)***December 31, 2010**

	Total	Level 1	Level 2	Level 3
Government-sponsored enterprises	\$ 1,502	\$	\$ 1,502	\$
Mortgage-backed securities	76		76	
Corporate bonds	434		434	
Servicing assets	95			95
Total assets at fair value	\$ 2,107	\$	\$ 2,012	\$ 95
Total liabilities at fair value	\$	\$	\$	\$

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. FAIR VALUE, CONTINUED

For the nine months ended September 30, 2011 and 2010, the changes in Level 3 assets and liabilities measured at fair value on a recurring basis were as follows:

	Level 3	
	2011 Fair Value	2010 Fair Value
<i>Balance, January 1</i>	\$ 94,878	\$
Capitalized		97,053
Amortization included in other income	(2,196)	(1,478)
<i>Balance, September 30</i>	\$ 92,682	\$ 95,575

Changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the three month period ended September 30, 2011 and September 30, 2010, was \$769 and \$720, respectively, which was amortized to other income.

Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

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

<i>(in thousands)</i>				
September 30, 2011	Total	Level 1	Level 2	Level 3
Loans-commercial and industrial	\$ 2,862	\$	\$ 2,862	\$
Loans-nonfarm, non-residential	1,724		1,724	
Loans-other	467		467	
Foreclosed assets	182		182	
Total assets at fair value	\$ 5,235	\$	\$ 5,235	\$
Total liabilities at fair value	\$	\$	\$	\$

<i>(in thousands)</i>				
December 31, 2010	Total	Level 1	Level 2	Level 3
Loans-commercial and industrial	\$ 3,469	\$	\$ 3,469	\$
Loans-nonfarm, non-residential	1,565		1,565	
Loans- 1- 4 family residential	90		90	
Loans-other	56		56	
Foreclosed assets	451		451	

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Total assets at fair value	\$ 5,631	\$	\$ 5,631	\$
Total liabilities at fair value	\$	\$	\$	\$

The Company had no Level 3 assets or liabilities measured at fair value on a non-recurring basis at September 30, 2011 or December 31, 2010.

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.

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. FAIR VALUE, CONTINUED

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.

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

	September 30, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets				
Cash and due from banks	\$ 2,570	\$ 2,570	\$ 2,398	\$ 2,398
Federal funds sold and interest-bearing deposits with banks	34,502	34,502	23,494	23,494
Securities, available for sale	2,512	2,512	2,012	2,012
Restricted equity securities	853	853	941	941
Loans, net of allowance for loan losses	176,116	169,231	171,794	163,470
Bank owned life insurance	3,363	3,363	3,285	3,285
Financial Liabilities				
Deposits	188,299	179,312	173,960	156,565
Long-term debt	8,100	8,670	9,450	9,848

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 9. STOCKHOLDERS EQUITY

On December 1, 2010, the Company issued 181,154 shares of Series D 5.0% Convertible Non-Cumulative Perpetual Preferred Stock for \$7.08 per share, netting proceeds of \$1,248,482 after issue costs. The shares have a liquidation value of \$7.08 per share and are convertible into one share of common stock at the election of the holder, but are not redeemable at the option of the holder. Provided that the market value of the Company's common stock is \$8.85 on or after January 1, 2014, the Company may redeem all or a portion of the outstanding shares of Series D Preferred Stock at a redemption price of \$7.08 per share. The shares were issued in a private placement and are held by approximately 15 stockholders of record. The shares are non-voting and convertible into one share of common stock.

On December 29, 2010, the Company repurchased all of its remaining outstanding Fixed Rate Cumulative Perpetual Preferred Stock, Series B and Fixed Rate Cumulative Perpetual Preferred Stock, Series C, which was issued by the Company to the United States Treasury Department, for an aggregate purchase price of \$2.1 million, including approximately \$13 thousand of accrued and unpaid dividends and approximately \$40 thousand in discount accretions. The Company funded the repurchase of the Preferred Stock primarily with cash on hand and the net proceeds received on December 1, 2010 upon the completion of its private placement of its Series D Preferred Stock as described above.

The following table details preferred stock transactions for the nine months ended September 30, 2011 and 2010.

	Convertible Preferred Stock Series A		Preferred Stock Series B		Preferred Stock Series C		Convertible Preferred Stock Series D	
	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount
Balance, January 1, 2010	189,356	\$ 2,620,325	2,000	\$ 1,903,283	100	\$ 103,222		\$
Dividends declared and accrued on Series B and Series C preferred stock, net of discount accretion and (premium) amortization				25,944		(2,208)		
Balance, September 30, 2010	189,356	\$ 2,620,325	2,000	\$ 1,929,227	100	\$ 101,014		\$
Balance, January 1, 2011	189,356	\$ 2,620,325		\$		\$	181,154	\$ 1,248,482
Balance, September 30, 2011	189,356	\$ 2,620,325		\$		\$	181,154	\$ 1,248,482

NOTE 10. LITIGATION SETTLEMENT

During the third quarter of 2011, a lawsuit was settled in mediation that resulted in the Bank paying damages to a customer arising from the ordinary operations of the Bank. The Bank has no other liability under the agreement.

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

Introduction

This discussion, analysis and related financial information are presented to explain the significant factors which affected Surrey Bancorp's financial condition and results of operations for the nine and three months ending September 30, 2011 and 2010. 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 September 30, 2011, was \$515,480 or \$0.15 per diluted share outstanding, compared to a \$240,505 or \$0.08 per diluted share outstanding, for the same period in 2010. Earnings for the three months ended September 30, 2011, are approximately 114.3% higher than for the same period in 2010. The increase results from a reduction in the provision for loan losses. The provision decreased from \$636,736 in the third quarter of 2010 to \$188,118 in 2011. Over the past two years reserves were increased due to weakness in the economy that necessitated an increase in reserves associated with impaired loans. During the first half of 2011 the level of impaired loans stabilized. Certain loans that were reserved in previous quarters were charged off resulting in an improvement of the credit quality of the loan portfolio, as noted in Note 6 to the financial statements. The reserve was further impacted by an increase in loans carrying government guarantees. At September 30, 2011, the guaranteed portion of loans equaled 20.8% of total loans compared to 18.1% at December 31, 2010. Net interest income increased slightly from \$2,148,654 in the third quarter of 2010 to \$2,263,325 in 2011. A reduction in the cost of deposits from the third quarter of 2010 to 2011 contributed to the margin improvement. Asset yields decreased from 5.28% to 5.09% from 2010 to 2011 due to the change in earning asset mix from higher yielding loans to lower yielding deposits in other banks. The cost of funds continued to decrease from 1.31% in the third quarter of 2010 to 1.05% in the third quarter of 2011. Noninterest income increased 2.8% in 2011 primarily due to an increase in revenues from the Company's insurance and investment subsidiary. Noninterest expenses increased 9.7% from \$1,616,525 in the third quarter of 2010, to \$1,773,472 in 2011. Most of the increase is associated with a litigation settlement during the third quarter. The settlement, agreed to in mediation, states, among other things, that the Bank has no further liability under the agreement.

Net income available for common stockholders for the nine months ended September 30, 2011, was \$1,687,891 or \$0.48 per diluted share outstanding compared to \$892,241 or \$0.27 per diluted share outstanding for the same period in 2010. This represents a 89.2% increase in earnings for the first nine months of 2011 compared to the same period in 2010. This increase is attributable to a reduction in the provision for loan losses. The provision decreased from \$1,840,578 in the first nine months of 2010 to \$67,190 during the same period in 2011. The charge off of nonperforming loans and the stabilization of the level of impaired loans during the period resulted in the lower provision.

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

Additionally loan guarantee enhancements increased as a percentage of total loans which further improved the credit quality of the loan portfolio. Net interest income increased slightly from \$6,462,407 in the first nine months of 2010 to \$6,558,755 in 2011. This increase is due to a reduction in deposit cost and deposit mix for the period ended September 30, 2011 versus the same period in 2010. Overall asset yields have decreased, but a corresponding reduction in the cost of deposits, primarily time deposits, and a larger mix of non interest bearing deposits maintained the margin percentage at near 2010 levels. Increases in overall interest earning assets over 2010 resulted in a larger net interest margin. Noninterest income decreased 11.7% in 2011 primarily due to a reduction in gains on the sale of a government guaranteed loan. No such sales were made in 2011 after recording income of \$244,924 in the first nine months of 2010. Noninterest expenses increased 8.1% from \$4,910,380 in the nine months ended September 30, 2010, to \$5,306,297 for the same period in 2011. Most of the increase is associated with write downs and expenses associated with foreclosed assets, the cost of litigation settlement and fees paid on government guaranteed loans. Foreclosed asset expense increased from \$23,644 in first nine months of 2010 to \$140,190 in 2011. Fees paid for guaranteed loans increased from \$84,916 in the nine months ended September 30, 2010 to \$124,246 in 2011.

On September 30, 2011, Surrey Bancorp's assets totaled \$229,007,209 compared to \$213,652,484 on December 31, 2010. Net loans were \$176,116,287 compared to \$171,794,247 on December 31, 2010. This increase was attributable to an increase in gross loans of approximately \$2,266,000 coupled with a net decrease in the loan loss reserve of approximately \$2,056,000. Commercial loans increased 8.1% during the nine month period ended September 30, 2011; however real estate loans decreased over 3.1% leading to an overall increase in gross loans of 1.3%. Interest-bearing deposits with banks increased from \$22,792,088 at December 31, 2010 to \$33,791,894 at September 30, 2011, due to approximately a \$14,339,000 increase in deposits over the first nine months of 2011.

Total deposits on September 30, 2011, were \$188,299,291 compared to \$173,960,073 at the end of 2010. This increase is attributable to increases in all primary deposit categories: demand deposits, savings deposits, including money market accounts and certificates of deposit. Demand deposits increased 13.4% from 2010 totals, while savings deposits increased 17.3%. Certificates of deposit increased 2.9% from December 31, 2010 totals.

Common stockholders' equity increased by \$1,737,374, or 7.01%, during the nine months ended September 30, 2011. The increase is comprised of net income of \$1,825,081, adjustments to Accumulated Other Comprehensive Income of \$13,503, proceeds from exercised stock options of \$18,825, and other stock based compensation of \$17,155. Decreases included the payment and accrual of preferred dividends of \$137,190. The net increase resulted in a common stock book value of \$8.24 per share, up from \$7.73 on December 31, 2010.

The book value per common share is calculated by taking total stockholders' equity, subtracting all preferred equity, and then dividing by the total number of common shares outstanding at the end of the reporting period.

Preferred stockholders' equity remained the same during the period ended September 30, 2011, as detailed in Note 9 to the financial statements. Combined preferred and common stockholders' equity increased \$1,737,374, or 6.07%, for the nine months ended September 30, 2011.

Financial Condition, Liquidity and Capital Resources

Investments

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

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

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

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

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

Investments in available for sale securities of \$2,512,078 consisted of U.S. Governmental Agency obligations with maturities ranging from 10 to 29 months, corporate bonds with maturities of 6.75 years to 7.0 years, that reprice quarterly, and GNMA adjustable rate mortgage securities, which adjust annually.

Loans

Net loans outstanding on September 30, 2011, were \$176,116,287 compared to \$171,794,247 on December 31, 2010. The Bank maintains a loan portfolio dominated by real estate and commercial loans diversified among various industries. Approximately 71.7% of the Bank's loans as of September 30, 2011, are fixed rate loans with 28.3% floating with the Bank's prime rate or other appropriate internal or external indices.

Deposits

Deposits on September 30, 2011, were \$188,299,291, compared to \$173,960,073 on December 31, 2010. The September total comes from a base of approximately 12,173 accounts compared to 12,295 accounts at December 31, 2010. Interest-bearing accounts represented 80.6% of September 30, 2011 period end deposits versus 83.9% at December 31, 2010.

Federal Funds Purchased

The Company had no federal funds purchased at September 30, 2011 or December 31, 2010. Federal funds purchased were not utilized due to the adequate liquidity resulting from the increase in deposits.

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

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

	Ratio	Minimum Required For Capital Adequacy Purposes
<i>September 30, 2011:</i>		
Total Capital		
(to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	18.31%	8.0%
Surrey Bank & Trust	18.15%	8.0%
Tier I Capital		
(to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	17.04%	4.0%
Surrey Bank & Trust	16.89%	4.0%
Tier I Capital		
(to Average Assets)		
Surrey Bancorp (Consolidated)	12.66%	4.0%
Surrey Bank & Trust	12.54%	4.0%
<i>December 31, 2010:</i>		
Total Capital		
(to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	17.24%	8.0%
Surrey Bank & Trust	16.99%	8.0%
Tier I Capital		
(to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	15.97%	4.0%
Surrey Bank & Trust	15.72%	4.0%
Tier I Capital		
(to Average Assets)		
Surrey Bancorp (Consolidated)	11.88%	4.0%
Surrey Bank & Trust	11.69%	4.0%

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

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

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

Nonperforming assets are detailed below.

	September 30, 2011	December 31, 2010
Nonaccrual loans	\$ 4,528,236	\$ 6,362,127
Loans past due 90 days and still accruing	2,562,139	
Foreclosed assets	182,480	450,532
Total	\$ 7,278,855	\$ 6,812,659
Total assets	\$ 229,007,209	\$ 213,652,484
Ratio of nonperforming assets to total assets	3.18%	3.19%

At September 30, 2011, the Bank had loans totaling \$4,528,236 in nonaccrual status. Loans past due 90 days and still accruing are primarily government guaranteed loans which will pay interest up to 120 days in arrears. The amount of loans over 90 days but less than 120 days past due equals \$2,064,214. The guaranteed loans past due 90 days and still accruing equals \$1,328,332 at September 30, 2011 of which the guaranteed portion is \$780,077. Foreclosed assets at September 30, 2011 primarily include 1-4 family dwellings and nonfarm, nonresidential property. Loans that were considered impaired but were still accruing interest at September 30, 2011, including troubled debt restructurings, totaled \$6,913,382. A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due under the contractual terms of the loan agreement. Specific reserves on nonaccrual and impaired loans totaled \$1,881,314 at quarter end, or 16.4% of the balances outstanding.

Nonaccrual and impaired loans still accruing are summarized below:

	September 30, 2011	December 31, 2010
Construction and development	\$ 93,385	\$ 136,703
1-4 family residential	949,971	2,172,065
Nonfarm, nonresidential	4,054,573	4,268,396
Commercial and industrial	6,338,214	8,050,109
Consumer	5,475	10,439
Total impaired and nonaccrual	\$ 11,441,618	\$ 14,637,712

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

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

	September 30, 2011		December 31, 2010	
Construction and development	\$ 5,253,339	2.91%	\$ 5,986,045	3.35%
1-4 family residential	41,806,459	23.13%	46,356,711	25.98%
Multi-family	2,259,445	1.25%	1,853,346	1.04%
Farmland	2,903,144	1.61%	2,854,481	1.60%
Nonfarm, non-residential	49,721,494	27.51%	48,170,698	27.00%
Total real estate	101,943,881	56.41%	105,221,281	58.97%
Agricultural	43,263	0.02%	73,852	0.04%
Commercial and industrial	71,722,630	39.69%	66,377,076	37.20%
Consumer	7,013,836	3.88%	6,759,770	3.79%
Total loans	\$ 180,723,610	100.00%	\$ 178,431,979	100.00%

The concentrations represented above do not, based on management's assessment, expose the Bank to any unusual concentration risk. Based on the Bank's asset size, the only concentration that is above area peer group analysis is commercial and industrial loans. Management recognizes the inherent risk associated with commercial lending, including whether or not a borrower's actual results of operations will correspond to those projected by the borrower when the loan was funded; economic factors such as the number of housing starts and increases in interest rates, etc.; depression of collateral values; and completion of projects within the original cost and time estimates. The Bank mitigates some of that risk by actively seeking government guarantees on these loans. Collectively, the Bank has approximately \$47,206,000 in loans that carry government guarantees. The guaranteed portion of these loans amounts to \$37,399,000 at September 30, 2011. Loan guarantees by loan class are below:

	September 30, 2011	Guaranteed Portion Amount	Percentage
Construction and development	\$ 5,253,339	\$	%
1-4 family residential	41,806,459	947,418	2.27%
Multi-family	2,259,445	27,148	1.20%
Farmland	2,903,144	543,302	18.71%
Nonfarm, non-residential	49,721,494	13,736,925	27.63%
Total real estate	101,943,881	15,254,793	14.96%
Agricultural	43,263		%
Commercial and industrial	71,722,630	22,144,446	30.88%
Consumer	7,013,836		%
Total loans	\$ 180,723,610	\$ 37,399,239	20.69%

Loans in higher risk categories, such as non-owner occupied nonfarm, non-residential property and commercial real estate construction represent a small segment of our loan portfolio. Commercial construction loans included in construction and development loans amounted to \$2,340,023 at September 30, 2011. Non-owner occupied nonfarm, non-residential properties included in nonfarm, non-residential loans above amounted to \$9,279,818 at September 30, 2011.

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

The consolidated provision for loan losses was \$67,190 in the first nine months of 2011 compared to a provision of \$1,840,578 for the same period in 2010. The decrease in the loan loss provision is primarily attributable to a stabilization of impaired loans in the first nine months of 2011. Additionally, certain loans that were reserved in previous quarters were charged off resulting in an improvement in the overall credit quality of the loan portfolio (see Note 6). These factors combined to negate the need for higher reserves during the period ended September 30, 2011. Charge offs totaling \$2,374,651 were taken by the Bank in the nine month period ended September 30, 2011. Additional charge offs of \$22,217 were taken by Freedom Finance, LLC, resulting in total consolidated charge offs of \$2,396,868 for the period. Reserves for nonaccrual and impaired loans at September 30, 2011 amounted to \$1,881,314, compared to \$4,069,260 at December 31, 2010.

The reserve for loan losses on September 30, 2011, was \$4,628,232 or 2.56% of period end loans. This percentage is derived from total loans. Approximately \$47,206,000 of the total loans outstanding at September 30, 2011, are government guaranteed loans for which the Bank's exposure ranges from zero% to 49% of the outstanding balance. When the guaranteed portions of the loans are removed from the equation, the loan loss reserve is approximately 3.18% of outstanding loans, compared to 4.57% as of December 31, 2010. This decrease is directly related to the charge off of troubled loans during the nine months ended September 30, 2011.

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 two years applied to its corresponding category of loans. However, historical losses only reflect a small portion of the Bank's loan loss reserve, although that portion did increase during the first nine months of 2011 due to the effect of charged off loans. The environmental factors represent risk from external economic influences on the credit quality of the loan portfolio. These factors include the movement of interest rates, unemployment rates, past due and charge off trends, loan grading migrations, movement in collateral values and the Bank's exposure to certain loan concentrations. Positive or negative movements in any of these factors have an effect on the credit quality of the loan portfolio. As a result, management continues to actively monitor the Bank's asset quality affected by these environmental factors. The following table is a summary of loans past due at September 30, 2011 and December 31, 2010.

	September 30, 2011		December 31, 2010	
	30-89 Days	90 Days Plus	30-89 Days	90 Days Plus
Construction and development	\$ 36,488	\$	\$ 67,993	\$ 39,267
1-4 family residential	490,283	710,586	766,017	272,405
Nonfarm, non-residential	940,468	686,495	229,393	220,321
Commercial and industrial	1,330,747	3,298,976	567,740	1,351,710
Consumer	148,817	5,475	143,832	
Other loans			3,472	
	\$ 2,946,803	\$ 4,701,532	\$ 1,778,447	\$ 1,883,703
Non-accrual loans included above	\$ 126,751	\$ 2,139,393	\$ 369,103	\$ 1,883,703
Guaranteed portion	\$ 1,443,114	\$ 2,315,316	\$ 226,094	\$ 994,931
Ratio to total loans	1.63%	2.60%	1.00%	1.06%
Ratio to total loans, net of guarantees	1.05%	1.66%	1.06%	0.61%

Past due loans are reviewed weekly and collection efforts assessed to determine potential problems arising in the loan portfolio. Proactive monitoring of past due accounts allows management to anticipate trends within the portfolio and make appropriate adjustments to collection efforts and to the allowance for loan losses. Collectively, past dues increased from December 31, 2010 to September 30, 2011. The largest increases were in commercial and industrial loans and nonfarm, non-residential loans. These increases are primarily attributable to four customers, two of which accounted for approximately \$1,098,000 of the commercial 30-89 day past dues at September 30, 2011 and \$760,000 of the nonfarm non-residential loans 30-89 days past due. Those same customers were not past due at December 31, 2010. Approximately, \$2,971,000 of the commercial 90 day past dues and \$309,000 of the nonfarm, non-residential 90 day past due loans at September 30, 2011 are attributable to two other customers. At December 31, 2010, \$1,282,000 of the commercial 90 day past dues was attributable to the same customers. Overall past dues increased approximately 47% from the end of 2010 to September 30, 2011. This increase in past dues is somewhat

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mitigated by the government guaranteed portions of the loans. At September 30, 2011, the guaranteed portion of total past due loans equals 49% compared to 33% at December 31, 2010.

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

Management believes that its loan portfolio is sufficiently diversified such that a downturn in a particular market or industry will not have a significant impact on the loan portfolio or the Bank's financial condition. Management believes that its provision and reserve offer an adequate allowance for loan losses and provide an appropriate reserve for the loan portfolio. The Bank lends primarily in Surry County, North Carolina and Patrick County, Virginia and surrounding counties.

Interest Rate Sensitivity and Liquidity

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

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

At September 30, 2011, the liquidity position of the Company was good, in management's opinion, with short-term liquid assets of \$37,071,915. Deposit increases accounted for the net increase in liquidity from December 31, 2010 totals. To provide supplemental liquidity, the Bank has six unsecured lines of credit with correspondent banks totaling \$25,500,000. At September 30, 2011, 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 \$14,761,000 of which \$8,100,000 of advances had been taken down at September 30, 2011.

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

ITEM 4. CONTROLS AND PROCEDURES

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

PART II OTHER INFORMATION

Item 1. Legal Proceedings
None

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

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

Item 3. Defaults Upon Senior Securities
Not Applicable

Item 4. (Removed and Reserved)

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
- 101 Interactive Data File

SIGNATURES

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

Surrey Bancorp

Date: November 14, 2011

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

Date: November 14, 2011

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