SURREY BANCORP
Form 10-Q
August 12, 2014

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 June 30, 2014

o TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT
For the transition period from ____________ to ___________

COMMISSION FILE NO. 000-50313

SURREY BANCORP

(Exact name of registrant as specified in its charter)

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

145 North Renfro Street, Mount Airy, NC 27030

(Address of principal executive offices)

(336) 783-3900

(Registrant's telephone number)

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

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

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 o Accelerated filer o

Non-accelerated filer o Smaller reporting company x

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

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

On August 12, 2014 there were 3,542,984 common shares issued and outstanding.

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Consolidated Balance Sheets
June 30, 2014 (Unaudited) and December 31, 2013 (Audited)

	June 2014	December 2013
Assets		
Cash and due from banks	$6,971,199	$7,424,593
Interest-bearing deposits with banks	41,871,263	34,351,505
Federal funds sold	1,212,154	1,311,641
Investment securities available for sale	4,370,738	4,549,702
Restricted equity securities	617,929	676,799
Loans, net of allowance for loan losses of $3,523,292 at June 30, 2014 and $3,375,350 at December 31, 2013	180,910,373	179,908,825
Property and equipment, net	4,403,132	4,440,215
Foreclosed assets	134,111	-
Accrued income	1,015,072	966,042
Goodwill	120,000	120,000
Bank owned life insurance	5,541,820	5,462,336
Other assets	2,888,539	1,707,319
Total assets	$250,056,330	$240,918,977
Liabilities and Stockholders' Equity		
Liabilities		
Deposits:		
Noninterest-bearing	$49,731,847	$42,713,122
Interest-bearing	153,625,052	153,087,839
Total deposits	203,356,899	195,800,961
Long-term debt	7,750,000	7,750,000
Dividends payable	45,730	790,259
Accrued interest payable	181,815	123,558
Other liabilities	3,104,570	2,236,573
Total liabilities	214,439,014	206,701,351
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, 10,000,000 shares authorized at no par value; 3,542,984 shares issued and outstanding at June 30, 2014 and December 31, 2013	12,061,153	12,061,153
Retained earnings	19,682,311	18,329,089
Accumulated other comprehensive income (loss)	5,045	(41,423)
Total stockholders' equity	35,617,316	34,217,626
Total liabilities and stockholders' equity	$250,056,330	$240,918,977

See Notes to Consolidated Financial Statements

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Consolidated Statements of Income
Three months ended June 30, 2014 and 2013 (Unaudited)

	2014	2013
Interest income		
Loans and fees on loans	$5,224,048	$5,220,767
Federal funds sold	1,354	905
Investment securities, taxable	32,407	26,800
Investment securities, dividends	7,131	6,021
Deposits with banks	47,244	38,703
Total interest income	5,312,184	5,293,196
Interest expense		
Deposits	546,508	599,132
Fed funds purchased	19	80
Short-term debt	-	38,543
Long-term debt	144,547	144,518
Total interest expense	691,074	782,273
Net interest income	4,621,110	4,510,923
Provision for (recapture of) loan losses	(6,575)	135,796
Net interest income after provision for loan losses	4,627,685	4,375,127
Noninterest income		
Service charges on deposit accounts	401,545	437,060
Gain on the sale of government guaranteed loans	127,362	229,130
Realized gain (loss) on the sale of investment securities	(2,543)	5,297
Fees on loans delivered to correspondents	6,117	35,320
Other service charges and fees	322,050	271,944
Income from Bank Owned Life Insurance	79,484	80,766
Other operating income	379,799	395,502
Total noninterest income	1,313,814	1,455,019
Noninterest expense		
Salaries and employee benefits	1,949,012	1,871,496
Occupancy expense	224,255	218,758
Equipment expense	133,117	120,635
Data processing	211,077	212,293
Foreclosed assets, net	7,304	24,305
Postage, printing and supplies	96,948	98,933
Professional fees	207,861	212,571
FDIC insurance premiums	59,183	46,868
Other expense	776,375	714,724
Total noninterest expense	3,665,132	3,520,583
Net income before income taxes	2,276,367	2,309,563
Income tax expense	832,188	856,944
Net income	1,444,179	1,452,619
Preferred stock dividends	(90,957)	(90,957)

Net income available to common stockholders	$1,353,222	$1,361,662
Basic earnings per common share	$0.38	$0.38
Diluted earnings per common share	$0.35	$0.35
Basic weighted average common shares outstanding	3,542,984	3,542,984
Diluted weighted average common shares outstanding	4,176,919	4,176,919

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Consolidated Statements of Income
Three months ended June 30, 2014 and 2013 (Unaudited)

	2014	2013
Interest income		
Loans and fees on loans	$2,631,578	$2,612,056
Federal funds sold	670	560
Investment securities, taxable	16,145	13,160
Investment securities, dividends	3,514	3,403
Deposits with banks	27,634	19,012
Total interest income	2,679,541	2,648,191
Interest expense		
Deposits	271,559	290,444
Fed funds purchased	2	80
Short-term debt	-	33,824
Long-term debt	72,673	72,705
Total interest expense	344,234	397,053
Net interest income	2,335,307	2,251,138
Provision for (recapture of) loan losses	55,787	93,402
Net interest income after provision for loan losses	2,279,520	2,157,736
Noninterest income		
Service charges on deposit accounts	202,461	205,735
Gain on the sale of government guaranteed loans	127,362	229,130
Realized gain (loss) on the sale of securities	(5,441)	3,339
Fees on loans delivered to correspondents	5,587	14,025
Other service charges and fees	176,034	143,620
Income from Bank Owned Life Insurance	39,474	40,311
Other operating income	186,409	160,483
Total noninterest income	731,886	796,643
Noninterest expense		
Salaries and employee benefits	939,512	910,375
Occupancy expense	116,371	119,015
Equipment expense	74,246	57,937
Data processing	105,766	110,622
Foreclosed assets, net	8,198	(18,030)
Postage, printing and supplies	51,322	61,199
Professional fees	92,538	86,981
FDIC insurance premiums	29,557	13,693
Other expense	380,235	336,965
Total noninterest expense	1,797,745	1,678,757
Net income before income taxes	1,213,661	1,275,622
Income tax expense	445,882	474,779
Net income	767,779	800,843

Preferred stock dividends	(45,730)	(45,730)
Net income available to common stockholders	$722,049	$755,113
Basic earnings per common share	$0.20	$0.21
Diluted earnings per common share	$0.18	$0.19
Basic weighted average common shares outstanding	3,542,984	3,542,984
Diluted weighted average common shares outstanding	4,176,919	4,174,919

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Consolidated Statements of Comprehensive Income
Three and Six months ended June 30, 2014 and 2013 (Unaudited)

	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Net income	$767,779	$800,843	$1,444,179	$1,452,619
Other comprehensive income (loss):				
Investment securities available for sale:				
Unrealized holding gains (losses)	65,746	(24,205)	70,311	5,339
Tax effect	(23,939)	8,925	(25,522)	(1,442)
Reclassification of (gains) losses recognized in net income	5,441	(3,339)	2,543	(5,297)
Tax effect	(1,849)	1,135	(864)	1,801
	45,399	(17,484)	46,468	401
Comprehensive income	$813,178	$783,359	$1,490,647	$1,453,020

See Notes to Consolidated Financial Statements

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Consolidated Statements of Cash Flows
Six months ended June 30, 2014 and 2013 (Unaudited)

	2014	2013
Cash flows from operating activities		
Net income	$1,444,179	$1,452,619
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	133,858	123,958
Gain on sale of property and equipment	(406)	(100)
Gain on the sale of government guaranteed loans	(127,362)	(229,130)
Gain (loss) on the sale of securities	2,543	(5,297)
Gain on the sale of foreclosed assets	(3,465)	(33,520)
Provision for (recapture of) loan losses	(6,575)	135,796
Deferred income tax expense (benefit)	(1,026)	2,853
Accretion of discount on securities, net of amortization of premiums	14	19
Increase in cash surrender value of life insurance	(79,484)	(80,766)
Changes in assets and liabilities:		
Accrued income	(49,030)	(20,305)
Other assets	(1,063,577)	(982,267)
Accrued interest payable	58,257	49,578
Other liabilities	724,995	1,154,737
Net cash provided by operating activities	1,032,921	1,568,175
Cash flows from investing activities		
Net (increase) decrease in interest-bearing deposits with banks	(7,519,758)	3,281,821
Net (increase) decrease in federal funds sold	99,487	(500,404)
Purchases of investment securities	(1,127,843)	(1,550,863)
Maturities of investment securities	1,253,612	1,003,508
Redemption of restricted equity securities	59,000	61,800
Purchase of restricted equity securities	(130)	(185)
Net increase in loans	(1,024,672)	(7,038,966)
Proceeds from the sale of investment securities	123,491	47,268
Proceeds from the sale of foreclosed assets	26,415	475,983
Purchases of property and equipment	(98,944)	(55,677)
Proceeds from the sale of property and equipment	2,575	100
Net cash used in investing activities	(8,206,767)	(4,275,615)
Cash flows from financing activities		
Net increase in deposits	7,555,938	2,324,811
Dividends paid	(835,486)	(91,333)
Net cash provided by financing activities	6,720,452	2,233,478
Net decrease in cash and cash equivalents	(453,394)	(473,962)
Cash and due from banks, beginning	7,424,593	5,973,042
Cash and due from banks, ending	$6,971,199	$5,499,080
Supplemental disclosures of cash flow information		
Interest paid	$632,817	$732,695
Taxes paid	$983,722	$872,255
Supplemental disclosures of non-cash transactions		

Loans transferred to foreclosed properties	$157,061	$30,300
Proceeds from the sale of guaranteed loan previously recorded as short term debt	$-	$3,743,820

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Consolidated Statements of Changes in Stockholders' Equity
Six months ended June 30, 2014 and 2013 (Unaudited)

	Preferred Stock Amount	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance, January 1, 2013	$3,868,807	3,542,984	$12,061,153	$16,367,187	$ (59,846)	$32,237,301
Net income	-	-	-	1,452,619	-	1,452,619
Other comprehensive income	-	-	-	-	401	401
Dividends declared and accrued on convertible Series A preferred stock ($.32 per share)	-	-	-	(59,157)	-	(59,157)
Dividends declared and accrued on convertible Series D preferred stock ($.18 per share)	-	-	-	(31,800)	-	(31,800)
Balance, June 30, 2013	$3,868,807	3,542,984	$12,061,153	$17,728,849	$ (59,445)	$35,599,364
Balance, January 1, 2014	$3,868,807	3,542,984	$12,061,153	$18,329,089	$ (41,423)	$34,217,626
Net income	-	-	-	1,444,179	-	1,444,179
Other comprehensive income	-	-	-	-	46,468	46,468
Dividends declared and accrued on convertible Series A preferred stock ($.32 per share)	-	-	-	(59,157)		(59,157)
Dividends declared and accrued on convertible Series D preferred stock ($.18 per share)	-	-	-	(31,800)		(31,800)
Balance, June 30, 2014	$3,868,807	3,542,984	$12,061,153	$19,682,311	$ 5,045	$35,617,316

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, 2014, the results of its operations and comprehensive income for the six and three months ended June 30, 2014 and 2013, and its changes in stockholders' equity and cash flows for the six months ended June 30, 2014 and 2013. These adjustments are of a normal and recurring nature. The results of operations for the six months ended June 30, 2014, 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, 2013, included in the Company's Form 10-K. The balance sheet at December 31, 2013, 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, 2013 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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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, 2014 and December 31, 2013, 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 June 30, 2014 and December 31, 2013.

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 2014, the FASB amended Receivables topic of the Accounting Standards Codification. The amendments are intended to resolve diversity in practice with respect to when a creditor should reclassify a collateralized consumer mortgage loan to other real estate owned (OREO). In addition, the amendments require a creditor reclassify a collateralized consumer mortgage loan to OREO upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. The amendments will be effective for the Company for annual periods, and interim periods within those annual period beginning after December 15, 2014, with early implementation of the guidance permitted. In implementing this guidance, assets that are reclassified from real estate to loans are measured at the carrying value of the real estate at the date of adoption. Assets reclassified from loans to real estate are measured at the lower of the net amount of the loan receivable or the fair value of the real estate less costs to sell at the date of adoption. The Company will apply the amendments prospectively. The Company does not expect these amendments to have a material effect on its financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Recent Accounting Pronouncements, continued

In May 2014, the FASB issued guidance to change the recognition of revenue from contracts with customers. The core principle of the new guidance is that an entity should recognize revenue to reflect the transfer of goods and services to customers in an amount equal to the consideration the entity receives or expects to receive. The guidance will be effective for the Company for reporting periods beginning after December 15, 2016. The Company will apply the guidance using a full retrospective approach. The Company does not expect these amendments to have a material effect on its financial statements.

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

Subsequent Events

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

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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, 2014 and December 31, 2013 follow:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
June 30, 2014				
Government-sponsored enterprises	$3,500,000	$ 3,500	$ 545	$3,502,955
Mortgage-backed securities	28,473	780	-	29,253
Corporate bonds	300,000	-	54,000	246,000
Equities and mutual funds	537,135	56,110	715	592,530
	$4,365,608	$ 60,390	$ 55,260	$4,370,738
December 31, 2013				
Government-sponsored enterprises	$3,500,000	$ 795	$ 2,030	$3,498,765
Mortgage-backed securities	32,099	1,022	-	33,121
Corporate bonds	550,000	-	99,000	451,000
Equities and mutual funds	535,326	43,260	11,770	566,816
	$4,617,425	$ 45,077	$ 112,800	$4,549,702

At June 30, 2014 and December 31, 2013, 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, 2014, were as follows:

	Amortized Cost	Fair Value
Due in one year or less	$1,037,135	$1,092,960
Due after one year through five years	3,308,142	3,256,754
Due after five years through ten years	10,209	10,580
Due after ten years	10,122	10,444
	$4,365,608	$4,370,738

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 June 30, 2014 and December 31, 2013. 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 June 30, 2014 and December 31, 2013.

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

	Value	Losses	Value	Losses	Value	Losses
June 30, 2014						
Government-sponsored enterprises	$499,555	$ 445	$999,900	$ 100	$1,499,455	$ 545
Corporate bonds	-	-	246,000	54,000	246,000	54,000
Equities and mutual funds	6,639	383	106,932	332	113,571	715
	$506,194	$ 828	$1,352,832	$ 54,432	$1,859,026	$ 55,260
December 31, 2013						
Government-sponsored enterprises	$1,497,970	$ 2,030	$-	$ -	$1,497,970	$ 2,030
Corporate bonds	-	-	451,000	99,000	451,000	99,000
Equities and mutual funds	245,218	11,770	-	-	245,218	11,770
	$1,743,188	$ 13,800	$451,000	$ 99,000	$2,194,188	$ 112,800

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SECURITIES, CONTINUED

Management considers the nature of the investment, the underlying causes of the decline in the market value and the severity and duration of the decline in market value in determining if impairment is other than temporary. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Based upon this evaluation, there are two securities in the portfolio at June 30, 2014, with unrealized losses for a period greater than 12 months. One of these securities also had unrealized losses for a period greater than 12 months at December 31, 2013. We have analyzed each individual security for Other Than Temporary Impairment (“OTTI”) purposes by reviewing delinquencies, loan-to-value ratios, and credit quality and concluded that all unrealized losses presented in the tables above are not related to an issuer’s financial condition but are due to changes in the level of interest rates and no declines are deemed to be other than temporary in nature.

The Company had realized losses of $2,543 from the sales of equity and mutual fund investment securities for the six month period ended June 30, 2014, and realized gains of $5,297 from the sales of equity and mutual fund investment securities for the six month periods ended June 30, 2013. Total proceeds from the sales amounted to $123,491 and $47,268 in 2014 and 2013, respectively.

NOTE 3. EARNINGS PER COMMON SHARE

Basic earnings per common share for the six and three months ended June 30, 2014 and 2013 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, 2014, the Company had commitments to extend credit, including unused lines of credit of approximately $43,277,000 and letters of credit outstanding of $2,266,620.

NOTE 5. LOANS

The major components of loans in the balance sheets at June 30, 2014 and December 31, 2013 are below.

	2014	2013
Commercial, net of discounts of $52,579 in 2014	$65,638,983	$66,612,984
Real estate:		
Construction and land development	8,554,036	6,353,787

Residential, 1-4 families	40,112,807	40,203,978
Residential, 5 or more families	1,335,218	1,515,239
Farmland	2,304,060	2,219,688
Nonfarm, nonresidential	60,709,768	60,316,018
Agricultural	422,791	107,974
Consumer, net of discounts of $12,235 in 2014 and $10,931 in 2013	5,072,907	5,685,407
	184,150,570	183,015,075
Deferred loan origination costs, net of (fees)	283,095	269,100
	184,433,665	183,284,175
Allowance for loan losses	(3,523,292)	(3,375,350)
	$180,910,373	$179,908,825

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NOTE 5. LOANS, CONTINUED

Residential, 1-4 family loans pledged as collateral against FHLB advances approximated $17,748,000 and $17,376,000 at June 30, 2014 and December 31, 2013, 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, 2014 and 2013 was as follows:

	Construction & Development	1-4 Family Residential	Nonfarm, Nonresidential	Commercial & Industrial	Consumer	Other	Total
June 30, 2014							
Allowance for credit losses:							
Beginning balance	$73,000	$617,629	$753,050	$1,708,962	$181,309	$41,400	$3,375,350
Charge-offs	-	(76,891)	(1,778)	(3,506)	(21,420)	-	(103,595)
Recoveries	-	1,463	78,604	147,917	30,128	-	258,112
Provision	37,500	179,624	(5,389)	(174,521)	(48,189)	4,400	(6,575)
Ending balance	$110,500	$721,825	$824,487	$1,678,852	$141,828	$45,800	$3,523,292
Ending balance: individually evaluated for impairment	$-	$47,025	$122,587	$253,152	$-	$-	$422,764
Ending balance: collectively evaluated for impairment	$110,500	$674,800	$701,900	$1,425,700	$141,828	$45,800	$3,100,528
Ending balance: loans acquired with deteriorated credit quality	$-	$-	$-	$-	$-	$-	$-
Loans Receivable:							
Ending balance	$8,554,036	$40,112,807	$60,709,768	$65,638,983	$5,072,907	$4,062,069	$184,150,570
Ending balance:	$244,821	$415,487	$2,814,048	$1,542,364	$-	$-	$5,016,720

individually evaluated for impairment							
Ending balance: collectively evaluated for impairment	$8,309,215	$39,697,320	$57,895,720	$64,096,619	$5,072,907	$4,062,069	$179,133,850
Ending balance: loans acquired with deteriorated credit quality	$-	$-	$-	$-	$-	$-	$-
June 30, 2013							
Allowance for credit losses:							
Beginning balance	$86,300	$668,700	$801,999	$1,604,510	$198,789	$42,800	$3,403,098
Charge-offs	-	(8,122)	(79,609)	(6,150)	(54,118)	-	(147,999)
Recoveries	517	401	949	19,892	18,719	-	40,478
Provision	3,983	26,321	153,631	(69,156)	17,017	4,000	135,796
Ending balance	$90,800	$687,300	$876,970	$1,549,096	$180,407	$46,800	$3,431,373
Ending balance: individually evaluated for impairment	$-	$-	$254,670	$217,296	$-	$-	$471,966
Ending balance: collectively evaluated for impairment	$90,800	$687,300	$622,300	$1,331,800	$180,407	$46,800	$2,959,407
Ending balance: loans acquired with deteriorated credit quality	$-	$-	$-	$-	$-	$-	$-
Loans Receivable:							
Ending balance	$5,524,198	$38,621,785	$62,740,245	$66,397,808	$6,086,325	$4,237,240	$183,607,601
Ending balance: individually evaluated for impairment	$86,589	$269,392	$3,345,220	$2,464,599	$-	$-	$6,165,800
	$5,437,609	$38,352,393	$59,395,025	$63,933,209	$6,086,325	$4,237,240	$177,441,801

Ending balance: collectively evaluated for impairment							
Ending balance: loans acquired with deteriorated credit quality	$-	$-	$-	$-	$-	$-	$-

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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, 2014 and December 31, 2013 and the recognized interest income per the related period:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
June 30, 2014					
With no related allowance recorded:					
Construction and development	$244,821	$244,821	$ -	$245,761	$ 8,163
1-4 family residential	187,597	187,597	-	187,691	5,550
Nonfarm, nonresidential	1,957,023	1,957,023	-	1,885,354	33,991
Commercial and industrial	154,577	154,577	-	161,686	4,937
Consumer	-	-	-	-	-
Other loans	-	-	-	-	-
	2,544,018	2,544,018	-	2,480,492	52,641
With an allowance recorded:					
Construction and development	$ -	$ -	$ -	$ -	$ -
1-4 family residential	227,890	227,890	47,025	230,031	1,913
Nonfarm, nonresidential	857,025	857,025	122,587	872,012	416
Commercial and industrial	1,387,787	1,387,787	253,152	1,406,334	6,208
Consumer	-	-	-	-	-
Other loans	-	-	-	-	-
	2,472,702	2,472,702	422,764	2,508,377	8,537
Combined:					
Construction and development	$244,821	$244,821	$ -	$245,761	$ 8,163
1-4 family residential	415,487	415,487	47,025	417,722	7,463
Nonfarm, nonresidential	2,814,048	2,814,048	122,587	2,757,366	34,407
Commercial and industrial	1,542,364	1,542,364	253,152	1,568,020	11,145
Consumer	-	-	-	-	-
Other loans	-	-	-	-	-
	$5,016,720	$5,016,720	$422,764	$4,988,869	$ 61,178
December 31, 2013					
With no related allowance recorded:					
Construction and development	$318,111	$318,111	$ -	$320,260	$ 21,825
1-4 family residential	263,562	263,562	-	261,364	21,295
Nonfarm, nonresidential	2,095,645	2,165,883	-	2,144,605	120,322
Commercial and industrial	1,359,371	1,561,253	-	1,393,077	71,409
Consumer	-	-	-	-	-
Other loans	-	-	-	-	-
	4,036,689	4,308,809	-	4,119,306	234,851

With an allowance recorded:					
Construction and development	$-	$-	$ -	$-	$ -
1-4 family residential	74,205	74,205	10,829	77,144	4,300
Nonfarm, nonresidential	816,776	816,776	131,950	930,060	24,653
Commercial and industrial	1,140,160	1,140,160	206,162	1,163,698	47,393
Consumer	-	-	-	-	-
Other loans	-	-	-	-	-
	2,031,141	2,031,141	348,941	2,170,902	76,346
Combined:					
Construction and development	$318,111	$318,111	$ -	$320,260	$ 21,825
1-4 family residential	337,767	337,767	10,829	338,508	25,595
Nonfarm, nonresidential	2,912,421	2,982,659	131,950	3,074,665	144,975
Commercial and industrial	2,499,531	2,701,413	206,162	2,556,775	118,802
Consumer	-	-	-	-	-
Other loans	-	-	-	-	-
	$6,067,830	$6,339,950	$ 348,941	$6,290,208	$ 311,197

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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
June 30, 2014							
Construction and development	$27,775	$-	$-	$27,775	$8,526,261	$8,554,036	$-
1-4 family residential	1,159,716	123,115	224,781	1,507,612	38,605,195	40,112,807	56,078
Nonfarm, nonresidential	226,788	492,302	137,512	856,602	59,853,166	60,709,768	-
Commercial and industrial	224,807	160,634	277,201	662,642	64,976,341	65,638,983	-
Consumer	151,161	25,682	29,744	206,587	4,866,320	5,072,907	28,623
Other loans	-	-	-	-	4,062,069	4,062,069	-
Total	$1,790,247	$801,733	$669,238	$3,261,218	$180,889,352	$184,150,570	$84,701
Percentage of total loans	0.97 %	0.44 %	0.36 %	1.77 %	98.23 %	100.00 %	
Non-accruals included above							
Construction and development	$-	$-	$-	$-	$-	$-	
1-4 family residential	-	-	168,702	168,702	169,064	337,766	
Nonfarm, nonresidential	-	-	137,512	137,512	1,156,548	1,294,060	
Commercial and industrial	44,223	157,327	277,201	478,751	940,358	1,419,109	
Consumer	7,992	-	1,122	9,114	-	9,114	
Other loans	-	-	-	-	-	-	
	$52,215	$157,327	$584,537	$794,079	$2,265,970	$3,060,049	
December 31, 2013							
	$-	$-	$-	$-	$6,353,787	$6,353,787	$-

Construction and development							
1-4 family residential	544,559	165,244	173,786	883,589	39,320,389	40,203,978	-
Nonfarm, nonresidential	193,411	336,036	791,148	1,320,595	58,995,423	60,316,018	-
Commercial and industrial	84,145	2,528	929,552	1,016,225	65,596,759	66,612,984	15,837
Consumer	103,463	68,767	20,742	192,972	5,492,435	5,685,407	19,602
Other loans	-	-	-	-	3,842,901	3,842,901	-
Total	$925,578	$572,575	$1,915,228	$3,413,381	$179,601,694	$183,015,075	$35,439
Percentage of total loans	0.51 %	0.31 %	1.05 %	1.87 %	98.13 %	100.00 %	
Non-accruals included above							
Construction and development	$-	$-	$-	$-	$70,058	$70,058	
1-4 family residential	29,269	-	173,786	203,055	190,032	393,087	
Nonfarm, nonresidential	85,646	-	791,148	876,794	1,222,090	2,098,884	
Commercial and industrial	-	-	913,715	913,715	321,592	1,235,307	
Consumer	259	547	1,141	1,947	1,044	2,991	
Other loans	-	-	-	-	-	-	
	$115,174	$547	$1,879,790	$1,995,511	$1,804,816	$3,800,327	

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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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
June 30, 2014					
Construction and development	$8,554,036	$8,554,036	$-	$ -	$ -
1-4 family residential	40,112,807	39,802,860	309,947	-	-
Nonfarm, nonresidential	60,709,768	59,010,710	1,699,058	-	-
Commercial and industrial	65,638,983	64,210,804	1,428,179	-	-
Consumer	5,072,907	5,071,581	1,326	-	-
Other loans	4,062,069	4,062,069	-	-	-
	$184,150,570	$180,712,060	$3,438,510	$ -	$ -
Percentage of total loans	100.0 %	98.1 %	1.9 %	- %	- %
Guaranteed portion of loans					
Construction and development	$67,692	$67,692	$	$	$ -
1-4 family residential	618,454	578,051	40,403	-	-
Nonfarm, nonresidential	26,875,544	25,933,275	942,269	-	-
Commercial and industrial	18,002,884	16,931,274	1,071,610	-	-
Consumer	-	-	-	-	-
Other loans	827,979	827,979	-	-	-
	$46,392,553	$44,338,271	$2,054,282	$ -	$ -

	Total	Pass Credits	Special Mention	Substandard	Doubtful
December 31, 2013					
Construction and development	$6,353,787	$6,283,729	$70,058	$ -	$ -
1-4 family residential	40,203,978	39,586,647	617,331	-	-
Nonfarm, nonresidential	60,316,018	58,188,799	2,022,868	104,351	-
Commercial and industrial	66,612,984	64,556,331	2,056,653	-	-
Consumer	5,685,407	5,684,245	1,162	-	-
Other loans	3,842,901	3,842,901	-	-	-
	$183,015,075	$178,142,652	$4,768,072	$ 104,351	$ -
Percentage of total loans	100.0 %	97.3 %	2.6 %	0.1 %	- %

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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
Guaranteed portion of loans					
Construction and development	$73,000	$73,000	$-	$ -	$ -
1-4 family residential	673,854	629,939	43,915	-	-
Nonfarm, nonresidential	26,835,404	26,063,658	771,746	-	-
Commercial and industrial	19,589,284	18,737,759	851,525	-	-
Consumer	-	-	-	-	-
Other loans	544,195	544,195	-	-	-
	$47,715,737	$46,048,551	$1,667,186	$ -	$ -

NOTE 7. TROUBLED DEBT RESTRUCTURINGS

For the six and three months ended June 30, 2014 and 2013, the following table presents loans modified during the period that were considered to be troubled debt restructurings.

	For the three months ended June 30, 2014			For the six months ended June 30, 2014		
	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	-	$ -	$ -	-	$ -	$ -
1-4 Family residential	-	-	-	3	159,927	163,627
Nonfarm, nonresidential	-	-	-	-	-	-
Commercial and industrial	-	-	-	-	-	-

	For the three months ended June 30, 2013			For the six months ended June 30, 2013		
	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	-	$ -	$ -	-	$ -	$ -
1-4 Family residential	1	54,376	54,376	1	54,376	54,376
Nonfarm, nonresidential	1	145,219	145,219	1	145,219	145,219
Commercial and industrial	-	-	-	-	-	-

During the six months ended June 30, 2014, the Bank modified three loans that were considered to be troubled debt restructurings. The interest rates were lowered and the terms extended on the three loans.

During the six months ended June 30, 2013, the Bank modified two loans that were considered to be troubled debt restructurings. The terms were extended on the loans.

During the six months ended June 30, 2014 and 2013, no loans that had previously been restructured were in default.

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

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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, 2014, 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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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, 2014	Total	Level 1	Level 2	Level 3
Government-sponsored enterprises	$3,503	$-	$3,503	$-
Mortgage-backed securities	29	-	29	-
Corporate bonds	246	-	-	246
Equities and mutual funds	593	593	-	-
Total assets at fair value	$4,371	$593	$3,532	$246
Total liabilities at fair value	$-	$-	$-	$-

(in thousands)

December 31, 2013	Total	Level 1	Level 2	Level 3
Government-sponsored enterprises	$3,499	$-	$3,499	$-
Mortgage-backed securities	33	-	33	-
Corporate bonds	451	-	-	451
Equities and mutual funds	567	567	-	-
Total assets at fair value	$4,550	$567	$3,532	$451
Total liabilities at fair value	$-	$-	$-	$-

For the six months ended June 30, 2014 and 2013, the changes in Level 3 assets and liabilities measured at fair value on a recurring basis were as follows:

	Level 3	
(in thousands)	2014 Fair Value	2013 Fair Value
Corporate Bonds – Available for Sale		
Balance, January 1	$451	$ 443
Total unrealized gain (loss) included in income	-	-
Total unrealized gain (loss) included in other comprehensive income	45	5
Bonds called	(250)	-
Balance, June 30	$246	$ 448

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SURREY BANCORP
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. FAIR VALUE, CONTINUED

There were no changes in Level 3 corporate bond assets measured at fair value on a recurring basis for the three month period ended June 30, 2014, except for the call of a $250,000 corporate bond with a recorded fair valued of $205,000. The change in the fair value of corporate bond assets for the three month period ended June 30, 2013 was ($2,750).

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, 2014	Total	Level 1	Level 2	Level 3
Loans-commercial and industrial	$1,135	$ -	$ -	$1,135
Loans-nonfarm, non-residential	734	-	-	734
Loans-1-4 family residential	181	-	-	181
Foreclosed assets	134	-	-	134
Servicing assets	356	-	-	356
Total assets at fair value	$2,540	$ -	$ -	$2,540
Total liabilities at fair value	$-	$ -	$ -	$-

(in thousands)

December 31, 2013	Total	Level 1	Level 2	Level 3
Loans-commercial and industrial	$934	$ -	$ -	$934
Loans-nonfarm, non-residential	685	-	-	685
Loans-1-4 family residential	63	-	-	63
Servicing assets	261	-	-	261
Total assets at fair value	$1,943	$ -	$ -	$1,943
Total liabilities at fair value	$-	$ -	$ -	$-

Financial Instruments

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Cash and due from banks: The carrying amounts reported in the balance sheet for cash and due from banks approximate their fair values.

Interest-bearing deposits with banks: Fair values for time deposits are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated contractual maturities on such time deposits.

Federal funds sold: Due to the short-term nature of these assets, the carrying value approximates fair value.

Securities: Fair values for securities, excluding restricted equity securities, are based on quoted market prices, where available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security’s credit rating, prepayment assumptions and other factors such as credit loss assumptions. The carrying values of restricted equity securities approximate fair values.

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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, 2014 and December 31, 2013. This table excludes financial instruments for which the carrying amount approximates fair value.

			Fair Value Measurements		
Inputs			Quoted Prices in Active Markets For Identical	Significant Other	Significant
(dollars in thousands)	Amount	Fair Value	(Level 1)	(Level 2)	(Level 3)
June 30, 2014					
Financial Instruments - Assets					
Loans, net	$180,910	$187,393	$-	$-	$187,393

Financial Instruments – Liabilities					
Deposits	203,357	202,715	-	202,715	-
Long-Term Debt	7,750	8,018	-	8,018	-
December 31, 2013					
Financial Instruments - Assets					
Loans, net	$ 179,909	$ 179,531	$ -	$ -	$ 179,531
Financial Instruments – Liabilities					
Deposits	195,801	171,649	-	171,649	-
Long-Term Debt	7,750	8,100	-	8,100	-

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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 and six months ended June 30, 2014 and 2013. 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, 2014, was $722,049 or $0.18 per diluted share outstanding, compared to a $755,113 or $0.19 per diluted share outstanding, for the same period in 2013. Earnings for the three months ended June 30, 2014, are approximately 4.4% lower than for the same period in 2013. The decrease results from a reduction in noninterest income and an increase in noninterest expenses. Noninterest income decreased from $796,643 in the second quarter of 2013 to $731,886 in 2014. The decrease results from a reduction in gains on the sale of government guaranteed loans, which dropped from $229,130 in the quarter ended June 30, 2013 to $127,362 in 2014. This reduction was partially offset by an increases in other service charges and fees and other operating income. Other service charges and fees increased from $143,620 in 2013 to $176,034 in 2014 as a result of an increase in the Bank’s fee structure. Other operating income increased from $160,483 in 2013 to $186,409 in 2014 due to increased revenue from the Bank’s investment and insurance subsidiary, Surrey Investment Service, Inc. Noninterest expenses increased 7.1% from $1,678,757 in the second quarter of 2013, to $1,797,745 in 2014. Salaries and employee benefits increased from $910,375 in 2013 to $939,512 in 2014. This increase was primarily due to normal salary adjustments. Expenses associated with foreclosed assets increased from a recovery of $18,030 in 2013 to an expense of $8,198 in 2014. Gains on the sales of foreclosed properties in 2013, which offset foreclosure expenses, was the reason for this increase. Other expenses increased 12.8% from $336,965 in 2013 to $380,235 in 2014, primarily due to cost associated with software license, consulting and electronic banking expenses.

The provision for loan losses decreased from $93,402 in the second quarter of 2013 to $55,787 in 2014. This decrease is partially due to net charge off recoveries in the second quarter of 2014 compared to 2013. Net recoveries amounted to $103,450 in 2014 compared to net charge offs of $4,064 in the second quarter of 2013, a $107,514 difference. These recoveries were reduced by certain environmental changes in the loan loss reserve calculation and a reduction in loans carrying government guarantees during the quarter. At June 30, 2014, the guaranteed portion of loans equaled 25.1% of total loans compared to 26.2% at March 31, 2014. This decrease indicates that a majority of loan growth during the quarter was in non-guaranteed loans, requiring larger reserves.

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

Net interest income increased from $2,251,138 in the second quarter of 2013 to $2,335,307 in 2014. This increase is due to loan growth. Asset yields decreased from 4.83% to 4.69% from the quarters ended June 2013 to June 2014 partially due to the change in average earning asset mix from higher yielding loans to lower yielding deposits in other banks. Loan yields increased from 5.71% in the second quarter of 2013 to 5.82% in the second quarter of 2014, but it was not enough to offset the change in earning asset mix. Loan yields increased due to the recoveries of previously charged off interest income on recoveries. A reduction in the cost of deposits from the second quarter of 2013 to 2014 was unable to offset the tightening asset yields. The cost of funds decreased from 0.80% in the second quarter of 2013 to 0.66% in the second quarter of 2014.

Net income available for common stockholders for the six months ended June 30, 2014, was $1,353,222 or $0.35 per diluted share outstanding compared to $1,361,662 or $0.35 per diluted share outstanding for the same period in 2013. This represents a 0.6% decrease in earnings for the first six months of 2014 compared to the same period in 2013. Earnings for the period remained flat although the loan loss provision was significantly lower in 2014 compared to 2013. The provision for loan losses decreased from $135,796 in the first six months of 2013 to a recapture of $6,575 for the same period in 2014. This decrease is due to a reduction in net loan charge offs from $107,521 during the first six month period of 2013 to net loan charge off recoveries $154,517 in 2014. However, the decrease in the provision for loan losses was offset by a reduction in noninterest income, which primarily resulted from a decreased in gains on the sale of government guaranteed loans. Gains on the sale of government guaranteed loans decreased from $229,130 in 2013 to $127,362 in 2014. Net interest income increased from $4,510,923 in the first six months of 2013 to $4,621,110 in 2014. This increase is due to an increase in average loans outstanding for the six month period ended June 30, 2014 versus the same period in 2013 and is also associated with the Bank's net charge off recoveries in 2014. The payoff of previously charged off nonaccrual loans recaptured the interest on those loans that had not been recorded since the loans were put on nonaccrual status. Overall assets yields have decreased as a result of lower yields on loans. Loan yields decreased slightly from 5.80% in the first six months of 2013 to 5.76% in 2014. Noninterest expenses increased 4.1% from $3,520,583 in the six months ended June 30, 2013, to $3,665,132 for the same period in 2014. Most of the increase is associated with salaries and employee benefits and fees paid on government guaranteed loans (Colson fees). Salaries and employee benefits increased from $1,871,496 in first six months of 2013 to $1,949,012 in 2014. Colson fees, which are included in other expense, increased from $87,419 in 2013 to $138,232 in 2014.

On June 30, 2014, Surrey Bancorp's assets totaled $250,056,330 compared to $240,918,977 on December 31, 2013. Net loans were $180,910,373 compared to $179,908,825 on December 31, 2013. This net increase was the result of a $1,149,490 increase in gross loans and a $147,942 net increase in the loan loss reserve. Real estate loans account for the increase, with construction loans representing most of the growth. There was a 34.6% increase in construction loans while other real estate loans collectively grew 0.2%. Overall gross loans increase 0.6%

Total deposits on June 30, 2014, were $203,356,899 compared to $195,800,961 at the end of 2013. This increase is attributable to a sizable increase in noninterest-bearing demand deposits accounts, which increased from $42,713,122 at December 31, 2013 to $49,731,847 at June 30, 2014. Overall, noninterest-bearing and interest-bearing demand deposits increased 7.2% from 2013 totals, while savings deposits, including money market accounts, increased 0.8%. Certificates of deposit increased 2.3% from December 31, 2013 totals.

Common stockholders' equity increased by $1,399,690, or 4.61%, during the six months ended June 30, 2014. The increase is comprised of net income of $1,444,179 and adjustments to other comprehensive income of $46,468. Decreases included the payment and accrual of preferred dividends of $90,957. The net increase resulted in a common stock book value of $8.96 per share, up from $8.57 on December 31, 2013.

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, 2014.

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

Financial Condition, Liquidity and Capital Resources

Investments

The Bank maintains a portfolio of securities as part of its asset/liability and liquidity management programs which emphasize effective yields and maturities to match its needs. The composition of the investment portfolio is examined periodically and appropriate realignments are initiated to meet liquidity and interest rate sensitivity needs for the Bank. The Company also invests funds in a brokerage account made up of selected equities and mutual funds. The investments were made to increase income in the holding company and improve yields.

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

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

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 $4,370,738 consisted of Government-sponsored enterprise obligations with maturities ranging from 8 to 32 months, corporate bonds with maturities of 4.25 years, that reprice quarterly, GNMA adjustable rate mortgage securities, which adjust annually, and equity securities and mutual funds.

Loans

Net loans outstanding on June 30, 2014, were $180,910,373 compared to $179,908,825 on December 31, 2013. The Bank maintains a loan portfolio dominated by real estate and commercial loans diversified among various industries. Approximately 60.7% of the Bank's loans as of June 30, 2014, are fixed rate loans with 39.3% floating with the Bank's prime rate or other appropriate internal or external indices.

Deposits

Deposits on June 30, 2014, were $203,356,899, compared to $195,800,961 on December 31, 2013. The June total consists of a base of approximately 12,682 accounts compared to 12,742 accounts at December 31, 2013. Interest-bearing accounts represent 75.5% of June 30, 2014 period end deposits versus 78.2% at December 31, 2013.

Federal Funds Purchased

The Company had no federal funds purchased at June 30, 2014 or December 31, 2013. Federal funds purchased were not utilized due to the adequate liquidity resulting from the increase in deposits.

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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 re−quirements 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
June 30, 2014:		
Total Capital (to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	21.86%	8.0%
Surrey Bank & Trust	21.63%	8.0%
Tier I Capital (to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	20.60%	4.0%
Surrey Bank & Trust	20.37%	4.0%
Tier I Capital (to Average Assets)		
Surrey Bancorp (Consolidated)	13.73%	4.0%
Surrey Bank & Trust	13.53%	4.0%
December 31, 2013:		
Total Capital (to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	21.90%	8.0%
Surrey Bank & Trust	21.46%	8.0%
Tier I Capital (to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	20.64%	4.0%
Surrey Bank & Trust	20.20%	4.0%
Tier I Capital (to Average Assets)		
Surrey Bancorp (Consolidated)	13.58%	4.0%
Surrey Bank & Trust	13.31%	4.0%

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

Asset Quality

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

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

Nonperforming assets are detailed below.

	June 30, 2014	December 31, 2013
Nonaccrual loans	$3,060,049	$3,800,327
Loans past due 90 days and still accruing	84,701	35,439
Foreclosed assets	134,111	-
Total	$3,278,861	$3,835,766
Total assets	$250,056,330	$240,918,977
Ratio of nonperforming assets to total assets	1.31 %	1.59 %

At June 30, 2014, the Bank had loans totaling $3,060,049 in nonaccrual status. Approximately $2,265,970 of the nonaccrual loans were current at the end of June. All of the loans past due 90 days and still accruing are less than 120 days past due. All the loans are secured loans. The guaranteed portion of nonaccrual loans at June 30, 2014 is $1,778,584. Foreclosed assets at June 30, 2014 primarily consist of 1-4 family dwellings. Loans that were considered impaired but were still accruing interest at June 30, 2014, including troubled debt restructurings, totaled $1,993,603. 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 $422,764 at June 30, 2014, or 8.4% of the balances outstanding.

Nonaccrual and impaired loans still accruing are summarized below:

	June 30, 2014	December 31, 2013
Construction and development	$244,821	$318,111
1-4 family residential	443,306	386,564
Nonfarm, nonresidential	2,814,048	2,912,421
Commercial and industrial	1,542,363	2,499,531
Consumer	9,114	2,991
Total impaired and nonaccrual	$5,053,652	$6,119,618
Guaranteed portion	$2,342,110	$2,235,481

At June 30, 2014, consumer loans totaling $36,932 are included above that were not individually evaluated for impairment in the determination of the allowance for loan loss reserve (See Note 6). These loans are primarily home equity loans collateralized by 1-4 family properties which are considered consumer loans. These loans are on nonaccrual status at June 30, 2014 and therefore considered impaired.

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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:

	June 30, 2014		December 31, 2013	
Construction and development	$8,554,036	4.65 %	$6,353,787	3.47 %
1-4 family residential	40,112,807	21.78 %	40,203,978	21.97 %
Multi-family	1,335,218	0.73 %	1,515,239	0.83 %
Farmland	2,304,060	1.25 %	2,219,688	1.21 %
Nonfarm, nonresidential	60,709,768	32.97 %	60,316,018	32.96 %
Total real estate	113,015,889	61.38 %	110,608,710	60.44 %
Agricultural	422,791	0.23 %	107,974	0.06 %
Commercial and industrial	65,638,983	35.64 %	66,612,984	36.40 %
Consumer	5,072,907	2.75 %	5,685,407	3.10 %
Total loans	$184,150,570	100.00%	$183,015,075	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 $58,783,599 in loans that carry government guarantees. The guaranteed portion of these loans amounts to $46,392,553 at June 30, 2014. Loan guarantees by loan class are below:

	June 30, 2014	Guaranteed Portion Amount	Percentage
Construction and development	$8,554,036	$67,692	0.79 %
1-4 family residential	40,112,807	618,454	1.54 %
Multi-family	1,335,218	7,586	0.57 %
Farmland	2,304,060	820,393	35.61 %
Nonfarm, nonresidential	60,709,768	26,875,544	44.27 %
Total real estate	113,015,889	28,389,669	25.12 %
Agricultural	422,791	-	- %
Commercial and industrial	65,638,983	18,002,884	27.43 %
Consumer	5,072,907	-	- %
Total loans	$184,150,570	$46,392,553	25.19 %

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 $6,064,973 at June 30, 2014. Non-owner occupied nonfarm, non-residential properties included in nonfarm, non-residential loans above amounted to $9,486,954 at June 30, 2014.

The consolidated provision for loan losses was a recapture of $6,575 for the first six months of 2014 compared to a provision of $135,796 for the same period in 2013. Significant charge off recoveries, in comparison to 2013, resulted in the provision decrease.

The reserve for loan losses on June 30, 2014, was $3,523,292 or 1.90% of period end loans. This percentage is derived from total loans. Approximately $58,784,000 of total loans outstanding at June 30, 2014, are government guaranteed loans which carry guarantees ranging from 49% to 100% of the outstanding loan balance. When the guaranteed portion of the loans, for which the Bank has no credit exposure, is removed from the equation the loan loss reserve is approximately 2.55% of outstanding loans. At December 31, 2013 the loan loss reserve percentage was 1.84% of total loans and 2.49% of loans net of government guarantees.

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

The level of reserve is established based upon management's evaluation of historical loss data and the effects of certain environmental factors on the loan portfolio. The historical loss portion of the reserve is computed using the average loss data from the past applied to its corresponding category of loans. However, historical losses only reflect a small portion of the Bank's loan loss reserve. That portion did decrease during the first six months of 2014 due to changes in the loan portfolio. The environmental factors represent risk from external economic influences on the credit quality of the loan portfolio. These factors include the movement of interest rates, unemployment rates, past due and charge off trends, loan grading migrations, movement in collateral values and the Bank's exposure to certain loan concentrations. Positive or negative movements in any of these factors have an effect on the credit quality of the loan portfolio. As a result, management continues to actively monitor the Bank's asset quality affected by these environmental factors. The following table is a summary of loans past due at June 30, 2014 and December 31, 2013.

	June 30, 2014		December 31, 2013	
	30-89 Days	90 Days Plus	30-89 Days	90 Days Plus
Construction and development	$27,775	$-	$-	$-
1-4 family residential	1,282,831	224,781	709,803	173,786
Nonfarm, non-residential	719,090	137,512	529,447	791,148
Commercial and industrial	385,441	277,201	86,673	929,552
Consumer	176,843	29,744	172,230	20,742
Other loans	-	-	-	-
	$2,591,980	$669,238	$1,498,153	$1,915,228
Non-accrual loans included above	$209,542	$584,537	$249,344	$1,879,790
Guaranteed portion	$635,520	$324,895	$288,601	$1,193,581
Ratio to total loans	1.41 %	0.81 %	0.82 %	1.05 %
Ratio to total loans, net of guarantees	1.42 %	0.41 %	0.89 %	0.53 %

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 slightly from December 31, 2013 to June 30, 2014. The decrease is in the 90 day plus time frame.

Net of loan guarantees, total past dues have increased from $1,931,199 at December 31, 2013, to $2,300,803 at June 30, 2014, or 19.1%. Total past due loans at June 30, 2014 consist of seventy-seven loans with an average balance of $42,353, compared to seventy-seven loans at December 31, 2013, with an average balance of $44,330. Loans over $250,000 delinquent at June 30, 2014 and December 31, 2013 amounted to $869,473 and $1,549,868, respectively. The June 2014 and December 2013 totals consist of three and four loans, respectively, two of which are the same. The guaranteed portion of these loans at June 30, 2014 and December 31, 2013, is $421,824 and $1,218,890, respectively.

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

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

Interest Rate Sensitivity and Liquidity

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

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

At June 30, 2014, the liquidity position of the Company was excellent, in management's opinion, with short-term liquid assets of $54,425,354 compared to $47,637,441 at December 31, 2013. Deposit growth in excess of increases in gross loan account for the increase in liquidity. To provide supplemental liquidity, the Bank has seven unsecured lines of credit with correspondent banks totaling $35,500,000. At June 30, 2014, 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 $11,009,000 of which $7,750,000 of advances had been taken down at June 30, 2014.

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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
101 Interactive Data File

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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, 2014	/s/ Edward C. Ashby, III
	Edward C. Ashby, III President and Chief Executive Officer (Principal Executive Officer)
Date: August 12, 2014	/s/ Mark H. Towe
	Mark H. Towe Sr. Vice President and Chief Financial Officer (Principal Financial Officer)