

SURREY BANCORP
Form 10-Q
November 12, 2008
Table of Contents

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, 2008

.. **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 checkmark whether the registrant is a larger accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "accelerated and large 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 3, 2008 there were 3,166,174 common shares issued and outstanding

Table of Contents

PART I FINANCIAL INFORMATION

| | | |
|----------|---|-------|
| Item 1. | Consolidated Financial Statements | |
| | <u>Consolidated Balance Sheets September 30, 2008 (Unaudited) and December 31, 2007</u> | 3 |
| | <u>Consolidated Statements of Income, Nine Months Ended September 30, 2008 and 2007 (Unaudited)</u> | 4 |
| | <u>Consolidated Statements of Income, Three Months Ended September 30, 2008 and 2007 (Unaudited)</u> | 5 |
| | <u>Consolidated Statements of Cash Flows, Nine Months Ended September 30, 2008 and 2007 (Unaudited)</u> | 6 |
| | <u>Consolidated Statements of Changes in Stockholders' Equity Nine Months Ended September 30, 2008 and 2007 (Unaudited)</u> | 7 |
| | <u>Notes to Consolidated Financial Statements</u> | 8-16 |
| Item 2. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 17-20 |
| Item 3. | <u>Quantitative and Qualitative Disclosures about Market Risk</u> | 21 |
| Item 4T. | <u>Controls and Procedures</u> | 22 |

PART II OTHER INFORMATION

| | | |
|---------|--|----|
| Item 1. | <u>Legal Proceedings</u> | 23 |
| Item 2. | <u>Unregistered Sales of Equity Securities and Use of Proceeds</u> | 23 |
| Item 3. | <u>Defaults Upon Senior Securities</u> | 23 |
| Item 4. | <u>Submission of Matters to a Vote of Security Holders</u> | 23 |
| Item 5. | <u>Other Information</u> | 23 |
| Item 6. | <u>Exhibits</u> | 23 |

SIGNATURES 24

CERTIFICATIONS 25 -27

Table of Contents**Consolidated Balance Sheets***September 30, 2008 (Unaudited) and December 31, 2007 (Audited)*

| | September 2008 | December 2007 |
|--|-----------------------|-----------------------|
| Assets | | |
| Cash and due from banks | \$ 1,635,194 | \$ 2,220,733 |
| Interest-bearing deposits with banks | 17,617,257 | 27,248,499 |
| Federal funds sold | 300,000 | 400,000 |
| Investment securities available for sale | 2,638,645 | 3,118,333 |
| Restricted equity securities | 1,036,214 | 994,014 |
| Loans, net of allowance for loan losses of \$3,048,849 in 2008 and \$2,781,565 in 2007 | 170,883,912 | 166,456,800 |
| Property and equipment, net | 5,121,884 | 4,902,097 |
| Foreclosed assets | 40,416 | 88,840 |
| Accrued income | 925,205 | 1,205,247 |
| Goodwill | 120,000 | 120,000 |
| Bank owned life insurance | 3,033,401 | 2,953,020 |
| Other assets | 2,175,221 | 1,249,790 |
| Total assets | \$ 205,527,349 | \$ 210,957,373 |
| Liabilities and Stockholders' Equity | | |
| Liabilities | | |
| Deposits: | | |
| Noninterest-bearing | \$ 25,678,974 | \$ 28,040,914 |
| Interest-bearing | 140,358,971 | 143,139,318 |
| Total deposits | 166,037,945 | 171,180,232 |
| Federal funds purchased and securities sold under agreements to repurchase | 491,005 | 147,327 |
| Other borrowings | 12,675,000 | 14,656,117 |
| Dividends payable | 29,986 | 504,483 |
| Accrued interest payable | 560,578 | 631,197 |
| Other liabilities | 1,567,853 | 854,826 |
| Total liabilities | 181,362,367 | 187,974,182 |
| 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 |
| Common stock, 5,000,000 shares authorized at no par value; 3,166,174 shares issued in 2008 and 3,162,764 shares issued in 2007 | 9,257,488 | 9,217,939 |
| Retained earnings | 12,305,054 | 11,141,839 |
| Accumulated other comprehensive income (loss) | (17,885) | 3,088 |
| Total stockholders' equity | 24,164,982 | 22,983,191 |
| Total liabilities and stockholders' equity | \$ 205,527,349 | \$ 210,957,373 |

See Notes to Consolidated Financial Statements

Table of Contents**Consolidated Statements of Income***Nine months ended September 30, 2008 and 2007 (Unaudited)*

| | 2008 | 2007 |
|--|--------------|---------------|
| Interest income | | |
| Loans and fees on loans | \$ 9,139,643 | \$ 10,349,455 |
| Federal funds sold | 6,631 | 15,792 |
| Investment securities, taxable | 112,716 | 154,580 |
| Deposits with banks | 276,975 | 729,037 |
| Total interest income | 9,535,965 | 11,248,864 |
| Interest expense | | |
| Deposits | 3,823,840 | 4,270,637 |
| Federal funds purchased and securities sold under agreements to repurchase | 5,651 | 19,972 |
| Other borrowings | 445,767 | 483,500 |
| Total interest expense | 4,275,258 | 4,774,109 |
| Net interest income | 5,260,707 | 6,474,755 |
| Provision for loan losses | 397,458 | 424,716 |
| Net interest income after provision for loan losses | 4,863,249 | 6,050,039 |
| Noninterest income | | |
| Service charges on deposit accounts | 852,439 | 824,630 |
| Gain on sale of government guaranteed loans | | 147,840 |
| Fees and yield spread premiums on loans delivered to correspondents | 95,854 | 164,667 |
| Other service charges and fees | 278,162 | 247,367 |
| Other operating income | 515,916 | 511,381 |
| Total noninterest income | 1,742,371 | 1,895,885 |
| Noninterest expense | | |
| Salaries and employee benefits | 2,380,178 | 2,270,494 |
| Occupancy expense | 297,004 | 284,429 |
| Equipment expense | 235,532 | 246,625 |
| Data processing | 274,476 | 281,850 |
| Foreclosed assets, net | 21,615 | 11,681 |
| Other expense | 1,449,752 | 1,442,293 |
| Total noninterest expense | 4,658,557 | 4,537,372 |
| Net income before income taxes | 1,947,063 | 3,408,552 |
| Income tax expense | 651,194 | 1,190,052 |
| Net income | 1,295,869 | 2,218,500 |
| Preferred stock dividends declared | (89,308) | (89,226) |

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| | | |
|--|------------------|------------------|
| Net income available to common shareholders | \$ 1,206,561 | \$ 2,129,274 |
| <i>Basic earnings per common share</i> | \$ 0.38 | \$ 0.68 |
| <i>Diluted earnings per common share</i> | \$ 0.36 | \$ 0.62 |
| <i>Basic weighted average common shares outstanding</i> | 3,165,730 | 3,115,052 |
| <i>Diluted weighted average common shares outstanding</i> | 3,588,338 | 3,555,692 |
| <i>See Notes to Consolidated Financial Statements</i> | | |

Table of Contents**Consolidated Statements of Income***Three months ended September 30, 2008 and 2007 (Unaudited)*

| | 2008 | 2007 |
|--|--------------|--------------|
| Interest income | | |
| Loans and fees on loans | \$ 2,998,951 | \$ 3,514,904 |
| Federal funds sold | 1,616 | 5,180 |
| Investment securities, taxable | 32,871 | 54,651 |
| Deposits with banks | 65,375 | 247,934 |
| Total interest income | 3,098,813 | 3,822,669 |
| Interest expense | | |
| Deposits | 1,158,586 | 1,452,384 |
| Federal funds purchased and securities sold under agreements to repurchase | 1,542 | 10,804 |
| Other borrowings | 141,862 | 165,696 |
| Total interest expense | 1,301,990 | 1,628,884 |
| Net interest income | 1,796,823 | 2,193,785 |
| Provision for loan losses | 161,791 | 192,592 |
| Net interest income after provision for loan losses | 1,635,032 | 2,001,193 |
| Noninterest income | | |
| Service charges on deposit accounts | 297,815 | 291,894 |
| Fees and yield spread premiums on loans delivered to correspondents | 24,977 | 51,404 |
| Other service charges and fees | 92,774 | 91,825 |
| Other operating income | 176,924 | 172,136 |
| Total noninterest income | 592,490 | 607,259 |
| Noninterest expense | | |
| Salaries and employee benefits | 802,972 | 755,727 |
| Occupancy expense | 103,464 | 93,650 |
| Equipment expense | 79,225 | 84,455 |
| Data processing | 88,959 | 96,951 |
| Foreclosed assets, net | (1,009) | (9,601) |
| Other expense | 463,145 | 432,178 |
| Total noninterest expense | 1,536,756 | 1,453,360 |
| Net income before income taxes | 690,766 | 1,155,092 |
| Income tax expense | 234,040 | 412,334 |
| Net income | 456,726 | 742,758 |
| Preferred stock dividends declared | (29,986) | (30,069) |
| Net income available to common shareholders | \$ 426,740 | \$ 712,689 |

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| | | |
|---|-----------|-----------|
| <i>Basic earnings per common share</i> | \$ 0.13 | \$ 0.23 |
| <i>Diluted earnings per common share</i> | \$ 0.13 | \$ 0.21 |
| <i>Basic weighted average common shares outstanding</i> | 3,166,174 | 3,160,633 |
| <i>Diluted weighted average common shares outstanding</i> | 3,585,666 | 3,595,781 |

See Notes to Consolidated Financial Statements

Table of Contents**Consolidated Statements of Cash Flows***Nine months ended September 30, 2008 and 2007 (Unaudited)*

| | 2008 | 2007 |
|--|--------------------|---------------------|
| <i>Cash flows from operating activities</i> | | |
| Net income | \$ 1,295,869 | \$ 2,218,500 |
| Adjustments to reconcile net income to net cash provided by operations: | | |
| Depreciation and amortization | 224,651 | 233,559 |
| Gain on the sale of fixed assets | (2,843) | (3,046) |
| Loss on the sale of foreclosed assets | 21,615 | 11,681 |
| Stock-based compensation, net of tax benefit | 25,637 | 3,861 |
| Provision for loan losses | 397,458 | 424,716 |
| Deferred income taxes | (54,930) | (78,548) |
| Accretion of discount on securities, net of amortization of premiums | (8,518) | (39,455) |
| Increase in cash surrender value of life insurance | (80,381) | (78,558) |
| Changes in assets and liabilities: | | |
| Accrued income | 280,042 | (182,692) |
| Other assets | (857,344) | (725,022) |
| Accrued interest payable | (70,619) | 51,977 |
| Other liabilities | 669,681 | 710,076 |
| Net cash provided by operating activities | 1,840,318 | 2,547,049 |
| <i>Cash flows from investing activities</i> | | |
| Net (increase) decrease in interest-bearing deposits with banks | 9,631,242 | (11,166,701) |
| Net (increase) decrease in federal funds sold | 100,000 | (4,000) |
| Purchases of investment securities | (4,558,261) | (3,452,960) |
| Sales and maturities of investment securities | 5,012,337 | 3,544,361 |
| Redemption of restricted equity securities | | 134,400 |
| Purchases of restricted equity securities | (42,200) | (77,084) |
| Net increase in loans | (4,991,969) | (8,223,217) |
| Proceeds from the sale of fixed assets | 3,215 | 9,900 |
| Proceeds from the sale of foreclosed assets | 194,208 | 337,311 |
| Purchases of property and equipment | (444,810) | (443,114) |
| Net cash provided by (used in) investing activities | 4,903,762 | (19,341,104) |
| <i>Cash flows from financing activities</i> | | |
| Net increase (decrease) in deposits | (5,142,287) | 14,181,702 |
| Net increase in federal funds purchased and securities sold under agreements to repurchase | 343,678 | 756,547 |
| Net increase (decrease) in other borrowings | (1,981,117) | 819,466 |
| Dividends paid | (563,805) | (89,226) |
| Common stock options exercised | 13,912 | 182,249 |
| Tax benefit related to exercise of non-incentive stock options | | 565,076 |
| Net cash provided by (used in) financing activities | (7,329,619) | 16,415,814 |
| Net decrease in cash and cash equivalents | (585,539) | (378,241) |
| <i>Cash and cash equivalents, beginning</i> | 2,220,733 | 1,830,516 |

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| | | |
|---|--------------|--------------|
| <i>Cash and cash equivalents, ending</i> | \$ 1,635,194 | \$ 1,452,275 |
| <i>Supplemental disclosures of cash flow information</i> | | |
| Interest paid | \$ 4,345,877 | \$ 4,722,132 |
| Taxes paid | \$ 877,229 | \$ 792,696 |
| Loans transferred to foreclosed properties | \$ 167,399 | \$ 432,629 |

See Notes to Consolidated Financial Statements

Table of Contents**Consolidated Statements of Changes in Stockholders' Equity***Nine months ended September 30, 2008 and 2007 (Unaudited)*

| | Preferred Stock | | Common Stock | | Retained | Accumulated Other Comprehensive | Total |
|--|-----------------|--------------|--------------|--------------|---------------|---------------------------------------|---------------|
| | Shares | Amount | Shares | Amount | Earnings | Income (Loss) | |
| Balance, January 1, 2007 | 189,356 | \$ 2,620,325 | 3,002,168 | \$ 8,461,247 | \$ 8,950,342 | \$ (4,460) | \$ 20,027,454 |
| Comprehensive income | | | | | | | |
| Net income | | | | | 2,218,500 | | 2,218,500 |
| Net change in unrealized gain (loss) on investment securities available for sale, net of income tax expense of \$4,118 | | | | | | 6,564 | 6,564 |
| Total comprehensive income | | | | | | | 2,225,064 |
| Common stock issued | | | | | | | |
| Common stock options exercised, net of shares surrendered in cashless exchange | | | 159,202 | 182,249 | | | 182,249 |
| Tax benefit related to exercise of non-qualified stock options | | | | 565,076 | | | 565,076 |
| Stock-based compensation, net of tax benefit | | | | 3,861 | | | 3,861 |
| Dividends declared on convertible preferred stock (\$0.47 per share) | | | | | (89,226) | | (89,226) |
| Balance, September 30, 2007 | 189,356 | \$ 2,620,325 | 3,161,370 | \$ 9,212,433 | \$ 11,079,616 | \$ 2,104 | \$ 22,914,478 |
| Balance, January 1, 2008, as previously reported | 189,356 | \$ 2,620,325 | 3,162,764 | \$ 9,217,939 | \$ 11,141,839 | \$ 3,088 | \$ 22,983,191 |
| Cumulative effect of initial adoption of EITF 06-4 | | | | | (43,346) | | (43,346) |
| Balance, January 1, 2008 | | | | | 11,098,493 | | 22,939,845 |
| Comprehensive income | | | | | | | |
| Net income | | | | | 1,295,869 | | 1,295,869 |
| Net change in unrealized gain on investment securities available for sale, net of income tax benefit of \$13,157 | | | | | | (20,973) | (20,973) |
| Total comprehensive income | | | | | | | 1,274,896 |
| Common stock issued | | | | | | | |
| Common stock options exercised | | | 3,410 | 13,912 | | | 13,912 |
| Stock-based compensation, net of tax benefit | | | | 25,637 | | | 25,637 |
| Dividends declared on convertible preferred stock (\$0.47 per share) | | | | | (89,308) | | (89,308) |
| Balance, September 30, 2008 | 189,356 | \$ 2,620,325 | 3,166,174 | \$ 9,257,488 | \$ 12,305,054 | \$ (17,885) | \$ 24,164,982 |

See Notes to Consolidated Financial Statements

Table of Contents

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 as of September 30, 2008 and December 31, 2007, the results of operations for the nine and three months ended September 30, 2008 and 2007, and its changes in stockholders' equity and cash flows for the nine and three months ended September 30, 2008 and 2007. All adjustments are of a normal and recurring nature. The results of operations for the nine months ended September 30, 2008, 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, 2007, included in the Company's Form 10-K. The balance sheet at December 31, 2007, has been taken from the audited financial statements at that date.

Organization

Surrey Bancorp (the "Company") 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 U-VEST.

On July 31, 2000, Surrey Bank & Trust formed Friendly Finance, LLC, ("Subsidiary") an operation specializing in the purchase of sales finance contracts from local automobile dealers. The Bank originally had a 60% majority interest in the company. On March 1, 2003, the Bank acquired the minority interest in Friendly Finance, LLC in exchange for the satisfaction of other commitments of the holder of the minority interest. On January 1, 2005, Friendly Finance, LLC's name was changed to Freedom Finance, LLC.

The accounting and reporting policies of the Company and 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, 2007 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.

Table of Contents

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.

Business Segments

The Company reports its activities in two business segments. In determining the appropriateness of segment definition, the Company considers the materiality of potential business segments and components of the business about which financial information is available and regularly evaluated relative to resource allocation and performance assessment.

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. Cash flows from demand deposits, NOW accounts and savings accounts are reported net since their original maturities are less than three months. Loans and time deposits are reported net per FASB Statement No. 104. 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, 2008 and December 31, 2007, the Bank had no investments classified as held to maturity.

Loans Held for Sale

The Bank originates and holds SBA and 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, 2008 and December 31, 2007.

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.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs. The Bank makes continuous credit reviews of the loan portfolio and considers economic conditions, historical loan loss experience, review of specific problem loans and other factors in determining the adequacy of the allowance balance.

Table of Contents

Activity in the allowance for loan losses for the nine months ended September 30, 2008 and 2007 follows:

| | September 30, | |
|----------------------------------|---------------|--------------|
| | 2008 | 2007 |
| Balance at beginning of year | \$ 2,781,565 | \$ 2,531,305 |
| Add provision charged to expense | 397,458 | 424,716 |
| Less net charge-offs | (130,174) | (340,534) |
| | \$ 3,048,849 | \$ 2,615,487 |

Interest on all loans is accrued daily on the outstanding balance. Accrual of interest is discontinued on a loan when management believes, after considering collection efforts and other factors, the borrower's financial condition is such that collection of interest is doubtful.

Recent Accounting Pronouncements

In March 2008, the FASB issued Statement of Financial Accounting Standards No. 161, *Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133*, (SFAS 161). SFAS 161 applies to all derivative instruments and related hedged items accounted for under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, (SFAS 133). SFAS 161 requires entities to provide greater transparency about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for under SFAS 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity's financial position, results of operations and cash flows. To meet those objectives, SFAS 161 requires (1) qualitative disclosures about objectives for using derivatives by primary underlying risk exposure (e.g., interest rate, credit or foreign exchange rate) and by purpose or strategy (fair value hedge, cash flow hedge, net investment hedge, and non-hedges), (2) information about the volume of derivative activity in a flexible format that the preparer believes is the most relevant and practicable, (3) tabular disclosures about balance sheet location and gross fair value amounts of derivative instruments, income statement and other comprehensive income location of gain and loss amounts on derivative instruments by type of contract, and (4) disclosures about credit-risk related contingent features in derivative agreements. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. Accordingly, the Company will adopt the provisions of SFAS 161 in the first quarter 2009. The Company does not expect the adoption of the provisions of SFAS 161 to have a material effect on the Company's financial condition and results of operations.

On January 1, 2008, the Company adopted SFAS No. 157, *Fair Value Measurements*, (SFAS 157), which defines fair value, establishes a framework for measuring fair value under accounting principles generally accepted in the United States, and enhances disclosures about fair value measurements. SFAS 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value and, therefore, does not expand the use of fair value in any new circumstances. Fair value is defined as the exchange price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 clarifies that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. The fair value hierarchy gives the highest priority to quoted prices in active markets and the lowest priority to unobservable data. SFAS 157 requires fair value measurements to be separately disclosed by level within the fair value hierarchy. Under SFAS 157, the Company bases fair values on the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. For assets and liabilities recorded at fair value, it is the Company's policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements, in accordance with the fair value hierarchy in SFAS 157.

Fair value measurements for assets and liabilities where there exists limited or no observable market data and, therefore, are based primarily upon estimates, are often calculated based on the economic and competitive environment, the characteristics of the asset or liability and other factors. Therefore, the results cannot be determined with precision and may not be realized in an actual sale or immediate settlement of the asset or liability. Additionally, there may be inherent weaknesses in any calculation technique, and changes in the underlying assumptions used, including discount rates and estimates of future cash flows, could significantly affect the results of current or future values. The application of SFAS 157 did not impact the Company's accounting measurements but did result in additional disclosures.

Table of Contents**Recent Accounting Pronouncements, continued**

Beginning January 1, 2008, the Company can prospectively elect to apply SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities – Including an amendment of FASB Statement No. 115*, (SFAS 159), and measure selected financial assets and liabilities at fair value on a contract-by-contract basis. The Company evaluated the guidance contained in SFAS 159, and decided not to elect the fair value option for any financial assets or liabilities at this time.

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations*, (SFAS 141(R)) which replaces SFAS 141. SFAS 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any controlling interest; recognizes and measures goodwill acquired in the business combination or a gain from a bargain purchase; and determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. FAS 141(R) is effective for acquisitions by the Company taking place on or after January 1, 2009. Early adoption is prohibited. Accordingly, a calendar year-end company is required to record and disclose business combinations following existing accounting guidance until January 1, 2009. The Company will assess the impact of SFAS 141(R) if and when a future acquisition occurs.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements – an amendment of Accounting Research Bulletin (ARB) No. 51* (SFAS 160). SFAS 160 establishes new accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary. Before this statement, limited guidance existed for reporting noncontrolling interests (minority interest). As a result, diversity in practice exists. In some cases minority interest is reported as a liability and in others it is reported in the mezzanine section between liabilities and equity. Specifically, SFAS 160 requires the recognition of a noncontrolling interest (minority interest) as equity in the consolidated financial statements and separate from the parent's equity. The amount of net income attributable to the noncontrolling interest will be included in consolidated net income on the face of the income statement. SFAS 160 clarifies that changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation are equity transactions if the parent retains its controlling financial interest. In addition, this statement requires that a parent recognize gain or loss in net income when a subsidiary is deconsolidated. Such gain or loss will be measured using the fair value of the noncontrolling equity investment on the deconsolidation date. SFAS 160 also includes expanded disclosure requirements regarding the interests of the parent and its noncontrolling interests. SFAS 160 is effective for the Company on January 1, 2009. Earlier adoption is prohibited. The Company is currently evaluating the impact, if any, the adoption of SFAS 160 will have on its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS 161). SFAS 161 requires enhanced disclosures about an entity's derivative and hedging activities and thereby improving the transparency of financial reporting. It is intended to enhance the current disclosure framework in SFAS 133 by requiring that objectives for using derivative instruments be disclosed in terms of underlying risk and accounting designation. This disclosure better conveys the purpose of derivative use in terms of the risks that the entity is intending to manage. SFAS 161 is effective for the Company on January 1, 2009. This pronouncement does not impact accounting measurements but will result in additional disclosures if the Company is involved in material derivative and hedging activities at that time.

In February 2008, the FASB issued FASB Staff Position No. 140-3, *Accounting for Transfers of Financial Assets and Repurchase Financing Transactions* (FSP 140-3). This FSP provides guidance on accounting for a transfer of a financial asset and the transferor's repurchase financing of the asset. This FSP presumes that an initial transfer of a financial asset and a repurchase financing are considered part of the same arrangement (linked transaction) under SFAS No. 140. However, if certain criteria are met, the initial transfer and repurchase financing are not evaluated as a linked transaction and are evaluated separately under Statement 140. FSP 140-3 will be effective for financial statements issued for fiscal years beginning after November 15, 2008, and interim periods within those fiscal years and earlier application is not permitted. Accordingly, this FSP is effective for the Company on January 1, 2009. The Company is currently evaluating the impact, if any, the adoption of FSP 140-3 will have on its financial position, results of operations and cash flows.

In April 2008, the FASB issued FASB Staff Position No. 142-3, *Determination of the Useful Life of Intangible Assets* (FSP 142-3). This FSP amends the factors that should be considered in developing renewal or extension

Table of Contents**Recent Accounting Pronouncements, continued**

assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets*. The intent of this FSP is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141(R), *Business Combinations*, and other U.S. generally accepted accounting principles. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years and early adoption is prohibited. Accordingly, this FSP is effective for the Company on January 1, 2009. The Company does not believe the adoption of FSP 142-3 will have a material impact on its financial position, results of operations or cash flows.

In May 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, (SFAS No. 162). SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). SFAS No. 162 will be effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board's amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. The FASB has stated that it does not expect SFAS No. 162 will result in a change in current practice. The application of SFAS No. 162 will have no effect on the Company's financial position, results of operations or cash flows.

FSP SFAS 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161*, (FSP SFAS 133-1 and FIN 45-4) was issued September 2008, effective for reporting periods (annual or interim) ending after November 15, 2008. FSP SFAS 133-1 and FIN 45-4 amends SFAS 133 to require the seller of credit derivatives to disclose the nature of the credit derivative, the maximum potential amount of future payments, fair value of the derivative, and the nature of any recourse provisions. Disclosures must be made for entire hybrid instruments that have embedded credit derivatives.

The staff position also amends FIN 45 to require disclosure of the current status of the payment/performance risk of the credit derivative guarantee. If an entity utilizes internal groupings as a basis for the risk, how the groupings are determined must be disclosed as well as how the risk is managed.

The staff position encourages that the amendments be applied in periods earlier than the effective date to facilitate comparisons at initial adoption. After initial adoption, comparative disclosures are required only for subsequent periods.

FSP SFAS 133-1 and FIN 45-4 clarifies the effective date of SFAS 161 such that required disclosures should be provided for any reporting period (annual or quarterly interim) beginning after November 15, 2008. The adoption of this Staff Position will have no material effect on the Company's financial position, results of operations or cash flows.

The SEC's Office of the Chief Accountant and the staff of the FASB issued press release 2008-234 on September 30, 2008 (Press Release) to provide clarifications on fair value accounting. The press release includes guidance on the use of management's internal assumptions and the use of market quotes. It also reiterates the factors in SEC Staff Accounting Bulletin (SAB) Topic 5M which should be considered when determining other-than-temporary impairment: the length of time and extent to which the market value has been less than cost; financial condition and near-term prospects of the issuer; and the intent and ability of the holder to retain its investment for a period of time sufficient to allow for any anticipated recovery in market value.

On October 10, 2008, the FASB issued FSP SFAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* (FSP SFAS 157-3). This FSP clarifies the application of SFAS No. 157, *Fair Value Measurements* (see Note 6) in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that asset is not active. The FSP is effective upon issuance, including prior periods for which financial statements have not been issued. For the Company, this FSP is effective for the quarter ended September 30, 2008.

The Company considered the guidance in the Press Release and in FSP SFAS 157-3 when conducting its review for other-than-temporary impairment as of September 30, 2008 and determined that it did not result in a change to its impairment estimation techniques.

Table of Contents

Recent Accounting Pronouncements, concluded

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.

NOTE 2. EARNINGS PER SHARE

Basic earnings per share for the nine and three months ended September 30, 2008 and 2007 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 convertible preferred stock which is convertible into 2.0868 shares of common stock.

NOTE 3. COMMITMENTS AND LETTERS OF CREDIT

At September 30, 2008, the Company had commitments to extend credit, including unused lines of credit of approximately \$30,410,000. Letters of credit totaling \$1,990,071 were outstanding.

NOTE 4. STOCK BASED COMPENSATION

The Company has two share-based compensation plans. The compensation cost that has been charged against income for those plans was approximately \$38,844 and \$5,851 for the nine-month periods ended September 30, 2008 and 2007, respectively. The income tax benefit recognized for share-based compensation arrangements was approximately \$13,207 and \$1,990 for the nine months ended September 30, 2008 and 2007, respectively.

The compensation cost that has been charged against income for those plans for the three-month period ended September 30, 2008 and 2007 was approximately \$12,948 and \$1,950, respectively. The income tax benefit recognized for share-based compensation arrangements was approximately \$4,402 and \$664 for the three months ended September 30, 2008 and 2007, respectively.

NOTE 5. RESTATEMENT OF BEGINNING RETAINED EARNINGS.

In September 2006, the FASB ratified the consensus reached by the FASB's Emerging Issues Task Force (EITF) relating to EITF 06-4, *Accounting for the Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangement* (EITF 06-4). Entities purchase life insurance for various reasons including protection against loss of key employees and to fund postretirement benefits. The two most common types of life insurance arrangements are endorsement split dollar life, which the Company owns, and collateral assignment split dollar life. EITF 06-4 covers the former and EITF 06-10 covers the latter. EITF 06-4 states that entities with endorsement split-dollar life insurance arrangements that provide a benefit to an employee that extends to postretirement periods should recognize a liability for future benefits in accordance with SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, (if, in substance, a postretirement benefit plan exists) or Accounting Principles Board (APB) Opinion No. 12, *Omnibus Opinion 1967* (if the arrangement is, in substance, an individual deferred compensation contract). The Company recognized the effects of applying this issue as a change in accounting principle through a cumulative-effect adjustment to retained earnings. The reduction of beginning retained earnings resulting from the cumulative-effect of the adoption of EITF 06-4 was \$43,346. Expense amounting to approximately \$11,100 was recognized in salaries and benefits expense in the period ended September 30, 2008.

NOTE 6. 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.

Table of Contents

Fair Value Hierarchy

Under SFAS 157, 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 SFAS 114, *Accounting by Creditors for Impairment of a Loan*, (SFAS 114). 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, 2008, substantially all of the total impaired loans were evaluated based on the fair value of the collateral. In accordance with SFAS 157, 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.

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.

Table of Contents**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.

| <i>(in thousands)</i> | Total | Level 1 | Level 2 | Level 3 |
|--|----------|---------|----------|---------|
| September 30, 2008 | | | | |
| Investment securities available for sale | \$ 2,639 | \$ | \$ 2,639 | \$ |
| Total assets at fair value | \$ 2,639 | \$ | \$ 2,639 | \$ |
| Total liabilities at fair value | \$ | \$ | \$ | \$ |

The Company had no Level 3 assets measured at fair value on a recurring basis at September 30, 2008.

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> | Total | Level 1 | Level 2 | Level 3 |
|---------------------------------|----------|---------|----------|---------|
| September 30, 2008 | | | | |
| Loans | \$ 1,344 | \$ | \$ 1,344 | \$ |
| Foreclosed assets | 40 | | 40 | |
| Total assets at fair value | \$ 1,384 | \$ | \$ 1,384 | \$ |
| Total liabilities at fair value | \$ | \$ | \$ | \$ |

The Company had no Level 3 assets measured at fair value on a non-recurring basis at September 30, 2008.

NOTE 7. SEGMENT REPORTING

The Company has two reportable segments, the Bank and Freedom Finance, LLC. The Bank provides mortgage, consumer and commercial loans. Freedom Finance, LLC specializes in the purchase of sales finance contracts from local automobile dealers. Information about reportable segments, and reconciliation of such information to the consolidated financial statements as of and for the nine months ended September 30, 2008 and 2007 is as follows:

| | Bank | Freedom Finance, LLC | Intersegment Elimination | Consolidated Totals |
|-------------------------------|--------------|----------------------|--------------------------|---------------------|
| September 30, 2008 | | | | |
| Net interest income | \$ 4,914,302 | \$ 346,405 | \$ | \$ 5,260,707 |
| Other income | 1,740,533 | 1,838 | | 1,742,371 |
| Depreciation and amortization | 222,698 | 1,953 | | 224,651 |
| Provision for loan losses | 384,367 | 13,091 | | 397,458 |
| Net income | 1,241,067 | 54,802 | | 1,295,869 |
| Assets | 205,155,167 | 2,023,354 | (1,651,172) | 205,527,349 |
| September 30, 2007 | | | | |
| Net interest income | \$ 6,047,242 | \$ 427,513 | \$ | \$ 6,474,755 |
| Other income | 1,891,649 | 4,236 | | 1,895,885 |
| Depreciation and amortization | 231,606 | 1,953 | | 233,559 |
| Provision for loan losses | 224,079 | 200,637 | | 424,716 |
| Net income | 2,222,517 | (4,017) | | 2,218,500 |

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| | | | | |
|--------|-------------|-----------|-------------|-------------|
| Assets | 205,115,446 | 3,036,587 | (1,635,713) | 206,516,320 |
|--------|-------------|-----------|-------------|-------------|

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company's reportable segments are strategic business units that offer different products and services.

Table of Contents

They are managed separately because each segment appeals to different markets and, accordingly, require different technology and marketing strategies.

The Company derives a majority of its revenue from interest income and relies primarily on net interest income to assess the performance of the segments and make decisions about resources to be allocated to the segment. Therefore, the segments are reported using net interest income for the period ended September 30, 2008. The Company does allocate income taxes to the segments. Other income represents noninterest income which is also allocated to the segments. The Company includes the holding company and an insurance and investment agency in its Bank segment above. The Company does not have any single external customer from which it derives 10 percent or more of its revenues and operations in any one geographical area.

NOTE 8. BENEFIT PLANS

The Company has a Supplemental Retirement Benefit Plan (SERP) to provide future compensation to certain members of management. Under plan provisions, annual payments projected to range from \$16,388 to \$89,914 are payable for the life of the executive, generally beginning at age 65. The liability accrued for the compensation under the plan was \$313,386 and \$220,726 at September 30, 2008 and 2007, respectively. Employee benefits expense, an actuarially determined amount, was \$69,007 and \$70,957 for the nine months ended September 30, 2008 and 2007, respectively. The assumed discount rate for the plan is 7.0%.

The Company also has a deferred compensation plan under which directors may elect to defer their directors' fees. Participating directors receive an additional 30% matching contribution and will be paid an annual benefit for a specified number of years after retirement, generally beginning at age 65. The maximum payout period is ten years. Deferred directors' fees accrued under the plan were \$373,826 and \$270,236 at September 30, 2008 and 2007, respectively. Deferred directors' fees expensed were \$73,485 and \$134,445 for the nine months ended September 30, 2008 and 2007, respectively.

The Company has purchased and is the primary beneficiary of life insurance policies indirectly related to the Supplemental Retirement Benefit Plan and the directors' deferred compensation liability. The cash value of the life insurance policies totaled \$3,033,401 and \$2,925,695 at September 30, 2008 and 2007, respectively.

Table of Contents

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, 2008 and 2007. This discussion should be read in conjunction with the financial statements and related notes contained within this report.

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

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

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

Highlights

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

Net income available for common stockholders for the three months ended September 30, 2008, was \$426,740 or \$0.13 per diluted share outstanding compared to a \$712,689 or \$0.21 per diluted share outstanding for the same period in 2007. Earnings for the three months ended September 30, 2008, are approximately 40.1% lower than for the same period in 2007. The decrease results from an 18.1% decrease in net interest income from \$2,193,785 in the third quarter of 2007 to \$1,796,823 in 2008. Noninterest income decreased 2.4% to \$592,490 in 2008 compared to \$607,259 in 2007. The net interest income decrease is primarily due to the steep decrease in interest rates over the past four quarters and the resulting contraction of the net interest margin. Additionally, deposit costs have remained relatively high putting further pressure on the net interest margin. The decrease in noninterest income is primarily due to a slowing of mortgage related activities during the quarter. Noninterest expenses increased 5.7% from \$1,453,360 in the third quarter of 2007, to \$1,536,756 in 2008. Most of this increase is associated with salaries and employee benefits.

Net income available for common shareholders for the nine months ended September 30, 2008, was \$1,206,561 or \$.36 per diluted share outstanding compared to \$2,129,274 or \$.62 per diluted share outstanding for the same period in 2007. Earnings for the nine months ended September 30, 2007, are approximately 43.3% lower than for the same period in 2007. The decrease primarily results from an 18.8% decrease in net interest income from \$6,475,755 in 2007 to \$5,260,707 in 2008.

On September 30, 2008, Surrey Bancorp's assets totaled \$205,527,349 compared to \$210,957,373 on December 31, 2007. Net loans were \$170,883,912 compared to \$166,456,800 on December 31, 2007. This increase is attributable to increases in most loan categories. Commercial loans, construction and development loans, and home equity loans increased 2.29%, 7.64% and 2.38%, respectively, from the 2007 year-end totals. Additionally, non-farm non-residential loans increased from \$570,276 at December 31, 2007 to \$2,448,106 at September 30, 2008, a 329.3% increase. These increases have been partially offset by minor decreases in other loan categories.

Table of Contents

Total deposits on September 30, 2008, were \$166,037,945 compared to \$171,180,232 at the end of 2007. This decrease is attributable to decreases in demand deposits and savings deposits. Demand deposits decreased 6.74% from 2007 totals, while savings deposits, which include money market accounts, decreased 13.34%. Certificates of deposit increased 1.18% from December 31, 2007 totals.

Common stockholders' equity increased by \$1,225,137 or 5.34% during the nine months ended September 30, 2008, after a cumulative effect adjustment to beginning retained earnings (see Note 5), resulting in a common stock book value of \$6.80 per share, up from \$6.44 on December 31, 2007.

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.

Bonds, notes, and debentures for which the Bank has the positive intent and ability to hold to maturity are reported at cost, adjusted by premiums and discounts that are recognized in interest income using the interest method over the period to maturity or to call dates. The Bank had no Held to Maturity securities at September 30, 2008 or December 31, 2007.

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 shareholders' 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 \$2,638,645 consisted of U.S. Governmental Agency obligations with maturities ranging from two to forty-four months, corporate bonds with maturities of ten years, that reprice quarterly, and GNMA adjustable rate mortgage securities, which adjust annually.

Loans

Net loans outstanding on September 30, 2008, were \$170,883,912 compared to \$166,456,800 on December 31, 2007. The Bank maintains a loan portfolio dominated by real estate and commercial loans diversified among various industries. Approximately 46.9% of the Bank's loans as of September 30, 2008, are fixed rate loans with 53.1% floating with the Bank's prime rate or other appropriate internal or external indices.

Deposits

Deposits on September 30, 2008, were \$166,037,945, compared to \$171,180,232 on December 31, 2007. The September total comes from a base of approximately 12,212 accounts compared to 12,213 accounts at December 31, 2007. Interest-bearing accounts represented 84.5% of the 2008 period-end deposits versus 83.6% at December 31, 2007.

Table of Contents**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, 2008:</i> | | |
| Total Capital | | |
| (to Risk-Weighted Assets) | | |
| Surrey Bancorp (Consolidated) | 14.83% | 8.0% |
| Surrey Bank & Trust | 13.86% | 8.0% |
| Tier I Capital | | |
| (to Risk-Weighted Assets) | | |
| Surrey Bancorp (Consolidated) | 13.57% | 4.0% |
| Surrey Bank & Trust | 12.61% | 4.0% |
| Tier I Capital | | |
| (to Average Assets) | | |
| Surrey Bancorp (Consolidated) | 11.31% | 4.0% |
| Surrey Bank & Trust | 10.50% | 4.0% |
| <i>December 31, 2007:</i> | | |
| Total Capital | | |
| (to Risk-Weighted Assets) | | |
| Surrey Bancorp (Consolidated) | 14.49% | 8.0% |
| Surrey Bank & Trust | 13.46% | 8.0% |
| Tier I Capital | | |
| (to Risk-Weighted Assets) | | |
| Surrey Bancorp (Consolidated) | 13.24% | 4.0% |
| Surrey Bank & Trust | 12.21% | 4.0% |
| Tier I Capital | | |
| (to Average Assets) | | |
| Surrey Bancorp (Consolidated) | 10.70% | 4.0% |
| Surrey Bank & Trust | 9.86% | 4.0% |

Asset Quality

The notes to the consolidated financial statements contained within this report provide details of the activity in the allowance for loan losses.

The consolidated provision for loan losses charged to operations was \$397,458 in the first nine months of 2008 compared to \$424,716 for the same period in 2007. The provision attributable to the Bank increased from \$224,079 in 2007 to \$384,367 in 2008. This increase is primarily attributable to increases in reserves on impaired loans. The provision in Freedom Finance, LLC decreased from \$200,637 to \$13,091 for the nine months ended September 30, 2007 and 2008, respectively. The decrease in the Freedom Finance, LLC provision was due to a reduction in charge offs from \$383,747 during the nine months ended September 30, 2008, to only \$84,225 in 2008. Additionally, the finance company's outstanding loans experienced a reduction of approximately 40% from \$2,598,839 at September 30, 2007, to \$1,739,309 at the end of September 2008.

The reserve for loan losses on September 30, 2008, was \$3,048,849 or 1.75% of period end loans. This percentage is derived from total loans. Approximately \$33,699,000 of the total loans outstanding at September 30, 2008, are government guaranteed loans which the Bank's exposure ranges from 10% to 49% of the outstanding balance. When the guaranteed portions of the loans are removed from the equation, the loan loss

reserve is approximately 2.04% of outstanding loans.

Table of Contents

The level of reserve is established based upon management's evaluation of portfolio composition, current and projected national and local economic conditions, and results of independent reviews of the loan portfolio by internal and external examination. Management recognizes the inherent risk associated with commercial and consumer 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. As a result, management continues to actively monitor the Bank's asset quality and lending policies. Management believes that its loan portfolio is diversified so 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.

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.

At September 30, 2008, the Bank had loans totaling approximately \$534,519 in nonaccrual status.

Interest Rate Sensitivity and Liquidity

One of the principal duties of the Bank's Asset/Liability Management 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, 2008, the liquidity position of the Company was adequate, with short-term liquid assets of \$19,552,451. Deposit decreases coupled with loan growth during the first nine months of 2008 decreased the liquidity position by approximately \$10,317,000 from December 31, 2007 totals. The Bank experiences large maturities of time deposits in the fourth quarter of the year which could decrease the liquidity further. To provide supplemental liquidity, the Bank has five lines of credit with correspondent banks totaling \$15,000,000. At September 30, 2008, there were no advances against these lines. Additionally, the Bank has a secured borrowing arrangement with the Federal Home Loan Bank. The maximum credit available under this agreement approximates \$16,655,000 of which \$12,200,000 of advances had been taken down at September 30, 2008. In addition, Freedom Finance, LLC has a secured revolving line of credit with another commercial bank in the amount of \$1,000,000. At September 30, 2008, \$475,000 was outstanding on this line.

Table of Contents

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The principal goals of our asset and liability management strategy are the maintenance of adequate liquidity and the management of interest rate risk. Liquidity is the ability to convert assets to cash to fund depositor's withdrawals or borrowers' loans without significant loss. Interest rate risk management balances the effects of interest rate changes on assets that earn interest or liabilities on which interest is paid, to protect the Bank from wide fluctuations in its net interest income which could result from interest rate changes.

We attempt to ensure that adequate funds are available at all times to meet the needs of our customers. On the asset side of the balance sheet, maturing investments, loan payments, maturing loans, federal funds sold, and unpledged investment securities are principal sources of liquidity. On the liability side of the balance sheet, liquidity sources include core deposits, the ability to increase large denomination certificates of deposit, federal fund lines from correspondent banks, borrowings from the Federal Home Loan Bank and the Federal Reserve Bank, as well as the ability to generate funds through the issuance of long-term debt and equity.

Interest rate risk is the effect that changes in interest rates would have on interest income and interest expense as interest-sensitive assets and interest-sensitive liabilities either re-price or mature. We attempt to maintain the portfolios of interest-earning assets and interest-bearing liabilities with maturities or re-pricing opportunities at levels that will afford protection from substantial erosion of the net interest margin, to the extent practical, from changes in interest rates.

We use a number of tools to manage our interest rate risk, including simulating net interest income under various scenarios, monitoring the present value change in equity under the same scenarios, and monitoring the difference or gap between rate sensitive assets and rate sensitive liabilities over various time periods.

Quantitative information about the Bank's interest rate risk is included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

Table of Contents

ITEM 4T. CONTROLS & 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.

Table of Contents

PART II OTHER INFORMATION

Item 1. Legal Proceedings

No significant changes in legal proceedings occurred during the quarter.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3. Defaults Upon Senior Securities

Not Applicable

Item 4. Submission of Matters to a Vote of Security Holders

None

Item 5. Other Information

None

Item 6. Exhibits

3.1 Surrey Bancorp Incorporated by reference to Exhibit 3(i) to Articles of Incorporation the Registrant's Form 8K dated May 1, 2003

3.2 Surrey Bancorp Incorporated by reference to Exhibit 3(i) to Bylaws the Registrant's Form 8K dated May 1, 2003

10.1 1997 Incentive Stock Option Plan Incorporated by reference to Exhibit 4.1 to the Registrant's Form S-8 dated September 11, 2003

10.2 1997 Non-statutory Stock Option Plan Incorporated by reference to Exhibit 4.1 to the Registrant's Form S-8 dated September 11, 2003

31.1 Certification

31.2 Certification

32.1 Certification

Table of Contents

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 12, 2008

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

Date: November 12, 2008

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