

SURREY BANCORP
Form 10-Q
November 12, 2015

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

FORM 10-Q

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

for the quarterly period ended September 30, 2015

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

For the transition period from _____ to _____

COMMISSION FILE NO. 000-50313

SURREY BANCORP

(Exact name of registrant as specified in its charter)

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

145 North Renfro Street, Mount Airy, NC 27030

(Address of principal executive offices)

(336) 783-3900

(Registrant's telephone number)

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

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

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

Large accelerated filer Accelerated filer

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Non-accelerated filer Smaller reporting company

Indicate by checkmark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

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

On November 12, 2015 there were 3,549,665 common shares issued and outstanding.

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Consolidated Balance Sheets

September 30, 2015 (Unaudited) and December 31, 2014 (Audited)

	September 2015	December 2014
Assets		
Cash and due from banks	\$5,040,193	\$6,236,749
Interest-bearing deposits with banks	54,449,791	37,315,779
Federal funds sold	1,217,554	1,212,776
Investment securities available for sale	5,343,021	4,363,805
Restricted equity securities	524,939	618,109
Loans, net of allowance for loan losses of \$3,567,517 at September 30, 2015 and \$3,554,664 at December 31, 2014	195,175,423	189,549,072
Property and equipment, net	5,061,728	4,368,589
Foreclosed assets	421,491	280,821
Accrued income	1,124,759	997,681
Goodwill	120,000	120,000
Bank owned life insurance	5,087,372	5,623,087
Other assets	3,349,697	2,514,855
Total assets	\$276,915,968	\$253,201,323
Liabilities and Stockholders' Equity		
Liabilities		
Deposits:		
Noninterest-bearing	\$60,441,761	\$52,969,691
Interest-bearing	169,507,737	153,696,890
Total deposits	229,949,498	206,666,581
Long-term debt	4,250,000	6,250,000
Dividends payable	46,233	827,159
Accrued interest payable	147,932	110,261
Other liabilities	3,641,905	2,576,668
Total liabilities	238,035,568	216,430,669
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; 3,549,665 shares issued and outstanding	12,101,480	12,101,480
Retained earnings	22,938,076	20,808,309
Accumulated other comprehensive loss	(27,963)	(7,942)
Total stockholders' equity	38,880,400	36,770,654
Total liabilities and stockholders' equity	\$276,915,968	\$253,201,323

See Notes to Consolidated Financial Statements

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Consolidated Statements of Income

Nine months ended September 30, 2015 and 2014 (Unaudited)

	2015	2014
Interest income		
Loans and fees on loans	\$8,096,051	\$7,908,742
Federal funds sold	2,046	2,036
Investment securities available for sale, taxable	54,184	45,837
Investment securities available for sale, dividends	11,782	10,656
Deposits with banks	74,108	69,381
Total interest income	8,238,171	8,036,652
Interest expense		
Deposits	702,058	816,409
Fed funds purchased	3	19
Long-term debt	162,591	218,019
Total interest expense	864,652	1,034,447
Net interest income	7,373,519	7,002,205
Provision for loan losses	85,717	132,952
Net interest income after provision for loan losses	7,287,802	6,869,253
Noninterest income		
Service charges on deposit accounts	592,842	598,988
Gain on the sale of government guaranteed loans	-	127,362
Fees on loans delivered to correspondents	71,583	18,464
Other service charges and fees	543,378	499,856
Gain (loss) on the sale of investment securities	5,244	(1,670)
Income from bank owned life insurance	111,190	119,720
Insurance commissions	374,972	388,778
Brokerage commissions	135,374	139,911
Other operating income	83,030	51,176
Total noninterest income	1,917,613	1,942,585
Noninterest expense		
Salaries and employee benefits	2,914,354	2,869,549
Occupancy expense	338,881	339,324
Equipment expense	206,926	204,098
Data processing	336,903	341,079
Foreclosed assets, net	119,015	12,770
Postage, printing and supplies	148,879	143,987
Professional fees	371,484	323,384
FDIC insurance premiums	87,228	89,503
Other expense	1,146,040	1,094,460
Total noninterest expense	5,669,710	5,418,154
Net income before income taxes	3,535,705	3,393,684
Income tax expense	1,268,748	1,234,817
Net income	2,266,957	2,158,867

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Preferred stock dividends	(137,190)	(137,190)
Net income available to common stockholders	\$2,129,767	\$2,021,677
Basic earnings per common share	\$0.60	\$0.57
Diluted earnings per common share	\$0.54	\$0.52
Basic weighted average common shares outstanding	3,549,665	3,542,984
Diluted weighted average common shares outstanding	4,186,647	4,178,933

See Notes to Consolidated Financial Statements

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Consolidated Statements of Income

Three months ended September 30, 2015 and 2014 (Unaudited)

	2015	2014
Interest income		
Loans and fees on loans	\$2,739,903	\$2,684,694
Federal funds sold	683	682
Investment securities available for sale, taxable	20,099	13,430
Investment securities available for sale, dividends	5,663	3,525
Deposits with banks	26,111	22,137
Total interest income	2,792,459	2,724,468
Interest expense		
Deposits	234,890	269,901
Long-term debt	44,127	73,472
Total interest expense	279,017	343,373
Net interest income	2,513,442	2,381,095
Provision for loan losses	129,213	139,527
Net interest income after provision for loan losses	2,384,229	2,241,568
Noninterest income		
Service charges on deposit accounts	193,177	197,443
Fees on loans delivered to correspondents	43,775	12,347
Other service charges and fees	183,890	177,806
Gain on the sale of investment securities	868	873
Income from bank owned life insurance	37,621	40,236
Insurance commissions	159,657	134,552
Brokerage commissions	32,914	50,260
Other operating income	15,462	15,254
Total noninterest income	667,364	628,771
Noninterest expense		
Salaries and employee benefits	922,424	920,537
Occupancy expense	110,303	115,069
Equipment expense	79,670	70,981
Data processing	105,695	130,002
Foreclosed assets, net	33,404	5,466
Postage, printing and supplies	42,238	47,039
Professional fees	123,479	115,523
FDIC insurance premiums	30,689	30,320
Other expense	351,758	318,085
Total noninterest expense	1,799,660	1,753,022
Net income before income taxes	1,251,933	1,117,317
Income tax expense	453,346	402,629
Net income	798,587	714,688
Preferred stock dividends	(46,233)	(46,233)

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Net income available to common stockholders	\$752,354	\$668,455
Basic earnings per common share	\$0.21	\$0.19
Diluted earnings per common share	\$0.19	\$0.17
Basic weighted average common shares outstanding	3,549,665	3,542,984
Diluted weighted average common shares outstanding	4,185,109	4,180,983

See Notes to Consolidated Financial Statements

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Consolidated Statements of Comprehensive Income

Three and Nine months ended September 30, 2015 and 2014 (Unaudited)

	Three Months		Nine Months	
	Ended September 30,		Ended September 30,	
	2015	2014	2015	2014
Net income	\$798,587	\$714,688	\$2,266,957	\$2,158,867
Other comprehensive income (loss):				
Investment securities available for sale:				
Unrealized holding gains (losses)	(32,904)	(4,561)	(22,693)	65,750
Tax effect	10,597	1,492	6,133	(24,030)
Reclassification of (gains) losses recognized in net income	(868)	(873)	(5,244)	1,670
Tax effect	295	296	1,783	(568)
	(22,880)	(3,646)	(20,021)	42,822
Comprehensive income	\$775,707	\$711,042	\$2,246,936	\$2,201,689

See Notes to Consolidated Financial Statements

Table of ContentsConsolidated Statements of Cash Flows
Nine months ended September 30, 2015 and 2014 (Unaudited)

	2015	2014
Cash flows from operating activities		
Net income	\$2,266,957	\$2,158,867
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	202,084	203,536
Gain on sale of property and equipment	(50)	(3,406)
Gain on the sale of government guaranteed loans	-	(127,362)
(Gain) loss on the sale of securities	(5,244)	1,670
(Gain) loss on the sale of foreclosed assets	21,248	(3,466)
Provision for of loan losses	85,717	132,952
Deferred income taxes	1,868	(3,828)
(Accretion) of discount on securities, net of amortization of premiums	(505)	21
Increase in cash surrender value of life insurance	(111,190)	(119,719)
Life insurance proceeds	1,001,320	-
Changes in assets and liabilities:		
Accrued income	(127,078)	(79,743)
Other assets	(1,247,944)	(1,595,392)
Accrued interest payable	37,671	76,734
Other liabilities	1,129,972	1,418,609
Net cash provided by operating activities	3,254,826	2,059,473
Cash flows from investing activities		
Net increase in interest-bearing deposits with banks	(17,134,012)	(2,234,562)
Net (increase) decrease in federal funds sold	(4,778)	99,166
Purchases of investment securities	(3,024,364)	(1,137,854)
Maturities of investment securities	2,004,016	1,255,282
Redemption of restricted equity securities	104,400	59,000
Purchase of restricted equity securities	(11,230)	(170)
Net increase in loans	(6,185,511)	(9,088,199)
Proceeds from the sale of investment securities	18,944	131,403
Proceeds from the sale of foreclosed assets	311,525	39,591
Purchases of property and equipment	(895,223)	(192,537)
Proceeds from the sale of property and equipment	50	5,575
Net cash used in investing activities	(24,816,183)	(11,063,305)
Cash flows from financing activities		
Net increase in deposits	23,282,917	8,919,589
Maturities of long-term debt	(2,000,000)	-
Dividends paid	(918,116)	(881,216)
Net cash provided by financing activities	20,364,801	8,038,373
Net decrease in cash and cash equivalents	(1,196,556)	(965,459)
Cash and due from banks, beginning	6,236,749	7,424,593
Cash and due from banks, ending	\$5,040,193	\$6,459,134
Supplemental disclosures of cash flow information		
Interest paid	\$826,981	\$957,713

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Taxes paid	\$1,292,479	\$1,486,722
Supplemental disclosures of non-cash transactions		
Loans transferred to foreclosed properties	\$473,443	\$177,461
Cash dividends declared but not paid	\$46,233	\$46,233

See Notes to Consolidated Financial Statements

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Table of ContentsConsolidated Statements of Changes in Stockholders' Equity
Nine months ended September 30, 2015 and 2014 (Unaudited)

	Preferred Stock	Common Stock		Retained	Accumulated Other Comprehensive	
	Amount	Shares	Amount	Earnings	Income (Loss)	Total
Balance, January 1, 2014	\$3,868,807	3,542,984	\$12,061,153	\$18,329,089	\$ (41,423) \$34,217,626
Net income	-	-	-	2,158,867	-	2,158,867
Other comprehensive income	-	-	-	-	42,822	42,822
Dividends declared and accrued on convertible Series A preferred stock (\$.47 per share)	-	-	-	(89,225) -	(89,225)
Dividends declared and accrued on convertible Series D preferred stock (\$.26 per share)	-	-	-	(47,965) -	(47,965)
Balance, September 30, 2014	\$3,868,807	3,542,984	\$12,061,153	\$20,350,766	\$ 1,399	\$36,282,125
Balance, January 1, 2015	\$3,868,807	3,549,665	\$12,101,480	\$20,808,309	\$ (7,942) \$36,770,654
Net income	-	-	-	2,266,957	-	2,266,957
Other comprehensive income	-	-	-	-	(20,021) (20,021)
Dividends declared and accrued on convertible Series A preferred stock (\$.47 per share)	-	-	-	(89,225) -	(89,225)
Dividends declared and accrued on convertible Series D preferred stock (\$.26 per share)	-	-	-	(47,965) -	(47,965)
Balance, September 30, 2015	\$3,868,807	3,549,665	\$12,101,480	\$22,938,076	\$ (27,963) \$38,880,400

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 September 30, 2015, the results of its operations and comprehensive income for the nine and three months ended September 30, 2015 and 2014, and its changes in stockholders' equity and cash flows for the nine months ended September 30, 2015 and 2014. These adjustments are of a normal and recurring nature. The results of operations for the nine months ended September 30, 2015, 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, 2014, included in the Company's Form 10-K. The balance sheet at December 31, 2014, 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, 2014 contain a summary of the significant accounting policies. The Company believes our policies with respect to the methodology for the determination of the allowance for loan losses, and asset impairment judgments, including the recoverability of intangible assets involve a higher degree of complexity and require management to make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could cause reported results to differ materially. These critical policies and their application

are periodically reviewed with the Audit Committee and our Board of Directors. See our Annual Report on Form 10-K for full details on critical accounting policies.

Principles of Consolidation

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

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Presentation of Cash Flows

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

Investment Securities

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

Investment securities classified as held to maturity are those debt securities that the Bank has the ability and intent to hold to maturity. Accordingly, these securities are carried at cost adjusted for amortization of premiums and accretion of discount, computed by the interest-method over their contractual lives. At September 30, 2015 and December 31, 2014, the Bank had no investments classified as held to maturity.

Loans Held for Sale

The Bank originates and holds Small Business Administration (SBA) and United States Department of Agriculture (USDA) guaranteed loans in its portfolio in the normal course of business. Occasionally, the Bank sells the guaranteed portions of these loans into the secondary market. The loans are generally variable rate loans, which eliminates the market risk to the Bank and are therefore carried at cost. Fixed rate loans are carried at the lower of cost or market. The Bank recognizes gains on the sale of the guaranteed portion upon the consummation of the transaction. The Bank plans to continue to originate guaranteed loans for sales, however no such loans were funded and held for sale at September 30, 2015 and December 31, 2014.

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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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Allowance for Loan Losses

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

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

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

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

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

Recent Accounting Pronouncements

The following is a summary of recent authoritative pronouncements:

In 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 became effective for the Company on January 1, 2015. 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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SURREY BANCORP

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, 2017. The Company will apply the guidance using a modified retrospective approach. The Company does not expect these amendments to have a material effect on its financial statements. In August 2015, the FASB deferred the effective date of ASU 2014-09, Revenue from Contracts with Customers. As a result of the deferral, the guidance in ASU 2014-09 will be effective for the Company for reporting periods beginning after December 15, 2017. The Company will apply the guidance using a modified retrospective approach. The Company does not expect these amendments to have a material effect on its financial statements.

In January 2015, the FASB issued guidance to eliminate from U.S. GAAP the concept of an extraordinary item, which is an event or transaction that is both (1) unusual in nature and (2) infrequently occurring. Under the new guidance, an entity will no longer (1) segregate an extraordinary item from the results of ordinary operations; (2) separately present an extraordinary item on its income statement, net of tax, after income from continuing operations; or (3) disclose income taxes and earnings-per-share data applicable to an extraordinary item. The amendments will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015, with early adoption permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The Company will apply the guidance prospectively. The Company does not expect these amendments to have a material effect on its financial statements.

In February 2015, the FASB issued guidance which amends the consolidation requirements and significantly changes the consolidation analysis required under U.S. GAAP. Although the amendments are expected to result in the deconsolidation of many entities, the Company will need to reevaluate all its previous consolidation conclusions. The amendments will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015, with early adoption permitted (including during an interim period), provided that the guidance is applied as of the beginning of the annual period containing the adoption date. The Company does not expect these amendments to have a material effect on its financial statements

In June 2015, the FASB issued amendments to clarify the Accounting Standards Codification (ASC), correct unintended application of guidance, and make minor improvements to the ASC that are not expected to have a significant effect on current accounting practice or create a significant administrative cost to most entities. The amendments were effective upon issuance (June 12, 2015) for amendments that do not have transition guidance. Amendments that are subject to transition guidance will be effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted, including adoption in an interim period. The Company does not expect these amendments to have a material effect on its financial statements.

In August 2015, the FASB issued amendments to the Interest topic of the Accounting Standards Codification to clarify the SEC staff's position on presenting and measuring debt issuance costs incurred in connection with line-of-credit arrangements. The amendments were effective upon issuance. 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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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SECURITIES

Debt and equity securities have been classified in the balance sheets according to management's intent. The amortized costs of securities available for sale and their approximate fair values at September 30, 2015 and December 31, 2014 follow:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
<u>September 30, 2015</u>				
Government-sponsored enterprises	\$4,498,020	\$ 6,335	\$ 720	\$4,503,635
Mortgage-backed securities	21,561	601	-	22,162
Corporate bonds	300,000	-	6,000	294,000
Equities and mutual funds	565,799	16,824	59,399	523,224
	\$5,385,380	\$ 23,760	\$ 66,119	\$5,343,021
<u>December 31, 2014</u>				
Government-sponsored enterprises	\$3,500,000	\$ 1,170	\$ 4,640	\$3,496,530
Mortgage-backed securities	25,592	715	-	26,307
Corporate bonds	300,000	-	45,000	255,000
Equities and mutual funds	552,635	42,900	9,567	585,968
	\$4,378,227	\$ 44,785	\$ 59,207	\$4,363,805

At September 30, 2015 and December 31, 2014, approximately \$3,931,000 of the 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 September 30, 2015, were as follows:

	Amortized Cost	Fair Value
Due in one year or less	\$565,799	\$523,224
Due after one year through five years	4,805,983	4,805,782
Due after five years through ten years	4,950	5,078
Due after ten years	8,648	8,937
	\$5,385,380	\$5,343,021

The following table shows investments' gross unrealized losses and fair value, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, at September 30, 2015 and December 31, 2014. These unrealized losses on investment securities are a result of volatility in interest rates which relate to government-sponsored enterprises and corporate bonds issued by other banks and market volatility as it relates to equity and mutual fund investments at September 30, 2015 and December 31, 2014.

Less Than 12 Months	12 Months or More	Total
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	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<u>September 30, 2015</u>						
Government-sponsored enterprises	\$999,280	\$ 720	\$-	\$ -	\$999,280	\$ 720
Corporate bonds	-	-	294,000	6,000	294,000	6,000
Equities and mutual funds	252,350	48,458	141,657	10,941	394,007	59,399
	\$1,251,630	\$ 49,178	\$435,657	\$ 16,941	\$1,687,287	\$ 66,119
<u>December 31, 2014</u>						
Government-sponsored enterprises	\$1,995,360	\$ 4,640	\$-	\$ -	\$1,995,360	\$ 4,640
Corporate bonds	-	-	255,000	45,000	255,000	45,000
Equities and mutual funds	69,129	5,592	107,999	3,975	177,128	9,567
	\$2,064,489	\$ 10,232	\$362,999	\$ 48,975	\$2,427,488	\$ 59,207

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SECURITIES, CONTINUED

Management considers the nature of the investment, the underlying causes of the decline in the market value and the severity and duration of the decline in market value in determining if impairment is other than temporary.

Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Based upon this evaluation, there are seven securities in the portfolio at September 30, 2015, with unrealized losses for a period greater than 12 months. Two of these securities also had unrealized losses for a period greater than 12 months at December 31, 2014. 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 market fluctuations. No declines are deemed to be other than temporary in nature.

The Company had realized gains of \$5,244 from the sales of equity and mutual fund investment securities for the nine month period ended September 30, 2015, and realized losses of \$1,670 from the sales of equity and mutual fund investment securities for the nine month periods ended September 30, 2014. Total proceeds from the sales amounted to \$18,944 and \$131,403 in 2015 and 2014, respectively.

NOTE 3. EARNINGS PER COMMON SHARE

Basic earnings per common share for the nine and three months ended September 30, 2015 and 2014 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 September 30, 2015, the Company had commitments to extend credit, including unused lines of credit of approximately \$49,729,000 and letters of credit outstanding of \$2,370,151.

NOTE 5. LOANS

The major components of loans in the balance sheets at September 30, 2015 and December 31, 2014 are below.

	2015	2014
Commercial	\$52,651,131	\$56,602,425
Real estate:		
Construction and land development	6,484,974	10,061,249

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Residential, 1-4 families	41,938,912	41,824,806
Residential, 5 or more families	1,178,251	1,109,586
Farmland	3,360,755	3,486,002
Nonfarm, nonresidential	83,725,388	74,275,793
Agricultural	4,846,125	675,474
Consumer, net of discounts of \$12,872 in 2015 and \$11,950 in 2014	4,373,523	4,997,023
	198,559,059	193,032,358
Deferred loan origination costs, net of (fees)	183,881	71,378
	198,742,940	193,103,736
Allowance for loan losses	(3,567,517)	(3,554,664)
	\$195,175,423	\$189,549,072

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5. LOANS, CONTINUED

Residential, 1-4 family loans pledged as collateral against FHLB advances approximated \$12,351,000 and \$18,124,000 at September 30, 2015 and December 31, 2014, respectively.

NOTE 6. ALLOWANCE FOR LOAN LOSSES

The activity of the allowance for loan losses by loan components during the nine months ended September 30, 2015 and 2014 was as follows:

	Construction & Development	1-4 Family Residential	Nonfarm, Nonresidential	Commercial & Industrial	Consumer	Other	Total
<u>September 30,</u>							
<u>2015</u>							
Allowance for credit losses:							
Beginning balance	\$ 160,100	\$ 798,199	\$ 1,067,315	\$ 1,301,900	\$ 158,750	\$ 68,400	\$ 3,554,664
Charge-offs	-	(153,023)	(8,481)	(198,523)	(95,503)	-	(455,530)
Recoveries	-	1,645	761	351,320	28,940	-	382,666
Provision	(57,200)	119,448	(65,395)	(50,097)	75,161	63,800	85,717
Ending balance	\$ 102,900	\$ 766,269	\$ 994,200	\$ 1,404,600	\$ 167,348	\$ 132,200	\$ 3,567,517
Ending balance:							
individually evaluated for impairment	\$-	\$ 4,869	\$-	\$-	\$-	\$-	\$ 4,869
Ending balance:							
collectively evaluated for impairment	\$ 102,900	\$ 761,400	\$ 994,200	\$ 1,404,600	\$ 167,348	\$ 132,200	\$ 3,562,648
Loans Receivable:							
Ending balance	\$ 6,484,974	\$ 41,938,912	\$ 83,725,388	\$ 52,651,131	\$ 4,373,523	\$ 9,385,131	\$ 198,559,059
Ending balance:							
individually evaluated for	\$ 11,729	\$ 1,107,891	\$ 2,582,894	\$ 644,828	\$-	\$ 11,585	\$ 4,358,927

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impairment
Ending
balance:
collectively
evaluated for
impairment

	\$6,473,245	\$40,831,021	\$81,142,494	\$52,006,303	\$4,373,523	\$9,373,546	\$194,200,132
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September 30,
2014

Allowance for
credit losses:

Beginning
balance

	\$73,000	\$617,629	\$753,050	\$1,708,962	\$181,309	\$41,400	\$3,375,350
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Charge-offs

	-	(76,891)	(1,778)	(3,506)	(41,118)	-	(123,293)
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Recoveries

	-	1,463	80,314	153,121	33,319	-	268,217
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Provision

	79,100	157,076	(10,304)	(81,778)	(22,042)	10,900	132,952
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Ending
balance

	\$152,100	\$699,277	\$821,282	\$1,776,799	\$151,468	\$52,300	\$3,653,226
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Ending
balance:
individually
evaluated for
impairment

	\$-	\$86,377	\$120,382	\$257,699	\$-	\$-	\$464,458
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Ending
balance:
collectively
evaluated for
impairment

	\$152,100	\$612,900	\$700,900	\$1,519,100	\$151,468	\$52,300	\$3,188,768
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Loans
Receivable:

Ending
balance

	\$10,988,313	\$40,577,088	\$61,894,643	\$69,456,737	\$5,009,585	\$4,486,996	\$192,413,362
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Ending
balance:
individually
evaluated for
impairment

	\$243,827	\$632,885	\$2,779,367	\$1,547,309	\$-	\$-	\$5,203,388
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Ending
balance:
collectively
evaluated for
impairment

	\$10,744,486	\$39,944,203	\$59,115,276	\$67,909,428	\$5,009,585	\$4,486,996	\$187,209,974
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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6. ALLOWANCE FOR LOAN LOSSES, CONTINUED

The following table presents impaired loans individually evaluated by class of loan as of September 30, 2015 and December 31, 2014 and the recognized interest income per the related period:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<u>September 30, 2015</u>					
With no related allowance recorded:					
Construction and development	\$ 11,729	\$ 11,729	\$ -	\$ 12,684	\$ 774
1-4 family residential	1,088,402	1,088,402	-	1,097,425	29,983
Nonfarm, nonresidential	2,582,894	2,582,894	-	2,739,901	82,669
Commercial and industrial	644,828	644,828	-	796,205	8,123
Consumer	-	-	-	-	-
Other loans	11,585	11,585	-	13,546	503
	4,339,438	4,339,438	-	4,659,761	122,052
With an allowance recorded:					
Construction and development	-	-	-	-	-
Construction and development	19,489	19,489	4,869	20,272	-
1-4 family residential	-	-	-	-	-
Nonfarm, nonresidential	-	-	-	-	-
Commercial and industrial	-	-	-	-	-
Consumer	-	-	-	-	-
Other loans	19,489	19,489	4,869	20,272	-
Combined:					
Construction and development	11,729	11,729	-	12,684	774
1-4 family residential	1,107,891	1,107,891	4,869	1,117,697	29,983
Nonfarm, nonresidential	2,582,894	2,582,894	-	2,739,901	82,669
Commercial and industrial	644,828	644,828	-	796,205	8,123
Consumer	-	-	-	-	-
Other loans	11,585	11,585	-	13,546	503
	\$ 4,358,927	\$ 4,358,927	\$ 4,869	\$ 4,680,033	\$ 122,052
<u>December 31, 2014</u>					
With no related allowance recorded:					
Construction and development	\$ 13,536	\$ 13,536	\$ -	\$ 13,788	\$ 2,710
1-4 family residential	174,314	174,314	-	174,882	7,269
Nonfarm, nonresidential	1,806,013	1,806,013	-	1,826,306	94,953
Commercial and industrial	844,682	844,682	-	986,462	9,452
Consumer	-	-	-	-	-
Other loans	228,111	228,111	-	228,884	15,244
	3,066,656	3,066,656	-	3,230,322	129,628
With an allowance recorded:					

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Construction and development	-	-	-	-	-
1-4 family residential	399,764	399,764	97,799	402,691	8,141
Nonfarm, nonresidential	852,925	852,925	117,215	852,872	358
Commercial and industrial	554,787	554,787	162,900	552,865	72
Consumer	-	-	-	-	-
Other loans	-	-	-	-	-
	1,807,476	1,807,476	377,914	1,808,428	8,571
Combined:					
Construction and development	13,536	13,536	-	13,788	2,710
1-4 family residential	574,078	574,078	97,799	577,573	15,410
Nonfarm, nonresidential	2,658,938	2,658,938	117,215	2,679,178	95,311
Commercial and industrial	1,399,469	1,399,469	162,900	1,539,327	9,524
Consumer	-	-	-	-	-
Other loans	228,111	228,111	-	228,884	15,244
	\$4,874,132	\$4,874,132	\$ 377,914	\$5,038,750	\$ 138,199

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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 Loans	Recorded Investment > 90 Days and Accruing
<u>September 30,</u>							
<u>2015</u>							
Construction and development	\$-	\$-	\$-	\$-	\$6,484,974	\$6,484,974	-
1-4 family residential	426,321	345,031	413,710	1,185,062	40,753,850	41,938,912	66,793
Nonfarm, nonresidential	533,724	71,648	317,421	922,793	82,802,595	83,725,388	-
Commercial and industrial	90,150	680,430	185,300	955,880	51,695,251	52,651,131	-
Consumer	127,833	17,368	44,467	189,668	4,183,855	4,373,523	43,345
Other loans	-	-	-	-	9,385,131	9,385,131	-
Total	\$1,178,028	\$1,114,477	\$960,898	\$3,253,403	\$195,305,656	\$198,559,059	\$110,138
Percentage of total loans	0.59	% 0.56	% 0.48	% 1.64	% 98.36	% 100.00	%

Non-accruals
included
above

Construction and development	\$-	\$-	\$-	\$-	\$-	\$-
1-4 family residential	-	-	346,917	346,917	252,324	599,241
Nonfarm, nonresidential	116,473	-	317,421	433,894	94,516	528,410
Commercial and industrial	-	-	185,300	185,300	-	185,300
Consumer	-	-	1,122	1,122	948	2,070
Other loans	-	-	-	-	-	-
	\$116,473	\$-	\$850,760	\$967,233	\$347,788	1,315,021

December 31,
2014

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Construction and development	\$94,736	\$-	\$-	\$94,736	\$9,966,513	\$10,061,249	\$-
1-4 family residential	362,406	274,595	172,981	809,982	41,014,824	41,824,806	-
Nonfarm, nonresidential	137,733	105,473	663,902	907,108	73,368,685	74,275,793	-
Commercial and industrial	63,744	20,476	1,271,937	1,356,157	55,246,268	56,602,425	-
Consumer	169,895	48,785	54,306	272,986	4,724,037	4,997,023	53,184
Other loans	-	-	-	-	5,271,062	5,271,062	-
Total	\$828,514	\$449,329	\$2,163,126	\$3,440,969	\$189,591,389	\$193,032,358	\$53,184
Percentage of total loans	0.43	% 0.23	% 1.12	% 1.78	% 98.22	% 100.00	%

Non-accruals included above

Construction and development	\$-	\$-	\$-	\$-	\$-	\$-
1-4 family residential	162,027	56,664	172,981	391,672	112,752	504,424
Nonfarm, nonresidential	133,147	-	663,902	797,049	395,558	1,192,607
Commercial and industrial	18,859	-	1,271,937	1,290,796	-	1,290,796
Consumer	-	-	1,122	1,122	-	1,122
Other loans	-	-	-	-	-	-
	\$314,033	\$56,664	\$2,109,942	\$2,480,639	\$508,310	\$2,988,949

Credit Quality Indicators:

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. Loans classified as substandard or special mention are reviewed quarterly by the Company for further impairment or improvement to determine if appropriately classified. All other loans greater than \$500,000, commercial lines greater than \$250,000 and personal lines of credit greater than \$100,000, and unsecured loans greater than \$100,000 are specifically reviewed at least annually to determine the appropriate loan grading. In addition, during the renewal process of any loan, as well as when a loan becomes past due, the Company will evaluate the loan grade.

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6. ALLOWANCE FOR LOAN LOSSES, CONTINUED

Loans excluded from the scope of the annual review process above are generally classified as pass credits until: (a) they become past due; (b) management becomes aware of deterioration in the credit worthiness of the borrower; or (c) the customer contacts the Company for a modification. In these circumstances, the loan is specifically evaluated for potential classification as to special mention, substandard or even charged off. The Company uses the following definitions for risk ratings:

Special Mention. Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

Substandard. Loans classified as substandard are inadequately protected by the current net worth and payment capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful. Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

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

	Total	Pass Credits	Special Mention	Substandard	Doubtful
<u>September 30, 2015</u>					
Construction and development	\$6,484,974	\$6,484,974	\$-	\$ -	\$ -
1-4 family residential	41,938,912	41,525,418	413,494	-	-
Nonfarm, nonresidential	83,725,388	82,729,531	995,857	-	-
Commercial and industrial	52,651,131	52,090,158	560,973	-	-
Consumer	4,373,523	4,367,593	4,982	948	-
Other loans	9,385,131	9,385,131	-	-	-
	\$198,559,059	\$196,582,805	\$1,975,306	\$ 948	\$ -
Percentage of total loans	100.0	% 99.0	% 1.0	% -	% -

Guaranteed portion of loans

Construction and development	\$14,649	\$14,649	\$-	\$ -	\$ -
1-4 family residential	587,856	587,856	-	-	-
Nonfarm, nonresidential	36,717,790	36,164,290	553,500	-	-
Commercial and industrial	11,640,206	11,521,859	118,347	-	-
Consumer	-	-	-	-	-
Other loans	752,397	752,397	-	-	-
	\$49,712,898	\$49,041,051	\$671,847	\$ -	\$ -

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	Total	Pass Credits	Special Mention	Substandard	Doubtful
<u>December 31, 2014</u>					
Construction and development	\$ 10,061,249	\$ 10,061,249	\$ -	\$ -	\$ -
1-4 family residential	41,824,806	41,009,963	641,862	172,981	-
Nonfarm, nonresidential	74,275,793	72,657,724	1,618,069	-	-
Commercial and industrial	56,602,425	55,274,007	1,328,418	-	-
Consumer	4,997,023	4,996,479	544	-	-
Other loans	5,271,062	5,254,896	16,166	-	-
	\$ 193,032,358	\$ 189,254,318	\$ 3,605,059	\$ 172,981	\$ -
	100.0	% 98.0	% 1.9	% 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
<u>Guaranteed portion of loans</u>					
Construction and development	\$15,604	\$15,604	\$-	\$ -	\$ -
1-4 family residential	584,842	306,212	278,630	-	-
Nonfarm, nonresidential	29,914,244	29,082,499	831,745	-	-
Commercial and industrial	13,858,258	12,877,497	980,761	-	-
Consumer	-	-	-	-	-
Other loans	768,869	760,786	8,083	-	-
	\$45,141,817	\$43,042,598	\$2,099,219	\$ -	\$ -

NOTE 7. TROUBLED DEBT RESTRUCTURINGS

For the nine and three months ended September 30, 2015 and 2014, the following table presents loans modified during the period that were considered to be troubled debt restructurings.

	For the three months ended September 30,		For the nine months ended September 30,			
	Pre- Modification of Outstanding Contracts Investment	Post- Modification Outstanding Recorded Investment	Pre- Modification of Outstanding Contracts Investment	Post- Modification Outstanding Recorded Investment		
<u>2015</u>						
1-4 Family residential	1	\$ 82,787	\$ 85,278	1	\$ 82,787	\$ 85,278
<u>2014</u>						
1-4 Family residential	1	167,797	167,797	4	327,724	327,724

During the nine and three months ended September 30, 2015 and 2014, 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.

NOTE 8. NORTH CAROLINA TAX RATE CHANGE

On July 23, 2013, North Carolina Governor Pat McCrory signed a major tax reform bill into law that lowered the North Carolina corporate income tax rate among other things. Specifically, the corporate income tax rate was reduced from 6.9% to 6% in 2014 and to 5% in 2015. The rate will be further reduced to 4% during the 2016 tax year and to 3% for post-2016 tax years provided that specified revenue growth targets are reached.

On July 28, 2015, McCrory announced the final revenue figures for the fiscal year ended on June 30, 2015 revealed that North Carolina had a \$445 million revenue surplus. Thus, the state met the necessary revenue target for fiscal year 2014-2015 to lower the corporate income tax rate from 5 percent to 4 percent effective for tax years beginning on or after January 1, 2016. As of September 30, the Company estimates the rate reduction trigger will result in a \$22,680 reduction in deferred income taxes. The Company has recorded the impact of this legislation as a reduction in deferred income taxes as of September 30, 2015.

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 9. FAIR VALUE

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

Fair Value Hierarchy

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

Level 1 Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2 Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

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

Investment Securities Available for Sale

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

Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with the Receivables Topic of the FASB ASC. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows.

Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At September 30, 2015, substantially all of the total impaired loans were evaluated based on the fair value of the collateral and discounted cash flows. In accordance with the Fair Value and Measurement Topic of the FASB ASC, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3.

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 9. 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)

		Level	Level	Level
September 30, 2015	Total	1	2	3
Government-sponsored enterprises	\$4,504	\$-	\$4,504	\$-
Mortgage-backed securities	22	-	22	-
Corporate bonds	294	-	-	294
Equities and mutual funds	523	523	-	-
Total assets at fair value	\$5,343	\$523	\$4,526	\$294

(in thousands)

		Level	Level	Level
December 31, 2014	Total	1	2	3
Government-sponsored enterprises	\$3,497	\$-	\$3,497	\$-
Mortgage-backed securities	26	-	26	-
Corporate bonds	255	-	-	255
Equities and mutual funds	586	586	-	-
Total assets at fair value	\$4,364	\$586	\$3,523	\$255

For the nine months ended September 30, 2015 and 2014, the changes in Level 3 assets and liabilities measured at fair value on a recurring basis were as follows:

Level 3	
2015	2014

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(in thousands)	Fair Value	Fair Value
Corporate Bonds – Available for Sale		
Balance, January 1	\$255	\$451
Total unrealized gain (loss) included in income	-	-
Total unrealized gain (loss) included in other comprehensive income	39	51
Bonds called	-	(250)
Balance, September 30	\$294	\$252

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 9. FAIR VALUE, CONTINUED

The change in the fair value of corporate bond assets for the nine and three month periods ended September 30, 2015 was \$39,000 and \$9,000, respectively. The change in the fair value of corporate bond assets for the nine and three month periods ended September 30, 2014 was \$6,000, except for the call of a \$250,000 corporate bond with a recorded fair valued of \$205,000.

Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis

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

(in thousands)

September 30, 2015	Total	Level	Level	Level
		1	2	3
Impaired loans:				
1-4 family residential	\$15	\$ -	\$ -	\$15
Foreclosed assets	421	-	-	421
Servicing assets	344	-	-	344
Total assets at fair value	\$780	\$ -	\$ -	\$780

(in thousands)

December 31, 2014

December 31, 2014	Total	Level	Level	Level
		1	2	3
Impaired loans:				
Commercial and industrial	\$392	\$ -	\$ -	\$392
Nonfarm, non-residential	736	-	-	736
1-4 family residential	302	-	-	302
Foreclosed assets	281	-	-	281
Servicing assets	350	-	-	350
Total assets at fair value	\$2,061	\$ -	\$ -	\$2,061

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 9. FAIR VALUE, CONTINUED

Loans receivable: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying amounts. The fair values for other loans are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Loan fair value estimates include judgments regarding future expected loss experience and risk characteristics. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows.

Bank owned life insurance: The carrying amount reported in the balance sheet approximates the fair value as it represents the cash surrender value of the life insurance.

Deposit liabilities: The fair values disclosed for demand and savings deposits are, by definition, equal to the amount payable on demand at the reporting date. The fair values for certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated contractual maturities on such time deposits.

Federal funds purchased, securities sold under agreements to repurchase and short-term debt: The carrying amounts of federal funds purchased, securities sold under agreements to repurchase and short-term debt approximate their fair values.

Long-term debt: The fair value of long-term debt is estimated using a discounted cash flow calculation that applies interest rates currently available on similar instruments.

Other liabilities: For fixed-rate loan commitments, fair value considers the difference between current levels of interest rates and the committed rates. The carrying amounts of other liabilities approximate fair value.

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Company's financial instruments as of September 30, 2015 and December 31, 2014. This table excludes financial instruments for which the carrying amount approximates fair value.

			Fair Value Measurements		
			Quoted		
			Prices		
			in		
			Active	Significant	Significant
			Markets	Other	Unobservable
	Carrying	Fair	for	Observable	Inputs
	Amount	Value	Identical	Inputs	(Level 3)
			Assets	(Level 2)	
			or		
			Liabilities		
			(Level		
			1)		
(dollars in thousands)					
September 30, 2015					
Financial Instruments – Assets					
Loans, net	\$ 195,175	\$ 203,431	\$-	\$ -	\$ 203,431

Financial Instruments-Liabilities

Deposits	229,949	222,945	-	81,862	141,083
Long-Term Debt	4,250	4,406	-	-	4,406

December 31, 2014

Financial Instruments – Assets

Loans, net	\$189,549	\$195,254	-	-	\$ 195,254
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Financial Instruments-Liabilities

Deposits	206,667	202,750	-	61,925	140,825
Long-Term Debt	6,250	6,486	-	-	6,486

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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 nine months ended September 30, 2015 and 2014. 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, 2015, was \$752,354 or \$0.19 per diluted share outstanding, compared to a \$668,455 or \$0.17 per diluted share outstanding, for the same period in 2014. Earnings for the three months ended September 30, 2015, are approximately 12.6% higher than for the same period in 2014. The increase in earnings results from an increase in net interest income. Net interest income increased from \$2,381,095 in the third quarter of 2014 to \$2,513,442 in 2015. Most of this increase is due to loan growth. Average loans outstanding increased 3.8% from the third quarter of 2014 to the third quarter of 2015, or approximately \$7,125,000. The net interest margin decreased from 4.15% to 4.00% from 2014 to 2015 due to a change in the average asset mix. Higher yielding loans averaged 80.7% of total interest earning assets in the third quarter of 2014 but only averaged 78.2% in the third quarter of 2015. As a result overall asset yields dropped from 4.75% in 2014 to 4.44% in 2015. The cost of funds decreased from 0.66% in the third quarter of 2014 to 0.49% in the third quarter of 2015 but was not enough to offset the reduction in asset yields. The provision for loan loss reserves decreased from \$139,527 in the third quarter of 2014 to a provision of \$129,213 in 2015. The decrease in the provision is partially due to a decrease in specific reserves on impaired loans. Noninterest expenses increased from \$1,753,022 in the third quarter of 2014 to \$1,799,660 in 2015, a 2.7% increase.

Net income available for common stockholders for the nine months ended September 30, 2015, was \$2,129,767 or \$0.54 per diluted share outstanding, compared to a \$2,021,677 or \$0.52 per diluted share outstanding, for the same period in 2014. Earnings for the nine months ended September 30, 2015, are approximately 5.4% higher than for the same period in 2014. The increase in earnings results from an increase in net interest income and a decrease in the provision for loan loss reserves. Net interest income increased from \$7,002,205 in the first nine months of 2014 to \$7,373,519 in 2015. Most of this increase is due to loan growth. Average loans outstanding increased 4.3% from the first nine months of 2014 to the same period in 2015, or approximately \$7,850,000. The net interest margin increased from 4.07% to 4.09% from 2014 to 2015 due to lower deposit costs. Asset yields dropped from 4.67% in

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

2014 to 4.57% in 2015 but the reduction was offset by a reduction in the cost of funds. The cost of funds decreased from 0.66% in the first nine months of 2014 to 0.53% in 2015. The provision for loan losses decreased from \$132,952 in 2014 to \$85,717 in 2015. Gross loans increased approximately \$5,526,000 from December 31, 2014 to September 30, 2015. However, the percentage of loans carrying government guarantees increased from \$45,141,818, or 23.4% of gross loans at the end of 2014 to \$49,712,898, or 25.0% of gross loans at September 30, 2015. The decreased credit exposure resulted in lower reserves. Noninterest income decreased from \$1,942,585 in the first nine months of 2014 to \$1,917,613 in 2015. The decrease primarily results a reduction in gains from the sale of government guaranteed loans. The Company had no gains for the first nine months of 2015, down from the \$127,362 reported in 2014. Noninterest expenses increased 4.6% from \$5,418,154 in 2014, to \$5,669,710 in 2015. This increase was due increases in salaries and benefits and to expenses associated with foreclosed assets. Salaries and benefits increased 1.6% from 2,869,549 in 2014 to 2,914,354 in 2015. Increases in foreclosed assets expense, professional fees and other expense all rose as a result of cost required to take possession and dispose of foreclosed properties.

On September 30, 2015, Surrey Bancorp's assets totaled \$276,915,968 compared to \$253,201,323 on December 31, 2014. Net loans were \$195,175,423 compared to \$189,549,072 on December 31, 2014. This net increase was the result of a \$5,639,204 increase in loans and net deferred fees and a \$12,853 net increase in the loan loss reserve. Nonfarm, nonresidential loans represent most of the growth in the loan portfolio increasing \$9,449,595 or 12.7% since the end of 2014. There was a 35.5% decrease in construction loans while other real estate loans collectively grew 7.9%. Commercial loans decreased by 7.0%. Overall gross loans increased 2.9%

Total deposits on September 30, 2015, were \$229,949,498 compared to \$206,666,581 at the end of 2014. This increase is attributable to an increase in demand deposit accounts, interest-bearing demand deposits accounts and savings accounts which increased collectively from \$126,665,409 at December 31, 2014 to \$158,410,691 at September 30, 2015. Large individual deposits account for much of the increase. These deposits are expected to reduce over the coming months. Overall, noninterest-bearing and interest-bearing demand deposits increased 35.9% from 2014 totals, while savings deposits, including money market accounts, increased 4.4%. Certificates of deposit decreased 10.6% from December 31, 2014 totals, or \$8,462,365.

Common stockholders' equity increased by \$2,109,746, or 6.41%, during the nine months ended September 30, 2015. The net increase is comprised of net income of \$2,266,957, a reduction in other comprehensive income of \$20,021 and the declaration and accrual of preferred dividends of \$137,190. The net increase resulted in a common stock book value of \$9.86 per share, up from \$9.27 on December 31, 2014.

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

Preferred stockholders' equity remained the same during the period ended September 30, 2015.

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ITEM MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF
2. 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 \$5,343,021 consisted of Government-sponsored enterprise obligations with maturities ranging from 17 to 34 months, corporate bonds with maturities of 3.0 years, that reprice quarterly, GNMA adjustable rate mortgage securities, which adjust annually, and equity securities and mutual funds.

Loans

Net loans outstanding on September 30, 2015, were \$195,175,423 compared to \$189,549,072 on December 31, 2014. The Bank maintains a loan portfolio dominated by real estate and commercial loans diversified among various industries. Approximately 63.4% of the Bank's loans as of September 30, 2015, are fixed rate loans with 36.6% floating with the Bank's prime rate or other appropriate internal or external indices.

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2. OPERATIONS, CONTINUEDDeposits

Deposits on September 30, 2015, were \$229,949,498, compared to \$206,666,581 on December 31, 2014. The September total consists of a base of approximately 12,795 accounts compared to 12,690 accounts at December 31, 2014. Interest-bearing accounts represent 73.7% of September 30, 2015 period end deposits versus 74.4% at December 31, 2014.

Stockholders' Equity

Surrey Bancorp and Surrey Bank & Trust are subject to various regulatory capital requirements administered by federal banking agencies. The Company and the Bank maintain strong capital positions which exceed all capital adequacy requirements of federal regulatory authorities. Common Equity Tier I Capital "CET1" is a new regulatory ratio resulting from BASEL III. CET1 primarily consist of the Company's and the Bank's common shares, common share surplus, retained earnings and accumulated other comprehensive income. The Company's and the Bank's capital ratios are presented in the following table.

	Ratio	Minimum Required For Capital Adequacy Purposes	
September 30, 2015:			
Total Capital (to Risk-Weighted Assets)			
Surrey Bancorp (Consolidated)	21.61 %	8.0	%
Surrey Bank & Trust	21.50 %	8.0	%
Common Equity Tier I Capital (to Risk-Weighted Assets)			
Surrey Bancorp (Consolidated)	18.27 %	5.0	%
Surrey Bank & Trust	20.23 %		