SURREY BANCORP
Form 10-Q
May 13, 2010

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 March 31, 2010

¨ **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	**(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 x No ¨

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

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

Large accelerated filer	¨	Accelerated filer	¨
Non-accelerated filer	¨	Smaller reporting company	x

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

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

On May 7, 2010 there were 3,206,495 common shares issued and outstanding.

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Consolidated Balance Sheets

March 31, 2010 (Unaudited) and December 31, 2009 (Audited)

	March 2010	December 2009
Assets		
Cash and due from banks	$ 1,755,684	$ 1,923,621
Interest-bearing deposits with banks	24,656,449	19,067,374
Federal funds sold	512,947	412,947
Investment securities available for sale	2,000,962	2,011,925
Restricted equity securities	1,047,479	1,047,514
Loans, net of allowance for loan losses of $5,437,608 at March 31, 2010 and $4,669,905 at December 31, 2009	176,870,907	180,442,154
Property and equipment, net	4,842,782	4,881,770
Foreclosed assets	220,912	53,336
Accrued income	1,039,862	1,032,989
Goodwill	120,000	120,000
Bank owned life insurance	3,200,278	3,173,307
Other assets	2,866,852	2,782,845
Total assets	$ 219,135,114	$ 216,949,782
Liabilities and Stockholders Equity		
Liabilities		
Deposits:		
Noninterest-bearing	$ 27,501,373	$ 24,709,970
Interest-bearing	148,519,498	149,264,588
Total deposits	176,020,871	173,974,558
Short-term debt	2,631,300	3,750,000
Long-term debt	10,200,000	9,200,000
Dividends payable	42,737	44,603
Accrued interest payable	313,284	291,111
Other liabilities	1,289,665	1,264,158
Total liabilities	190,497,857	188,524,430
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
2,000 shares of Series B, issued and outstanding with no par value, fixed rate (5%) cumulative perpetual, with a liquidation value of $1,000 per share, net of accreted discount;	1,911,608	1,903,283
100 shares of Series C, issued and outstanding with no par value, fixed rate (9%) cumulative perpetual, with a liquidation value of $1,000 per share, net of amortized premium	102,504	103,222
Common stock, 10,000,000 shares authorized at no par value; 3,206,495 and 3,198,105 shares issued and outstanding at March 31, 2010 and December 31, 2009, respectively	9,448,137	9,406,429
Retained earnings	14,634,805	14,468,089
Accumulated other comprehensive loss	(80,122)	(75,996)
Total stockholders equity	28,637,257	28,425,352

Total liabilities and stockholders equity	$ 219,135,114	$ 216,949,782

See Notes to Consolidated Financial Statements

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Consolidated Statements of Income

Three months ended March 31, 2010 and 2009 (Unaudited)

	2010	2009
Interest income		
Loans and fees on loans	$ 2,765,188	$ 2,621,312
Federal funds sold	156	141
Investment securities, taxable	13,628	20,073
Deposits with banks	4,153	6,388
Total interest income	2,783,125	2,647,914
Interest expense		
Deposits	526,275	808,092
Federal funds purchased and securities sold under agreements to repurchase		387
Short-term debt	3,761	7,694
Long-term debt	99,076	108,068
Total interest expense	629,112	924,241
Net interest income	2,154,013	1,723,673
Provision for loan losses	949,357	754,716
Net interest income after provision for loan losses	1,204,656	968,957
Noninterest income		
Service charges on deposit accounts	262,175	286,717
Gain on sale of government guaranteed loans	212,059	
Fees and yield spread premiums on loans delivered to correspondents	26,683	29,717
Other service charges and fees	99,135	89,747
Other operating income	204,708	168,586
Life insurance proceeds		1,000,000
Total noninterest income	804,760	1,574,767
Noninterest expense		
Salaries and employee benefits	871,010	859,992
Occupancy expense	109,309	115,673
Equipment expense	64,036	64,753
Data processing	96,559	89,076
Foreclosed assets, net	4,192	17,929
FDIC insurance premiums	51,882	26,291
Other expense	459,752	455,567
Total noninterest expense	1,656,740	1,629,281
Net income before income taxes	352,676	914,443
Income tax expense (benefit)	122,900	(71,225)

Net income	229,776	985,668
Preferred stock dividends and accretion of discount	(63,060)	(61,633)
Net income available to common stockholders	$ 166,716	$ 924,035
Basic earnings per common share	$ 0.05	$ 0.29
Diluted earnings per common share	$ 0.05	$ 0.27
Basic weighted average common shares outstanding	3,206,029	3,179,773
Diluted weighted average common shares outstanding	3,604,712	3,574,921

See Notes to Consolidated Financial Statements

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Consolidated Statements of Cash Flows

Three months ended March 31, 2010 and 2009 (Unaudited)

	2010	2009
Cash flows from operating activities		
Net income	$ 229,776	$ 985,668
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	63,441	68,047
Loss on the sale of foreclosed assets	(237)	17,929
Stock-based compensation, net of tax benefit	7,258	7,508
Provision for loan losses	949,357	754,716
Deferred income taxes	(12,628)	(15,025)
Accretion of discount on securities, net of amortization of premiums	1,927	2,710
Increase in cash surrender value of life insurance	(26,971)	(26,615)
Changes in assets and liabilities:		
Accrued income	(6,873)	183,558
Other assets	(68,791)	34,217
Accrued interest payable	22,173	(82,801)
Other liabilities	25,507	(36,895)
Net cash provided by operating activities	1,183,939	1,893,017
Cash flows from investing activities		
Net (increase) decrease in interest-bearing deposits with banks	(5,589,075)	4,116,471
Net (increase) decrease in federal funds sold	(100,000)	(100,000)
Purchases of investment securities	(1,500,000)	(999,780)
Sales and maturities of investment securities	1,502,322	502,575
Redemption of restricted equity securities	35	168,900
Purchases of restricted equity securities		(112,550)
Net (increase) decrease in loans	2,439,864	(2,156,992)
Proceeds from the sale of foreclosed assets	14,687	84,812
Purchases of property and equipment	(24,453)	(36,060)
Net cash (used in) provided by investing activities	(3,256,620)	1,467,376
Cash flows from financing activities		
Net increase in deposits	2,046,313	1,732,576
Net (decrease) in federal funds purchased and securities sold under agreements to repurchase		(1,856,032)
Net (decrease) increase in short-term debt	(1,118,700)	1,010,000
Net increase (decrease) in long-term debt	1,000,000	(750,000)
Dividends paid	(57,319)	(40,866)
Common stock options exercised	34,450	82,322
Proceeds from the issuance of preferred stock, net		1,975,015
Tax benefit related to exercise of non-incentive stock options		19,903
Net cash provided by financing activities	1,904,744	2,172,898
Net increase (decrease) in cash and cash equivalents	(167,937)	5,533,291
Cash and cash equivalents, beginning	1,923,621	1,293,770
Cash and cash equivalents, ending	$ 1,755,684	$ 6,827,061

Supplemental disclosures of cash flow information		
Interest paid	$ 606,939	$ 1,007,042
Taxes paid	$ 69,577	$
Loans transferred to foreclosed properties	$ 182,026	$ 79,345

See Notes to Consolidated Financial Statements

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Consolidated Statements of Changes in Stockholders Equity and Comprehensive Income

Three months ended March 31, 2010 and 2009 (Unaudited)

	Convertible Preferred Stock Series A		Preferred Stock Series B		Preferred Stock Series C		Common Stock		Retained Earnings	Unrealized Appreciation (Depreciation) on Securities	Total
	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount			
Balance, January 1, 2009	189,356	$ 2,620,325		$		$	3,167,568	$ 9,270,253	$ 12,493,763	$ (1,338)	$ 24,383,003
Comprehensive income											
Net income									985,668		985,668
Net change in unrealized gain on investment securities available for sale, net of income tax of $6,704										(9,742)	(9,742)
Total comprehensive income											975,926
Common stock options exercised							29,013	82,322			82,322
Tax benefit related to exercise of non-qualified stock options								19,903			19,903
Stock-based compensation, net of tax benefit								7,508			7,508
Issue Series B preferred stock to the U.S. Treasury, net of issuance costs			2,000	1,975,015							1,975,015
Issue Series C preferred stock to the U.S. Treasury				(106,000)	100	106,000					
Dividends declared on convertible Series A preferred stock ($.47 per share)									(29,415)		(29,415)

Dividends declared and accrued on Series B and Series C preferred stock, net of discount accretion and (premium) amortization				7,938		(548)			(32,217)		(24,827)
Balance, March 31, 2009	189,356	$ 2,620,325	2,000	$ 1,876,953	100	$ 105,452	3,196,581	$ 9,379,986	$ 13,417,799	$ (11,080)	$ 27,389,435
Balance, January 1, 2010	189,356	$ 2,620,325	2,000	$ 1,903,283	100	$ 103,222	3,198,105	$ 9,406,429	$ 14,468,089	$ (75,996)	$ 28,425,352
Comprehensive income											
Net income									229,776		229,776
Net change in unrealized gain on investment securities available for sale, net of income tax of $2,588										(4,126)	(4,126)
Total comprehensive income											225,650
Common stock options exercised							8,390	34,450			34,450
Stock-based compensation, net of tax benefit								7,258			7,258
Dividends declared on convertible Series A preferred stock ($.16 per share)									(29,415)		(29,415)
Dividends declared and accrued on Series B and Series C preferred stock, net of discount accretion and (premium) amortization				8,325		(718)			(33,645)		(26,038)
Balance, March 31, 2010	189,356	$ 2,620,325	2,000	$ 1,911,608	100	$ 102,504	3,206,495	$ 9,448,137	$ 14,634,805	$ (80,122)	$ 28,637,257

See Notes to Consolidated Financial Statements

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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, (the Company), as of March 31, 2010, the results of operations for the three months ended March 31, 2010 and 2009, and its changes in stockholders equity and comprehensive income and cash flows for the three months ended March 31, 2010 and 2009. All adjustments are of a normal and recurring nature. The results of operations for the three months ended March 31, 2010, 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, 2009, included in the Company s Form 10-K. The balance sheet at December 31, 2009, 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 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, 2009 contain a summary of the significant accounting policies. The Company believes our policies with respect to the methodology for the determination of the allowance for loan losses, and asset impairment judgments, including the recoverability of intangible assets involve a higher degree of complexity and require management to make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could cause reported results to differ materially. These critical policies and their application are periodically reviewed with the Audit Committee and our Board of Directors. See our Annual Report for full details on critical accounting policies.

Principles of Consolidation

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

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

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. 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 March 31, 2010 and December 31, 2009, the Bank had no investments classified as held to maturity.

Loans Held for Sale

The Bank originates and holds Small Business Administration (SBA) and United States Department of Agriculture (USDA) guaranteed loans in its portfolio in the normal course of business. Occasionally, the Bank sells the guaranteed portions of these loans into the secondary market. The loans are generally variable rate loans, which eliminates the market risk to the Bank and are therefore carried at cost. The Bank recognizes gains on the sale of the guaranteed portion upon the consummation of the transaction. The Bank plans to continue to originate guaranteed loans for sales, however no such loans were funded at March 31, 2010 and December 31, 2009.

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.

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Loans Receivable, continued

Activity in the allowance for loan losses for the three months ended March 31, 2010 and 2009 follows:

	March 31, 2010	March 31, 2009
Balance at beginning of year	$ 4,669,905	$ 3,365,370
Add provision charged to expense	949,357	754,716
Less net charge-offs	(181,654)	(114,879)
	$ 5,437,608	$ 4,005,207

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

The following is a summary of recent authoritative pronouncements:

In January 2010, fair value guidance was amended to require disclosures for significant amounts transferred in and out of Levels 1 and 2 and the reasons for such transfers and to require that gross amounts of purchases, sales, issuances and settlements be provided in the Level 3 reconciliation. The new disclosures are effective for the Company for the current quarter and have been reflected in the Fair Value footnote.

Guidance related to subsequent events was amended in February 2010 to remove the requirement for an SEC filer to disclose the date through which subsequent events were evaluated. The amendments were effective upon issuance and had no significant impact on the Company s 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

The Company has evaluated events and transactions subsequent to the date of these financial statements for potential recognition or disclosure. On April 28, 2010, the shareholders of the Company approved increasing the number of common shares authorized from 5,000,000 to 10,000,000, which has been reflected on the balance sheet.

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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 carrying amounts of securities available for sale and their approximate fair values at March 31, 2010 and December 31, 2009 follow:

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
March 31, 2010				
Government-sponsored enterprises	$ 1,500,000	$	$ 3,190	$ 1,496,810
Mortgage-backed securities	81,348	2,054		83,402
Corporate bonds	550,000		129,250	420,750
	$ 2,131,348	$ 2,054	$ 132,440	$ 2,000,962
December 31, 2009				
Government-sponsored enterprises	$ 1,501,913	$ 3,687	$ 145	$ 1,505,455
Mortgage-backed securities	83,684	2,036		85,720
Corporate bonds	550,000		129,250	420,750
	$ 2,135,597	$ 5,723	$ 129,395	$ 2,011,925

Maturities of mortgage-backed bonds are stated based on contractual maturities. Actual maturities of these bonds may vary as the underlying mortgages are prepaid. The scheduled maturities of securities (all available for sale) at March 31, 2010, were as follows:

	Amortized Cost	Fair Value
Due in one year or less	$	$
Due after one year through five years	1,500,000	1,496,810
Due after five years through ten years	601,014	472,877
Due after ten years	30,334	31,275
	$ 2,131,348	$ 2,000,962

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 March 31, 2010 and December 31, 2009. These unrealized losses on investment securities are a result of volatility in interest rates and primarily relate to government-sponsored enterprises and corporate bonds issued by other banks at March 31, 2010 and December 31, 2009.

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

March 31, 2010						
Government-sponsored enterprises	$ 1,496,810	$ 3,190	$	$	$ 1,496,810	$ 3,190
Corporate bonds			420,750	129,250	420,750	129,250
	$ 1,496,810	$ 3,190	$ 420,750	$ 129,250	$ 1,917,560	$ 132,440
December 31, 2009						
Government-sponsored enterprises	$ 499,855	$ 145	$	$	$ 499,855	$ 145
Corporate bonds			420,750	129,250	420,750	129,250
	$ 499,855	$ 145	$ 420,750	$ 129,250	$ 920,605	$ 129,395

Management considers the nature of the investment, the underlying causes of the decline in market value, the severity and duration of the decline in market value and other evidence, on a security by security basis, in determining if the decline in market value is other than temporary. Management believes all unrealized losses presented in the table above to be temporary in nature.

The Company had no gross realized gains or losses for the three month periods ended March 31, 2010 and 2009.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. EARNINGS PER SHARE

Basic earnings per share for the three months ended March 31, 2010 and 2009 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 each share of which is convertible into 2.0868 shares of common stock.

NOTE 4. COMMITMENTS AND LETTERS OF CREDIT

At March 31, 2010, the Company had commitments to extend credit, including unused lines of credit of approximately $34,834,000. Letters of credit totaling $1,662,512 were outstanding.

NOTE 5. 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 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.

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5. FAIR VALUE, CONTINUED

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 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 March 31, 2010, substantially all of the total impaired loans were evaluated based on the fair value of the collateral. In accordance with the Fair Value and Measurement Topic of the FASB ASC, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3.

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.

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5. FAIR VALUE, CONTINUED

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)	Total	Level 1	Level 2	Level 3
March 31, 2010				
Government-sponsored enterprises	$ 1,497	$	$ 1,497	$
Mortgage-backed securities	83		83	
Corporate bonds	421		421	
Total assets at fair value	$ 2,001	$	$ 2,001	$
Total liabilities at fair value	$	$	$	$

(in thousands)	Total	Level 1	Level 2	Level 3
December 31, 2009				
Government-sponsored enterprises	$ 1,505	$	$ 1,505	$
Mortgage-backed securities	86		86	
Corporate bonds	421		421	
Total assets at fair value	$ 2,012	$	$ 2,012	$
Total liabilities at fair value	$	$	$	$

The Company had no Level 3 assets or liabilities measured at fair value on a recurring basis at March 31, 2010 or December 31, 2009.

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)	Total	Level 1	Level 2	Level 3
March 31, 2010				

Loans-commercial and industrial	$ 3,266	$	$ 3,266	$
Loans-nonfarm, non-residential	285		285	
Loans-other	218		218	
Foreclosed assets	221		221	
Total assets at fair value	$ 3,990	$	$ 3,990	$
Total liabilities at fair value	$	$	$	$

(in thousands)	**Total**	**Level 1**	**Level 2**	**Level 3**
December 31, 2009				
Loans-commercial and industrial	$ 2,790	$	$ 2,790	$
Loans-nonfarm, non-residential	652		652	
Loans-other	393		393	
Foreclosed assets	53		53	
Total assets at fair value	$ 3,888	$	$ 3,888	$
Total liabilities at fair value	$	$	$	$

The Company had no Level 3 assets or liabilities measured at fair value on a non-recurring basis at March 31, 2010 or December 31, 2009.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 5. FAIR VALUE, CONTINUED

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.

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. The carrying amount of accrued interest receivable approximates its fair value.

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. The carrying amount of accrued interest payable approximates fair value.

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 approximates fair value.

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NOTE 5. FAIR VALUE, CONTINUED

Financial Instruments, continued

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

	March 31, 2010		December 31, 2009	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets				
Cash and due from banks	$ 1,756	$ 1,756	$ 1,924	$ 1,924
Federal funds sold and interest-bearing deposits with banks	25,169	25,169	19,480	19,480
Securities, available for sale	2,001	2,001	2,012	2,012
Restricted equity securities	1,047	1,047	1,048	1,048
Loans, net of allowance for loan losses	176,871	172,178	180,442	180,354
Bank owned life insurance	3,200	3,200	3,173	3,173
Financial Liabilities				
Deposits	176,021	166,364	173,975	163,638
Long-term and short-term debt	12,831	12,831	12,950	12,953
Commitments and contingencies				

NOTE 6. 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 three months ended March 31, 2010 and 2009 is as follows:

	Bank	Freedom Finance, LLC	Intersegment Elimination	Consolidated Totals
March 31, 2010				
Net interest income	$ 2,099,942	$ 54,071	$	$ 2,154,013
Other income	804,656	104		804,760
Depreciation and amortization	63,210	231		63,441
Provision for loan losses	950,876	(1,519)		949,357
Net income	228,249	1,527		229,776
Assets	219,495,688	1,268,828	(1,629,402)	219,135,114
March 31, 2009				
Net interest income	$ 1,635,973	$ 88,861	$	$ 1,724,834
Other income	573,389	1,000,217		