

SURREY BANCORP
Form 10QSB
August 11, 2005
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

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

For the quarterly period ended June 30, 2005

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

For the transition period from _____ to _____

COMMISSION FILE NUMBER 0000-50313

SURREY BANCORP

(Exact name of small business issuer as specified in its charter)

North Carolina
(State or other jurisdiction of

59-3772016
(IRS Employer

Edgar Filing: SURREY BANCORP - Form 10QSB

incorporation or organization)

Identification No.)

145 North Renfro Street, Mount Airy NC 27030

(Address of principal executive offices)

(336) 783-3900

(Issuer's telephone number)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Check whether the issuer (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

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

On August 9, 2005, there were 1,225,326 common shares issued and outstanding

Transitional Small Business Disclosure Format (Check one): Yes No

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements	
<u>Consolidated Balance Sheets June 30, 2005 (Unaudited) and December 31, 2004</u>	3
<u>Consolidated Statements of Income, Six Months Ended June 30, 2005 and 2004 (Unaudited)</u>	4
<u>Consolidated Statements of Income, Three Months Ended June 30, 2005 and 2004 (Unaudited)</u>	5
<u>Consolidated Statements of Cash Flows, Six Months Ended June 30, 2005 and 2004 (Unaudited)</u>	6
<u>Consolidated Statements of Changes in Shareholders' Equity, Six Months Ended June 30, 2005 and 2004 (Unaudited)</u>	7
<u>Notes to Consolidated Financial Statements</u>	8-12
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	13-17
Item 3. <u>Controls and Procedures</u>	18

PART II OTHER INFORMATION

Item 6. <u>Exhibits and Reports on Form 8-K</u>	19
Exhibits	
10.1 Executive Salary Continuation Agreement for Edward C. Ashby, III	20-29
10.2 Executive Salary Continuation Agreement for Brenda J. Harding	30-39
10.3 Executive Salary Continuation Agreement for Pedro A. Pequeno, II	40-49
10.4 Executive Salary Continuation Agreement for Mark H. Towe	50-59

<u>SIGNATURES</u>	19
CERTIFICATIONS	60-63

Table of Contents

Consolidated Balance Sheets June 30, 2005 and December 31, 2004	Unaudited	Audited
	June	December
	2005	2004
Assets		
Cash and due from banks	\$ 2,238,501	\$ 1,810,543
Interest-bearing deposits with banks	13,532,170	12,759,356
Federal funds sold	502,000	301,000
Investment securities available for sale	3,164,131	2,692,151
Restricted equity securities	1,007,130	790,660
Loans, net of allowance of loan losses of \$2,290,043 in 2005 and \$2,294,131 in 2004	143,164,449	133,046,165
Property and equipment, net	4,458,971	4,232,424
Accrued income	761,358	583,365
Goodwill	120,000	120,000
Bank owned life insurance	2,686,596	
Other assets	1,492,682	957,276
	<u>\$ 173,127,988</u>	<u>\$ 157,292,940</u>
Liabilities and Shareholders Equity		
<i>Liabilities:</i>		
Deposits:		
Noninterest-bearing	\$ 23,772,347	\$ 18,201,595
Interest-bearing	117,293,120	108,752,371
	<u>141,065,467</u>	<u>126,953,966</u>
Total deposits		
Federal funds purchased and securities sold under agreements to repurchase	376,281	3,447,823
Long-term debt	14,496,738	11,298,952
Dividends payable on preferred stock	29,742	29,987
Accrued interest payable	274,172	161,103
Other liabilities	893,683	355,688
	<u>157,136,083</u>	<u>142,247,519</u>
Commitments and contingencies		
<i>Shareholders equity:</i>		
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 liquidation value of \$14 per share in 2005 and 2004	2,620,325	2,620,325
Common stock, 5,000,000 shares authorized at no par value 1,225,326 shares issued in 2005 and 1,211,008 shares issued in 2004.	8,184,871	8,100,261
Retained earnings	5,200,576	4,337,224
Accumulated other comprehensive income (loss)	(13,867)	(12,389)
	<u>15,991,905</u>	<u>15,045,421</u>
	<u>\$ 173,127,988</u>	<u>\$ 157,292,940</u>

See Notes to Consolidated Financial Statements.

Table of Contents

Consolidated Statements of Income

Unaudited

Six months ended June 30, 2005 and 2004

	<u>Six months ended June 30,</u>	
	<u>2005</u>	<u>2004</u>
Interest income:		
Loans and fees on loans	\$ 4,724,728	\$ 3,971,650
Federal funds sold	5,721	
Investment securities, taxable	60,056	41,533
Investment securities, non taxable		456
Deposits with banks	112,942	29,263
	<u>4,903,447</u>	<u>4,042,902</u>
Interest expense:		
Deposits	1,388,620	975,248
Federal funds purchased	1,108	1,697
Securities sold under agreements to repurchase	6,304	1,295
Short-term borrowings		5,291
Long-term borrowings	227,463	112,931
	<u>1,623,495</u>	<u>1,096,462</u>
Net interest income	3,279,952	2,946,440
Provision for loan losses	172,681	126,643
Net interest income after provision for loan losses	<u>3,107,271</u>	<u>2,819,797</u>
Noninterest income:		
Service charges on deposit accounts	459,631	458,060
Gain and fees from sale of mortgage servicing rights		501,610
Other service charges and fees	170,826	221,139
Other operating income	265,321	217,856
	<u>895,778</u>	<u>1,398,665</u>
Noninterest expense:		
Salaries and employee benefits	1,228,786	1,288,198
Occupancy expense	171,956	170,080
Equipment expense	182,692	232,437
Data processing	175,396	179,634
Other expense	759,713	630,531
	<u>2,518,543</u>	<u>2,500,880</u>
Net income before income taxes	1,484,506	1,717,582
Income tax expense	561,996	664,200
Net income	<u>922,510</u>	<u>1,053,382</u>

Edgar Filing: SURREY BANCORP - Form 10QSB

<i>Preferred stock dividend declared</i>	(59,158)	(59,305)
Net income available for common shareholders	\$ 863,352	\$ 994,077
<i>Basic earnings per share</i>	\$ 0.71	\$ 0.84
<i>Diluted earnings per share</i>	\$ 0.62	\$ 0.73
<i>Basic weighted average shares outstanding</i>	1,215,718	1,188,709
<i>Diluted weighted average shares outstanding</i>	1,477,764	1,450,297

See Notes to Consolidated Financial Statements.

Table of Contents

Consolidated Statements of Income

Unaudited

Three months ended June 30, 2005 and 2004

	Three months ended June 30,	
	2005	2004
Interest income:		
Loans and fees on loans	\$ 2,470,411	\$ 2,010,717
Federal funds sold	3,542	
Investment securities, taxable	33,669	18,929
Investment securities, non taxable		
Deposits with banks	52,825	25,286
	<u>2,560,447</u>	<u>2,054,932</u>
Interest expense:		
Deposits	738,358	515,525
Federal funds purchased	444	
Securities sold under agreements to repurchase	4,194	533
Short-term borrowings		1,256
Long-term borrowings	118,117	62,530
	<u>861,113</u>	<u>579,844</u>
Net interest income	1,699,334	1,475,088
Provision for loan losses	52,675	41,484
Net interest income after provision for loan losses	<u>1,646,659</u>	<u>1,433,604</u>
Noninterest income:		
Service charges on deposit accounts	235,104	241,715
Gain and fees from the sale of mortgage servicing rights		501,610
Other service charges and fees	86,834	91,996
Other operating income	111,431	70,582
	<u>433,369</u>	<u>905,903</u>
Noninterest expense:		
Salaries and employee benefits	592,337	651,319
Occupancy expense	86,193	89,916
Equipment expense	92,731	118,920
Data processing	87,763	88,199
Other expense	380,531	344,156
	<u>1,239,555</u>	<u>1,292,510</u>
Net income before income taxes	840,473	1,046,997
Income tax expense	313,972	405,900
Net income	<u>526,501</u>	<u>641,097</u>

Edgar Filing: SURREY BANCORP - Form 10QSB

<i>Preferred stock dividend declared</i>	(29,742)	(29,653)
Net income available for common shareholders	\$ 496,759	\$ 611,444
<i>Basic earnings per share</i>	\$ 0.41	\$ 0.51
<i>Diluted earnings per share</i>	\$ 0.36	\$ 0.44
<i>Basic weighted average shares outstanding</i>	1,220,251	1,196,407
<i>Diluted weighted average shares outstanding</i>	1,472,039	1,460,659

See Notes to Consolidated Financial Statements.

Table of Contents

Consolidated Statements of Cash Flows

Unaudited

Six months ended June 30, 2005 and 2004

	<u>Six months ended June 30,</u>	
	<u>2005</u>	<u>2004</u>
<i>Cash flows from operating activities:</i>		
Net income	\$ 922,510	\$ 1,053,382
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	168,629	195,094
Loss on the sale/abandonment of fixed assets	3,813	
Provision for loan losses	172,681	126,643
Deferred income taxes	(10,304)	
Accretion of discount on securities, net of amortization of premiums	(18,201)	(6,156)
Increase in cash surrender value of life insurance	(36,596)	
Changes in assets and liabilities:		
Accrued income	(177,993)	33,561
Other assets	(524,174)	(456,151)
Accrued interest payable	113,069	16,386
Other liabilities	537,995	441,376
Net cash provided by operating activities	<u>1,151,429</u>	<u>1,404,135</u>
<i>Cash flows from investing activities:</i>		
Net increase in interest-bearing deposits with banks	(772,814)	(15,244,291)
Net increase in federal funds sold	(201,000)	
Purchase of investment securities	(3,481,285)	(2,495,797)
Sales and maturities of investment securities	3,025,100	4,925,945
(Purchase) redemption of restricted equity securities	(216,470)	32,500
Net increase in loans	(10,290,965)	(6,361,857)
Purchases of property and equipment	(398,989)	(90,843)
Purchase of bank owned life insurance	(2,650,000)	
Net cash used in investing activities	<u>(14,986,423)</u>	<u>(19,234,343)</u>
<i>Cash flows from financing activities:</i>		
Net increase in deposits	14,111,501	18,570,698
Net decrease in fed funds purchased and securities sold under agreements to repurchase	(3,071,542)	(2,841,811)
Net decrease in short-term debt		(1,400,000)
Net increase in long-term debt	3,197,786	3,105,912
Dividends paid on preferred stock	(59,403)	(59,722)
Common stock options exercised	84,610	152,178
Net cash provided by financing activities	<u>14,262,952</u>	<u>17,527,255</u>
Net increase (decrease) in cash and cash equivalents	427,958	(302,953)
<i>Cash and cash equivalents, beginning</i>	<u>1,810,543</u>	<u>1,956,473</u>
<i>Cash and cash equivalents, ending</i>	<u>\$ 2,238,501</u>	<u>\$ 1,653,520</u>
<i>Supplemental disclosure of cash flow information:</i>		
Interest paid	\$ 1,510,426	\$ 1,080,076

Taxes paid	\$ 584,574	\$ 490,292
------------	------------	------------

See Notes to Consolidated Financial Statements.

Table of Contents

Consolidated Statements of Changes in Shareholders' Equity

Unaudited

Six months ended June 30, 2005 and 2004

	Convertible				Retained Earnings	Unrealized Appreciation (Depreciation) on Securities	Total
	Preferred Stock		Common Stock				
	Shares	Amount	Shares	Amount			
Balance January 1, 2004	189,356	\$ 2,620,325	1,170,189	\$ 7,822,387	\$ 2,627,529	\$ 3,225	\$ 13,073,466
Comprehensive income							
Net income					1,053,382		1,053,382
Change in unrealized appreciation on investment securities available for sale, net of income taxes of \$12,127						(19,330)	(19,330)
Total comprehensive income							1,034,052
Common stock issued							
Common stock options exercised			26,218	152,178			152,178
Dividends declared on convertible preferred stock					(59,305)		(59,305)
Balance, June 30, 2004	189,356	\$ 2,620,325	1,196,407	\$ 7,974,565	\$ 3,621,606	\$ (16,105)	\$ 14,200,391
Balance January 1, 2005	189,356	2,620,325	1,211,008	\$ 8,100,261	\$ 4,337,224	\$ (12,389)	\$ 15,045,421
Comprehensive income							
Net income					922,510		922,510
Change in unrealized depreciation on investment securities available for sale, net of income tax benefits of \$927						(1,478)	(1,478)
Total comprehensive income							921,032
Common stock issued							
Common stock options exercised			14,318	84,610			84,610
Dividends declared on convertible preferred stock					(59,158)		(59,158)
Balance, June 30, 2005	189,356	\$ 2,620,325	1,225,326	\$ 8,184,871	\$ 5,200,576	\$ (13,867)	\$ 15,991,905

See Notes to Consolidated Financial Statements.

Table of Contents

SURREY BANCORP

NOTES TO FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION

The accompanying unaudited financial statements were prepared in accordance with instructions for Form 10-QSB 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 financial statements contain all adjustments necessary to present fairly the financial condition of Surrey Bancorp as of June 30, 2005 and December 31, 2004, the results of operations for the six and three months ended June 30, 2005 and 2004, and its changes in stockholders' equity and cash flows for the six months ended June 30, 2005 and 2004. All adjustments are of a normal and recurring nature. The results of operations for the six months ended June 30, 2005 are not necessarily indicative of the results expected for the full year. These financial statements should be read in conjunction with the Company's audited financial statements and related disclosures for the year ended December 31, 2004 included in the Company's Form 10-KSB.

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. Shareholders of the bank received six shares of Surrey Bancorp common stock for every five shares of Surrey Bank & Trust common stock owned.

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

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

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

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

Table of Contents

CRITICAL ACCOUNTING POLICIES

The notes to our audited consolidated financial statements for the year ended December 31, 2004 contain a summary of our significant accounting policies. We believe our policies with respect to the methodology for our 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 with often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumption 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.

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 due from banks includes cash and amounts due from depository institutions (including cash items in process of collection). Overnight interest bearing deposits, and federal funds sold are shown separately. Cash flows from demand deposits, NOW accounts and savings accounts are reported net since their original maturities are less than three months. Loans and time deposits are reported net per FASB Statement No. 104. Federal Funds purchased are shown separately.

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.

Edgar Filing: SURREY BANCORP - Form 10QSB

Investment securities classified as held to maturity are those debt securities that the Bank has the ability and intent to hold to maturity. Accordingly, these securities are carried at cost adjusted for amortization of premiums and accretion of discount, computed by the interest-method over their contractual lives. At June 30, 2005 and December 31, 2004, the Bank had no investments classified as held to maturity.

Table of Contents

Loans Held for Sale

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated market value in the aggregate. Net unrealized losses are recognized through a valuation allowance by charges to income. At June 30, 2005 and December 31, 2004, the Bank had no loans classified as available for sale.

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.

Activity in the allowance for loan losses for the six months ended June 30, 2005 and 2004 follows:

	June 30,	
	2005	2004
Balance at beginning of year	\$ 2,294,131	\$ 2,109,820
Add provision charged to expense	172,681	126,643
Less net charge-offs	(176,769)	(87,352)
	\$ 2,290,043	\$ 2,149,111

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 that the borrower's financial condition is such that collection of interest is doubtful.

Stock-based Compensation

The Company accounts for its stock-based compensation plans using the accounting prescribed by Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*. The Company is not required to adopt the fair value based recognition provisions prescribed under

Edgar Filing: SURREY BANCORP - Form 10QSB

SFAS No. 123, *Accounting for Stock Based Compensation*, but complies with the disclosure requirements set forth in the Statement (as amended by SFAS No. 148), which include disclosing pro forma net income as if the fair value based method of accounting had been applied.

NOTE 2. EARNINGS PER SHARE

Basic earnings per share for the six and three months ended June 30, 2005 and 2004 were calculated by dividing net income available to common shareholders by the weighted average number of shares outstanding during the period.

Table of Contents

The computation of diluted earnings per share is similar to the computation of basic earnings per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if dilutive potential common shares had been issued. The numerator is adjusted for any changes in income or loss that would result from the assumed conversion of those potential common shares. The potential dilutive shares are represented by common stock options and by the Series A convertible preferred stock which is convertible into .8695 shares of common stock.

NOTE 3. BALANCE SHEETS

The balance sheet at December 31, 2004, has been taken from the audited financial statements at that date.

NOTE 4. COMMITMENTS AND LETTERS OF CREDIT

At June 30, 2005, the Company had commitments to extend credit, including unused lines of credit of approximately \$26,389,000. Letters of credit totaling \$1,500,116 were outstanding.

NOTE 5. STOCK OPTION PLANS

The Company has adopted a qualified incentive stock option plan which reserves, as amended, 64,517 shares (adjusted for stock exchange, dividends and exercised shares) for purchase by eligible employees. Options granted under this plan vest at the rate of 20% per year, expire not more than ten years from the date of grant, and are exercisable at not less than the fair market value of the stock at the date of the grant.

The Company also adopted a non-qualified stock option plan which reserves, as amended, 85,671 shares (adjusted for stock exchange, dividends and exercised shares) for purchase by non-employee directors. Options granted under this plan are exercisable after six months from the date of the grant at not less than the fair market value of the stock at the date of the grant. The life of such options shall not extend more than ten years from the date of the grant.

Information related to pro forma net income for the periods presented is as follows:

	June 30,	
	2005	2004
Compensation cost recognized in income for all stock-based compensation awards	\$	\$
Pro forma net income available to common shareholders, based on SFAS No. 123	\$ 852,800	\$ 984,984

Edgar Filing: SURREY BANCORP - Form 10QSB

Pro forma earnings per common share, based on SFAS No. 123	\$ 0.70	\$ 0.83
	<u> </u>	<u> </u>
Pro forma earnings per fully dilutive common share, based on SFAS No. 123	\$ 0.62	\$ 0.72
	<u> </u>	<u> </u>

Table of Contents**NOTE 6. SEGMENT REPORTING**

The Company has two reportable segments, the Bank and Freedom Finance, LLC (subsidiary). 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 six months ended June 30, 2005 and 2004 is as follows:

	Bank	Freedom Finance, LLC	Intersegment Elimination	Consolidated Totals
June 30, 2005				
Net interest income	\$ 3,144,809	\$ 135,143	\$	\$ 3,279,952
Other revenue external customers	890,733	5,045		895,778
Depreciation and Amortization	167,327	1,302		168,629
Provision for loan losses	172,624	57		172,681
Net income	907,326	15,184		922,510
Assets	189,658,877	1,674,445	(18,205,334)	173,127,988
June 30, 2004				
Net interest income	\$ 2,811,164	\$ 135,276	\$	\$ 2,946,440
Other revenue external customers	1,384,465	14,200		1,398,665
Depreciation and Amortization	193,002	2,092		195,094
Provision for loan losses	148,388	(21,745)		126,643
Net income	989,903	63,479		1,053,382
Assets	169,154,141	1,594,063	(16,652,130)	154,096,074

The accounting policies of the segments are the same as those described in the summary of significant accounting policies. The Company's reportable segments are strategic business units that offer different products and services. They are managed separately because each segment appeals to different markets and, accordingly, require different technology and marketing strategies.

The Bank derives a majority of its revenue from interest income and relies primarily on net interest income to assess the performance of the segments and make decisions about resources to be allocated to the segment. Therefore, the segments are reported using net interest income for the period ended June 30, 2005. The Bank does allocate income taxes to the segments. Other revenue represents noninterest income which is also allocated to the segments. The Bank includes the holding company and an insurance and investment agency in its Bank segment above. The Bank does not have any single external customer from which it derives 10 percent or more of its revenues and operations in one geographical area.

Table of Contents

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

Introduction

This discussion, analysis and related financial information are presented to explain the significant factors which affected Surrey Bancorp's financial condition and results of operations for the six and three months ending June 30, 2005 and 2004. 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.

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 shareholders for the three months ended June 30, 2005, was \$496,759 or \$.36 per diluted share outstanding compared to a \$611,444 or \$.44 per diluted share outstanding for the same period in 2004. Earnings for the three months ended June 30, 2005 are approximately 18.8% lower than for the same period in 2004. The decrease primarily results from a reduction in fee income due to a one time gain of \$501,610 earned in 2004 from the sale of the Company's mortgage servicing rights. Exclusive of this one time gain, non interest income increased 7.2% compared to the same three month period in 2004. Net income available to common shareholders, exclusive of the 2004 one time gain, increased approximately 63.3% compared to the second quarter of 2004. This is generally due to an increase in net interest income from \$1,475,088 during the second quarter of 2004 to \$1,699,334 for the second quarter of 2005, an increase of 15.2%.

Edgar Filing: SURREY BANCORP - Form 10QSB

Net income available for common shareholders for the six months ended June 30, 2005, was \$863,352 or \$.62 per diluted share outstanding compared to a \$994,077 or \$.73 per diluted share outstanding for the same period in 2004. Earnings for the six months ended June 30, 2005 are approximately 13.2% lower than for the same period in 2004. The decrease primarily results from a reduction in fee income due to a one time gain of \$501,610 earned in 2004 from the sale of the Company's mortgage servicing rights. Exclusive of this one time gain, non interest income remained relatively flat compared to the same period in 2004. Net income available to common

Table of Contents

shareholders, exclusive of the 2004 one time gain, increased approximately 25.8%. This is due to an increase in net interest income of 11.3%, from \$2,946,440 in 2004 to \$3,279,952 in 2005, and a modest increase in non interest expenses of less than 1.0%.

On June 30, 2005, Surrey Bancorp's assets totaled \$173,127,988 compared to \$157,292,940 on December 31, 2004. Net loans were \$143,164,449 compared to \$133,046,165 on December 31, 2004. This growth was primarily in the commercial loan area which increased 9.7% over December 2004 totals.

Total deposits on June 30, 2005, were \$141,065,467 compared to \$126,953,966 at the end of 2004. This increase is attributable to increases in demand deposit and time deposit accounts. Demand deposits increased 12.9% over 2004 totals. Certificates of deposit increased 18.4% over December 31, 2004 totals, while savings deposits decreased 17.7%.

Common shareholders' equity increased by \$946,484 or 6.3% during the six months ended June 30, 2005 resulting in a common stock book value of \$10.91 per share, up from \$10.26 on December 31, 2004.

Financial Condition, Liquidity and Capital Resources

Investments

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

Bonds, notes, and debentures for which the Bank has the positive intent and ability to hold to maturity are reported at cost, adjusted by premiums and discounts that are recognized in interest income using the interest method over the period to maturity or to call dates. The Bank had no Held to Maturity securities at June 30, 2005 or December 31, 2004.

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

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

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

Investments in available for sale securities of \$3,164,131 consisted of U.S. Governmental Agency obligations with maturities ranging from one to twenty-nine months, and GNMA adjustable rate mortgage securities, which adjust annually.

Loans

Net loans outstanding on June 30, 2005, were \$143,164,449 compared to \$133,046,165 on December 31, 2004. The Bank maintains a loan portfolio dominated by real estate and commercial loans diversified among various industries. Approximately 39.5% of the Bank's loans as of June 30, 2005 are fixed rate loans with 60.5% floating with the Bank's prime rate or other appropriate internal or external indices.

Table of Contents

Deposits

Deposits on June 30, 2005, were \$141,065,467, compared to \$126,953,966 on December 31, 2004.

The June total comes from a base of approximately 10,426 accounts compared to 9,845 accounts at December 31, 2004; a 5.9% increase. Interest-bearing accounts represented 83.2% of the 2005 period-end deposits versus 85.8% at December 31, 2004.

Shareholders Equity

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

The Company's and the Bank's capital ratios are presented in the following table.

	<u>Ratio</u>	<u>Minimum Required For Capital Adequacy Purposes</u>
June 30, 2005:		
Total Capital (to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	11.14%	8.0%
Surrey Bank & Trust	10.20%	8.0%
Tier I Capital (to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	9.88%	4.0%
Surrey Bank & Trust	8.94%	4.0%
Tier I Capital (to Average Assets)		
Surrey Bancorp (Consolidated)	9.12%	4.0%
Surrey Bank & Trust	8.25%	4.0%
December 31, 2004:		
Total Capital (to Risk-Weighted Assets)	11.61%	8.0%
	10.52%	8.0%

Edgar Filing: SURREY BANCORP - Form 10QSB

Surrey Bancorp (Consolidated)

Surrey Bank & Trust

Tier I Capital
(to Risk-Weighted Assets)

Surrey Bancorp (Consolidated)

10.36%

4.0%

Surrey Bank & Trust

9.26%

4.0%

Tier I Capital
(to Average Assets)

Surrey Bancorp (Consolidated)

8.98%

4.0%

Surrey Bank & Trust

8.08%

4.0%

Table of Contents

Asset Quality

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

The provision for loan losses charged to operations was \$172,681 in the first six months of 2005 compared to \$126,643 for the same period in 2004. The reserve for loan losses on June 30, 2005 was \$2,290,043 or 1.57% of period end loans. This percentage is derived from total loans. Approximately \$28,733,000 of loans at June 30, 2005 are government guaranteed loans which the Bank's exposure ranges from 10% to 49% of the outstanding balance. When the guaranteed portions of the loans are removed from the equation the loan loss reserve is approximately 1.83% of outstanding loans.

The level of reserve is established based upon management's evaluation of portfolio composition, current and projected national and local economic conditions, and results of independent reviews of the loan portfolio by internal and external examination. Management recognizes the inherent risk associated with commercial and consumer lending, including whether or not a borrower's actual results of operations will correspond to those projected by the borrower when the loan was funded; economic factors such as the number of housing starts and increases in interest rates, etc.; depression of collateral values; and completion of projects within the original cost and time estimates. As a result, management continues to actively monitor the Bank's asset quality and lending policies. Management believes that its loan portfolio is diversified so that a downturn in a particular market or industry will not have a significant impact on the loan portfolio or the Bank's financial condition. Management believes that its provision and reserve offer an adequate allowance for loan losses and provide a sound reserve for the loan portfolio.

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

At June 30, 2005, the Bank had loans totaling approximately \$860,097 in nonaccrual status.

Interest Rate Sensitivity and Liquidity

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

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

Edgar Filing: SURREY BANCORP - Form 10QSB

At June 30, 2005 the liquidity position of the Company was good, with short-term liquid assets of \$16,272,671. Deposit growth was approximately \$3,997,000 greater than the growth in loans in the six months of 2005 resulting in a slightly more liquid position compared to December 31, 2004. During the period the Bank invested in Bank Owned Life Insurance (BOLI) which reduced the net funds growth produced by deposits and loans. To provide supplemental liquidity, the Bank has six lines of credit with correspondent banks totaling \$13,700,000. There were no outstanding advances against these lines at June 30, 2005. Additionally, the Bank has a secured borrowing

Table of Contents

arrangement with the Federal Home Loan Bank. The maximum credit available under this agreement approximates \$18,578,000 at June 30, 2005. Advances taken down against the Federal Home Loan Bank line amounted to \$14,450,000 at June 30, 2005. In addition, Freedom Finance, LLC has a secured revolving line of credit with another commercial bank in the amount of \$1,200,000. At June 30, 2005 no balance was due on this line.

Table of Contents

ITEM 3. CONTROLS & PROCEDURES

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

Table of Contents

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

No significant changes in legal proceedings occurred during the quarter.

Item 2. Changes in Securities

None

Item 3. Defaults Upon Senior Securities

Not Applicable

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

None

Item 5. Other Information

None

Item 6. Exhibits and Reports on Form 8-K

(a.) Exhibits

10.1 Executive Salary Continuation Agreement for Edward C. Ashby, III

10.2 Executive Salary Continuation Agreement for Brenda J. Harding

10.3 Executive Salary Continuation Agreement for Pedro A. Pequeno, II

10.4 Executive Salary Continuation Agreement for Mark H. Towe

31.1 Certification

31.2 Certification

32. Certification

(b.) Reports on 8-K

Incorporated by Reference to 8-Ks filed April 29, 2005 and June 27, 2005

SIGNATURES

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

Surrey Bancorp

Date: August 11, 2005

/s/ Edward C. Ashby, III

Edward C. Ashby, III
President and Chief Executive Officer

Date: August 11, 2005

/s/ Mark H. Towe

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