SURREY BANCORP
Form 10-Q
May 14, 2012

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, 2012

[ ] TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE EXCHANGE ACT
For the transition period from __________ to __________

COMMISSION FILE NO. 000-50313

SURREY BANCORP

(Exact name of registrant as specified in its charter)

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

145 North Renfro Street, Mount Airy, NC 27030

(Address of principal executive offices)

(336) 783-3900

(Registrant s telephone number)

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

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

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, 2012 there were 3,542,984 common shares issued and outstanding.

PART I FINANCIAL INFORMATION

Consolidated Balance Sheets

March 31, 2012 (Unaudited) and December 31, 2011 (Audited)

	$xxx,xxx,xx,xx **March 2012**	$xxx,xxx,xx,xx **December 2011**
Assets		
Cash and due from banks	$ 9,088,032	$ 2,269,116
Interest-bearing deposits with banks	24,094,705	30,757,636
Federal funds sold	710,026	709,836
Investment securities available for sale	2,494,651	2,506,426
Restricted equity securities	811,879	809,754
Loans, net of allowance for loan losses of $3,901,758 at March 31, 2012 and $3,880,581 at December 31, 2011	177,420,797	175,446,206
Property and equipment, net	4,555,132	4,569,301
Foreclosed assets	451,642	560,018
Accrued income	950,804	962,614
Goodwill	120,000	120,000
Bank owned life insurance	5,172,573	3,389,447
Other assets	2,550,940	2,627,410
Total assets	$ 228,421,181	$ 224,727,764
Liabilities and Stockholders Equity		
Liabilities		
Deposits:		
Noninterest-bearing	$ 36,226,518	$ 30,750,902
Interest-bearing	150,958,053	153,187,474
Total deposits	187,184,571	183,938,376
Long-term debt	8,100,000	8,100,000
Dividends payable	45,605	576,741
Accrued interest payable	196,087	185,362
Other liabilities	2,049,464	1,700,723
Total liabilities	197,575,727	194,501,202
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
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; 3,536,724 shares issued and outstanding at March 31, 2012 and December 31, 2011	12,016,118	12,009,588
Retained earnings	15,023,919	14,405,467
Accumulated other comprehensive loss	(63,390)	(57,300)
Total stockholders equity	30,845,454	30,226,562
Total liabilities and stockholders equity	$ 228,421,181	$ 224,727,764

See Notes to Consolidated Financial Statements

Consolidated Statements of Income

Three months ended March 31, 2012 and 2011 (Unaudited)

	$xxx,xxx,xxx **2012**	$xxx,xxx,xxx **2011**
Interest income		
Loans and fees on loans	$ 2,744,976	$ 2,724,152
Federal funds sold	392	337
Investment securities, taxable	14,203	12,414
Deposits with banks	10,447	5,331
Total interest income	2,770,018	2,742,234
Interest expense		
Deposits	373,012	474,070
Long-term debt	76,406	91,536
Total interest expense	449,418	565,606
Net interest income	2,320,600	2,176,628
Provision for loan losses	67,218	158,897
Net interest income after provision for loan losses	2,253,382	2,017,731
Noninterest income		
Service charges on deposit accounts	235,942	247,891
Fees and yield spread premiums on loans delivered to correspondents	40,821	27,176
Other service charges and fees	131,906	118,959
Other operating income	251,168	199,452
Total noninterest income	659,837	593,478
Noninterest expense		
Salaries and employee benefits	927,383	878,585
Occupancy expense	118,162	95,460
Equipment expense	63,213	58,863
Data processing	92,415	86,831
Foreclosed assets, net	33,230	19,424
Postage, printing and supplies	41,192	42,503
Professional fees	132,045	123,207
FDIC insurance premiums	48,855	83,290
Other expense	397,149	342,209
Total noninterest expense	1,853,644	1,730,372

Net income before income taxes		1,059,575		880,837
Income tax expense		395,518		328,646
Net income		664,057		552,191
Preferred stock dividends		(45,605)		(45,228)
Net income available to common stockholders	$	618,452	$	506,963
Basic earnings per common share	$	0.17	$	0.14
Diluted earnings per common share	$	0.16	$	0.13
Basic weighted average common shares outstanding		3,536,724		3,528,987
Diluted weighted average common shares outstanding		4,171,028		4,162,922

See Notes to Consolidated Financial Statements

Consolidated Statements of Comprehensive Income

Three months ended March 31, 2012 and 2011 (Unaudited)

	$xxx,xxx,xxx **2012**	$xxx,xxx,xxx **2011**
Net income	$ 664,057	$ 552,191
Other comprehensive income:		
Unrealized gains (losses) arising during the period	(9,911)	(2,200)
Tax related to unrealized gains (losses)	3,821	848
Total other comprehensive income (loss)	(6,090)	(1,352)
Total comprehensive income	$ 657,967	$ 550,839

See Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows

Three months ended March 31, 2012 and 2011 (Unaudited)

	2012	2011
Cash flows from operating activities		
Net income	$ 664,057	$ 552,191
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	56,734	59,177
Gain on sale of property and equipment	(450)	(300)
Loss on the sale of foreclosed assets	(35,779)	(1,780)
Stock-based compensation, net of tax benefit	6,530	5,271
Provision for loan losses	67,218	158,897
Deferred income taxes	2,429	(89)
Accretion of discount on securities, net of amortization of premiums	385	219
Increase in cash surrender value of life insurance	(33,126)	(26,615)
Changes in assets and liabilities:		
Accrued income	11,810	47,744
Other assets	77,862	37,810
Accrued interest payable	10,725	30,068
Other liabilities	348,741	437,910
Net cash provided by operating activities	1,177,136	1,300,503
Cash flows from investing activities		
Net (increase) decrease in interest-bearing deposits with banks	6,662,931	(6,098,702)
Net increase in federal funds sold	(190)	(3,123)
Purchases of investment securities	(1,500,000)	(1,502,500)
Sales and maturities of investment securities	1,501,479	1,002,416
Purchase of Bank Owned Life Insurance	(1,750,000)	-
Purchase of restricted equity securities	(2,125)	-
Net increase in loans	(2,098,391)	(5,062,055)
Proceeds from the sale of foreclosed assets	200,737	67,371
Purchases of property and equipment	(44,033)	(21,246)
Proceeds from the sale of property and equipment	1,918	300
Net cash provided by (used in) investing activities	2,972,326	(11,617,539)
Cash flows from financing activities		
Net increase in deposits	3,246,195	10,681,848
Dividends paid	(576,741)	(35,515)
Common stock options exercised	-	12,311
Net cash provided by financing activities	2,669,454	10,658,644
Net increase in cash and cash equivalents	6,818,916	341,608

Cash and due from banks, beginning	2,269,116	2,398,433
Cash and due from banks, ending	$ 9,088,032	$ 2,740,041
Supplemental disclosures of cash flow information		
Interest paid	$ 438,693	$ 535,538
Taxes paid	$ -	$ 39,419
Loans transferred to foreclosed properties	$ 56,582	$ 228,362

See Notes to Consolidated Financial Statements

Consolidated Statements of Changes in Stockholders Equity

Three months ended March 31, 2012 and 2011 (Unaudited)

		$xxx,xxx,xxx,xx	$xxx,xxx,xxx,xx		$xxx,xxx,xxx,xx		$xxx,xxx,xxx,xx		$xxx,xxx,xxx,xx		$xxx,xxx,xxx,xx
		Preferred Stock Amount	**Common Stock Shares**		**Common Stock Amount**		**Retained Earnings**		**Accumulated Other Comprehensive Loss**		**Total**
Balance, January 1, 2011	$	3,868,807	3,206,495	$	9,464,178	$	15,380,083	$	(68,913)	$	28,644,155
Net income		-	-		-		552,191		-		552,191
Net change in unrealized gain (loss) on investment securities available for sale, net of income tax of $848		-	-		-		-		(1,352)		(1,352)
Common stock options exercised		-	4,790		12,311		-		-		12,311
Stock-based compensation, net of tax benefit		-	-		5,271		-		-		5,271
Dividends declared and accrued on convertible Series A preferred stock ($.16 per share)		-	-		-		(29,415)		-		(29,415)
Dividends declared and accrued on convertible Series D preferred stock ($.09 per share)		-	-		-		(15,813)		-		(15,813)
Balance, March 31, 2011	$	3,868,807	3,211,285	$	9,481,760	$	15,887,046	$	(70,265)	$	29,167,348
Balance, January 1, 2012	$	3,868,807	3,536,724	$	12,009,588	$	14,405,467	$	(57,300)	$	30,226,562
Net income		-	-		-		664,057		-		664,057
Net change in unrealized gain (loss) on investment securities available for sale, net of income tax of $3,821		-	-		-		-		(6,090)		(6,090)
Stock-based compensation, net of tax benefit		-	-		6,530		-		-		6,530
Dividends declared on Series A convertible preferred stock ($.16 per share)		-	-		-		(29,661)		-		(29,661)
Dividends declared on Series D convertible preferred stock ($.09 per share)		-	-		-		(15,944)		-		(15,944)

Balance, March 31, 2012	$	3,868,807	3,536,724	$	12,016,118	$	15,023,919	$	(63,390)	$	30,845,454

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 March 31, 2012, the results of operations for the three months ended March 31, 2012 and 2011, and its changes in stockholders equity, comprehensive income and cash flows for the three months ended March 31, 2012 and 2011. The results of operations for the three months ended March 31, 2012, 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, 2011, included in the Company s Form 10-K. The balance sheet at December 31, 2011, 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. 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 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, 2011 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.

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 March 31, 2012 and December 31, 2011, 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, 2012 and December 31, 2011.

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.

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 September 2011, the Intangibles topic was amended to permit an entity to consider qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. These amendments were effective for the Company on January 1, 2012.

In April 2011, the criteria used to determine effective control of transferred assets in the Transfers and Servicing topic of the ASC was amended by ASU 2011-03. The requirement for the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms and the collateral maintenance implementation guidance related to that criterion were removed from the assessment of effective control. The other criteria to assess effective control were not changed. The amendments were effective for the Company on January 1, 2012 and had no effect on the financial statements.

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Recent Accounting Pronouncements, continued

ASU 2011-04 was issued in May 2011 to amend the Fair Value Measurement topic of the ASC by clarifying the application of existing fair value measurement and disclosure requirements and by changing particular principles or requirements for measuring fair value or for disclosing information about fair value measurements. The amendments were effective for the Company beginning January 1, 2012 and have been included in Note 8.

The Comprehensive Income topic of the ASC was amended in June 2011. The amendment eliminates the option to present other comprehensive income as a part of the statement of changes in stockholders equity and requires consecutive presentation of the statement of net income and other comprehensive income. The amendments were applicable to the Company on January 1, 2012 and have been applied retrospectively. In December 2011, the topic was further amended to defer the effective date of presenting reclassification adjustments from other comprehensive income to net income on the face of the financial statements. Companies should continue to report reclassifications out of accumulated other comprehensive income consistent with the presentation requirements in effect prior to the amendments while FASB redeliberates future requirements.

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.

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 March 31, 2012 and December 31, 2011 follow:

	xxxxxxxxxxx Amortized Cost	xxxxxxxxxxx Unrealized Gains	xxxxxxxxxxx Unrealized Losses	xxxxxxxxxxx Fair Value
March 31, 2012				
Government-sponsored enterprises	$ 2,000,000	$ 800	$ 3,695	$ 1,997,105
Mortgage-backed securities	47,808	1,488	-	49,296
Corporate bonds	550,000	-	101,750	448,250
	$ 2,597,808	$ 2,288	$ 105,445	$ 2,494,651
December 31, 2011				
Government-sponsored enterprises	$ 2,000,374	$ 4,311	$ -	$ 2,004,685
Mortgage-backed securities	49,298	1,443	-	50,741
Corporate bonds	550,000	-	99,000	451,000
	$ 2,599,672	$ 5,754	$ 99,000	$ 2,506,426

At March 31, 2012 and December 31, 2011, substantially all government-sponsored enterprises securities were pledged as collateral on public deposits and for other purposes as required or permitted by law. The mortgage-backed securities were pledged to the Federal Home Loan Bank.

Maturities of mortgage-backed bonds are stated based on contractual maturities. Actual maturities of these bonds may vary as the underlying mortgages are prepaid. The scheduled maturities of securities (all available for sale) at March 31, 2012, were as follows:

	xxxxxxxxxxx Amortized Cost	xxxxxxxxxxx Fair Value
Due in one year or less	$ -	$ -
Due after one year through five years	2,000,000	1,997,105
Due after five years through ten years	583,993	483,283
Due after ten years	13,815	14,263
	$ 2,597,808	$ 2,494,651

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, 2012 and December 31, 2011. These unrealized losses on investment securities are a result of volatility in interest rates and primarily relate to corporate bonds issued by other banks at March 31, 2012 and December 31, 2011.

	xxxxxxxxx	xxxxxxxxx	xxxxxxxxx	xxxxxxxxx	xxxxxxxxx	xxxxxxxxx
	Less Than 12 Months		**12 Months or More**		**Total**	
	Fair Value	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**	**Fair Value**	**Unrealized Losses**
March 31, 2012						
Government-sponsored enterprises						