

SURREY BANCORP  
Form 10-Q  
May 14, 2015

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934  
for the quarterly period ended March 31, 2015

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

COMMISSION FILE NO. 000-50313

SURREY BANCORP

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(Exact name of registrant as specified in its charter)

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

145 North Renfro Street, Mount Airy, NC 27030

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(Address of principal executive offices)

(336) 783-3900

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(Registrant's telephone number)

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

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

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

Large accelerated filer    Accelerated filer

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Non-accelerated filer    Smaller reporting company

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

Yes    No

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

On May 14, 2015 there were 3,549,665 common shares issued and outstanding.

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PART I – FINANCIAL INFORMATION

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## Consolidated Balance Sheets

March 31, 2015 (Unaudited) and December 31, 2014 (Audited)

	March 2015	December 2014
<b>Assets</b>		
Cash and due from banks	\$5,401,971	\$6,236,749
Interest-bearing deposits with banks	42,625,181	37,315,779
Federal funds sold	1,215,007	1,212,776
Investment securities available for sale	4,373,630	4,363,805
Restricted equity securities	629,209	618,109
Loans, net of allowance for loan losses of \$3,419,908 at March 31, 2015 and \$3,554,664 at December 31, 2014	189,141,256	189,549,072
Property and equipment, net	4,545,762	4,368,589
Foreclosed assets	175,526	280,821
Accrued income	1,001,168	997,681
Goodwill	120,000	120,000
Bank owned life insurance	5,013,006	5,623,087
Other assets	2,003,253	2,514,855
<b>Total assets</b>	<b>\$256,244,969</b>	<b>\$253,201,323</b>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
<b>Deposits:</b>		
Noninterest-bearing	\$53,981,233	\$52,969,691
Interest-bearing	155,925,316	153,696,890
<b>Total deposits</b>	<b>209,906,549</b>	<b>206,666,581</b>
Long-term debt	6,250,000	6,250,000
Dividends payable	45,227	827,159
Accrued interest payable	133,070	110,261
Other liabilities	2,451,126	2,576,668
<b>Total liabilities</b>	<b>218,785,972</b>	<b>216,430,669</b>
<b>Commitments and contingencies (Note 4)</b>		
<b>Stockholders' equity</b>		
Preferred stock, 1,000,000 shares authorized, 189,356 shares of Series A issued and outstanding with no par value 4.5% convertible non-cumulative, perpetual, with a liquidation value of \$14 per share;	2,620,325	2,620,325
181,154 shares of Series D issued and outstanding with no par value 5.0% convertible non-cumulative, perpetual; with a liquidation value of \$7.08 per share;	1,248,482	1,248,482
Common stock, 10,000,000 shares authorized at no par value; 3,549,665 shares issued and outstanding at March 31, 2015 and December 31, 2014	12,101,480	12,101,480
Retained earnings	21,491,516	20,808,309
Accumulated other comprehensive loss	(2,806 )	(7,942 )
<b>Total stockholders' equity</b>	<b>37,458,997</b>	<b>36,770,654</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$256,244,969</b>	<b>\$253,201,323</b>

See Notes to Consolidated Financial Statements

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## Consolidated Statements of Income

Three months ended March 31, 2015 and 2014 (Unaudited)

	2015	2014
Interest income		
Loans and fees on loans	\$2,679,309	\$2,592,470
Federal funds sold	691	684
Investment securities available for sale, taxable	16,807	16,262
Investment securities available for sale, dividends	2,234	3,617
Deposits with banks	20,837	19,610
Total interest income	2,719,878	2,632,643
Interest expense		
Deposits	236,397	274,949
Fed funds purchased	-	17
Long-term debt	60,705	71,874
Total interest expense	297,102	346,840
Net interest income	2,422,776	2,285,803
Recapture of loan losses	(113,794 )	(62,362 )
Net interest income after recapture of loan losses	2,536,570	2,348,165
Noninterest income		
Service charges on deposit accounts	191,344	199,084
Fees on loans delivered to correspondents	5,646	530
Other service charges and fees	171,193	146,016
Gain on the sale of investment securities	4,376	2,898
Income from bank owned life insurance	36,824	40,010
Insurance commissions	83,777	93,336
Brokerage commissions	79,041	47,132
Other operating income	53,033	52,922
Total noninterest income	625,234	581,928
Noninterest expense		
Salaries and employee benefits	1,032,331	1,009,500
Occupancy expense	109,348	107,884
Equipment expense	62,896	58,871
Data processing	123,006	105,311
Foreclosed assets, net	38,844	(894 )
Postage, printing and supplies	41,324	45,626
Professional fees	141,999	115,323
FDIC insurance premiums	24,458	29,626
Other expense	458,462	396,140
Total noninterest expense	2,032,668	1,867,387
Net income before income taxes	1,129,136	1,062,706
Income tax expense	400,702	386,306
Net income	728,434	676,400

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Preferred stock dividends	(45,227 )	(45,227 )
Net income available to common stockholders	\$683,207	\$631,173
Basic earnings per common share	\$0.19	\$0.18
Diluted earnings per common share	\$0.17	\$0.16
Basic weighted average common shares outstanding	3,549,665	3,542,984
Diluted weighted average common shares outstanding	4,187,410	4,176,919

See Notes to Consolidated Financial Statements

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Consolidated Statements of Comprehensive Income  
 Three months ended March 31, 2015 and 2014 (Unaudited)

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	2015	2014
Net income	\$728,434	\$676,400
Other comprehensive income:		
Investment securities available for sale:		
Unrealized holding gains	12,825	4,565
Tax effect	(4,801 )	(1,583 )
Reclassification of gains recognized in net income	(4,376 )	(2,898 )
Tax effect	1,488	985
	5,136	1,069
Comprehensive income	\$733,570	\$677,469

See Notes to Consolidated Financial Statements

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## Consolidated Statements of Cash Flows

Three months ended March 31, 2015 and 2014 (Unaudited)

	2015	2014
Cash flows from operating activities		
Net income	\$728,434	\$676,400
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	67,627	66,677
Gain on sale of property and equipment	(50 )	(75 )
Gain on the sale of securities	(4,376 )	(2,898 )
Loss on the sale of foreclosed assets	8,507	-
Recapture of loan losses	(113,794 )	(62,362 )
Deferred income tax expense (benefit)	(2,071 )	(1,036 )
Accretion of discount on securities, net of amortization of premiums	(103 )	7
Increase in cash surrender value of life insurance	(36,824 )	(40,010 )
Life insurance proceeds	1,001,320	-
Changes in assets and liabilities:		
Accrued income	(3,487 )	10,813
Other assets	91,210	(31,738 )
Accrued interest payable	22,809	29,029
Other liabilities	(60,807 )	193,123
Net cash provided by operating activities	1,698,395	837,930
Cash flows from investing activities		
Net increase in interest-bearing deposits with banks	(5,309,402)	(11,768,946)
Net (increase) decrease in federal funds sold	(2,231 )	98,686
Purchases of investment securities	(1,009,610)	(1,011,509 )
Maturities of investment securities	1,001,578	1,001,223
Redemption of restricted equity securities	-	59,000
Purchase of restricted equity securities	(11,100 )	(60 )
Net decrease in loans	481,474	798,931
Proceeds from the sale of investment securities	11,135	9,259
Proceeds from the sale of foreclosed assets	136,924	-
Purchases of property and equipment	(244,800 )	(57,536 )
Proceeds from the sale of property and equipment	50	75
Net cash used in investing activities	(4,945,982)	(10,870,877)
Cash flows from financing activities		
Net increase in deposits	3,239,968	9,314,599
Dividends paid	(827,159 )	(790,259 )
Net cash provided by financing activities	2,412,809	8,524,340
Net decrease in cash and cash equivalents	(834,778 )	(1,508,607 )
Cash and due from banks, beginning	6,236,749	7,424,593
Cash and due from banks, ending	\$5,401,971	\$5,915,986
Supplemental disclosures of cash flow information		
Interest paid	\$274,293	\$317,840
Taxes paid	\$-	\$63,722
Supplemental disclosures of non-cash transactions		

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Loans transferred to foreclosed properties	\$40,136	\$144,521
Cash dividends declared but not paid	\$45,227	\$45,227

See Notes to Consolidated Financial Statements

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Three months ended March 31, 2015 and 2014 (Unaudited)

	Preferred Stock	Common Stock		Retained	Accumulated Other Comprehensive	Total
	Amount	Shares	Amount	Earnings	Income (Loss)	
Balance, January 1, 2014	\$3,868,807	\$3,542,984	12,061,153	\$18,329,089	\$ (41,423 )	\$34,217,626
Net income	-	-	-	676,400	-	676,400
Other comprehensive income	-	-	-	-	1,069	1,069
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)	-	-	-	(15,812 )	-	(15,812 )
Balance, March 31, 2014	\$3,868,807	\$3,542,984	12,061,153	\$18,960,262	\$ (40,354 )	\$34,849,868
Balance, January 1, 2015	\$3,868,807	\$3,549,665	12,101,480	\$20,808,309	\$ (7,942 )	\$36,770,654
Net income	-	-	-	728,434	-	728,434
Other comprehensive income	-	-	-	-	5,136	5,136
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)	-	-	-	(15,812 )	-	(15,812 )
Balance, March 31, 2015	\$3,868,807	\$3,549,665	12,101,480	\$21,491,516	\$ (2,806 )	\$37,458,997

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, 2015, the results of its operations and comprehensive income for the three months ended March 31, 2015 and 2014, and its changes in stockholders’ equity and cash flows for the three months ended March 31, 2015 and 2014. These adjustments are of a normal and recurring nature. The results of operations for the three months ended March 31, 2015, are not necessarily indicative of the results expected for the full year. These consolidated financial statements should be read in conjunction with the Company’s audited financial statements and related disclosures for the year ended December 31, 2014, included in the Company’s Form 10-K. The balance sheet at December 31, 2014, has been taken from the audited financial statements at that date.

Organization

Surrey Bancorp began operation on May 1, 2003 and was created for the purpose of acquiring all the outstanding shares of common stock of Surrey Bank & Trust (“the Bank”). Stockholders of the bank received six shares of Surrey Bancorp common stock for every five shares of Surrey Bank & Trust common stock owned. The Company is subject to regulation by the Federal Reserve.

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

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

On July 31, 2000, Surrey Bank & Trust formed Freedom Finance, LLC, a subsidiary operation specializing in the purchase of sales finance contracts from local automobile dealers.

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

Critical Accounting Policies

The notes to the audited consolidated financial statements for the year ended December 31, 2014 contain a summary of the significant accounting policies. The Company believes our policies with respect to the methodology for the determination of the allowance for loan losses, and asset impairment judgments, including the recoverability of intangible assets involve a higher degree of complexity and require management to make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could cause reported results to differ materially. These critical policies and their application

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

#### Principles of Consolidation

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

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Presentation of Cash Flows

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

Investment Securities

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

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

Loans Held for Sale

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

Loans Receivable

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding principal amount adjusted for any charge-offs, the allowance for loan losses, and any deferred fees or cost on originated loans and unamortized premiums or discounts on purchased loans.

Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan using the interest method. Discounts and premiums on any purchased residential real estate loans are amortized to income using the interest method over the remaining period to contractual maturity, adjusted for anticipated prepayments. Discounts and premiums on any purchased consumer loans are recognized over the expected lives of the loans using methods that approximate the interest method.

Interest is accrued and credited to income based on the principal amount outstanding. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When the interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is

subsequently recognized only to the extent cash payments are received. Payments received on nonaccrual loans are first applied to principal and any residual amounts are then applied to interest. When facts and circumstances indicate the borrower has regained the ability to meet the required payments, the loan is returned to accrual status. Past due loans are determined on the basis of contractual terms.

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Allowance for Loan Losses

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

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

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

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

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

Recent Accounting Pronouncements

The following is a summary of recent authoritative pronouncements:

In January 2014, the FASB amended Receivables topic of the Accounting Standards Codification. The amendments are intended to resolve diversity in practice with respect to when a creditor should reclassify a collateralized consumer mortgage loan to other real estate owned (OREO). In addition, the amendments require a creditor reclassify a collateralized consumer mortgage loan to OREO upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. The amendments will be effective for the Company for annual periods, and

interim periods within those annual period beginning after December 15, 2014, with early implementation of the guidance permitted. In implementing this guidance, assets that are reclassified from real estate to loans are measured at the carrying value of the real estate at the date of adoption. Assets reclassified from loans to real estate are measured at the lower of the net amount of the loan receivable or the fair value of the real estate less costs to sell at the date of adoption. The Company will apply the amendments prospectively. The Company does not expect these amendments to have a material effect on its financial statements.

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION, CONTINUED

Recent Accounting Pronouncements, continued

In May 2014, the FASB issued guidance to change the recognition of revenue from contracts with customers. The core principle of the new guidance is that an entity should recognize revenue to reflect the transfer of goods and services to customers in an amount equal to the consideration the entity receives or expects to receive. The guidance will be effective for the Company for reporting periods beginning after December 15, 2017. The Company will apply the guidance using a full retrospective approach. The Company does not expect these amendments to have a material effect on its financial statements.

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

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

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Non-recognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through the date the financial statements were issued and no subsequent events have occurred requiring accrual or disclosure.

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## SURREY BANCORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 2. SECURITIES

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

	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
<u>March 31, 2015</u>				
Government-sponsored enterprises	\$3,497,609	\$ 395	\$ 5,524	\$3,492,480
Mortgage-backed securities	24,008	704	-	24,712
Corporate bonds	300,000	-	30,000	270,000
Equities and mutual funds	557,986	38,684	10,232	586,438
	\$4,379,603	\$ 39,783	\$ 45,756	\$4,373,630
<u>December 31, 2014</u>				
Government-sponsored enterprises	\$3,500,000	\$ 1,170	\$ 4,640	\$3,496,530
Mortgage-backed securities	25,592	715	-	26,307
Corporate bonds	300,000	-	45,000	255,000
Equities and mutual funds	552,635	42,900	9,567	585,968
	\$4,378,227	\$ 44,785	\$ 59,207	\$4,363,805

At March 31, 2015 and December 31, 2014, 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 investment in equities and mutual funds by nature have no maturity date and are classified as due in one year or less. The scheduled maturities of securities (all available for sale) at March 31, 2015, were as follows:

	Amortized Cost	Fair Value
Due in one year or less	\$1,057,986	\$1,086,833
Due after one year through five years	3,306,866	3,271,574
Due after five years through ten years	5,546	5,685
Due after ten years	9,205	9,538
	\$4,379,603	\$4,373,630

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, 2015 and December 31, 2014. These unrealized losses on investment securities are a result of volatility in interest rates which relate to government-sponsored enterprises and corporate bonds issued by other banks and market volatility as it relates to equity and mutual fund investments at March 31, 2015 and December 31, 2014.

Less Than 12 Months	12 Months or More	Total
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	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<u>March 31, 2015</u>						
Government-sponsored enterprises	\$2,492,110	\$ 5,499	\$499,975	\$ 25	\$2,992,085	\$ 5,524
Corporate bonds	-	-	270,000	30,000	270,000	30,000
Equities and mutual funds	144,979	9,753	53,261	479	198,240	10,232
	\$2,637,089	\$ 15,252	\$823,236	\$ 30,504	\$3,460,325	\$ 45,756
<u>December 31, 2014</u>						
Government-sponsored enterprises	\$1,995,360	\$ 4,640	\$-	\$ -	\$1,995,360	\$ 4,640
Corporate bonds	-	-	255,000	45,000	255,000	45,000
Equities and mutual funds	69,129	5,592	107,999	3,975	177,128	9,567
	\$2,064,489	\$ 10,232	\$362,999	\$ 48,975	\$2,427,488	\$ 59,207

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## SURREY BANCORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 2. SECURITIES, CONTINUED

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

Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Based upon this evaluation, there are two securities in the portfolio at March 31, 2015, with unrealized losses for a period greater than 12 months. One of these securities also had unrealized losses for a period greater than 12 months at December 31, 2014. We have analyzed each individual security for Other Than Temporary Impairment (“OTTI”) purposes by reviewing delinquencies, loan-to-value ratios, and credit quality and concluded that all unrealized losses presented in the tables above are not related to an issuer’s financial condition but are due to changes in the level of interest rates and no declines are deemed to be other than temporary in nature.

The Company had realized gains of \$4,376 from the sales of equity and mutual fund investment securities for the three month period ended March 31, 2015, and realized gains of \$2,898 from the sales of equity and mutual fund investment securities for the three month periods ended March 31, 2014. Total proceeds from the sales amounted to \$11,135 and \$9,259 in 2015 and 2014, respectively.

## NOTE 3. EARNINGS PER COMMON SHARE

Basic earnings per common share for the three months ended March 31, 2015 and 2014 were calculated by dividing net income available to common stockholders by the weighted average number of common shares outstanding during the period.

The computation of diluted earnings per common share is similar to the computation of basic earnings per common share except that the denominator is increased to include the number of additional common shares that would have been outstanding if dilutive potential common shares had been issued. The numerator is adjusted for any changes in income or loss that would result from the assumed conversion of those potential common shares. The potential dilutive shares are represented by common stock options and by the Series A and D convertible preferred stock. Each share of the Series A preferred is convertible into 2.2955 shares of common stock. Each share of Series D preferred is convertible into 1.10 shares of common stock.

## NOTE 4. COMMITMENTS AND LETTERS OF CREDIT

At March 31, 2015, the Company had commitments to extend credit, including unused lines of credit of approximately \$43,318,000 and letters of credit outstanding of \$2,414,247.

## NOTE 5. LOANS

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

	2015	2014
Commercial	\$52,969,456	\$56,602,425
Real estate:		
Construction and land development	5,788,579	10,061,249

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Residential, 1-4 families	42,097,111	41,824,806
Residential, 5 or more families	1,229,561	1,109,586
Farmland	3,660,210	3,486,002
Nonfarm, nonresidential	81,314,177	74,275,793
Agricultural	633,283	675,474
Consumer, net of discounts of \$13,915 in 2015 and \$11,950 in 2014	4,743,081	4,997,023
	192,435,458	193,032,358
Deferred loan origination costs, net of (fees)	125,706	71,378
	192,561,164	193,103,736
Allowance for loan losses	(3,419,908 )	(3,554,664 )
	\$189,141,256	\$189,549,072

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## SURREY BANCORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 5. LOANS, CONTINUED

Residential, 1-4 family loans pledged as collateral against FHLB advances approximated \$18,141,000 and \$18,124,000 at March 31, 2015 and December 31, 2014, respectively.

## NOTE 6. ALLOWANCE FOR LOAN LOSSES

The activity of the allowance for loan losses by loan components during the three months ended March 31, 2015 and 2014 was as follows:

	Construction & Development	1-4 Family Residential	Nonfarm, Nonresidential	Commercial & Industrial	Consumer	Other	Total
<u>March 31,</u>							
<u>2015</u>							
Allowance for credit losses:							
Beginning balance	\$ 160,100	\$ 798,199	\$ 1,067,315	\$ 1,301,900	\$ 158,750	\$ 68,400	\$ 3,554,664
Charge-offs	-	(47,169 )	-	(897 )	(35,562 )	-	(83,628 )
Recoveries	-	889	205	49,023	12,549	-	62,666
Provision	(68,000 )	28,773	35,371	(137,135 )	22,997	4,200	(113,794 )
Ending balance	\$ 92,100	\$ 780,692	\$ 1,102,891	\$ 1,212,891	\$ 158,734	\$ 72,600	\$ 3,419,908
Ending balance: individually evaluated for impairment	\$ -	\$ 64,992	\$ 113,491	\$ 143,291	\$ -	\$ -	\$ 321,774
Ending balance: collectively evaluated for impairment	\$ 92,100	\$ 715,700	\$ 989,400	\$ 1,069,600	\$ 158,734	\$ 72,600	\$ 3,098,134
Loans Receivable:							
Ending balance	\$ 5,788,579	\$ 42,097,111	\$ 81,314,177	\$ 52,969,456	\$ 4,743,081	\$ 5,523,054	\$ 192,435,458
Ending balance: individually evaluated for	\$ 12,953	\$ 706,295	\$ 2,904,189	\$ 1,052,132	\$ -	\$ 242,361	\$ 4,917,930

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impairment Ending balance: collectively evaluated for impairment	\$ 5,775,626	\$41,390,816	\$ 78,409,988	\$ 51,917,324	\$4,743,081	\$5,280,693	\$ 187,517,528
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March 31,  
2014

Allowance for credit losses: Beginning balance	\$ 73,000	\$617,629	753,050	\$ 1,708,962	\$ 181,309	\$41,400	\$3,375,350
Charge-offs	-	(77,957 )	(1,778 )	(3,283 )	(14,460 )	-	(97,478 )
Recoveries	-	219	133	144,173	4,019	-	148,544
Provision	20,600	184,445	2,268	(279,273 )	9,298	300	(62,362 )
Ending balance	\$ 93,600	\$724,336	\$753,673	\$1,570,579	\$ 180,166	\$41,700	\$3,364,054

Ending balance: individually evaluated for impairment	\$-	\$54,436	\$ 132,173	\$258,579	\$-	\$-	\$445,188
Ending balance: collectively evaluated for impairment	\$ 93,600	\$669,900	\$ 621,500	\$1,312,000	\$ 180,166	\$41,700	\$2,918,866

Loans Receivable: Ending balance	\$ 7,367,581	\$39,564,157	\$ 59,798,495	\$66,457,837	\$5,436,073	\$3,491,934	\$ 182,116,077
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Ending balance: individually evaluated for impairment	\$ 315,826	\$556,204	\$ 2,817,421	\$2,514,876	\$-	\$-	\$6,204,327
Ending balance: collectively evaluated for impairment	\$ 7,051,755	\$39,007,953	\$ 56,981,074	\$63,942,961	\$5,436,073	\$3,491,934	\$ 175,911,750

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## SURREY BANCORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 6. ALLOWANCE FOR LOAN LOSSES, CONTINUED

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

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<u>March 31, 2015</u>					
With no related allowance recorded:					
Construction and development	\$12,953	\$12,953	\$-	\$13,261	\$ 265
1-4 family residential	474,593	474,593	-	482,174	5,467
Nonfarm, nonresidential	2,130,362	2,130,362	-	2,149,197	22,701
Commercial and industrial	743,378	879,937	-	764,445	2,071
Consumer	-	-	-	-	-
Other loans	242,361	242,361	-	243,371	3,885
	3,603,647	3,740,206	-	3,652,448	34,389
With an allowance recorded:					
Construction and development	-	-	-	-	-
1-4 family residential	231,702	271,053	64,992	265,176	-
Nonfarm, nonresidential	773,827	773,827	113,491	776,175	-
Commercial and industrial	308,754	308,754	143,291	552,054	-
Consumer	-	-	-	-	-
Other loans	-	-	-	-	-
	1,314,283	1,353,634	321,774	1,593,405	-
Combined:					
Construction and development	12,953	12,953	-	13,261	265
1-4 family residential	706,295	745,646	64,992	747,350	5,467
Nonfarm, nonresidential	2,904,189	2,904,189	113,491	2,925,372	22,701
Commercial and industrial	1,052,132	1,188,691	143,291	1,316,499	2,071
Consumer	-	-	-	-	-
Other loans	242,361	242,361	-	243,371	3,885
	\$4,917,930	\$5,093,840	\$ 321,774	\$5,245,853	\$ 34,389
<u>December 31, 2014</u>					
With no related allowance recorded:					
Construction and development	\$13,536	\$13,536	\$-	\$13,788	\$ 2,710
1-4 family residential	174,314	174,314	-	174,882	7,269
Nonfarm, nonresidential	1,806,013	1,806,013	-	1,826,306	94,953
Commercial and industrial	844,682	844,682	-	986,462	9,452
Consumer	-	-	-	-	-
Other loans	228,111	228,111	-	228,884	15,244
	3,066,656	3,066,656	-	3,230,322	129,628

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With an allowance recorded:

Construction and development	-	-	-	-	-
1-4 family residential	399,764	399,764	97,799	402,691	8,141
Nonfarm, nonresidential	852,925	852,925	117,215	852,872	358
Commercial and industrial	554,787	554,787	162,900	552,865	72
Consumer	-	-	-	-	-
Other loans	-	-	-	-	-
	1,807,476	1,807,476	377,914	1,808,428	8,571

Combined:

Construction and development	13,536	13,536	-	13,788	2,710
1-4 family residential	574,078	574,078	97,799	577,573	15,410
Nonfarm, nonresidential	2,658,938	2,658,938	117,215	2,679,178	95,311
Commercial and industrial	1,399,469	1,399,469	162,900	1,539,327	9,524
Consumer	-	-	-	-	-
Other loans	228,111	228,111	-	228,884	15,244
	\$4,874,132	\$4,874,132	\$377,914	\$5,038,750	\$138,199

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## SURREY BANCORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 6. ALLOWANCE FOR LOAN LOSSES, CONTINUED

The following presents by class, an aging analysis of the recorded investment in loans.

	30-59 Days Past Due	60-89 Days Past Due	90 Days Plus Past Due	Total Past Due	Current	Total Financing Receivables	Recorded Investment > 90 Days and Accruing
<u>March 31,</u>							
<u>2015</u>							
Construction and development	\$ 14,539	\$-	\$-	\$ 14,539	\$ 5,774,040	\$ 5,788,579	\$-
1-4 family residential	697,334	567,061	59,840	1,324,235	40,772,876	42,097,111	-
Nonfarm, nonresidential	55,113	243,365	663,902	962,380	80,351,797	81,314,177	-
Commercial and industrial	110,934	-	878,035	988,969	51,980,487	52,969,456	-
Consumer	149,748	58,551	28,182	236,481	4,506,600	4,743,081	27,059
Other loans	-	-	-	-	5,523,054	5,523,054	-
Total	\$ 1,027,668	\$ 868,977	\$ 1,629,959	\$ 3,526,604	\$ 188,908,854	\$ 192,435,458	\$ 27,059
Percentage of total loans	0.53	% 0.45	% 0.85	% 1.83	% 98.17	% 100.00	%
Non-accruals included above							
Construction and development	\$-	\$-	\$-	\$-	\$-	\$-	
1-4 family residential	159,100	214,322	59,841	433,263	95,071	528,334	
Nonfarm, nonresidential	55,113	52,488	663,902	771,503	405,249	1,176,752	
Commercial and industrial	-	-	878,035	878,035	55,310	933,345	
Consumer	-	-	1,122	1,122	-	1,122	
Other loans	-	-	-	-	-	-	
	\$ 214,213	\$ 266,810	\$ 1,602,900	\$ 2,083,923	\$ 555,630	\$ 2,639,553	
<u>December 31,</u>							
<u>2014</u>							
	\$ 94,736	\$-	\$-	\$ 94,736	\$ 9,966,513	\$ 10,061,249	\$-

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

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

Credit Quality Indicators:

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

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## SURREY BANCORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 6. ALLOWANCE FOR LOAN LOSSES, CONTINUED

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

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

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

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

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

	Total	Pass Credits	Special Mention	Substandard	Doubtful
<u>March 31, 2015</u>					
Construction and development	\$5,788,579	\$5,788,579	\$-	\$ -	\$ -
1-4 family residential	42,097,111	41,282,941	762,112	52,058	-
Nonfarm, nonresidential	81,314,177	79,716,603	1,597,574	-	-
Commercial and industrial	52,969,456	52,005,812	963,644	-	-
Consumer	4,743,081	4,733,603	9,478	-	-
Other loans	5,523,054	5,507,916	15,138	-	-
	\$192,435,458	\$189,035,454	\$3,347,946	\$ 52,058	\$ -
Percentage of total loans	100.0	% 98.2	% 1.8	% -	% - %

Guaranteed portion of loans

Construction and development	\$15,455	\$15,455	\$-	\$ -	\$ -
1-4 family residential	576,171	341,677	234,494	-	-
Nonfarm, nonresidential	35,034,171	34,208,947	825,224	-	-
Commercial and industrial	13,443,941	12,730,033	713,908	-	-
Consumer	-	-	-	-	-
Other loans	765,446	765,446	-	-	-
	\$49,835,184	\$48,061,558	\$1,773,626	\$ -	\$ -

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	Total	Pass Credits	Special Mention	Substandard	Doubtful
<u>December 31, 2014</u>					
Construction and development	\$ 10,061,249	\$ 10,061,249	\$ -	\$ -	\$ -
1-4 family residential	41,824,806	41,009,963	641,862	172,981	-
Nonfarm, nonresidential	74,275,793	72,657,724	1,618,069	-	-
Commercial and industrial	56,602,425	55,274,007	1,328,418	-	-
Consumer	4,997,023	4,996,479	544	-	-
Other loans	5,271,062	5,254,896	16,166	-	-
	\$ 193,032,358	\$ 189,254,318	\$ 3,605,059	\$ 172,981	\$ -
	100.0	% 98.0	% 1.9	% 0.1	% - %

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 6. ALLOWANCE FOR LOAN LOSSES, CONTINUED

	Total	Pass Credits	Special Mention	Substandard	Doubtful
<u>Guaranteed portion of loans</u>					
Construction and development	\$15,604	\$15,604	\$-	\$ -	\$ -
1-4 family residential	584,842	306,212	278,630	-	-
Nonfarm, nonresidential	29,914,244	29,082,499	831,745	-	-
Commercial and industrial	13,858,258	12,877,497	980,761	-	-
Consumer	-	-	-	-	-
Other loans	768,869	760,786	8,083	-	-
	\$45,141,817	\$43,042,598	\$2,099,219	\$ -	\$ -

## NOTE 7. TROUBLED DEBT RESTRUCTURINGS

For the three months ended March 31, 2015 and 2014, the following table presents loans modified during the period that were considered to be troubled debt restructurings.

	For the three months ended March 31, 2015		For the three months ended March 31, 2014	
	Pre- Modification of Outstanding Construction Investment	Post- Modification Outstanding Recorded Investment	Pre- Modification of Outstanding Construction Investment	Post- Modification Outstanding Recorded Investment
Troubled Debt Restructurings				
Construction and development	- \$ -	\$ -	- \$ -	\$ -
1-4 Family residential	-	-	3	159,927
Nonfarm, nonresidential	-	-	-	-
Commercial and industrial	-	-	-	-

During the three months ended March 31, 2015 and 2014, no loans that had previously been restructured were in default.

In the determination of the allowance for loan losses, management considers troubled debt restructurings and subsequent defaults in these restructurings by adjusting the loan grades of such loans, which figure into the environmental factors associated with the allowance. Defaults resulting in charge-offs affect the historical loss experience ratios which are a component of the allowance calculation. Additionally, specific reserves may be established on restructured loans evaluated individually.

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SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. FAIR VALUE

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

Fair Value Hierarchy

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

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

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

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

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

Investment Securities Available for Sale

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

Loans

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

Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At March 31, 2015, substantially all of the total impaired loans were evaluated based on the fair value of the collateral and discounted cash flows. In accordance with the Fair Value and Measurement Topic of the FASB ASC, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3.

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## SURREY BANCORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 8. FAIR VALUE, CONTINUED

## Servicing Assets

A valuation of loan servicing rights is performed on an individual basis due to the small number of loans serviced. Loans are evaluated on a discounted earnings basis to determine the present value of future earnings. The present value of the future earnings is the estimated market value for the loan, calculated using consensus assumptions that a first party purchaser would utilize in evaluating a potential acquisition of the servicing. As such, the Company classifies loan servicing rights as Level 3.

## Foreclosed Assets

Foreclosed assets are adjusted to fair value upon transfer of the loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value or fair value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the foreclosed asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3.

## Assets and Liabilities Recorded at Fair Value on a Recurring Basis

The table below presents the recorded amount of assets and liabilities measured at fair value on a recurring basis.

(in thousands)

	Total	Level 1	Level 2	Level 3
March 31, 2015				
Government-sponsored enterprises	\$3,492	\$-	\$3,492	\$-
Mortgage-backed securities	25	-	25	-
Corporate bonds	270	-	-	270
Equities and mutual funds	587	587	-	-
Total assets at fair value	\$4,374	\$587	\$3,517	\$270

(in thousands)

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

For the three months ended March 31, 2015 and 2014, the changes in Level 3 assets and liabilities measured at fair value on a recurring basis were as follows:

Level 3	2015	2014

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(in thousands)	Fair Value	Fair Value
Corporate Bonds – Available for Sale		
Balance, January 1	\$255	\$ 451
Total unrealized gain (loss) included in income	-	-
Total unrealized gain (loss) included in other comprehensive income	15	-
Bonds called	-	-
Balance, March 31	\$270	\$ 451

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## SURREY BANCORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 8. FAIR VALUE, CONTINUED

The change in the fair value of corporate bond assets for the three month period ended March 31, 2015 was \$15,000. There was no change in the fair value for the three months period ended March 31, 2104.

## 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)

March 31, 2015	Total	Level 1	Level 2	Level 3
Impaired loans:				
Commercial and industrial	\$165	\$ -	\$ -	\$165
Nonfarm, non-residential	660	-	-	660
1-4 family residential	167	-	-	167
Foreclosed assets	176	-	-	176
Servicing assets	348	-	-	348
Total assets at fair value	\$1,516	\$ -	\$ -	\$1,516

(in thousands)

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

## Financial Instruments

The following methods and assumptions were used by the Company in estimating its fair value disclosures for financial instruments:

Cash and due from banks: The carrying amounts reported in the balance sheet for cash and due from banks approximate their fair values.

Interest-bearing deposits with banks: Fair values for time deposits are estimated using a discounted cash flow analysis that applies interest rates currently being offered on certificates to a schedule of aggregated contractual maturities on

such time deposits.

Federal funds sold: Due to the short-term nature of these assets, the carrying value approximates fair value.

Securities: Fair values for securities, excluding restricted equity securities, are based on quoted market prices, where available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. The carrying values of restricted equity securities approximate fair values.

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## SURREY BANCORP

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

## NOTE 8. FAIR VALUE, CONTINUED

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

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

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

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

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

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

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

(dollars in thousands)	Carrying Amount	Fair Value	Fair Value Measurements		
			Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
March 31, 2015					
Financial Instruments – Assets					
Loans, net	\$ 189,141	\$ 196,053	\$-	\$ -	\$ 196,053

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Financial Instruments-Liabilities

Deposits	209,907	205,987	-	65,516	140,471
Long-Term Debt	6,250	6,427	-	-	6,427

December 31, 2014