SURREY BANCORP
Form 10QSB
November 06, 2006

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-QSB

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
for the quarterly period ended September 30, 2006

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

COMMISSION FILE NO. 0000-50313

SURREY BANCORP

(Exact name of small business issuer 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

(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 **x** No ¨

Indicate by check mark 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 November 3, 2006 there were 1,494,423 common shares issued and outstanding

Transitional Small Business Disclosure Format (Check One): Yes ¨ No **x**

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Consolidated Balance Sheets

September 30, 2006 (Unaudited) and December 31, 2005 (Audited)

	September 2006	December 2005
Assets		
Cash and due from banks	$ 1,720,644	$ 1,789,131
Interest-bearing deposits with banks	17,288,148	20,515,582
Federal funds sold	408,000	504,000
Investment securities available for sale	3,627,767	4,129,223
Restricted equity securities	1,051,230	1,007,130
Loans, net of allowance for loan losses of $2,528,533 in 2006 and $2,311,298 in 2005	145,687,311	142,385,041
Property and equipment, net	4,455,566	4,607,952
Foreclosed assets	76,323	36,045
Accrued income	975,634	813,667
Goodwill	120,000	120,000
Bank owned life insurance	2,820,804	2,740,420
Other assets	2,158,546	922,636
Total assets	$ 180,389,973	$ 179,570,827
Liabilities and Stockholders Equity		
Liabilities		
Deposits:		
Noninterest-bearing	$ 26,403,203	$ 23,953,425
Interest-bearing	118,011,965	121,902,246
Total deposits	144,415,168	145,855,671
Federal funds purchased and securities sold under agreements to repurchase	366,367	1,157,917
Long-term debt	13,990,929	14,494,525
Dividends payable on preferred stock	30,069	30,068
Accrued interest payable	527,945	312,869
Other liabilities	1,676,663	458,991
Total liabilities	161,007,141	162,310,041
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
Common stock, 5,000,000 shares authorized at no par value; 1,494,423 shares issued in 2006 and 1,472,094 shares issued in 2005	8,415,593	8,236,917
Retained earnings	8,352,594	6,418,744
Accumulated other comprehensive income (loss)	(5,680)	(15,200)
Total stockholders equity	19,382,832	17,260,786
Total liabilities and stockholders equity	$ 180,389,973	$ 179,570,827

See Notes to Consolidated Financial Statements

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Consolidated Statements of Income

Nine months ended September 30, 2006 and 2005 (Unaudited)

	2006	2005
Interest income		
Loans and fees on loans	$ 9,154,043	$ 7,400,901
Federal funds sold	14,536	9,991
Investment securities, taxable	151,476	90,581
Deposits with banks	510,855	189,933
Total interest income	9,830,910	7,691,406
Interest expense		
Deposits	3,195,298	2,221,050
Federal funds purchased		1,108
Securities sold under agreements to repurchase	25,264	9,257
Short-term debt	28,010	
Long-term debt	454,546	361,686
Total interest expense	3,703,118	2,593,101
Net interest income	6,127,792	5,098,305
Provision for loan losses	409,984	275,583
Net interest income after provision for loan losses	5,717,808	4,822,722
Noninterest income		
Service charges on deposit accounts	767,815	733,055
Net gain on sale of mortgage loans	78,282	80,805
Gain on sale of government guaranteed loans	27,588	181,545
Fees on mortgage loans delivered to correspondents	90,203	83,455
Other service charges and fees	142,500	104,417
Other operating income	418,388	365,176
Total noninterest income	1,524,776	1,548,453
Noninterest expense		
Salaries and employee benefits	2,106,617	1,869,640
Occupancy expense	276,913	272,486
Equipment expense	249,266	271,420
Data processing	256,882	268,176
Foreclosed assets, net	(1,691)	525
Other expense	1,244,169	1,200,702
Total noninterest expense	4,132,156	3,882,949
Net income before income taxes	3,110,428	2,488,226
Income tax expense	1,087,352	940,869
Net income	2,023,076	1,547,357
Preferred stock dividends declared	(89,226)	(89,225)

Net income available to common shareholders	$ 1,933,850	$ 1,458,132
Basic earnings per share	$ 1.31	$ 1.00
Diluted earnings per share	$ 1.15	$ 0.89
Basic weighted average shares outstanding	1,479,715	1,462,892
Diluted weighted average shares outstanding	1,754,804	1,742,494

See Notes to Consolidated Financial Statements

Consolidated Statements of Income

Three months ended September 30, 2006 and 2005 (Unaudited)

	2006	2005
Interest income		
Loans and fees on loans	$ 3,201,689	$ 2,676,173
Federal funds sold	5,248	4,270
Investment securities, taxable	56,489	30,525
Deposits with banks	186,060	76,991
Total interest income	3,449,486	2,787,959
Interest expense		
Deposits	1,168,025	832,430
Securities sold under agreements to repurchase	8,576	2,953
Long-term debt	161,797	134,223
Total interest expense	1,338,398	969,606
Net interest income	2,111,088	1,818,353
Provision for loan losses	128,521	102,902
Net interest income after provision for loan losses	1,982,567	1,715,451
Noninterest income		
Service charges on deposit accounts	257,617	273,424
Net gain on sale of mortgage loans	27,315	26,105
Gain on the sale of government guaranteed loans		181,545
Fees on mortgage loans delivered to correspondents	31,416	33,788
Other service charges and fees	49,139	37,958
Other operating income	121,150	99,855
Total noninterest income	486,637	652,675
Noninterest expense		
Salaries and employee benefits	735,870	640,854
Occupancy expense	93,079	100,530
Equipment expense	82,187	88,728
Data processing	93,250	92,780
Foreclosed assets, net	(2,440)	525
Other expense	388,232	440,989
Total noninterest expense	1,390,178	1,364,406
Net income before income taxes	1,079,026	1,003,720
Income tax expense	345,617	378,872
Net income	733,409	624,848
Preferred stock dividends declared	(30,069)	(30,068)
Net income available to common shareholders	$ 703,340	$ 594,780
Basic earnings per share	$ 0.47	$ 0.40

Diluted earnings per share	$ 0.41	$ 0.36
Basic weighted average shares outstanding	1,493,855	1,470,821
Diluted weighted average shares outstanding	1,768,019	1,750,631

See Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows

Nine months ended September 30, 2006 and 2005 (Unaudited)

	2006	2005
Cash flows from operating activities		
Net income	$ 2,023,076	$ 1,547,357
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation and amortization	252,387	261,572
Loss on the sale/abandonment of fixed assets		20,672
Gain on the sale of foreclosed assets	(1,691)	
Stock-based compensation	15,489	
Provision for loan losses	409,984	275,583
Deferred income taxes	(85,318)	(18,032)
Accretion of discount on securities, net of amortization of premiums	(35,202)	(25,056)
Increase in cash surrender value of life insurance	(80,384)	(64,043)
Changes in assets and liabilities:		
Accrued income	(161,967)	(205,946)
Other assets	(1,156,564)	(828,958)
Accrued interest payable	215,076	186,222
Other liabilities	1,217,672	848,789
Net cash provided by operating activities	2,612,558	1,998,160
Cash flows from investing activities		
Net (increase) decrease in interest-bearing deposits with banks	3,227,434	(82,687)
Net (increase) decrease in federal funds sold	96,000	(202,000)
Purchases of investment securities	(3,467,143)	(4,475,286)
Sales and maturities of investment securities	4,019,293	4,040,097
Purchases of restricted equity securities	(44,100)	(216,470)
Net increase in loans	(3,977,751)	(9,340,136)
Proceeds from the sale of foreclosed assets	226,910	
Purchases of property and equipment	(100,001)	(728,939)
Purchase of bank owned life insurance		(2,650,000)
Net cash provided by (used in) investing activities	(19,358)	(13,655,421)
Cash flows from financing activities		
Net increase (decrease) in deposits	(1,440,503)	11,987,837
Net decrease in federal funds purchased and securities sold under agreements to repurchase	(791,550)	(2,559,294)
Net increase (decrease) in long-term debt	(503,596)	1,696,679
Dividends paid on preferred stock	(89,225)	(89,144)
Common stock options exercised	115,788	89,036
Fractional shares purchased	(19,641)	
Tax benefit related to exercise of non-incentive stock options	67,040	45,686
Net cash provided by (used in) financing activities	(2,661,687)	11,170,800
Net increase (decrease) in cash and cash equivalents	(68,487)	(486,461)
Cash and cash equivalents, beginning	1,789,131	1,810,543
Cash and cash equivalents, ending	$ 1,720,644	$ 1,324,082
Supplemental disclosures of cash flow information		
Interest paid	$ 3,488,042	$ 2,406,879

Taxes paid	$ 1,172,140	$ 898,824
Loans transferred to foreclosed properties	$ 265,497	$ 116,132

See Notes to Consolidated Financial Statements

Consolidated Statements of Stockholders Equity

Nine months ended September 30, 2006 and 2005 (Unaudited)

	Preferred Stock		Common Stock			Unrealized Appreciation (Depreciation) On	
	Shares	Amount	Shares	Amount	Retained Earnings	Securities	Total
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					1,547,357		1,547,357
Net change in unrealized gain (loss) on investment securities available for sale, net of income tax benefit of $3,016						(4,808)	(4,808)
Total comprehensive income							1,542,549
Common stock issued							
Common stock options exercised			15,037	89,036			89,036
Tax benefit related to exercise of non-qualified stock options				45,686			45,686
Dividends declared on convertible preferred stock ($.47 per share)					(89,225)		(89,225)
Balance, September 30, 2005	189,356	$ 2,620,325	1,226,045	$ 8,234,983	$ 5,795,356	$ (17,197)	$ 16,633,467
Balance, January 1, 2006	189,356	$ 2,620,325	1,472,094	$ 8,236,917	$ 6,418,744	$ (15,200)	$ 17,260,786
Comprehensive income							
Net income					2,023,076		2,023,076
Net change in unrealized gain (loss) on investment securities available for sale, net of income tax expense of $5,972						9,520	9,520
Total comprehensive income							2,032,596
Common stock issued							
Common stock options exercised			23,171	115,788			115,788
Tax benefit related to exercise of non-qualified stock options				67,040			67,040
Fractional shares purchased			(842)	(19,641)			(19,641)
Stock-based compensation				15,489			15,489
Dividends declared on convertible preferred stock ($.47 per share)					(89,226)		(89,226)
Balance, September 30, 2006	189,356	$ 2,620,325	1,494,423	$ 8,415,593	$ 8,352,594	$ (5,680)	$ 19,382,832

See Notes to Consolidated Financial Statements

SURREY BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements were prepared in accordance with instructions for Form 10-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 consolidated financial statements contain all adjustments necessary to present fairly the financial condition of Surrey Bancorp as of September 30, 2006 and December 31, 2005, the results of operations for the nine and three months ended September 30, 2006 and 2005, and its changes in stockholders equity and cash flows for the nine and three months ended September 30, 2006 and 2005. All adjustments are of a normal and recurring nature. The results of operations for the nine months ended September 30, 2006 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, 2005 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.

Critical Accounting Policies

The notes to our audited consolidated financial statements for the year ended December 31, 2005 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, 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.

Business Segments

The Company reports its activities in two business segments. In determining the appropriateness of segment definition, the Company considers the materiality of potential business segments and components of the business about which financial information is available and regularly evaluated relative to resource allocation and performance assessment.

Presentation of Cash Flows

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

Investment securities classified as held to maturity are those debt securities that the Bank has the ability and intent to hold to maturity. Accordingly, these securities are carried at cost adjusted for amortization of premiums and accretion of discount, computed by the interest-method over their contractual lives. At September 30, 2006 and December 31, 2005, the Bank had no investments classified as held to maturity.

Loans Held for Sale

The Bank originates and holds SBA and USDA guaranteed loans in its portfolio in the normal course of business. During the third quarter of 2005, the Bank entered a program to sell 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 sale. The Bank plans to continue to originate guaranteed loans for sales, however no such loans were funded at September 30, 2006.

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 nine months ended September 30, 2006 and 2005 follows:

	September 30,	
	2006	**2005**
Balance at beginning of year	$ 2,311,298	$ 2,294,131
Add provision charged to expense	409,984	275,583
Less net charge-offs	(192,749)	(290,226)
	$ 2,528,533	$ 2,279,488

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

During the first quarter of 2006, the Company adopted the provisions of, and began accounting for stock-based compensation in accordance with, the Financial Accounting Standards Board s (FASB) Statement of Financial Accounting Standards No. 123-revised 2004 (SFAS 123R), *Share-Based Payment* which replaces Statement of Financial Accounting Standards No. 123 (SFAS 123), *Accounting for Stock-Based Compensation* and supersedes APB Opinion No. 25 (APB 25), *Accounting for Stock Issued to Employees.* Under the fair value recognition provisions of this statement, stock-based compensation is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is the vesting period. The Company elected the modified prospective method, under which prior periods are not revised for comparative purposes. The valuation provisions of SFAS 123R apply to new grants and to grants that were outstanding as of the effective date and are subsequently modified. Estimated compensation for the grants that were outstanding as of the effective date will be recognized over the remaining service period using the compensation cost estimated for the SFAS 123 pro forma disclosures.

The adoption of SFAS 123R did not have a material impact on the Company s consolidated financial position, results of operations and cash flows. See Note 5 for further information regarding the Company s stock based compensation assumptions and expenses.

NOTE 2. EARNINGS PER SHARE

Basic earnings per share for the nine and three months ended September 30, 2006 and 2005 were calculated by dividing net income available to common shareholders by the weighted average number of shares outstanding during the period.

The computation of diluted earnings per share is similar to the computation of basic earnings per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if dilutive potential common shares had been issued. The numerator is adjusted for any changes in income or loss that would result from the assumed conversion of those potential common shares. The potential dilutive shares are represented by common stock options and by the Series A convertible preferred stock which is convertible into 1.0434 shares of common stock.

NOTE 3. BALANCE SHEETS

The balance sheet at December 31, 2005, has been taken from the audited financial statements at that date.

NOTE 4. COMMITMENTS AND LETTERS OF CREDIT

At September 30, 2006, the Company had commitments to extend credit, including unused lines of credit of approximately $31,431,000. Letters of credit totaling $1,308,107 were outstanding.

NOTE 5. STOCK BASED COMPENSATION

Effective January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment,* (SFAS No. 123R) which was issued by the FASB in December 2004. SFAS No. 123R revises SFAS No. 123, *Accounting for Stock Based Compensation*, and supersedes APB No. 25, *Accounting for Stock Issued to Employees*, and its related interpretations. SFAS No. 123R requires recognition of the services received in exchange for an award based on the grant-date fair value of the award. SFAS No. 123R also amends SFAS No. 95, *Statement of Cash Flows*, to require that excess tax benefits be reported as financing cash inflows, rather than as a reduction of taxes paid, which is included within operating cash flows.

The Company adopted SFAS No. 123R using the modified prospective application as permitted under SFAS No. 123R. Accordingly, prior period amounts have not been restated. Under this application, the Company is required to record compensation expense for all awards granted after the date of adoption and for the unvested portion of previously granted awards that remain outstanding at the date of adoption.

Prior to the adoption of SFAS No. 123R, the Company used the intrinsic value method as prescribed by APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB No. 25), and thus recognized no compensation expense for options granted with exercise prices equal to the fair market value of the Company s common stock on the date of grant.

The Company has two share-based compensation plans, which are described below. The compensation cost that has been charged against income for those plans was approximately $23,468 and $0 for the nine-month periods ended September 30, 2006 and 2005, respectively. The income tax benefit recognized for share-based compensation arrangements was approximately $7,979 and $0 for the nine months ended September 30, 2006 and 2005, respectively.

In 1997, the Company has adopted a qualified incentive stock option plan which reserves, as amended, 65,114 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 in 1997, which reserves, as amended, 90,236 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.

The fair value of each option award is estimated on the date of grant using the Black-Scholes option pricing model. No options were granted for the periods ended September 30, 2006 and 2005.

The risk-free interest rate is based on the U.S. Treasury rate for the expected life at the time of grant. Volatility is based on the average long-term implied volatilities of our Company. The expected life is based on the average life of the options of 10 years and the weighted average graded vesting period of 5 years, and forfeitures are considered immaterial based on the historical data of the Company.

A summary of option activity under the stock option plans as of September 30, 2006, and changes during the nine month period ended September 30, 2006 is presented below:

	Options Available	Options Outstanding	Weighted Average Exercise Price
Balance at December 31, 2005	21,651	156,872	$ 5.38
Exercised		(23,171)	5.00
Authorized			
Forfeited			
Granted			
Balance at September 30, 2006	21,651	133,701	$ 5.45

The following table sets forth the exercise prices, the number of options outstanding and the number of options exercisable at September 30, 2006:

Exercise Price	Number of Options Outstanding	Weighted Average Exercise Price	Weighted Average Contractual Life Remaining (Years)	Number of Options Exercisable	Weighted Average Exercise Price
$4.83	84,619	$ 4.83	0.7	84,619	$ 4.83
6.05	5,240	6.05	2.8	5,240	6.05
7.89	6,653	7.89	4.3	6,653	7.89
5.13	29,629	5.13	4.8	29,629	5.13
10.59	5,760	10.59	6.8	3,456	10.59
12.29	1,800	12.29	7.6	720	12.29
Total/Average	133,701	$ 5.45	2.2	130,317	$ 5.30

The following table sets forth information pertaining to the Company s exercisable options and options expected to vest:

	Nine Months Ended September 30, 2006
Incentive and non qualified stock options:	
Fair value of options granted during period expected to vest	$ n/a
Aggregate intrinsic value of exercisable and nonvested options expected to vest	$ 2,347,798
Number of nonvested options expected to vest	3,384
Weighted average price of nonvested options expected to vest	$ 11.13
Weighted average remaining life of nonvested options expected to vest	5.45
Intrinsic value of nonvested options expected to vest	$ 40,168

No options were granted in the nine or three months ended September 30, 2006.

As of September 30, 2006, there was $17,118 of total unrecognized compensation cost related to non-vested share-based compensation arrangements granted under the Company s stock option plans. That cost is expected to be recognized over a weighted-average period of .45 years. The total fair value of shares vested during the nine month period ended September 30, 2006 was $139,433.

The following table illustrates the effect on net income available to common stockholders if the Company had applied the fair value recognition provisions of SFAS No. 123 with respect to the nine and three month periods ended September 30, 2005.

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income available to common shareholders, as reported	$ 594,780	$ 1,458,132
Add: Stock-based employee compensation expense included in reported net income, net of related income tax effects		
Less: Stock-based employee compensation expense determined under fair value based method of all awards, net of related income tax effects	(5,276)	(15,828)
Pro forma net income	$ 589,504	$ 1,442,304
Earnings per share basic, as reported	$ 0.41	$ 1.00
Earnings per share diluted, as reported	$ 0.36	$ 0.89
Earnings per share basic, proforma	$ 0.40	$ 0.98
Earnings per share diluted, proforma	$ 0.34	$ 0.88

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 nine months ended September 30, 2006 and 2005 is as follows:

	Bank	Freedom Finance, LLC	Intersegment Elimination	Consolidated Totals
September 30, 2006				
Net interest income	$ 5,734,658	$ 393,134	$	$ 6,127,792
Other revenue external customers	1,522,567	2,209		1,524,776
Depreciation and amortization	250,332	2,055		252,387
Provision for loan losses	156,583	253,401		409,984
Net income	2,085,461	(62,385)		2,023,076
Assets	178,928,608	3,120,823	(1,659,458)	180,389,973
September 30, 2005				
Net interest income	$ 4,875,903	$ 222,402	$	$ 5,098,305
Other revenue external customers	1,545,831	2,622		1,548,453
Depreciation and amortization	259,619	1,953		261,572
Provision for loan losses	272,868	2,715		275,583
Net income	1,521,290	26,067		1,547,357
Assets	171,160,918	1,690,652	(1,810,270)	171,041,300

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, requires different technology and marketing strategies.

The Company 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 September 30, 2006. The Company does allocate income taxes to the segments. Other revenue represents noninterest income which is also allocated to the segments. The Company includes the holding company and an insurance and investment agency in its Bank segment above. The Company does not have any single external customer from which is derives 10 percent or more of its revenues and operations in one geographical area.

NOTE 7. BENEFIT PLANS

During the first quarter of 2005, the Company adopted a Supplemental Retirement Benefit Plan (SERP) to provide future compensation to certain members of management. Under plan provisions, annual payments projected to range from $16,388 to $89,914 are payable for the life of the executive, generally beginning at age 65. The liability accrued for the compensation under the plan was $127,636 and $46,767 at September 30, 2006 and 2005, respectively. Employee benefits expense, an actuarially determined amount, was $60,826 and $46,767 for the nine months ended September 30, 2006 and 2005, respectively. The assumed discount rate, rate of compensation increase, and expected long-term rate of return on plan assets used in the initial calculations for the plan were 7%, 4% and 6.62%, respectively.

During the first quarter of 2005, the Company also adopted a deferred compensation plan under which directors may elect to defer their directors fees. Participating directors receive an additional 30% matching contribution and will be paid an annual benefit for a specified number of years after retirement, generally beginning at age 65. The maximum payout period is ten years. Deferred directors fees accrued under the plan were $121,870 and $43,128 at September 30, 2006 and 2005, respectively. Deferred directors fees expensed were $58,590 and $43,128 for the nine months ended September 30, 2006 and 2005, respectively. The amounts deferred are held in a rabbi trust.

The Company has purchased and is the primary beneficiary of life insurance policies designed to fund the Supplemental Retirement Benefit Plan and the directors deferred compensation liability. The cash value of the life insurance policies totaled $2,820,804 and $2,714,043 at September 30, 2006 and 2005, respectively.

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 nine and three months ending September 30, 2006 and 2005. 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 September 30, 2006, was $703,340 or $.41 per diluted share outstanding compared to a $594,780 or $.36 per diluted share outstanding for the same period in 2005. Earnings for the three months ended September 30, 2006 are approximately 18.3% higher than for the same period in 2005. The increase results from a 16.1% increase in net interest income. The net interest income increase is due to an increase in our average interest earnings assets in the third quarter of 2006 over the same period in 2005, and an improvement in our net interest margin.

Net income available for common shareholders for the nine months ended September 30, 2006, was $1,933,850 or $1.15 per diluted share outstanding compared to a $1,458,132 or $.89 per diluted share outstanding for the same period in 2005. Earnings for the nine months ended September 30, 2006 are approximately 32.6% higher than for the same period in 2005. The increase primarily results from a 20.2% increase in net interest income from $5,098,305 in 2005 to $6,127,792 in 2006.

On September 30, 2006, Surrey Bancorp s assets totaled $180,389,973 compared to $179,570,827 on December 31, 2005. Net loans were $145,687,311 compared to $142,385,041 on December 31, 2005. This increase is due to increases in commercial, construction and consumer loans over December 2005 totals. Commercial, construction and consumer loans have increased 3.4%, 72.8% and 12.2%, respectively over 2005 year end totals. However, these increases have been partially offset by decreases in mortgage and home equity loans. Mortgage and home equity loans have decreased 10.9% and 4.0%, respectively from December 31, 2005 totals.

Total deposits on September 30, 2006, were $144,415,168 compared to $145,855,671 at the end of 2005. This decrease is primarily attributable to decreases in demand deposit and money market accounts. The money market decreases result from funds invested by depositors at December 31, 2005, on a temporary basis before moving them to other investment opportunities during the first quarter of 2006. Demand deposits decreased 2.4% from 2005 totals. Certificates of deposit increased 2.9% from December 31, 2005 totals, while savings deposits, which include money market accounts, decreased 15.6%.

Common shareholders equity increased by $2,122,046 or 14.49% during the nine months ended September 30, 2006 resulting in a common stock book value of $11.22 per share, up from $9.95 on December 31, 2005.

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 September 30, 2006 or December 31, 2005.

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 $3,627,767 consisted of U.S. Governmental Agency obligations with maturities ranging from one to eighteen months, and GNMA adjustable rate mortgage securities, which adjust annually.

Loans

Net loans outstanding on September 30, 2006, were $145,687,311 compared to $142,385,041 on December 31, 2005. The Bank maintains a loan portfolio dominated by real estate and commercial loans diversified among various industries. Approximately 41.7% of the Bank s loans as of September 30, 2006 are fixed rate loans with 58.3% floating with the Bank s prime rate or other appropriate internal or external indices.

Deposits

Deposits on September 30, 2006, were $144,415,168, compared to $145,855,671 on December 31, 2005. The September total comes from a base of approximately 11,123 accounts compared to 10,713 accounts at December 31, 2005; a 3.8% increase. Interest-bearing accounts represented 81.7% of the 2006 period-end deposits versus 83.6% at December 31, 2005.

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.

	Ratio	Minimum Required For Capital Adequacy Purposes
September 30, 2006:		
Total Capital (to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	13.87%	8.0%
Surrey Bank & Trust	12.84%	8.0%
Tier I Capital (to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	12.61%	4.0%
Surrey Bank & Trust	11.58%	4.0%
Tier I Capital (to Average Assets)		
Surrey Bancorp (Consolidated)	10.41%	4.0%
Surrey Bank & Trust	9.56%	4.0%
December 31, 2005:		
Total Capital (to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	13.01%	8.0%
Surrey Bank & Trust	11.99%	8.0%
Tier I Capital (to Risk-Weighted Assets)		
Surrey Bancorp (Consolidated)	11.75%	4.0%
Surrey Bank & Trust	10.74%	4.0%
Tier I Capital (to Average Assets)		
Surrey Bancorp (Consolidated)	9.45%	4.0%
Surrey Bank & Trust	8.64%	4.0%

Asset Quality

The notes to the consolidated 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 $409,984 in the first nine months of 2006 compared to $275,583 for the same period in 2005. Freedom Finance, LLC s portion of the loan loss provision was $253,401 during the period compared to $2,715 for the same period in 2005. This was due to significant loan growth. Loans in Freedom Finance, LLC have basically doubled since December 31, 2005, from $1,637,000 to $3,091,000.

The reserve for loan losses on September 30, 2006 was $2,528,533 or 1.71% of period end loans. This percentage is derived from total loans. Approximately $26,451,000 of loans at September 30, 2006 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 1.94% 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 September 30, 2006, the Bank had loans totaling approximately $436,160 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 utilitizes 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.

At September 30, 2006, the liquidity position of the Company was good, with short-term liquid assets of $19,416,792. Deposit declines coupled with loan growth during the first nine months of 2006 reduced the liquidity position by approximately $3,392,000 from December 31, 2005 totals. To provide supplemental liquidity, the Bank has six lines of credit with correspondent banks totaling $12,700,000. There were no outstanding advances against these lines at September 30, 2006. Additionally, the Bank has a secured borrowing arrangement with the Federal Home Loan Bank. The maximum credit available under this agreement approximates $15,138,000 at September 30, 2006. Advances taken down against the Federal Home Loan Bank line amounted to $12,450,000 at September 30, 2006. In addition, Freedom Finance, LLC has a secured revolving line of credit with another commercial bank in the amount of $2,250,000. At September 30, 2006, $1,500,000 was outstanding on this line.

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.

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

31.1	Certification
31.2	Certification
32.	Certification

(b.) Reports on 8-K

Incorporated by Reference to 8-Ks filed July 25, 2006

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: November 6, 2006

/s/ Edward C. Ashby, III
Edward C. Ashby, III
President and Chief Executive Officer

Date: November 6, 2006

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