

CONSOLIDATED FINANCIAL STATEMENTS  
AND INDEPENDENT AUDITORS' REPORT

**VERUS ACQUISITION GROUP, INC.  
AND SUBSIDIARY**

December 31, 2013 and 2012

**INDEPENDENT AUDITORS' REPORT**

Board of Directors  
Verus Acquisition Group, Inc.  
Fort Collins, Colorado

We have audited the accompanying consolidated financial statements of Verus Acquisition Group, Inc. and Subsidiary which are comprised of the consolidated balance sheets as of December 31, 2013 and 2012, and the related consolidated statements of income, stockholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

**Management's Responsibility for the Consolidated Financial Statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

**Auditor's Responsibility**

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

**Opinion**

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Verus Acquisition Group, Inc. and Subsidiary at December 31, 2013 and 2012 and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Denver, Colorado  
March 26, 2014

**Verus Acquisition Group, Inc. and Subsidiary**  
**CONSOLIDATED BALANCE SHEETS**

	December 31,	
	2013	2012
	(in thousands)	
<b>ASSETS</b>		
Cash and due from banks	\$ 2,784	\$ 3,939
Interest-bearing deposits with banks	15,777	18,363
Federal funds sold	496	495
Total cash and cash equivalents	19,057	22,797
Nonmarketable equity securities	1,563	1,546
Loans	241,979	237,567
Less allowance for loan losses	(3,124)	(2,195)
Total loans	238,855	235,372
Foreclosed real estate	2,724	2,687
Premises and equipment, net	345	446
Accrued interest receivable	693	814
Core deposit intangible	487	788
Goodwill	733	733
Other assets	2,594	3,096
	\$ 267,051	\$ 268,279
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Liabilities		
Deposits		
Noninterest-bearing	\$ 32,547	\$ 26,144
Interest-bearing	184,752	200,526
Total deposits	217,299	226,670
Federal Home Loan Bank borrowings	4,211	4,211
Short-term borrowings	1,300	-
Accrued interest payable	50	68
Other liabilities	5,670	864
Total liabilities	228,530	231,813
Commitments (notes D and J)		
Stockholders' equity		
Preferred stock - 9,740 shares authorized, no par value per share, 9,740 shares issued and outstanding	9,740	9,740
Common stock - 5,000,000 shares authorized, no par value per share, 1,206,101 shares issued and outstanding	12,050	12,042
Retained earnings	2,664	1,813
Total equity attributable to common stock	24,454	23,595
Noncontrolling interest	14,067	12,871
Total stockholders' equity	38,521	36,466
	\$ 267,051	\$ 268,279

The accompanying notes are an integral part of these consolidated financial statements.

**Verus Acquisition Group, Inc. and Subsidiary**  
**CONSOLIDATED STATEMENTS OF INCOME**

	Years Ended December 31,	
	2013	2012
	(in thousands)	
Interest and dividend income		
Interest and fees on loans	\$ 14,935	\$ 15,574
Interest on federal funds sold	1	2
Interest-bearing deposits with banks	95	46
Dividends	63	58
Total interest and dividend income	15,094	15,680
Interest expense		
Deposits	1,706	2,115
Federal Home Loan Bank borrowings	68	68
Notes payable	-	20
Total interest expense	1,774	2,203
Net interest income	13,320	13,477
Provision for loan losses	953	1,347
Net interest income after provision for loan losses	12,367	12,130
Noninterest income		
Service charges on deposit accounts	215	129
Fees from servicing government guaranteed loans	82	113
Gain on sale of foreclosed real estate	437	61
Gain on sale of government-guaranteed loans	-	10
Other	282	173
	1,016	486
Noninterest expenses		
Salaries and employee benefits	1,755	2,632
Occupancy and equipment	642	626
Writedowns on foreclosed real estate	249	161
Core deposit amortization	301	480
Other expenses	1,488	1,243
	4,435	5,142
Income before income taxes	8,948	7,474
Income tax expense	3,512	2,914
Net income before noncontrolling interests	5,436	4,560
Less net income attributable to noncontrolling interests	(2,770)	(2,460)
<b>NET INCOME</b>	<b>\$ 2,666</b>	<b>\$ 2,100</b>
Net income	\$ 2,666	\$ 2,100
Less: Preferred dividends	102	98
Net income available to common shareholders	\$ 2,564	\$ 2,002

The accompanying notes are an integral part of these consolidated financial statements.

**Verus Acquisition Group, Inc. and Subsidiary**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**  
Years ended December 31, 2013 and 2012

	Preferred stock	Common stock	Retained earnings	Total	Non- controlling interests	Total equity
			(in thousands)			
<b>Balance at December 31, 2011</b>	\$ 9,740	\$ 12,111	\$ 1,560	\$ 23,411	\$ 13,825	\$ 37,236
Repurchase of minority interest common stock	-	-	-	-	(92)	(92)
Issuance of minority interest common stock	-	-	-	-	289	289
Repurchase of 5,000 shares of common stock	-	(69)	-	(69)	-	(69)
Comprehensive income						
Net income	-	-	2,100	2,100	2,460	4,560
Less dividends on common stock	-	-	(1,749)	(1,749)	(3,611)	(5,360)
Less dividends on preferred stock	-	-	(98)	(98)	-	(98)
<b>Balance at December 31, 2012</b>	9,740	12,042	1,813	23,595	12,871	36,466
Repurchase of minority interest common stock	-	-	-	-	(13)	(13)
Issuance of minority interest common stock	-	-	-	-	340	340
Adjustment of prior year stock repurchase	-	8	-	8	-	8
Comprehensive income						
Net income	-	-	2,666	2,666	2,770	5,436
Less dividends on common stock	-	-	(1,713)	(1,713)	(1,901)	(3,614)
Less dividends on preferred stock	-	-	(102)	(102)	-	(102)
<b>Balance at December 31, 2013</b>	<u>\$ 9,740</u>	<u>\$ 12,050</u>	<u>\$ 2,664</u>	<u>\$ 24,454</u>	<u>\$ 14,067</u>	<u>\$ 38,521</u>

The accompanying notes are an integral part of these consolidated financial statements.

**Verus Acquisition Group, Inc. and Subsidiary**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Year ended December 31,	
	2013	2012
	(in thousands)	
Cash flows from operating activities		
Net income	\$ 2,666	\$ 2,100
Adjustments to reconcile net income to net cash flows from operating activities		
Depreciation and amortization	183	204
Core deposit amortization	301	480
Valuation allowance on foreclosed real estate	249	161
Provision for loan losses	953	1,347
Federal Home Loan Bank stock dividends	(3)	(3)
Gain on sale of foreclosed real estate	(437)	(61)
Accretion of loan discount	(1,207)	(1,665)
Gain on sale of government guaranteed loans	-	(10)
Minority interest in subsidiary	2,770	2,460
Deferred income taxes	11	(150)
Net change in:		
Accrued interest receivable and other assets	612	141
Accrued interest payable and other liabilities	4,788	(166)
Net cash provided by operating activities	10,886	4,838
Cash flows from investing activities		
Purchase of nonmarketable equity securities	(14)	(263)
Loan originations and principal collections, net	(5,699)	(15,626)
Expenditures for premises and equipment	(82)	(5)
Proceeds from the sale of foreclosed real estate	2,621	1,232
Net cash used in investing activities	(3,174)	(14,662)
Cash flows from financing activities		
Net change in deposits	(9,371)	19,935
Repurchase of common stock	(5)	(161)
Proceeds from sale of common stock	340	289
Advancement of short-term borrowings	1,300	-
Payments on note payable	-	(2,225)
Cash dividends paid on common stock	(3,614)	(5,360)
Cash dividends paid on preferred stock	(102)	(98)
Net cash provided by (used in) financing activities	(11,452)	12,380
Net change in cash and cash equivalents	(3,740)	2,556
Cash and cash equivalents at beginning of period	22,797	20,241
Cash and cash equivalents at end of period	\$ 19,057	\$ 22,797
Supplemental Disclosures of Cash Flow Information		
Cash paid during the period for:		
Interest expense	\$ 1,792	\$ 2,247
Income taxes	3,548	2,678

The accompanying notes are an integral part of these consolidated financial statements.

**Verus Acquisition Group, Inc. and Subsidiary**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2013 and 2012**

**NOTE A - SUMMARY OF ACCOUNTING POLICIES**

The accounting and reporting policies of Verus Acquisition Group, Inc. and Subsidiary conform to accounting principles generally accepted in the United States of America and to general practice within the banking industry. The following is a summary of the significant accounting and reporting policies:

**Organization and Principles of Consolidation**

Verus Acquisition Group, Inc. (Verus) was incorporated on March 2, 2010 for the purpose of becoming a bank holding company. On October 29, 2010, Verus purchased the 51% interests in the following banks (the Banks) from subsidiaries of Capital Bancorp Limited, a national community bank development company: Fort Collins Commerce Bank (FCCB), Larimer Bank of Commerce (LRBC) and Loveland Bank of Commerce (LVBC). The entities are collectively referred to as "the Company."

On February 14, 2011, LRBC and LVBC were merged into FCCB. Following the merger, the name of the Bank was changed to Verus Bank of Commerce (Bank). The merger was accounted for as a combination of commonly controlled entities.

The accompanying consolidated financial statements include the consolidated totals of the accounts of Verus and its subsidiary. The consolidated financial statements include the operations of the Bank for the period endings December 31, 2013 and 2012, respectively.

All significant intercompany accounts and transactions have been eliminated in consolidation.

**Nature of Operations**

The Company provides a full range of banking and mortgage services to individual and corporate customers, principally in Larimer County, Colorado and the surrounding area. The Company is subject to competition from other financial institutions for loan and deposit accounts. The Company is also subject to regulation by certain governmental agencies and undergoes periodic examinations by those regulatory agencies.

## **Use of Estimates**

The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period. Actual results could differ significantly from those estimates.

Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan losses and valuation of foreclosed real estate.

In connection with the determination of the allowance for loan losses, management obtains independent appraisals for significant properties and assesses estimated future cash flows from borrowers' operations and the liquidation of loan collateral.

Management believes that the allowance for loan losses is adequate. While management uses available information to recognize loan losses, changes in economic conditions may necessitate revisions in future years.

## **Significant Group Concentrations of Credit Risk**

Most of the Company's activities are with customers located in the Larimer County, Colorado area. Note B discusses the types of lending that the Company engages in.

## **Cash and Cash Equivalents**

For purposes of the statements of cash flows, cash and cash equivalents include cash and balances due from banks, interest-bearing deposits with banks, Bank held certificates of deposit and federal funds sold.

## **Nonmarketable Equity Securities**

Nonmarketable equity securities, consisting of Federal Home Loan Bank and Federal Reserve Bank stock, are recorded at cost.

## **Loans**

The Company primarily grants construction, land and land development and real estate loans to customers primarily in the Larimer County, Colorado area. The ability of the Company's borrowers to honor their contracts is dependent upon the real estate and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs and the allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are

deferred and recognized as an adjustment on the related loan yield using the effective yield method.

Past due loans are any loans for which payments of interest, principal or both have not been received within the timeframes designated by the loan agreements. Loans with payments in arrears but for which borrowers have resumed making scheduled payments are considered past due until arrearages are brought current. Loans that experience insignificant payment delays or payment shortfalls generally are not considered past due. 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.

The accrual of interest on all loans is discontinued at the time a loan is 90 days delinquent unless the loan is well secured and in process of collection. Additionally, loans are placed on nonaccrual at an earlier date if collection of principal or interest is considered doubtful. When placing a loan on nonaccrual status, interest accrued to date is generally reversed and is charged against the current year's interest income. Payments received on a loan on nonaccrual status are applied against the balance of the loan. A loan is returned to accrual status when principal and interest are no longer past due and collectability is no longer doubtful.

Troubled debt restructurings are loans for which concessions in terms have been made as a result of the borrower experiencing financial difficulty. Generally, concessions granted to customers include lower interest rates and modification of the payment stream to lower or defer payments. Interest on troubled debt restructurings is accrued under the new terms if the loans are performing and full collection of principal and interest is expected. However, interest accruals are discontinued on troubled debt restructurings that meet the Company's nonaccrual criteria.

Generally, loans are charged off in whole or in part on a loan-by-loan basis after they become significantly past due and based upon management's review of the collectability of all or a portion of the loan unless the loan is in the process of restructuring. Charge off amounts are determined based upon the carrying amount of loans and the amount estimated to be collectible as determined by analyses of expected future cash flows and the liquidation of loan collateral.

### **Purchased Loans**

With the application of purchase accounting due to the previously described merger, the Company was deemed to have acquired all of its loans at fair value on October 29, 2010, without the carryover of the Banks' previously accrued allowance for loan losses. Losses on these loans that are incurred subsequent to the date of acquisition are recognized by a provision for loan losses.

Loan discounts on unimpaired loans are accreted into income over the anticipated life of the portfolio. For impaired loans, the difference between the contractual balance and the

estimated fair value has been treated as a non-accretable discount and, if applicable, will be recognized as interest income after the carrying amount of these loans has been recovered.

### **Allowance for Loan Losses**

The allowance for loan losses is a valuation allowance for probable incurred credit losses, and is established through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance consists of specific and general components as follows:

The specific component relates to loans that are considered impaired, and is comprised of valuation allowances calculated on a loan-by-loan basis. Impaired loans are all specifically identified loans for which it is probable that the Company will not collect all amounts due according to the contractual terms of the loan agreement. Factors considered by management in determining whether a loan is impaired include payment status, collateral value, the borrower's financial condition and overall loan quality as determined by an internal loan grading system. Included in impaired loans are all nonaccrual loans and all accruing troubled debt restructurings. Loans that experience insignificant payment delays or payment shortfalls generally are not considered impaired. For impaired loans for which repayment is expected solely from the collateral, impairment is measured based on the fair value of the collateral. For other impaired loans, impairment may be measured based on the fair value of the collateral or on the present value of expected future cash flows discounted at the loan's original effective interest rate. When the measure of the impaired loan is less than the recorded investment in the loan, the impairment is recorded through a valuation allowance.

The general component relates to non-impaired loans, and is based on historical loss experience adjusted for the effects of qualitative factors that are likely to cause estimated credit losses as of the evaluation date to differ from the portfolio's historical loss experience. Qualitative factors include the following: economic conditions; industry conditions; changes in lending policies and procedures; trends in the volume and terms of loans; the experience, ability and depth of lending staff; levels and trends in delinquencies; levels and trends in charge-off and recovery activity; levels and trends of loan quality as determined by an internal loan grading system; and portfolio concentrations.

Although the allowance contains a specific component, the entire allowance is available for any loan that, in management's judgment, should be charged-off.

On a monthly basis, management estimates the allowance balance required using the criteria identified above in relation to the relevant risks for each of the Company's major loan segments. Significant overall risk factors for both the Company's real estate, commercial and consumer portfolios include the strength of the real estate market and the strength of economy in the Company's lending area.

The quality of the Company's loan portfolio is assessed as a function of the levels of past due loans and impaired loans, and internal credit quality ratings which are updated monthly by management. The ratings on the Company's internal credit scale are broadly grouped into the categories "non-classified" and "classified." Non-classified loans are those loans with minimal identified credit risk, as well as loans with potential credit weaknesses which deserve management's attention but for which full collection of contractual principal and interest is not significantly at risk. Classified loans are those loans that have well-defined weakness that put full collection of contractual principal or interest at risk, and classified loans for which it is probable that the Company will not collect all contractual principal or interest are also considered impaired. The credit quality ratings are an important part of the Company's overall credit risk management process and are considered in the determination of the allowance for loan losses.

Determination of the allowance is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance. Such agencies may require the Company to recognize additional losses based on their judgments about information available to them at the time of their examination.

### **Off- Balance Sheet Financial Instruments**

In the ordinary course of business, the Company enters into off-balance-sheet financial instruments consisting of commitments to extend credit, unused lines of credit, standby letters of credit and undisbursed loans in process. These financial instruments are recorded in the financial statements when they are funded.

In conjunction with the determination of the allowance for loan losses, and using the same criteria, the Company determines the extent of credit risk on its off-balance sheet financial instruments and whether there are probable incurred credit losses on those instruments for which a loss provision is necessary. The Company has determined that there is minimal credit risk on its off-balance sheet financial instruments, and accordingly has not recorded a loss provision or allowance for those instruments.

## **Foreclosed Real Estate**

Real estate acquired through, or in lieu of, loan foreclosure is held for sale and is initially recorded at fair value less cost to sell at the date of acquisition, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in other expenses.

## **Premises and Equipment**

Premises, equipment and leasehold improvements are stated at cost. Depreciation and amortization are provided for in amounts sufficient to relate the cost of depreciable assets to operations over their estimated service lives or lease periods, principally on the straight-line method.

## **Intangible Assets**

### **Core Deposit Intangible**

The core deposit intangible resulted from Verus' acquisition of the Banks, and represents the excess of the fair value of deposits acquired over their book value at the time of acquisition. The core deposit intangible is amortized to expense over a ten year period. In addition, the core deposit intangible is assessed at least annually for impairment, and any impairment losses are recognized in earnings in the period identified.

### **Goodwill**

Goodwill resulting from Verus' acquisition of the Banks represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is assessed at least annually for impairment, and any impairment losses are recognized in earnings in the period identified.

## **Income Taxes**

Verus and its subsidiary each file separate federal and state returns. The Company is no longer subject to U.S. federal income tax examinations by tax authorities for years before 2010.

Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws. Realization of deferred tax assets is dependent upon the generation of a sufficient level of future taxable income and recoverable taxes paid in prior years. Management periodically assesses the deferred tax asset, and a valuation allowance is recorded if the full amount is not expected to be realized.

The Company has adopted guidance issued by the Financial Accounting Standards Board with respect to accounting for uncertainty in income taxes. A tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that a portion of the deferred tax asset may not be realized within one year.

### **Transfers of Financial Assets**

Transfers of financial assets are accounted for as sales when control over the assets has been relinquished. Control over transferred assets is deemed to be relinquished when the assets have been isolated from the Company, the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before maturity.

### **Subsequent Events**

Management evaluates events occurring subsequent to the balance sheet date, through the date the financial statements are eligible to be issued, to determine whether the events require recognition or disclosure in the financial statements. If a subsequent event evidences conditions existing at the balance sheet date, the effects are recognized in the financial statements (recognized subsequent event). If a subsequent event evidences conditions arising after the balance sheet date, the effects are not recognized in the financial statements but rather disclosed in the notes to the consolidated financial statements (non-recognized subsequent events). The effects of subsequent events are only recognized if material, or disclosed if the financial statements would otherwise be misleading.

The Company has evaluated subsequent events for recognition and disclosure through March 26, 2014, which is the date the financial statements were available to be issued.

### **Comprehensive Income**

Comprehensive income consists of net income and other comprehensive income.

In 2012, the Company adopted new accounting guidance that requires comprehensive income to be disclosed in a single, continuous statement of comprehensive income, or in two separate but consecutive statements of income and comprehensive income. The Company has no other comprehensive income for the years ended December 31, 2013 and 2012.

## NOTE B - LOANS AND ALLOWANCE FOR LOAN LOSSES

A summary of the balances of loans follows:

	December 31,	
	2013	2012
	(in thousands)	
Construction, land and land development		
Residential 1-4 family	\$ 5,663	\$ 3,582
Other	24,124	10,820
	<u>29,787</u>	<u>14,402</u>
Real estate		
Residential 1-4 family	21,357	25,929
Multifamily	12,350	12,834
Commercial	157,056	158,416
Farmland	2,362	6,234
	<u>193,125</u>	<u>203,413</u>
Commercial and industrial	19,910	21,829
Consumer and other	178	151
	<u>243,000</u>	<u>239,795</u>
Less loan discount	<u>(1,021)</u>	<u>(2,228)</u>
	<u>\$ 241,979</u>	<u>\$ 237,567</u>

At December 31, 2013, the Company had approximately \$50,700,000 of SBA 504 and \$7,600,000 of SBA 7A loans. Management believes these loans are considered liquid assets given the active and mature secondary market for these loans as well as their associated premiums. Management includes these assets as part of its liquidity measurement and includes them in the Company's Contingent Liquidity Plan, which is updated quarterly. These loans may be periodically sold for liquidity purposes and to manage industry concentrations and interest rate risk.

As a result of the previously described acquisition, and the application of purchase accounting on October 29, 2010, the Company was deemed to have acquired all loans on that date at fair value. For loans deemed to be impaired, it was probable that all contractually required payments would not be collected. However, the expected cash flows on these loans are uncertain and management has elected to treat the purchase discounts on these loans as non-accretable and to recognize those discounts in interest income on the cash basis after the initial purchase cost of the loans have been recovered. In 2011, the Company changed its estimate of the accretable loan discount (decreasing it by \$250,000) to more accurately reflect the yield on the purchased loan portfolio and to more accurately reflect the non-accretable

purchase discount. The remaining loan related to this transaction was transferred to foreclosed real estate during 2013.

Activity in the loan discount follows:

	(in thousands)
Balance at December 31, 2012	\$ 2,228
Less amount accreted to income	<u>(1,207)</u>
Balance at December 31, 2013	<u><u>\$ 1,021</u></u>

Transactions in the allowance for loan losses are as follows:

	Year ended December 31, 2013 (in thousands)				
	<u>Construction, land and land development</u>	<u>Real estate</u>	<u>Commercial and industrial</u>	<u>Consumer and other</u>	<u>Total</u>
Balance at December 31, 2012	\$ 401	\$ 1,564	\$ 229	\$ 1	\$ 2,195
Provision for loan losses	109	(458)	1,302	-	953
Charge-offs	(17)	-	(184)	-	(201)
Recoveries	-	7	169	1	177
Net (charge-offs) recoveries	<u>(17)</u>	<u>7</u>	<u>(15)</u>	<u>1</u>	<u>(24)</u>
Balance at December 31, 2013	<u><u>\$ 493</u></u>	<u><u>\$ 1,113</u></u>	<u><u>\$ 1,516</u></u>	<u><u>\$ 2</u></u>	<u><u>\$ 3,124</u></u>

Year ended December 31, 2012  
(in thousands)

	Construction, land and land development	Real estate	Commercial and industrial	Consumer and other	Total
Balance at December 31, 2011	\$ 160	\$ 607	\$ 187	\$ 1	\$ 955
Provision for loan losses	328	986	33	-	1,347
Charge-offs	(87)	(29)	-	-	(116)
Recoveries	-	-	9	-	9
Net (charge-offs) recoveries	(87)	(29)	9	-	(107)
Balance at December 31, 2012	<u>\$ 401</u>	<u>\$ 1,564</u>	<u>\$ 229</u>	<u>\$ 1</u>	<u>\$ 2,195</u>

Components of the allowance for losses, and the related carrying amount of loans for which the allowance is determined, are as follows:

December 31, 2013  
(in thousands)

	Construction, land and land development	Real estate	Commercial and industrial	Consumer and other	Total
<b><u>Allocation of Allowance To:</u></b>					
Impaired loans - evaluated individually	\$ -	\$ -	\$ 1,418	\$ -	\$ 1,418
Impaired loans - evaluated collectively	-	-	-	-	-
Total impaired loans	-	-	1,418	-	1,418
Unimpaired loans - evaluated collectively	493	1,113	98	2	1,706
	<u>\$ 493</u>	<u>\$ 1,113</u>	<u>\$ 1,516</u>	<u>\$ 2</u>	<u>\$ 3,124</u>
<b><u>Recorded Investment In:</u></b>					
Impaired loans - evaluated individually	\$ -	\$ -	\$ 1,418	\$ -	\$ 1,418
Impaired loans - evaluated collectively	-	-	-	-	-
Total impaired loans	-	-	1,418	-	1,418
Unimpaired loans - evaluated collectively	29,660	192,341	18,383	177	240,561
	<u>\$ 29,660</u>	<u>\$ 192,341</u>	<u>\$ 19,801</u>	<u>\$ 177</u>	<u>\$ 241,979</u>

December 31, 2012  
(in thousands)

	Construction, land and land development	Real estate	Commercial and industrial	Consumer and other	Total
<b><u>Allocation of Allowance To:</u></b>					
Impaired loans - evaluated individually	\$ -	\$ 485	\$ -	\$ -	\$ 485
Impaired loans - evaluated collectively	-	-	32	-	32
Total impaired loans	-	485	32	-	517
Unimpaired loans - evaluated collectively	401	1,079	197	1	1,678
	\$ 401	\$ 1,564	\$ 229	\$ 1	\$ 2,195
<b><u>Recorded Investment In:</u></b>					
Impaired loans - evaluated individually	\$ -	\$ 1,990	\$ -	\$ -	\$ 1,990
Impaired loans - evaluated collectively	-	-	148	-	148
Total impaired loans	-	1,990	148	-	2,138
Unimpaired loans - evaluated collectively	14,157	199,905	21,220	147	235,429
	\$ 14,157	\$ 201,895	\$ 21,368	\$ 147	\$ 237,567

Information relative to impaired loans is as follows:

As of and for the year ended December 31, 2013  
(in thousands)

	Recorded Investment In Impaired Loans With No Valuation Allowance	Recorded Investment In Impaired Loans With A Valuation Allowance	Total Impaired Loans	Valuation Allowance On Impaired Loans	Contractual Principal Of Impaired Loans	Commitments To Extend Credit On Impaired Loans	Average Impaired Loans
Construction, land and land development							
Residential 1-4 family	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Other	-	-	-	-	-	-	-
	-	-	-	-	-	-	-
Real estate							
Residential 1-4 family	-	-	-	-	-	-	1,048
Multifamily	-	-	-	-	-	-	122
Commercial	-	-	-	-	-	-	4
Farmland	-	-	-	-	-	-	108
	-	-	-	-	-	-	1,282
Commercial and industrial	-	1,418	1,418	1,418	1,418	-	2,113
Consumer and other	-	-	-	-	-	-	-
	\$ -	\$ 1,418	\$ 1,418	\$ 1,418	\$ 1,418	\$ -	\$ 3,395

As of and for the year ended December 31, 2012  
(in thousands)

	Recorded Investment In Impaired Loans With No Valuation Allowance	Recorded Investment In Impaired Loans With A Valuation Allowance	Total Impaired Loans	Valuation Allowance On Impaired Loans	Contractual Principal Of Impaired Loans	Commitments To Extend Credit On Impaired Loans	Average Impaired Loans
Construction, land and land development							
Residential 1-4 family	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Other	-	-	-	-	-	-	-
	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
Real estate							
Residential 1-4 family	716	576	1,292	450	1,292	-	1,398
Multifamily	-	-	-	-	-	-	-
Commercial	-	51	51	35	51	-	161
Farmland	647	-	647	-	647	-	651
	<u>1,363</u>	<u>627</u>	<u>1,990</u>	<u>485</u>	<u>1,990</u>	<u>-</u>	<u>2,210</u>
Commercial and industrial	-	148	148	32	148	-	154
Consumer and other	-	-	-	-	-	-	-
	<u>\$ 1,363</u>	<u>\$ 775</u>	<u>\$ 2,138</u>	<u>\$ 517</u>	<u>\$ 2,138</u>	<u>\$ -</u>	<u>\$ 2,364</u>

Interest income recognized on impaired loans was immaterial for the two years ended December 31, 2013 and 2012, respectively.

The Company had no troubled debt restructurings for the years ended December 31, 2013 and 2012.

The carrying amounts of loans by performance status and credit quality indicator are as follows:

December 31, 2013  
(in thousands)

	Loans By Past Due and Performance Status					Loans By Credit Quality Indicator		
	Accruing Loans					Classified		
	Current	30-89 Days Past Due	90 Days or More Past Due	Nonaccrual Loans	Total Loans	Non- classified	Unimpaired	Impaired
Construction, land and land development								
Residential 1-4 family	\$ 5,643	\$ -	\$ -	\$ -	\$ 5,643	\$ 5,643	\$ -	\$ -
Other	24,017	-	-	-	24,017	22,003	2,014	-
	29,660	-	-	-	29,660	27,646	2,014	-
Real estate								
Residential 1-4 family	21,218	-	-	-	21,218	21,122	96	-
Multifamily	12,311	-	-	-	12,311	12,311	-	-
Commercial	156,486	-	-	-	156,486	156,344	142	-
Farmland	2,326	-	-	-	2,326	2,326	-	-
	192,341	-	-	-	192,341	192,103	238	-
Commercial and industrial	18,383	-	-	1,418	19,801	18,383	-	1,418
Consumer and other	177	-	-	-	177	177	-	-
	<u>\$ 240,561</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 1,418</u>	<u>\$ 241,979</u>	<u>\$ 238,309</u>	<u>\$ 2,252</u>	<u>\$ 1,418</u>

December 31, 2012  
(in thousands)

	Loans By Past Due and Performance Status					Loans By Credit Quality Indicator			
	Accruing Loans					Classified			
	Current	30-89 Days Past Due	90 Days or More Past Due	Nonaccrual Loans	Total Loans	Non- classified	Unimpaired	Impaired	
Construction, land and land development									
Residential 1-4 family	\$ 3,545	\$ -	\$ -	\$ -	\$ 3,545	\$ 3,545	\$ -	\$ -	
Other	10,612	-	-	-	10,612	8,596	2,016	-	
	14,157	-	-	-	14,157	12,141	2,016	-	
Real estate									
Residential 1-4 family	24,218	155	-	1,292	25,665	24,357	16	1,292	
Multifamily	12,758	-	-	-	12,758	12,758	-	-	
Commercial	156,128	1,130	-	51	157,309	156,893	365	51	
Farmland	5,516	-	-	647	6,163	5,516	-	647	
	198,620	1,285	-	1,990	201,895	199,524	381	1,990	
Commercial and industrial	21,220	-	52	96	21,368	21,220	-	148	
Consumer and other	147	-	-	-	147	147	-	-	
	<u>\$ 234,144</u>	<u>\$ 1,285</u>	<u>\$ 52</u>	<u>\$ 2,086</u>	<u>\$ 237,567</u>	<u>\$ 233,032</u>	<u>\$ 2,397</u>	<u>\$ 2,138</u>	

## NOTE C – FORECLOSED REAL ESTATE

A summary of the activity in foreclosed real estate held for sale is as follows:

	Year Ended December 31,	
	2013	2012
	(in thousands)	
Balance at beginning of year	\$ 2,687	\$ 2,487
Transfers from loans	2,470	1,532
Valuation allowances recorded	(249)	(161)
Disposition	<u>(2,184)</u>	<u>(1,171)</u>
Balance at end of year	<u>\$ 2,724</u>	<u>\$ 2,687</u>

Net expense from foreclosed real estate included in noninterest expenses is as follows:

	Year Ended December 31,	
	2013	2012
	(in thousands)	
Net (gain) loss on disposition	\$ (437)	\$ (61)
Valuation allowances recorded	249	161
Other related expenses	<u>299</u>	<u>159</u>
Balance at end of year	<u>\$ 111</u>	<u>\$ 259</u>

#### NOTE D - PREMISES AND EQUIPMENT

At December 31, premises and equipment, less accumulated depreciation and amortization consisted of the following:

	December 31,	
	2013	2012
	(in thousands)	
Leasehold improvements	\$ 785	\$ 785
Furniture, fixtures and equipment	<u>1,273</u>	<u>1,191</u>
	2,058	1,976
Accumulated depreciation and amortization	<u>(1,713)</u>	<u>(1,530)</u>
	<u>\$ 345</u>	<u>\$ 446</u>

The Company rents office space under an operating lease. The lease is for five years with renewal options. Rent expense in 2013 and 2012 was \$323,000 and \$252,000, respectively.

Future lease payments under the lease are as follows:

Years ending <u>December 31,</u>	(in thousands)
2014	\$ 236
2015	14
Thereafter	<u>-</u>
	<u>\$ 250</u>

## NOTE E – CORE DEPOSIT INTANGIBLE

The core deposit intangible asset consists of the:

	<u>December 31,</u>	
	<u>2013</u>	<u>2012</u>
	(in thousands)	
Core deposit intangible	\$ 2,166	\$ 2,166
Less accumulated amortization	<u>(1,679)</u>	<u>(1,378)</u>
	<u>\$ 487</u>	<u>\$ 788</u>

Future annual amortization of the core deposit intangible is as follows:

<u>Years ending</u> <u>December 31,</u>	(in thousands)
2014	\$ 189
2015	119
2016	75
2017	47
2018	57
Thereafter	<u>-</u>
	<u>\$ 487</u>

## NOTE F - DEPOSITS

The aggregate amount of time deposits in denominations of \$100,000 or more at December 31, 2013 and 2012 was \$44,399,000 and \$56,455,000, respectively.

At December 31, 2013, the scheduled maturities of certificates of deposit are as follows:

<u>Years ending</u> <u>December 31,</u>	(in thousands)
2014	\$ 52,087
2015	33,630
2016	6,709
2017	2,227
2018	7,829
Thereafter	<u>3,688</u>
	<u>\$ 106,170</u>

## NOTE G – FEDERAL HOME LOAN BANK BORROWINGS

At December 31, 2013 and 2012, long-term debt (debt with original maturities of more than one year) of \$4,211,000, consisted of a Federal Home Loan Bank fixed-rate advances with rates ranging from 1.10%-1.68%, with a weighted average interest rate of 1.17%.

At December 31, 2013 and 2012, short-term borrowings of \$1,300,000 and \$0, consisted of Federal Home Loan Bank fixed-rate advances with an interest rate of 0.19%. These borrowings mature within 30 days.

At December 31, 2013 and 2012, loans totaling \$128,869,000 and \$131,114,000 were pledged to secure all Federal Home Loan Bank borrowings. At December 31, 2013, the Bank had additional borrowing capacity at the Federal Home Loan Bank of approximately \$76,147,000.

At December 31, 2013, the Bank maintained various additional short and long-term lines of credit from the Federal Home Loan Bank and other institutions with available facilities of \$16,000,000.

At December 31, 2013, scheduled maturities of long-term borrowings were as follows:

Years ending <u>December 31,</u>	(in thousands)
2014	\$ 3,711
2015	-
2016	500
Thereafter	-
	<hr/>
	<u>\$ 4,211</u>

## NOTE H – NOTE PAYABLE

On October 28, 2010, the Company entered into a loan agreement with an unaffiliated bank (the Lender) to borrow up to \$5 million under a line of credit. Interest was computed at .5% above the New York prime rate as published in the Wall Street Journal. The interest rate on the note had a floor of 6% and a ceiling of 9%. Interest on the note was due quarterly. The note was collateralized by all of the common stock of the Banks that is owned by Verus. The note was guaranteed by certain key officers and directors of the Company. Also, the Company was required to purchase life insurance policies on these individuals. The Company deposited \$600,000 (an amount equal to estimated interest on the note for two years) with the Lender in an “interest reserve account.” Amounts in this account may be applied to accrued interest by the Lender at its discretion.

The loan agreement for the note contained covenants and restrictions relative to the use of dividend payments, maintaining adequate capital levels, the allowance for loan losses, levels

of classified assets in relation to equity, earnings and other factors. At December 31, 2012, the loan was subject to a term out provision. The loan was paid in full, prior to December 31, 2012.

## NOTE I – INCOME TAXES

Following is an analysis of income taxes included in the statements of income:

	<u>2013</u>	<u>2012</u>
	(in thousands)	
Current tax expense (benefit)		
Federal	\$ 3,063	\$ 2,683
State	437	381
	<u>3,500</u>	<u>3,064</u>
Deferred tax expense (benefit)		
Federal	10	(132)
State	1	(18)
	<u>11</u>	<u>(150)</u>
	<u>\$ 3,511</u>	<u>\$ 2,914</u>

Listed below are the components of the net deferred tax assets, which are included in other assets:

	<u>December 31,</u>	
	<u>2013</u>	<u>2012</u>
	(in thousands)	
Deferred tax assets		
Allowance for loan losses	\$ 1,158	\$ 814
Basis of loans	378	825
Net operating loss carryforwards	-	50
Organizational costs	230	259
Writedowns on foreclosed real estate	202	130
Deferred loan fees	142	140
Other	130	130
Total deferred tax assets	<u>2,240</u>	<u>2,348</u>
Deferred tax liabilities		
Core deposit intangible	(180)	(292)
Other	(15)	-
Total deferred tax liabilities	<u>(195)</u>	<u>(292)</u>
Net deferred tax asset	<u>\$ 2,045</u>	<u>\$ 2,056</u>

The reasons for the differences between the statutory federal income tax rate and the effective tax rate are summarized as follows:

	<u>Year Ended December 31,</u>	
	<u>2013</u>	<u>2012</u>
	(percentage)	
Statutory federal tax rate	34.0	34.0
Increase (decrease) resulting from:		
State tax, net of federal tax benefit	3.5	3.5
Net operating loss carryforward	-	(3.0)
Taxable dividends from Bank	0.1	3.3
Other	<u>1.6</u>	<u>1.3</u>
Effective rate	<u><u>39.2</u></u>	<u><u>39.1</u></u>

As described in Note A, Verus and the Bank each file separate income tax returns. Verus used all operating loss carryforwards during 2012. The Bank used remaining operating loss carry forwards during 2013.

#### **NOTE J - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK**

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and stand-by letters of credit.

Those instruments involve, to a varying degree, elements of credit risk in excess of the amount recognized in the statement of financial position. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit and stand-by letters of credit is represented by the contractual notional amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

At December 31, 2013 and 2012, the following financial instruments were outstanding whose contract amounts represent credit risk:

	<u>Contract Amount</u>	
	<u>2013</u>	<u>2012</u>
	(in thousands)	
Commitments to extend credit	\$ 24,462	\$ 22,588
Stand-by letters of credit	246	256

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee.

Since many of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's credit-worthiness on a case-by-case basis. The amount of collateral obtained if deemed necessary by the Company upon extension of credit is based on management's credit evaluation. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment and income-producing commercial properties.

Stand-by letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

## **NOTE K - EMPLOYEE BENEFIT AND COMPENSATION PLANS**

### **401(k) Plan**

The Company maintains a 401(k) retirement plan whereby substantially all employees who meet certain age and length of service requirements may participate in the plan. For the period ended December 31, 2013 and 2012, expense attributable to the Plan amounted to \$49,000 and \$49,000, respectively.

### **Employment Agreement**

The Company has employment agreements with its CEO and President. The agreements establish a salary that is increased annually based on performance factors relating to Company earnings, asset growth and asset quality. The CEO and President are also entitled to participate in annual bonuses based on Company earnings and asset quality. These are subject to annual review and approval by the Board of Directors.

### **Stock Appreciation Rights**

The Company has adopted a Stock Appreciation Rights (SAR) plan for senior officers during 2012. Under the plan, participants are granted a number of SARs at the discretion of the Company's Board of Directors. Each SAR entitles the holder to the book value appreciation in one share of the Company's common stock for the periods following the date of grant. The value of the stock appreciation vests immediately, at which time the holder is entitled to receive the value in cash. Expense attributable to the plan in 2013 and 2012 was \$0 and \$389,000, respectively. All expenses were paid as part of 2013 and 2012 compensation, and no liability related to this expense existed as of December 31, 2013 and 2012.

## **NOTE L – RELATED PARTY TRANSACTIONS**

In the ordinary course of business, the Company may make loans to executive officers, directors and principal shareholders of the Company, including their immediate families and companies in which they are principal owners. At December 31, 2013 and 2012, loans to these persons totaled \$2,330,000 and \$3,921,000, respectively. Deposits from related parties held by the Company at December 31, 2013 and 2012 amounted to \$2,383,000 and \$3,395,000, respectively.

## **NOTE M – STOCKHOLDERS' EQUITY AND DIVIDENDS**

### **Preferred Stock**

In 2011, the Company issued 9,740 shares of perpetual, non-cumulative preferred stock (\$1,000 per share liquidation preference) to the United States Department of Treasury as part of the Treasury's Small Business Lending Fund (SBLF) program. Total proceeds from the transaction were \$9,740,000.

The SBLF is a dedicated investment fund that encourages lending to small businesses by providing capital to qualified community banks. The SBLF is structured to encourage small business lending through a tiered dividend structure where the dividend rate on the preferred stock is based on the growth of the Company's small business lending. The initial dividend rate payable on SBLF capital is, at most, 5%, and the rate falls to 1% if a company's small business lending increases by 10% or more. Companies that increase their lending by less than 10% pay dividend rates between 2% and 4%. If a company's lending does not increase in the first two years after issuance, however, the dividend rate increases to 7%. Four and one-half years after issuance, the dividend rate for all companies increases to 9%. Dividends on the SBLF preferred stock are payable quarterly in arrears each January 1, April 1, July 1 and October 1. The Company's dividend rate in 2013 and 2012 was 1%.

## **Dividends**

Federal banking regulations place certain restrictions on dividends paid by the Bank to its shareholders. Approval by the banking regulators is required if the total of all dividends declared by the Bank exceeds the total of their net profits for the year combined with their retained net profits of the preceding two years.

In addition, dividends paid by the Bank would be prohibited if the effect thereof would cause the Banks capital to be deemed below the applicable minimum capital requirements.

## **NOTE N - MINIMUM REGULATORY CAPITAL REQUIREMENTS**

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Banks' financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2013 and 2012, that the Bank met all capital adequacy requirements to which they are subject.

As of December 31, 2013 and 2012, the most recent notification from bank regulators categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized an institution must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios are also presented in the following table.

	Actual		Minimum capital requirement		Minimum to be well capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(in thousands)						
<b><u>As of December 31, 2013</u></b>						
Total capital (to risk weighted assets)	\$ 40,342	17.3%	\$ 18,667	8.0%	\$ 23,334	10.0%
Tier 1 capital (to risk weighted assets)	37,413	16.0	9,334	4.0	14,000	6.0
Tier 1 capital (to average assets)	37,413	14.0	10,682	4.0	13,352	5.0
<b><u>As of December 31, 2012</u></b>						
Total capital (to risk weighted assets)	\$ 38,471	15.9%	\$ 19,417	8.0%	\$ 24,271	10.0%
Tier 1 capital (to risk weighted assets)	35,424	14.6	9,708	4.0	14,562	6.0
Tier 1 capital (to average assets)	35,424	13.7	10,366	4.0	12,958	5.0

#### **NOTE O – FAIR VALUE MEASUREMENT**

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

*Level 1* – Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

*Level 2* – Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

*Level 3* – Significant unobservable inputs that reflect a company’s own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Company used the following methods and significant assumptions to estimate fair value:

*Impaired Loans* - The Company does not record loans at fair value on a recurring basis. However, from time to time, fair value adjustments are recorded on these loans to reflect (1) partial write-downs that are based on the current appraised or market-quoted value of the underlying collateral or (2) the full charge-off of the loan carrying value. In some cases, the properties for which market quotes or appraised values have been obtained are located in areas where comparable sales data is limited, outdated, or unavailable. Fair value

estimates for impaired loans are obtained from independent appraisers or other third-party consultants (Level 3).

*Foreclosed Real Estate* - Nonrecurring adjustments to certain commercial and residential real estate properties classified as foreclosed real estate are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Assets and liabilities measured at fair value on a non-recurring basis are summarized below:

	December 31, 2013			
	Level 1	Level 2	Level 3	Total
	(in thousands)			
Impaired loans	\$ -	\$ -	\$ -	\$ -
Foreclosed real estate	-	-	2,724	2,724

  

	December 31, 2012			
	Level 1	Level 2	Level 3	Total
	(in thousands)			
Impaired loans	\$ -	\$ -	\$ 1,621	\$ 1,621
Foreclosed real estate	-	-	2,687	2,687

At December 31, 2013 and 2012, impaired loans, which are measured for impairment using the fair value of the collateral, with a carrying value of \$1,418,000 and \$2,138,000, respectively, were written down to their fair value of \$0 and \$1,621,000, resulting in an additional provision for loan losses of \$1,418,000 and \$517,000, respectively, which was included in earnings for the year.

At December 31, 2013 and 2012, foreclosed real estate with a cost basis of \$3,263,000 and \$3,048,000, respectively, is carried at its estimated fair value of \$2,724,000 and \$2,687,000, respectively. The valuation allowance of \$539,000 and \$361,000, respectively, has been recorded through expense.

During 2013 and 2012, there were no changes or amounts in Level 3 assets or liabilities recorded at fair value on a recurring basis.

The following summary presents the methodologies and assumptions used to estimate the fair value of the Company's financial instruments. The Company operates as a going concern and, except for its investment portfolio, no active market exists for its financial instruments. Much of the information used to determine fair value is highly subjective and judgmental in nature and, therefore, the results may not be precise. The subjective factors include, among other things, estimates of cash flows, risk characteristics, credit quality and interest rates, all of which are subject to change. Since the fair value is estimated as of the balance sheet date, the amounts which will actually be realized or paid upon settlement or maturity of the various financial instruments could be significantly different.

### **Cash and Cash Equivalents**

The carrying amounts of cash and short-term instruments approximate fair values. Interest-bearing deposits in other financial institutions are carried at cost. Fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk of similar types of products.

### **Nonmarketable Equity Securities**

The carrying amount of nonmarketable equity securities approximates fair value based on the redemption provision of the securities.

### **Loans**

The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. For variable rate loans, the carrying amount is a reasonable estimate of fair value. For loans where collection of principal is in doubt, an allowance for losses has been estimated. Loans with similar characteristics were aggregated for purposes of the calculations.

### **Deposits**

The fair value of demand deposits, savings accounts, NOW accounts, and certain money market deposits is the amount payable on demand at the reporting date (i.e. their carrying amount). The fair value of fixed maturity time deposits is estimated using a discounted cash flow calculation that applies the rates currently offered for deposits of similar remaining maturities.

### **Federal Home Loan Bank Borrowings**

The fair values of the Company's borrowed funds are estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements.

### **Short-term borrowings**

The carrying amount is the estimate of fair value because the interest rate on the note is variable.

### **Accrued interest**

The carrying amounts of accrued interest approximate fair value.

### **Off-balance Sheet Instruments**

Off-balance sheet commitments are not addressed for fair value disclosure considerations. Because of the difficulty in assessing and valuing the likelihood of advancing the proceeds of letters of credit and unadvanced commitments, management believes it is not feasible or practicable to fairly and accurately disclose a fair value of off-balance sheet commitments.

### **Limitations**

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

The estimated fair value and related carrying amounts of the Company's financial instruments as of December 31, 2013 and 2012 are as follows:

	December 31,			
	2013		2012	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(in thousands)			
<u>Financial Assets</u>				
Cash and cash equivalents	\$ 19,057	\$ 18,993	\$ 22,797	\$ 22,816
Nonmarketable equity securities	1,563	1,563	1,546	1,546
Loans, less allowance for loan losses	238,855	237,942	235,372	237,514
Accrued interest receivable	693	693	814	814
<u>Financial Liabilities</u>				
Deposits	\$217,299	\$217,795	\$226,670	\$225,848
Federal Home Loan Bank borrowings	4,211	4,239	4,211	4,259
Short-term borrowings	1,300	1,300	-	-
Accrued interest payable	50	50	68	68