



**JOHN MARSHALL BANK**

**Reston, Virginia**

**FINANCIAL STATEMENTS**

**DECEMBER 31, 2014 and 2013**



## INDEPENDENT AUDITOR'S REPORT

To the Audit Committee of the Board of Directors  
John Marshall Bank  
Reston, Virginia

### Report on the Financial Statements

We have audited the accompanying financial statements of John Marshall Bank which comprise the balance sheets as of December 31, 2014 and 2013, and the related statements of income, comprehensive income, changes in shareholders' equity and cash flows for the years then ended and the related notes to the financial statements.

### Management's Responsibility for the 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 financial statements referred to above present fairly, in all material respects, the financial position of John Marshall Bank as of December 31, 2014 and 2013, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*Yount, Hyde & Barbour, P.C.*

Winchester, Virginia  
March 10, 2015

# JOHN MARSHALL BANK

## Balance Sheets

December 31, 2014 and 2013

(In thousands, except share and per share data)

| <b>Assets</b>                                                                                                                                             | <b>2014</b>       | <b>2013</b>       |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------|-------------------|
| Cash and due from banks                                                                                                                                   | \$ 10,799         | \$ 5,978          |
| Interest-bearing deposits in banks                                                                                                                        | 17,786            | 23,198            |
| Securities available-for-sale, at fair value                                                                                                              | 13,482            | 48,743            |
| Securities held-to-maturity, fair value of \$50,499 in 2014<br>and \$2,625 in 2013                                                                        | 49,934            | 2,466             |
| Restricted securities, at cost                                                                                                                            | 5,401             | 4,005             |
| Loans, net of allowance for loan losses of \$6,506 in 2014<br>and \$5,748 in 2013                                                                         | 676,777           | 566,729           |
| Bank premises and equipment, net                                                                                                                          | 3,041             | 3,112             |
| Accrued interest receivable                                                                                                                               | 2,168             | 1,894             |
| Other assets                                                                                                                                              | 7,450             | 6,415             |
| Total assets                                                                                                                                              | <u>\$ 786,838</u> | <u>\$ 662,540</u> |
| <b>Liabilities and Shareholders' Equity</b>                                                                                                               |                   |                   |
| <b>Liabilities</b>                                                                                                                                        |                   |                   |
| Deposits:                                                                                                                                                 |                   |                   |
| Non-interest bearing demand deposits                                                                                                                      | \$ 121,219        | \$ 84,350         |
| Interest bearing demand deposits                                                                                                                          | 198,438           | 145,354           |
| Savings deposits                                                                                                                                          | 6,500             | 5,073             |
| Time deposits                                                                                                                                             | 291,456           | 280,149           |
| Total deposits                                                                                                                                            | 617,613           | 514,926           |
| Repurchase agreements                                                                                                                                     | 12,404            | 13,305            |
| Federal Home Loan Bank advances                                                                                                                           | 52,000            | 39,000            |
| Accrued interest payable                                                                                                                                  | 132               | 132               |
| Other liabilities                                                                                                                                         | 5,040             | 4,509             |
| Total liabilities                                                                                                                                         | <u>687,189</u>    | <u>571,872</u>    |
| <b>Shareholders' Equity</b>                                                                                                                               |                   |                   |
| Preferred stock, par value \$5 per share; authorized 1,000,000 shares;<br>none issued                                                                     | --                | --                |
| Common stock, nonvoting, par value \$5 per share; authorized<br>1,000,000 shares; none issued                                                             | --                | --                |
| Common stock, voting, par value \$5 per share; authorized<br>10,000,000 shares; issued and outstanding, 8,305,086 shares<br>in 2014 and 8,286,336 in 2013 | 41,525            | 41,432            |
| Additional paid-in capital                                                                                                                                | 39,023            | 38,605            |
| Retained earnings                                                                                                                                         | 19,288            | 11,269            |
| Accumulated other comprehensive loss                                                                                                                      | (187)             | (638)             |
| Total shareholders' equity                                                                                                                                | <u>99,649</u>     | <u>90,668</u>     |
|                                                                                                                                                           | <u>\$ 786,838</u> | <u>\$ 662,540</u> |

See Notes to Financial Statements.

# JOHN MARSHALL BANK

## Statements of Income

Years Ended December 31, 2014 and 2013

(In thousands, except per share data)

|                                                     | <u>2014</u>            | <u>2013</u>            |
|-----------------------------------------------------|------------------------|------------------------|
| <b>Interest and Dividend Income</b>                 |                        |                        |
| Interest and fees on loans                          | \$ 32,873              | \$ 29,388              |
| Interest on investment securities, taxable          | 1,061                  | 658                    |
| Interest on investment securities, tax-exempt       | 91                     | 74                     |
| Dividends                                           | 237                    | 157                    |
| Interest on deposits in banks                       | <u>74</u>              | <u>52</u>              |
| Total interest and dividend income                  | <u>34,336</u>          | <u>30,329</u>          |
| <b>Interest Expense</b>                             |                        |                        |
| Deposits                                            | 3,926                  | 3,462                  |
| Federal Home Loan Bank advances                     | 392                    | 442                    |
| Other short-term borrowings                         | <u>54</u>              | <u>35</u>              |
| Total interest expense                              | <u>4,372</u>           | <u>3,939</u>           |
| Net interest income                                 | 29,964                 | 26,390                 |
| <b>Provision for loan losses</b>                    | <u>1,018</u>           | <u>760</u>             |
| Net interest income after provision for loan losses | <u>28,946</u>          | <u>25,630</u>          |
| <b>Noninterest Income</b>                           |                        |                        |
| Service charges on deposit accounts                 | 409                    | 320                    |
| Other service charges and fees                      | <u>57</u>              | <u>51</u>              |
| Total noninterest income                            | <u>466</u>             | <u>371</u>             |
| <b>Noninterest Expenses</b>                         |                        |                        |
| Salaries and employee benefits                      | 10,154                 | 8,775                  |
| Occupancy expense of premises                       | 1,581                  | 1,425                  |
| Furniture and equipment expenses                    | 994                    | 899                    |
| Other operating expenses                            | <u>4,294</u>           | <u>3,942</u>           |
| Total noninterest expenses                          | <u>17,023</u>          | <u>15,041</u>          |
| Income before income taxes                          | 12,389                 | 10,960                 |
| <b>Income tax expense</b>                           | <u>4,370</u>           | <u>3,871</u>           |
| Net income                                          | <u><u>\$ 8,019</u></u> | <u><u>\$ 7,089</u></u> |
| <b>Earnings Per Common Share</b>                    |                        |                        |
| Basic                                               | \$ 0.97                | \$ 1.15                |
| Diluted                                             | \$ 0.92                | \$ 1.12                |

See Notes to Financial Statements.

# JOHN MARSHALL BANK

## Statements of Comprehensive Income

Years Ended December 31, 2014 and 2013

(In thousands)

|                                                                                                             | <u>2014</u>     | <u>2013</u>     |
|-------------------------------------------------------------------------------------------------------------|-----------------|-----------------|
| Net income                                                                                                  | \$ 8,019        | \$ 7,089        |
| Other comprehensive income (loss):                                                                          |                 |                 |
| Unrealized gain (loss) on available for sale securities,<br>net of tax of \$226 and \$481                   | 444             | (940)           |
| Amortization of unrealized loss on securities<br>transferred to held to maturity, net of tax of \$4 and \$1 | <u>7</u>        | <u>3</u>        |
| Total other comprehensive income (loss), net of tax                                                         | <u>451</u>      | <u>(937)</u>    |
| Total comprehensive income                                                                                  | <u>\$ 8,470</u> | <u>\$ 6,152</u> |

See Notes to Financial Statements.

# JOHN MARSHALL BANK

## Statements of Changes in Shareholders' Equity

Years Ended December 31, 2014 and 2013

(In thousands)

|                                                            | Common<br>Stock  | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Total<br>Shareholders'<br>Equity |
|------------------------------------------------------------|------------------|----------------------------------|----------------------|--------------------------------------------------------|----------------------------------|
| <b>Balance, December 31, 2012</b>                          | \$ 23,539        | \$ 25,046                        | \$ 4,180             | \$ 299                                                 | \$ 53,064                        |
| Net income                                                 | --               | --                               | 7,089                | --                                                     | 7,089                            |
| Other comprehensive loss, net of tax                       | --               | --                               | --                   | (937)                                                  | (937)                            |
| Exercise of stock options                                  | 8                | 5                                | --                   | --                                                     | 13                               |
| 5 for 4 stock split in the form<br>of a 25% stock dividend | 5,885            | (5,885)                          | --                   | --                                                     | --                               |
| Issuance of common stock<br>in regards to stock offering   | 12,000           | 18,896                           | --                   | --                                                     | 30,896                           |
| Share-based compensation                                   | --               | 543                              | --                   | --                                                     | 543                              |
| <b>Balance, December 31, 2013</b>                          | \$ 41,432        | \$ 38,605                        | \$ 11,269            | \$ (638)                                               | \$ 90,668                        |
| Net income                                                 | --               | --                               | 8,019                | --                                                     | 8,019                            |
| Other comprehensive income, net of tax                     | --               | --                               | --                   | 451                                                    | 451                              |
| Exercise of stock options                                  | 93               | 60                               | --                   | --                                                     | 153                              |
| Share-based compensation                                   | --               | 358                              | --                   | --                                                     | 358                              |
| <b>Balance, December 31, 2014</b>                          | <u>\$ 41,525</u> | <u>\$ 39,023</u>                 | <u>\$ 19,288</u>     | <u>\$ (187)</u>                                        | <u>\$ 99,649</u>                 |

See Notes to Financial Statements.

# JOHN MARSHALL BANK

## Statements of Cash Flows

Years Ended December 31, 2014 and 2013

(In thousands)

|                                                                                           | <u>2014</u>         | <u>2013</u>         |
|-------------------------------------------------------------------------------------------|---------------------|---------------------|
| <b>Cash Flows from Operating Activities</b>                                               |                     |                     |
| Net income                                                                                | \$ 8,019            | \$ 7,089            |
| Adjustments to reconcile net income to net cash provided by operating activities:         |                     |                     |
| Depreciation                                                                              | 710                 | 650                 |
| Provision for loan losses                                                                 | 1,018               | 760                 |
| Share-based compensation                                                                  | 358                 | 543                 |
| Net amortization of securities                                                            | 321                 | 319                 |
| Gain on sale of other real estate                                                         | - -                 | (9)                 |
| Deferred tax (benefit)                                                                    | (482)               | (357)               |
| Loss on disposal of fixed assets                                                          | 3                   | - -                 |
| Changes in assets and liabilities:                                                        |                     |                     |
| (Increase) in accrued interest receivable                                                 | (274)               | (218)               |
| (Increase) in other assets                                                                | (783)               | (3,074)             |
| Increase (decrease) in accrued interest payable                                           | - -                 | 4                   |
| Increase in other liabilities                                                             | 531                 | 3,200               |
| Net cash provided by operating activities                                                 | <u>\$ 9,421</u>     | <u>\$ 8,907</u>     |
| <b>Cash Flows from Investing Activities</b>                                               |                     |                     |
| Decrease (increase) in interest bearing deposits in banks                                 | \$ 5,412            | \$ (11,882)         |
| Net (increase) in loans                                                                   | (111,066)           | (74,809)            |
| Purchase of available-for-sale securities                                                 | (22,069)            | (23,222)            |
| Purchase of held-to-maturity securities                                                   | (1,106)             | - -                 |
| Proceeds from maturities, calls and principal repayments of available-for-sale securities | 7,078               | 8,223               |
| Proceeds from maturities, calls and principal repayments of held-to-maturity securities   | 4,250               | 1,257               |
| Net (purchase) of restricted securities                                                   | (1,396)             | (125)               |
| Proceeds from sale of other real estate                                                   | - -                 | 495                 |
| Purchases of bank premises and equipment                                                  | (642)               | (1,352)             |
| Net cash used in investing activities                                                     | <u>\$ (119,539)</u> | <u>\$ (101,415)</u> |
| <b>Cash Flows from Financing Activities</b>                                               |                     |                     |
| Net increase in deposits                                                                  | \$ 102,687          | \$ 51,600           |
| Net proceeds from FHLB advances                                                           | 13,000              | 1,000               |
| (Decrease) increase in repurchase agreements                                              | (901)               | 5,747               |
| Issuance of common stock                                                                  | 153                 | 30,909              |
| Net cash provided by financing activities                                                 | <u>\$ 114,939</u>   | <u>\$ 89,256</u>    |

See Notes to Financial Statements.

**Statements of Cash Flows (continued)**  
Years Ended December 31, 2014 and 2013  
(In thousands)

|                                                                    | <u>2014</u>             | <u>2013</u>            |
|--------------------------------------------------------------------|-------------------------|------------------------|
| Net increase (decrease) in cash and cash equivalents               | \$ 4,821                | \$ (3,252)             |
| Cash and cash equivalents at beginning of period                   | <u>5,978</u>            | <u>9,230</u>           |
| Cash and cash equivalents at end of period                         | <u><u>\$ 10,799</u></u> | <u><u>\$ 5,978</u></u> |
| <b>Supplemental Disclosures of Cash Flow Information</b>           |                         |                        |
| Cash payments for:                                                 |                         |                        |
| Interest                                                           | <u>\$ 4,372</u>         | <u>\$ 3,935</u>        |
| Income taxes                                                       | <u>\$ 4,540</u>         | <u>\$ 3,806</u>        |
| <b>Supplemental Disclosures of Noncash Transactions</b>            |                         |                        |
| Unrealized gain (loss) on securities available for sale            | <u>\$ 670</u>           | <u>\$ (1,421)</u>      |
| Securities transferred from available for sale to held to maturity |                         |                        |
| to held to maturity                                                | <u>\$ 50,875</u>        | <u>\$ -</u>            |
| Amortization of unrealized loss on securities transferred          |                         |                        |
| to held to maturity                                                | <u>\$ 11</u>            | <u>\$ 4</u>            |

See Notes to Financial Statements

## **Notes to Financial Statements**

### **JOHN MARSHALL BANK**

## **Notes to Financial Statements**

#### **Note 1. Nature of Banking Activities and Significant Accounting Policies**

##### **Nature of Banking Activities**

John Marshall Bank (the Bank) is a corporation formed on April 5, 2005 under the laws of the Commonwealth of Virginia and was chartered on February 9, 2006, under the State Corporation Commission – Bureau of Financial Institutions. The Bank is a member of the Federal Reserve and is subject to the rules and regulations of the Virginia State Banking Commission, the Federal Reserve and the Federal Deposit Insurance Corporation. The Bank opened for business on April 17, 2006 and provides banking services to its customers primarily in the Washington, D.C. Metropolitan area.

The accounting and reporting policies of John Marshall Bank conform to generally accepted accounting principles in the United States of America and reflect practices of the banking industry. The policies are summarized below.

##### **Significant Accounting Policies**

###### **Use of Estimates**

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, 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 reported amounts of revenues and expenses during the reporting period. Actual results could differ 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, the valuation of foreclosed real estate, deferred tax assets, other-than-temporary impairment of securities, and the fair value of financial instruments.

###### **Concentrations of Credit Risk**

Most of the Bank's activities are with customers located in the Washington, D.C. Metropolitan area. Real estate loans, including commercial and construction and land development loans, represented 88% and 82% of the total portfolio at December 31, 2014 and 2013. The Bank does not have any significant concentrations to any one industry or customer.

###### **Reclassifications**

Certain amounts in the prior year's financial statements have been reclassified to conform to the current year's presentation. The only significant reclassification was related to a change in loan coding during 2014. Loan balances totaling \$12.7 million reported in the prior year were reclassified from the commercial segment to commercial real estate segment of the portfolio. All related tables have been updated to reflect this change.

## **Notes to Financial Statements**

### **Cash and Cash Equivalents**

For the purposes of the statements of cash flows, cash and cash equivalents include cash and balances due from banks, all of which mature within ninety days.

### **Interest-Bearing Deposits in Banks**

Interest-bearing deposits in banks mature within one year and are carried at cost.

### **Securities**

Certain debt securities that management has the positive intent and ability to hold to maturity are classified as “held to maturity” and recorded at amortized cost. Securities not classified as held to maturity, including equity securities with readily determinable fair value, are classified as “available for sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either (a) the intent is to sell the security or (b) it is more likely than not that it will be necessary to sell the security prior to recovery of its amortized cost basis. If, however, the Bank’s intent is not to sell the security and it is not more than likely that the Bank will be required to sell the security before recovery, the Bank must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income.

For equity securities carried at cost as restricted securities, impairment is considered to be other-than-temporary based on the Bank’s ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in income.

The Bank regularly reviews each security for other-than-temporary impairment based on criteria that include the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, the security’s ratings, the Bank’s best estimate of the present value of cash flows expected to be collected from debt securities, the intention with regards to holding the security to maturity and the likelihood that the Bank would be required to sell the security before recovery.

### **Loans**

The Bank grants real estate, commercial and consumer loans to customers (representing the Bank’s loan segments). A substantial portion of the loan portfolio is represented by mortgage loans in the Washington, D.C. Metropolitan area. Within the real estate segment, the Bank has also identified

## **Notes to Financial Statements**

the residential, commercial and construction classes. The ability of the Bank's debtors to honor their contracts is dependent upon the real estate and general economic conditions in this area.

Underwriting and risk characteristics of each loan class are summarized as follows:

- Real estate residential mortgage loans carry risks associated with the continued creditworthiness of the borrower and changes in the value of the collateral.
- Real estate commercial mortgage loans carry risks associated with the successful operation of a business, the continued creditworthiness of the borrower and any related guarantors and changes in the value of the collateral. In the case of investor-owned commercial real estate, risks are expanded to include the financial strength of the tenants occupying the property and the stability of occupancy and lease rates.
- Real estate construction loans carry risks that the project will not be finished according to schedule, the project will not be finished according to budget and the value of the collateral may, at any point in time, be less than the principal amount of the loan. Construction loans also bear the risk that the general contractor, who may or may not be a customer of the Bank, may be unable to finish the construction project as planned because of financial pressure unrelated to the project.
- Commercial loans carry risks associated with the successful operation of a business and the financial strength of any related guarantors. In addition, there is risk associated with the value of collateral other than real estate which may depreciate over time and cannot be appraised with as much precision.
- Consumer loans carry the risks associated with the continued creditworthiness of the borrower and the value of any collateral. Consumer loans are more likely than real estate loans to be immediately adversely affected by job loss, divorce, illness or personal bankruptcy.

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 the allowance for loan losses and any deferred fees or costs on originated loans. 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 of the related loan yield using the interest method.

The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in the process of collection. Other personal loans are typically charged off no later than 180 days past due. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

### **Allowance for Loan Losses**

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Real estate loans are

## **Notes to Financial Statements**

generally written down to the net realizable value when the loan is 180 days past due. Commercial and consumer loans are generally charged off when the loan is 180 days past due. Subsequent recoveries, if any, are credited to the allowance.

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

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired. For such loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers nonclassified loans and is based on historical loss experience adjusted for qualitative factors. Qualitative factors used for each segment include an analysis of the levels of and trends in delinquencies, nonaccrual loans, and watch list loans; trends in volume and terms of loans; effects of any changes in lending policies and practices; experience, ability, and depth of management; and national and local economic trends and conditions. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

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

### **Troubled Debt Restructurings**

In situations where, for economic or legal reasons related to a borrower's financial condition, the Bank may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a troubled debt restructuring (TDR). The Bank strives to identify borrowers in financial difficulty early and work with them to modify their loan to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to

## **Notes to Financial Statements**

avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of either interest or principal, management measures any impairment on the restructuring as noted above for impaired loans.

### **Bank Premises and Equipment**

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation of property and equipment is computed on the straight-line method over the useful lives of the assets, ranging from three to fifteen years, or the expected term of leases, if shorter. Expected terms include lease option periods to the extent that the exercise of such options is reasonably assured. Maintenance and repairs of property and equipment are charged to operations and major improvements are capitalized.

### **Other Real Estate**

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. Operating costs after acquisition are expensed.

### **Transfers of Financial Assets**

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (a) the assets have been isolated from the Bank – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (b) 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 (c) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

### **Income Taxes**

Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences, operating loss carryforwards, and tax credit carryforwards. Deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with

## **Notes to Financial Statements**

any associated interest and penalties that would be payable to the taxing authorities upon examination. The Bank recorded no liability for unrecognized tax benefits at December 31, 2014 or 2013.

### **Earnings Per Common Share**

Basic earnings per common share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares relate solely to outstanding stock options and are determined using the treasury stock method.

### **Advertising Costs**

The Bank follows the policy of charging the production costs of advertising to expense as incurred. Advertising expense was \$432 thousand and \$564 thousand for the years ended December 31, 2014 and 2013, respectively.

### **Share-Based Compensation**

The Bank recognizes the compensation cost relating to share-based payment transactions based on the grant date fair value of the equity instruments issued. The share compensation accounting guidance requires that compensation cost for all share-based awards be calculated and recognized over the employees' service period, generally defined as the vesting period. For awards with graded-vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. A Black-Scholes model is used to estimate the fair value of stock options.

### **Comprehensive Income**

Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains (losses) on securities available for sale, which is also recognized as a separate component of equity.

### **Fair Value of Financial Instruments**

Fair values of various assets and liabilities are estimated using relevant market information, valuation techniques and other assumptions, as more fully disclosed in Note 14. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

### **Recent Accounting Pronouncements**

In January 2014, the FASB issued ASU 2014-04, "Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)." The amendments in this ASU clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments

## Notes to Financial Statements

require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Bank is currently assessing the impact that ASU 2014-04 will have on its financial statements.

In June 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers: Topic 606." This ASU applies to any entity using U.S. GAAP that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The guidance supersedes the revenue recognition requirements in Topic 605, "Revenue Recognition," most industry-specific guidance, and some cost guidance included in Subtopic 605-35, "Revenue Recognition—Construction-Type and Production-Type Contracts." The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To be in alignment with the core principle, an entity must apply a five step process including: identification of the contract(s) with a customer, identification of performance obligations in the contract(s), determination of the transaction price, allocation of the transaction price to the performance obligations, and recognition of revenue when (or as) the entity satisfies a performance obligation. Additionally, the existing requirements for the recognition of a gain or loss on the transfer of nonfinancial assets that are not in a contract with a customer have also been amended to be consistent with the guidance on recognition and measurement. The amendments in this ASU are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is not permitted. The Bank is currently assessing the impact that ASU 2014-09 will have on its financial statements.

In June 2014, the FASB issued ASU No. 2014-11, "Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures." This ASU aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement. The amendments in the ASU also require a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction. Additional disclosures will be required for the nature of collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. The amendments in this ASU are effective for the first interim or annual period beginning after December 15, 2014; however, the disclosure for transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and interim periods beginning after March 15, 2015. Early adoption is not permitted. The Bank is currently assessing the impact that ASU 2014-11 will have on its financial statements.

In June 2014, the FASB issued ASU No. 2014-12, "Compensation – Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period." The new guidance applies to reporting entities that grant employees share-based payments in which the terms of the award allow a performance target to be achieved after the requisite service period. The amendments

## Notes to Financial Statements

in the ASU require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Existing guidance in “Compensation – Stock Compensation (Topic 718),” should be applied to account for these types of awards. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Early adoption is permitted and reporting entities may choose to apply the amendments in the ASU either on a prospective or retrospective basis. The Bank is currently assessing the impact that ASU 2014-12 will have on its financial statements.

In August 2014, the FASB issued ASU No. 2014-14, “Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure.” The amendments in this ASU apply to creditors that hold government-guaranteed mortgage loans and are intended to eliminate the diversity in practice related to the classification of these guaranteed loans upon foreclosure. The new guidance stipulates that a mortgage loan be derecognized and a separate other receivable be recognized upon foreclosure if (1) the loan has a government guarantee that is not separable from the loan prior to foreclosure, (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim, and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the other receivable should be measured on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2014. Entities may adopt the amendments on a prospective basis or modified retrospective basis as of the beginning of the annual period of adoption; however, the entity must apply the same method of transition as elected under ASU 2014-04. Early adoption is permitted provided the entity has already adopted ASU 2014-04. The Bank is currently assessing the impact that ASU 2014-14 will have on its financial statements.

In January 2015, the FASB issued ASU No. 2015-01, “Income Statement—Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items.” The amendments in this ASU eliminate from U.S. GAAP the concept of extraordinary items. Subtopic 225-20, Income Statement - Extraordinary and Unusual Items, required that an entity separately classify, present, and disclose extraordinary events and transactions. Presently, an event or transaction is presumed to be an ordinary and usual activity of the reporting entity unless evidence clearly supports its classification as an extraordinary item. If an event or transaction meets the criteria for extraordinary classification, an entity is required to segregate the extraordinary item from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. The entity also is required to disclose applicable income taxes and either present or disclose earnings-per-share data applicable to the extraordinary item. The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The Bank does not expect the adoption of ASU 2015-01 to have a material impact on its financial statements.

## Notes to Financial Statements

### Note 2. Securities

The amortized cost and fair values of securities available for sale and held to maturity as of December 31, 2014 and 2013 are as follows:

| <b>Available for Sale</b>           |                           |                                       |                                          |                       |
|-------------------------------------|---------------------------|---------------------------------------|------------------------------------------|-----------------------|
|                                     | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>(Losses)</b> | <b>Fair<br/>Value</b> |
| (In thousands)                      | <b>2014</b>               |                                       |                                          |                       |
| U.S government and federal agencies | 13,500                    | 27                                    | (45)                                     | 13,482                |
|                                     | <u>\$ 13,500</u>          | <u>\$ 27</u>                          | <u>\$ (45)</u>                           | <u>\$ 13,482</u>      |
|                                     | <b>2013</b>               |                                       |                                          |                       |
| U.S government and federal agencies | \$ 14,648                 | \$ 32                                 | \$ (440)                                 | \$ 14,240             |
| Taxable municipal                   | 6,290                     | 4                                     | (154)                                    | 6,140                 |
| Tax-exempt municipal                | 4,485                     | 18                                    | (63)                                     | 4,440                 |
| Mortgage-backed                     | 24,246                    | 60                                    | (383)                                    | 23,923                |
|                                     | <u>\$ 49,669</u>          | <u>\$ 114</u>                         | <u>\$ (1,040)</u>                        | <u>\$ 48,743</u>      |
| <b>Held to Maturity</b>             |                           |                                       |                                          |                       |
|                                     | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>(Losses)</b> | <b>Fair<br/>Value</b> |
|                                     | <b>2014</b>               |                                       |                                          |                       |
| U.S government and federal agencies | \$ 9,366                  | \$ 28                                 | \$ (81)                                  | \$ 9,313              |
| Taxable municipal                   | 7,321                     | 130                                   | (20)                                     | 7,431                 |
| Tax-exempt municipal                | 6,071                     | 96                                    | (18)                                     | 6,149                 |
| Mortgage-backed                     | 27,176                    | 488                                   | (58)                                     | 27,606                |
|                                     | <u>\$ 49,934</u>          | <u>\$ 742</u>                         | <u>\$ (177)</u>                          | <u>\$ 50,499</u>      |
|                                     | <b>2013</b>               |                                       |                                          |                       |
| Mortgage-backed                     | <u>\$ 2,466</u>           | <u>\$ 159</u>                         | <u>\$ - -</u>                            | <u>\$ 2,625</u>       |

In 2014, the Bank transferred securities with a fair value of \$50.9 million from the available for sale to the held to maturity classification. The net unrealized holding loss of \$238 thousand at the time of the transfer remained in accumulated other comprehensive loss and is being amortized to income over the remaining lives of the securities.

## Notes to Financial Statements

The amortized cost and fair value of securities available for sale and held to maturity as of December 31, 2014, by contractual maturity are shown below. Expected maturities may differ from contractual maturities because the securities may be called or prepaid without any penalties.

|                                        | Available for Sale |                  | Held to Maturity |                  |
|----------------------------------------|--------------------|------------------|------------------|------------------|
|                                        | Amortized Cost     | Fair Value       | Amortized Cost   | Fair Value       |
| (In thousands)                         |                    |                  |                  |                  |
| Due in one year or less                | \$ --              | \$ --            | \$ 505           | \$ 508           |
| Due after one year through five years  | 6,501              | 6,485            | 9,460            | 9,510            |
| Due after five years through ten years | 4,999              | 5,000            | 12,483           | 12,627           |
| Due after ten years                    | 2,000              | 1,997            | 27,486           | 27,854           |
|                                        | <u>\$ 13,500</u>   | <u>\$ 13,482</u> | <u>\$ 49,934</u> | <u>\$ 50,499</u> |

The following table shows the gross unrealized losses and fair value of the Bank's investments with unrealized losses that are not deemed to be other-than-temporarily impaired aggregated by category and length of time that individual securities have been in a continuous loss position at December 31, 2014 and 2013.

|                                      | Less Than 12 Months     |                  | 12 Months or Longer     |                  |
|--------------------------------------|-------------------------|------------------|-------------------------|------------------|
|                                      | Gross Unrealized Losses | Fair Value       | Gross Unrealized Losses | Fair Value       |
| (In thousands)                       |                         |                  |                         |                  |
| <u>2014</u>                          |                         |                  |                         |                  |
| Mortgage-backed                      | \$ 5                    | \$ 830           | \$ 53                   | \$ 4,762         |
| U.S. government and federal agencies | 29                      | 5,471            | 97                      | 6,246            |
| Taxable municipal                    | 4                       | 1,586            | 16                      | 527              |
| Tax-exempt municipal                 | 5                       | 1,688            | 13                      | 1,292            |
|                                      | <u>\$ 43</u>            | <u>\$ 9,575</u>  | <u>\$ 179</u>           | <u>\$ 12,827</u> |
| <u>2013</u>                          |                         |                  |                         |                  |
| Mortgage-backed                      | \$ 364                  | \$ 15,154        | \$ 19                   | \$ 289           |
| U.S. government and federal agencies | 378                     | 8,704            | 62                      | 938              |
| Taxable municipal                    | 154                     | 5,818            | -                       | -                |
| Tax-exempt municipal                 | 63                      | 2,664            | -                       | -                |
|                                      | <u>\$ 959</u>           | <u>\$ 32,340</u> | <u>\$ 81</u>            | <u>\$ 1,227</u>  |

### U.S. Government and Federal Agencies

The unrealized losses in thirteen and twelve investments in direct obligations of U.S. government agencies at December 31, 2014 and 2013, respectively, were caused by interest rate changes. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not consider those investments to be other-than-temporarily impaired at December 31, 2014 or 2013.

### Mortgage-Backed Securities

The unrealized losses on the Bank's investment in twelve and twenty-five federal agency mortgage-backed securities at December 31, 2014 and 2013, respectively, were caused by interest rate

## Notes to Financial Statements

changes. The contractual cash flows of those investments are guaranteed by an agency of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost bases of the Bank's investments. Because the decline in market value is attributable to change in interest rates and not credit quality, and because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not consider those investments to be other-than-temporarily impaired at December 31, 2014 or 2013.

### Municipal Securities

The unrealized losses in seven and sixteen investments in municipal securities at December 31, 2014 and 2013, respectively, were caused by interest rate changes. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not consider those investments to be other-than-temporarily impaired at December 31, 2014 or 2013.

Securities having an amortized cost of \$58.6 million and \$40.2 million at December 31, 2014 and 2013, respectively, were pledged to secure public deposits and for other purposes required by law. These securities had a carrying value of \$59.1 million and \$39.4 million at December 31, 2014 and 2013, respectively.

### Note 3. Loans

A summary of the balances of loans follows:

|                                   | <b>December 31,</b>   |                   |
|-----------------------------------|-----------------------|-------------------|
|                                   | <b>2014</b>           | <b>2013</b>       |
|                                   | <i>(In thousands)</i> |                   |
| Real estate loans:                |                       |                   |
| Residential                       | \$ 23,503             | \$ 19,515         |
| Commercial                        | 437,891               | 379,019           |
| Construction and land development | 140,480               | 82,286            |
| Total real estate loans           | 601,874               | 480,820           |
| Commercial loans                  | 81,504                | 91,289            |
| Consumer installment loans        | 1,232                 | 1,325             |
| Total loans                       | 684,610               | 573,434           |
| Less: Allowance for loan losses   | (6,506)               | (5,748)           |
| Net deferred loan fees            | (1,327)               | (957)             |
| Loans, net                        | <u>\$ 676,777</u>     | <u>\$ 566,729</u> |

## Notes to Financial Statements

### Note 4. Allowance for Loan Losses

The following tables present, as of December 31, 2014 and December 31, 2013, the total allowance for loan losses, the allowance by impairment methodology, and loans by impairment methodology:

#### Allowance for Loan Losses Rollforward by Portfolio Segment For the Years Ended December 31, 2014 and 2013

|                                       | December 31, 2014<br>(in thousands)                  |             |             |            |          |             |            |
|---------------------------------------|------------------------------------------------------|-------------|-------------|------------|----------|-------------|------------|
|                                       | Real Estate<br>Construction<br>& Land<br>Development |             |             |            |          |             |            |
|                                       | Commercial                                           | Development | Residential | Commercial | Consumer | Unallocated | Total      |
| Allowance for loan losses:            |                                                      |             |             |            |          |             |            |
| Beginning Balance, December 31, 2013  | \$ 2,990                                             | \$ 672      | \$ 267      | \$ 1,797   | \$ 22    | \$ --       | \$ 5,748   |
| Charge-offs                           | --                                                   | --          | -           | (262)      | --       | --          | (262)      |
| Recoveries                            | --                                                   | --          | --          | 2          | --       | --          | 2          |
| Provision                             | 1,103                                                | 497         | (30)        | (552)      | (2)      | 2           | 1,018      |
| Ending Balance, December 31, 2014     | \$ 4,093                                             | \$ 1,169    | \$ 237      | \$ 985     | \$ 20    | \$ 2        | \$ 6,506   |
| Individually evaluated for impairment | \$ 392                                               | \$ --       | \$ --       | \$ 183     | \$ --    | \$ --       | \$ 575     |
| Collectively evaluated for impairment | \$ 3,701                                             | \$ 1,169    | \$ 237      | \$ 802     | \$ 20    | \$ 2        | \$ 5,931   |
| Financing Receivables:                |                                                      |             |             |            |          |             |            |
| Ending Balance, December 31, 2014     | \$ 437,891                                           | \$ 140,480  | \$ 23,503   | \$ 81,504  | \$ 1,232 | \$ --       | \$ 684,610 |
| Individually evaluated for impairment | \$ 2,264                                             | \$ --       | \$ 534      | \$ 768     | \$ --    | \$ --       | \$ 3,566   |
| Collectively evaluated for impairment | \$ 435,627                                           | \$ 140,480  | \$ 22,969   | \$ 80,736  | \$ 1,232 | \$ --       | \$ 681,044 |
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|                                       |                                                      |             |             |            |          |             |            |
|                                       |                                                      |             |             |            |          |             |            |
|                                       |                                                      |             |             |            |          |             |            |
|                                       |                                                      |             |             |            |          |             |            |
|                                       |                                                      |             |             |            |          |             |            |
|                                       |                                                      |             |             |            |          |             |            |

Impaired loans and the related allowance at December 31, 2014 and December 31, 2013, were as follows:

## Notes to Financial Statements

December 31, 2014  
(in thousands)

|                                   | Unpaid<br>Principal<br>Balance | Recorded<br>Investment<br>with No<br>Allowance | Recorded<br>Investment<br>with<br>Allowance | Total<br>Recorded<br>Investment | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-----------------------------------|--------------------------------|------------------------------------------------|---------------------------------------------|---------------------------------|----------------------|-----------------------------------|----------------------------------|
| Real Estate                       |                                |                                                |                                             |                                 |                      |                                   |                                  |
| Commercial                        | \$ 2,264                       | \$ --                                          | \$ 2,264                                    | \$ 2,264                        | \$ 392               | \$ 2,283                          | \$ 36                            |
| Construction and land development | --                             | --                                             | --                                          | --                              | --                   | --                                | --                               |
| Residential                       | 534                            | 534                                            | --                                          | 534                             | -                    | 539                               | 20                               |
| Commercial                        | 768                            | 585                                            | 183                                         | 768                             | 183                  | 815                               | 22                               |
| Consumer                          | --                             | --                                             | --                                          | --                              | --                   | --                                | --                               |
| Total impaired loans              | <u>\$ 3,566</u>                | <u>\$ 1,119</u>                                | <u>\$ 2,447</u>                             | <u>\$ 3,566</u>                 | <u>\$ 575</u>        | <u>\$ 3,637</u>                   | <u>\$ 78</u>                     |

December 31, 2013  
(in thousands)

|                                   | Unpaid<br>Principal<br>Balance | Recorded<br>Investment<br>with No<br>Allowance | Recorded<br>Investment<br>with<br>Allowance | Total<br>Recorded<br>Investment | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-----------------------------------|--------------------------------|------------------------------------------------|---------------------------------------------|---------------------------------|----------------------|-----------------------------------|----------------------------------|
| Real Estate                       |                                |                                                |                                             |                                 |                      |                                   |                                  |
| Commercial                        | \$ 995                         | \$ --                                          | \$ 995                                      | \$ 995                          | \$ 82                | \$ 1,000                          | \$ 36                            |
| Construction and land development | 1,283                          | --                                             | 1,283                                       | 1,283                           | 10                   | 1,295                             | 123                              |
| Residential                       | 546                            | --                                             | 546                                         | 546                             | 10                   | 551                               | 19                               |
| Commercial                        | 387                            | --                                             | 387                                         | 387                             | 270                  | 433                               | 8                                |
| Consumer                          | --                             | --                                             | --                                          | --                              | --                   | --                                | --                               |
| Total impaired loans              | <u>\$ 3,211</u>                | <u>\$ --</u>                                   | <u>\$ 3,211</u>                             | <u>\$ 3,211</u>                 | <u>\$ 372</u>        | <u>\$ 3,279</u>                   | <u>\$ 186</u>                    |

As of December 31, 2014, \$1.8 million of impaired loans were classified as troubled debt restructurings. All were in compliance with the modified terms as of December 31, 2014. During 2014, one troubled debt restructuring of \$118 thousand in the commercial and industrial segment was paid in full by the borrower. Two other troubled debt restructuring totaling \$263 thousand were charged off. Two loans in the commercial and industrial segment totaling \$293 thousand were recognized as a troubled debt restructuring during 2014. The following tables provide further information regarding troubled debt restructurings recognized during 2014 and 2013.

December 31, 2014  
(in thousands)

|                                   | Number of<br>Contracts | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
|-----------------------------------|------------------------|-----------------------------------------------------------|------------------------------------------------------------|
| Real Estate                       |                        |                                                           |                                                            |
| Commercial                        | --                     | \$ --                                                     | \$ --                                                      |
| Construction and land development | --                     | --                                                        | --                                                         |
| Residential                       | --                     | --                                                        | --                                                         |
| Commercial                        | 2                      | 293                                                       | 293                                                        |
| Consumer                          | --                     | --                                                        | --                                                         |
| Total                             | <u>2</u>               | <u>\$ 293</u>                                             | <u>\$ 293</u>                                              |

## Notes to Financial Statements

| December 31, 2013<br>(in thousands) |                        |                                                           |                                                            |
|-------------------------------------|------------------------|-----------------------------------------------------------|------------------------------------------------------------|
|                                     | Number of<br>Contracts | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Real Estate                         |                        |                                                           |                                                            |
| Commercial                          | --                     | \$ --                                                     | \$ --                                                      |
| Construction and land development   | --                     | --                                                        | --                                                         |
| Residential                         | --                     | --                                                        | --                                                         |
| Commercial                          | 2                      | 313                                                       | 266                                                        |
| Consumer                            | --                     | --                                                        | --                                                         |
| Total                               | <u>2</u>               | <u>\$ 313</u>                                             | <u>\$ 266</u>                                              |

The Bank converted the commercial and industrial loans referenced above to interest-only to provide for a reduction in required monthly payments while the borrower seeks to improve its cash flow. The loans are well secured and no impairment was indicated as of December 31, 2014.

There were no troubled debt restructurings that subsequently defaulted within the first twelve months after modification during year ended December 31, 2014, with default being defined as past due thirty or more days.

All troubled debt restructurings have loan loss reserves allocated to them equal to 100% of estimated impairment on the loan. Impairment is determined on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent.

Following is a summary of past due and non-accrual loans by class as of December 31, 2014 and December 31, 2013:

### Loans Past Due and Nonaccruals

| December 31, 2014<br>(in thousands) |                        |                        |                             |                 |                   |                   |                                           |                     |
|-------------------------------------|------------------------|------------------------|-----------------------------|-----------------|-------------------|-------------------|-------------------------------------------|---------------------|
|                                     | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days or<br>More Past Due | Total Past Due  | Current           | Total Loans       | 90-Days Past<br>Due and Still<br>Accruing | Nonaccrual<br>Loans |
| Real Estate                         |                        |                        |                             |                 |                   |                   |                                           |                     |
| Commercial                          | \$ --                  | \$ --                  | \$ 1,287                    | \$ 1,287        | \$ 436,604        | \$ 437,891        | \$ --                                     | \$ 1,287            |
| Construction and land development   | --                     | --                     | --                          | --              | 140,480           | 140,480           | --                                        | --                  |
| Residential                         | --                     | --                     | --                          | --              | 23,503            | 23,503            | --                                        | --                  |
| Commercial                          | --                     | 15                     | 403                         | 418             | 81,086            | 81,504            | --                                        | 475                 |
| Consumer                            | --                     | --                     | --                          | --              | 1,232             | 1,232             | --                                        | --                  |
| Total                               | <u>\$ --</u>           | <u>\$ 15</u>           | <u>\$ 1,690</u>             | <u>\$ 1,705</u> | <u>\$ 682,905</u> | <u>\$ 684,610</u> | <u>\$ --</u>                              | <u>\$ 1,762</u>     |

  

| December 31, 2013<br>(in thousands) |                        |                        |                             |                 |                   |                   |                                           |                     |
|-------------------------------------|------------------------|------------------------|-----------------------------|-----------------|-------------------|-------------------|-------------------------------------------|---------------------|
|                                     | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days or<br>More Past Due | Total Past Due  | Current           | Total Loans       | 90-Days Past<br>Due and Still<br>Accruing | Nonaccrual<br>Loans |
| Real Estate                         |                        |                        |                             |                 |                   |                   |                                           |                     |
| Commercial                          | \$ 1,282               | \$ --                  | \$ --                       | \$ 1,282        | \$ 377,737        | \$ 379,019        | \$ --                                     | \$ --               |
| Construction and land development   | --                     | --                     | --                          | --              | 82,286            | 82,286            | --                                        | --                  |
| Residential                         | 334                    | --                     | --                          | 334             | 19,181            | 19,515            | --                                        | --                  |
| Commercial                          | 41                     | --                     | 121                         | 162             | 91,127            | 91,289            | --                                        | 268                 |
| Consumer                            | --                     | --                     | --                          | --              | 1,325             | 1,325             | --                                        | --                  |
| Total                               | <u>\$ 1,657</u>        | <u>\$ --</u>           | <u>\$ 121</u>               | <u>\$ 1,778</u> | <u>\$ 571,656</u> | <u>\$ 573,434</u> | <u>\$ --</u>                              | <u>\$ 268</u>       |

## Notes to Financial Statements

Following is a summary of the Bank's credit quality information for loans by class as of December 31, 2014 and December 31, 2013:

### Credit Quality By Class

| December 31, 2014<br>(in thousands) |                   |                 |                 |               |              |                   |
|-------------------------------------|-------------------|-----------------|-----------------|---------------|--------------|-------------------|
|                                     | Pass              | Special Mention | Substandard     | Doubtful      | Loss         | Total             |
| Real Estate                         |                   |                 |                 |               |              |                   |
| Commercial                          | \$ 434,119        | \$ 1,003        | \$ 2,769        | \$ --         | \$ --        | \$ 437,891        |
| Construction and land development   | 140,480           | --              | --              | --            | --           | 140,480           |
| Residential                         | 22,589            | 914             | --              | --            | --           | 23,503            |
| Commercial                          | 79,635            | 712             | 974             | 183           | --           | 81,504            |
| Consumer                            | 1,220             | 12              | --              | --            | --           | 1,232             |
| Total                               | <u>\$ 678,043</u> | <u>\$ 2,641</u> | <u>\$ 3,743</u> | <u>\$ 183</u> | <u>\$ --</u> | <u>\$ 684,610</u> |

  

| December 31, 2013<br>(in thousands) |                   |                 |                 |               |              |                   |
|-------------------------------------|-------------------|-----------------|-----------------|---------------|--------------|-------------------|
|                                     | Pass              | Special Mention | Substandard     | Doubtful      | Loss         | Total             |
| Real Estate                         |                   |                 |                 |               |              |                   |
| Commercial                          | \$ 376,719        | \$ --           | \$ 2,300        | \$ --         | \$ --        | \$ 379,019        |
| Construction and land development   | 81,003            | --              | 1,283           | --            | --           | 82,286            |
| Residential                         | 18,572            | 943             | --              | --            | --           | 19,515            |
| Commercial                          | 90,101            | 848             | 72              | 268           | --           | 91,289            |
| Consumer                            | 1,325             | --              | --              | --            | --           | 1,325             |
| Total                               | <u>\$ 567,720</u> | <u>\$ 1,791</u> | <u>\$ 3,655</u> | <u>\$ 268</u> | <u>\$ --</u> | <u>\$ 573,434</u> |

The Bank assesses credit quality based on internal risk rating of loans. Internal risk rating definitions are:

**Pass:** These include satisfactory loans which have acceptable levels of risk.

**Special Mention:** These loans have a potential weakness that requires management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Bank's credit position at some future date. These credits do not expose the Bank to sufficient risk to warrant further adverse classification.

**Substandard:** A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as such must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

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

**Loss:** Loans classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be received in the future.

## Notes to Financial Statements

### Note 5. Bank Premises and Equipment

The major classes of bank premises and equipment and the total accumulated depreciation are as follows:

|                                  | <b>December 31,</b> |                 |
|----------------------------------|---------------------|-----------------|
|                                  | <b>2014</b>         | <b>2013</b>     |
| (In thousands)                   |                     |                 |
| Leasehold improvements           | \$ 2,393            | \$ 2,159        |
| Furniture and equipment          | <u>3,602</u>        | <u>3,259</u>    |
|                                  | \$ 5,995            | \$ 5,418        |
| Less accumulated depreciation    | <u>(2,954)</u>      | <u>(2,306)</u>  |
| Bank premises and equipment, net | <u>\$ 3,041</u>     | <u>\$ 3,112</u> |

Depreciation expense was \$710 thousand and \$650 thousand for the years ended December 31, 2014 and 2013, respectively.

Pursuant to the terms of noncancelable lease agreements at December 31, 2014, pertaining to Bank premises and equipment, future minimum rent commitments under various operating leases are as follows:

|                     |                 |
|---------------------|-----------------|
| (In thousands)      |                 |
| 2015                | \$ 1,298        |
| 2016                | 1,157           |
| 2017                | 1,184           |
| 2018                | 1,094           |
| 2019                | 595             |
| 2020 and thereafter | <u>1,859</u>    |
|                     | <u>\$ 7,187</u> |

The leases contain options to extend for periods from five to ten years. The cost of such rental is not included above.

Total rent expense amounted to \$1.2 million and \$1.1 million for the years ended December 31, 2014 and 2013, respectively.

### Note 6. Income Taxes

The Bank files income tax returns in the U.S. federal jurisdiction, the Commonwealth of Virginia, the District of Columbia and the state of Maryland. With few exceptions, the Bank is no longer subject to U.S. federal, state and local income tax examinations by tax authorities for years prior to 2011.

## Notes to Financial Statements

Net deferred tax assets consist of the following components as of December 31, 2014 and 2013:

| (In thousands)                   | <u>2014</u>     | <u>2013</u>     |
|----------------------------------|-----------------|-----------------|
| Deferred tax assets:             |                 |                 |
| Allowance for loan losses        | \$ 2,200        | \$ 1,906        |
| Start-up costs                   | 78              | 93              |
| Deferred loan fees               | 456             | 327             |
| Share-based compensation expense | 252             | 195             |
| Unrealized losses on securities  | 97              | 328             |
| Other                            | 104             | 86              |
|                                  | <u>\$ 3,187</u> | <u>\$ 2,935</u> |
| Deferred tax liabilities:        |                 |                 |
| Depreciation                     | \$ 89           | \$ 88           |
|                                  | <u>\$ 89</u>    | <u>\$ 88</u>    |
| Net deferred tax assets          | <u>\$ 3,098</u> | <u>\$ 2,847</u> |

The provision for income taxes charged to operations for the years ended December 31, 2014 and 2013, consists of the following:

| (In thousands)         | <u>2014</u>     | <u>2013</u>     |
|------------------------|-----------------|-----------------|
| Current tax expense    | \$ 4,852        | \$ 4,228        |
| Deferred tax (benefit) | <u>(482)</u>    | <u>(357)</u>    |
|                        | <u>\$ 4,370</u> | <u>\$ 3,871</u> |

Income tax expense differs from the amount of tax determined by applying the federal income tax rate to pretax income due to the following:

| (In thousands)                                      | <u>2014</u>     | <u>2013</u>     |
|-----------------------------------------------------|-----------------|-----------------|
| Computed "expected" tax expense                     | \$ 4,249        | \$ 3,748        |
| Increase (decrease) in income taxes resulting from: |                 |                 |
| Tax-exempt interest income                          | (31)            | (54)            |
| Stock-based compensation                            | 66              | 124             |
| State income taxes, net of federal benefit          | 111             | 109             |
| Other, net                                          | <u>(25)</u>     | <u>(56)</u>     |
|                                                     | <u>\$ 4,370</u> | <u>\$ 3,871</u> |

### Note 7. Fund Restrictions and Reserve Balance

The Bank must maintain a reserve against its deposits in accordance with Regulation D of the Federal Reserve Act. For the final weekly reporting period in the years ended December 31, 2014

## Notes to Financial Statements

and 2013, the aggregate amounts of daily average required balances were approximately \$3.8 million and \$2.2 million.

### Note 8. Related Party Transactions

The Bank has had, and may be expected to have in the future, banking transactions in the ordinary course of business with directors, principal shareholders, executive officers, their immediate families and affiliated companies in which they are principal shareholders (commonly referred to as related parties), on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others. At December 31, 2014 and 2013, these loans totaled \$7.0 million and \$5.6 million, respectively. During 2014, total principal additions were \$2.4 million and total principal payments were \$1.0 million. Principal payments include loan balances for individuals no longer considered related parties. Deposits of directors and executive officers totaled \$21.0 million and \$13.9 million at December 31, 2014 and 2013, respectively.

### Note 9. Deposits

The aggregate amount of certificates of deposit with a minimum denomination of \$250,000 was \$103.9 million and \$95.2 million at December 31, 2014 and 2013, respectively.

At December 31, 2014, the scheduled maturities of time deposits (including brokered deposits) are as follows:

| (In thousands) |                   |
|----------------|-------------------|
| 2015           | \$ 202,681        |
| 2016           | 57,268            |
| 2017           | 17,706            |
| 2018           | 8,211             |
| 2019           | <u>5,590</u>      |
|                | <u>\$ 291,456</u> |

At December 31, 2014 and 2013, overdraft demand deposits reclassified to loans totaled \$113 and \$3 thousand, respectively. The Bank obtains certain deposits through the efforts of third-party brokers. At December 31, 2014 and 2013, brokered deposits (not including CDARS) totaled \$21.3 million and \$17.5 million respectively, and were included in time deposits on the Bank's balance sheets. At December 31, 2014 and 2013, CDARS deposits totaled \$73.4 million and \$72.7 million, respectively.

At December 31, 2014, one depositor held \$40.2 million or 6.5% of the Bank's total deposits.

### Note 10. Federal Home Loan Bank Advances and Other Borrowings

The Bank has entered into various note agreements with the Federal Home Loan Bank of Atlanta. At December 31, 2014, the Bank had entered into short-term note agreements for \$24 million maturing through December 31, 2015 at a weighted average interest rate of 0.73%. The Bank also has \$28 million in fixed-rate term borrowings at a weighted rate of 1.17%. These advances mature \$16 million in 2016, \$5 million in 2017, \$4 million in 2018 and \$3 million in 2019. These advances are secured by a blanket floating lien on all real estate mortgage loans secured by 1 to 4 family residential properties, unpledged U.S. Government and agencies and mortgage-backed securities and any other real estate related collateral. Total collateral under the blanket lien amounted to

## Notes to Financial Statements

approximately \$99.5 million as of December 31, 2014. Total FHLB available borrowing capacity was \$137.6 million at December 31, 2014.

The Bank also has federal funds lines of credit with correspondent banks available for overnight borrowing of \$18 million. No amounts were drawn on these lines at December 31, 2014.

Securities sold under agreements to repurchase amounted to \$12.4 million at December 31, 2014, mature on a daily basis and are secured by U.S. government securities. The weighted average interest rate on these agreements was 0.40% at December 31, 2014.

### Note 11. Other Operating Expenses

Other operating expenses in the statements of income include the following components:

|                                | Years Ended December 31, |                 |
|--------------------------------|--------------------------|-----------------|
|                                | 2014                     | 2013            |
| (In thousands)                 |                          |                 |
| Advertising expense            | \$ 432                   | \$ 564          |
| Data processing                | 1,140                    | 982             |
| FDIC insurance                 | 348                      | 317             |
| Professional fees              | 485                      | 367             |
| State franchise tax            | 653                      | 392             |
| Other operating expense        | 1,236                    | 1,320           |
| Total other operating expenses | <u>\$ 4,294</u>          | <u>\$ 3,942</u> |

### Note 12. Commitments and Contingencies

In the normal course of business, there are outstanding various commitments and contingent liabilities, which are not reflected in the accompanying financial statements. The Bank does not anticipate any material losses as a result of these transactions. See Note 13 with respect to financial instruments with off-balance-sheet risk.

### Note 13. Financial Instruments With Off-Balance-Sheet Risk

The Bank is 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, standby letters of credit and financial guarantees. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit and financial guarantees written is represented by the contractual notional amount of those instruments.

The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

## Notes to Financial Statements

A summary of the contract or notional amount of the Bank's exposure to off-balance-sheet risk as of December 31, 2014 and 2013 is as follows:

|                              | <u>2014</u> | <u>2013</u> |
|------------------------------|-------------|-------------|
| (In thousands)               |             |             |
| Commitments to extend credit | \$ 183,429  | \$ 134,883  |
| Standby letters of credit    | 13,456      | 8,607       |

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

Unfunded commitments under lines of credit are commitments for possible future extensions of credit to existing customers. Those lines of credit may not be drawn upon to the total extent to which the Company is committed.

Standby letters of credit written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

### **Note 14. Fair Value Measurements**

#### **Determination of Fair Value**

The Bank uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the Fair Value Measurements and Disclosures topic of FASB ASC, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Bank's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date

## **Notes to Financial Statements**

under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

### **Fair Value Hierarchy**

In accordance with this guidance, the Bank groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1 - Valuation is based on quoted prices in active markets for identical assets and liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 - Valuation is based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on 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 for substantially the full term of the asset or liability.

Level 3 - Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

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

### **Cash and Cash Equivalents and Interest-Bearing Deposits in Banks**

The carrying amounts of cash and short-term instruments approximate fair values based on the short-term nature of the assets.

Fair values of other interest-bearing deposits are estimated using discounted cash flow analyses based on current rates for similar types of deposits.

### **Securities**

Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data (level 2). If the inputs used to provide the evaluation for certain securities are unobservable and/or there is little, if any, market activity then the security would fall to the lowest level of the hierarchy (level 3).

## **Notes to Financial Statements**

The Bank's investment portfolio is primarily valued using fair value measurements that are considered to be level 2. The Bank has contracted with a third party portfolio accounting service vendor for valuation of its securities portfolio. The vendor's primary source for security valuation is Reuters and J.J. Kenny Drake, which evaluates securities based on market data. Reuters and J.J. Kenny Drake utilize evaluated pricing models that vary by asset class and include available trade, bid, and other market information. Generally, the methodology includes broker quotes, proprietary models, vast descriptive terms and conditions databases, as well as extensive quality control programs.

The vendor utilizes proprietary valuation matrices for valuing all municipals securities. The initial curves for determining the price, movement, and yield relationships within the municipal matrices are derived from industry benchmark curves or sourced from a municipal trading desk. The securities are further broken down according to issuer, credit support, state of issuance and rating to incorporate additional spreads to the industry benchmark curves.

### **Loans**

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for other loans, commercial real estate and investment property mortgage loans, and commercial and industrial loans are estimated using discounted cash flow analyses, using market interest rates for comparable loans. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

### **Deposit Liabilities**

The fair values disclosed for demand deposits (for example, interest and noninterest checking, savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates on comparable instruments to a schedule of aggregated expected monthly maturities on time deposits.

### **Borrowings**

The carrying amounts of federal funds purchased, borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on current market rates and similar types of borrowing arrangements. Current market rates for debt with similar terms, and remaining maturities are used to estimate fair value of long-term debt. Fair value of long-term debt is based on quoted market prices or dealer quotes for the identical liability when traded as an asset in an active market. If a quoted market price is not available, an expected present value technique is used to estimate fair value.

### **Accrued Interest**

The carrying amounts of accrued interest approximate fair value.

## Notes to Financial Statements

### Off-Balance Sheet Credit-Related Instruments

Fair values for off-balance-sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking in to account the remaining terms of the agreements and the counterparties' credit standing. Those items were deemed immaterial.

### Assets Measured at Fair Value on a Recurring Basis

Assets measured at fair value on a recurring basis are summarized below:

| (In thousands)<br>Description           | Balance   | Fair Value Measurements Using                                                 |                                                           |                                                    |
|-----------------------------------------|-----------|-------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
|                                         |           | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| December 31, 2014                       |           |                                                                               |                                                           |                                                    |
| Assets:                                 |           |                                                                               |                                                           |                                                    |
| U.S. government and<br>federal agencies | \$ 13,482 | \$ --                                                                         | \$ 13,482                                                 | \$ --                                              |
| December 31, 2013                       |           |                                                                               |                                                           |                                                    |
| Assets:                                 |           |                                                                               |                                                           |                                                    |
| U.S. government and<br>federal agencies | \$ 14,240 | \$ --                                                                         | \$ 14,240                                                 | \$ --                                              |
| Taxable municipal                       | 6,140     | --                                                                            | 6,140                                                     | --                                                 |
| Tax-exempt municipal                    | 4,440     | --                                                                            | 4,440                                                     | --                                                 |
| Mortgage-backed                         | 23,923    | --                                                                            | 23,923                                                    | --                                                 |

### Assets Measured at Fair Value on a Nonrecurring Basis

Under certain circumstances, the Bank makes adjustment to fair value for assets and liabilities although they are not measured at fair value on an ongoing basis. The following describes the valuation techniques used by the Bank to measure certain assets recorded at fair value on a nonrecurring basis in the financial statements:

**Impaired Loans:** Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreements will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the Bank's collateral is real estate. The value of real estate collateral is determined utilizing a market valuation approach based on an appraisal, of one year or less, conducted by an independent, licensed appraiser using observable market data (level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the property is more than one year old and not solely based on observable market comparables or management determines the fair value of the collateral is further impaired below the appraised value, then a level 3 valuation is considered to measure the fair value. The value of business equipment is based upon an outside appraisal, of one year or less, if deemed significant, or the net book value on the applicable business's financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (level 3). Impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Statements of Income.

## Notes to Financial Statements

**Other Real Estate Owned:** Fair values of other real estate owned (“OREO”) are carried at the lower of carrying value or fair value less selling costs. Fair value is based upon independent market prices, appraised values of the collateral or management’s estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Bank records the foreclosed asset as level 2 valuation. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Bank records the foreclosed asset as level 3 valuation. Any fair value adjustments are recorded in the period incurred and expensed against current earnings. The Bank had no other real estate owned as of December 31, 2014 and 2013.

The following table summarizes the Bank’s assets that were measured at fair value on a nonrecurring basis during the period.

|                                            |          | Fair Value Measurements Using                                                 |    |                                                           |                                                    |
|--------------------------------------------|----------|-------------------------------------------------------------------------------|----|-----------------------------------------------------------|----------------------------------------------------|
|                                            |          | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) |    | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (In thousands)                             |          |                                                                               |    |                                                           |                                                    |
| Description                                | Balance  |                                                                               |    |                                                           |                                                    |
| December 31, 2014                          |          |                                                                               |    |                                                           |                                                    |
| Assets:                                    |          |                                                                               |    |                                                           |                                                    |
| Impaired loans, net of valuation allowance | \$ 1,872 | \$                                                                            | -- | \$                                                        | --                                                 |
|                                            |          |                                                                               |    |                                                           | \$ 1,872                                           |
| December 31, 2013                          |          |                                                                               |    |                                                           |                                                    |
| Assets:                                    |          |                                                                               |    |                                                           |                                                    |
| Impaired loans, net of valuation allowance | \$ 2,839 | \$                                                                            | -- | \$                                                        | --                                                 |
|                                            |          |                                                                               |    |                                                           | \$ 2,839                                           |

| Fair Value Measurements at December 31, 2014 |                      |                                                                            |                                                                      |                 |
|----------------------------------------------|----------------------|----------------------------------------------------------------------------|----------------------------------------------------------------------|-----------------|
| Fair Value                                   | Valuation Techniques | Unobservable Inputs                                                        | Range                                                                |                 |
| (In thousands)                               |                      |                                                                            |                                                                      |                 |
| Commercial Real Estate                       | \$ 1,872             | Present value of future cash flows<br>Value of mortgage insurance coverage | Discount rate at loan interest rate<br>Mortgage guarantee percentage | 3.75%<br>35.00% |
|                                              | <u>\$ 1,872</u>      |                                                                            |                                                                      |                 |

The estimated fair values, and related carrying or notional amounts, of the Bank’s financial instruments are as follows:

## Notes to Financial Statements

|                                 | Carrying<br>Value | Active Markets<br>for Identical<br>Assets<br>Level 1 | Other<br>Observable<br>Inputs<br>Level 2 | Significant<br>Unobservable<br>Inputs<br>Level 3 | Total Fair<br>Value<br>Balance |
|---------------------------------|-------------------|------------------------------------------------------|------------------------------------------|--------------------------------------------------|--------------------------------|
|                                 |                   |                                                      | (In Thousands)                           |                                                  |                                |
| Financial assets:               |                   |                                                      |                                          |                                                  |                                |
| Cash and short-term investments | \$ 28,585         | \$ 28,585                                            | \$ --                                    | \$ --                                            | \$ 28,585                      |
| Securities available for sale   | 13,482            | --                                                   | 13,482                                   | --                                               | 13,482                         |
| Securities held to maturity     | 49,934            | --                                                   | 50,499                                   | --                                               | 50,499                         |
| Loans, net                      | 676,777           | --                                                   | --                                       | 684,293                                          | 684,293                        |
| Accrued interest receivable     | 2,168             | --                                                   | 2,168                                    | --                                               | 2,168                          |
| Financial liabilities:          |                   |                                                      |                                          |                                                  |                                |
| Deposits                        | \$ 617,613        | \$ --                                                | \$ 619,501                               | \$ --                                            | \$ 619,501                     |
| FHLB advances and other debt    | 64,404            | --                                                   | 64,513                                   | --                                               | 64,513                         |
| Accrued interest payable        | 132               | --                                                   | 132                                      | --                                               | 132                            |

| Fair Value Measurements at December 31, 2013 |                   |                                                                          |                                                         |                                                  |                                |
|----------------------------------------------|-------------------|--------------------------------------------------------------------------|---------------------------------------------------------|--------------------------------------------------|--------------------------------|
|                                              | Carrying<br>Value | Quoted Prices in<br>Active Markets<br>for Identical<br>Assets<br>Level 1 | Significant<br>Other<br>Observable<br>Inputs<br>Level 2 | Significant<br>Unobservable<br>Inputs<br>Level 3 | Total Fair<br>Value<br>Balance |
|                                              |                   |                                                                          | (In Thousands)                                          |                                                  |                                |
| Financial assets:                            |                   |                                                                          |                                                         |                                                  |                                |
| Cash and short-term investments              | \$ 29,176         | \$ 29,176                                                                | \$ --                                                   | \$ --                                            | \$ 29,176                      |
| Securities available for sale                | 48,743            | --                                                                       | 48,743                                                  | --                                               | 48,743                         |
| Securities held to maturity                  | 2,466             | --                                                                       | 2,625                                                   | --                                               | 2,625                          |
| Loans, net                                   | 566,729           | --                                                                       | --                                                      | 572,788                                          | 572,788                        |
| Accrued interest receivable                  | 1,894             | --                                                                       | 1,894                                                   | --                                               | 1,894                          |
| Financial liabilities:                       |                   |                                                                          |                                                         |                                                  |                                |
| Deposits                                     | \$ 514,926        | \$ --                                                                    | \$ 517,550                                              | \$ --                                            | \$ 517,550                     |
| FHLB advances and other debt                 | 52,305            | --                                                                       | 52,656                                                  | --                                               | 52,656                         |
| Accrued interest payable                     | 132               | --                                                                       | 132                                                     | --                                               | 132                            |

The Bank assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Bank's financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the Bank. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to repay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the Bank's overall interest rate risk.

### Note 15. Concentration Risk

The Bank maintains its cash accounts in several correspondent banks. As of December 31, 2014, deposits in excess of amounts insured by the Federal Deposit Insurance Corporation (FDIC) were insignificant.

## Notes to Financial Statements

### Note 16. Stock Compensation Plan

The Bank has granted stock options under the September 2006 Stock Option Plan (the Plan) to directors and employees to advance the interests of the Bank by encouraging stock ownership. During 2008, the Plan was amended to increase the maximum number of shares available for grant from 281,250 shares to 693,750 shares. During 2011, the Plan was amended to increase the maximum number of shares available for grant from 693,750 shares to 881,250 shares. During 2014, the Plan was amended to increase the maximum number of shares available for grant from 881,250 to 1,242,250 shares. Under the Plan, shares may be granted at not less than 100 percent of the fair market value at the grant date. As of December 31, 2014, 384,891 shares are available to grant in future periods under the Plan. All options have a 10 year term from date of grant.

A summary of the status of the Plan is presented below:

|                                                                   | <b>2014</b>    |                                                    |                                        |
|-------------------------------------------------------------------|----------------|----------------------------------------------------|----------------------------------------|
|                                                                   | <b>Shares</b>  | <b>Weighted<br/>Average<br/>Exercise<br/>Price</b> | <b>Average<br/>Intrinsic<br/>Value</b> |
| Outstanding at beginning of year                                  | 827,984        | \$ 8.41                                            |                                        |
| Granted                                                           | 28,875         | 17.85                                              |                                        |
| Exercised                                                         | (18,750)       | 8.17                                               |                                        |
| Forfeited                                                         | (10,875)       | 11.19                                              |                                        |
| Outstanding at end of year                                        | <u>827,234</u> | <u>\$ 8.71</u>                                     | <u>\$ 7,438,927</u>                    |
| Exercisable at end of year                                        | <u>643,934</u> | <u>\$ 8.21</u>                                     | <u>\$ 6,109,269</u>                    |
| Weighted average fair value of options<br>granted during the year | <u>\$ 6.71</u> |                                                    |                                        |

The aggregate intrinsic value of stock options in the table above represents the total amount by which the current market value of the underlying stock exceeds the exercise price of the option that would have been received by the Bank had all option holders exercised their options on December 31, 2014. This amount changes based on changes in the market value of the Bank's stock. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model.

Information pertaining to options outstanding at December 31, 2014 is as follows:

## Notes to Financial Statements

|                            |                               | <b>Options Outstanding</b> |                                                                    | <b>Options Exercisable</b>    |                                                                    |
|----------------------------|-------------------------------|----------------------------|--------------------------------------------------------------------|-------------------------------|--------------------------------------------------------------------|
|                            |                               |                            | <b>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Life</b> |                               | <b>Weighted<br/>Average<br/>Remaining<br/>Contractual<br/>Life</b> |
| <b>Exercise<br/>Prices</b> | <b>Number<br/>Outstanding</b> |                            |                                                                    | <b>Number<br/>Exercisable</b> |                                                                    |
| \$ 8.00                    | 518,671                       |                            | 4.81 years                                                         | 510,171                       | 4.80 years                                                         |
| 8.39                       | 6,250                         |                            | 5.79 years                                                         | 5,000                         | 5.79 years                                                         |
| 8.40                       | 7,750                         |                            | 6.13 years                                                         | 3,750                         | 6.13 years                                                         |
| 8.80                       | 31,688                        |                            | 6.85 years                                                         | 15,375                        | 6.78 years                                                         |
| 9.00                       | 212,500                       |                            | 7.49 years                                                         | 104,688                       | 7.49 years                                                         |
| 10.08                      | 11,000                        |                            | 8.05 years                                                         | 2,325                         | 8.05 years                                                         |
| 11.53                      | 3,125                         |                            | 8.39 years                                                         | 625                           | 8.39 years                                                         |
| 12.70                      | 10,000                        |                            | 8.64 years                                                         | 2,000                         | 8.64 years                                                         |
| 17.30                      | 5,750                         |                            | 9.14 years                                                         | -                             | -                                                                  |
| 18.63                      | 5,250                         |                            | 9.22 years                                                         | -                             | -                                                                  |
| 17.90                      | 9,250                         |                            | 9.47 years                                                         | -                             | -                                                                  |
| 18.03                      | 6,000                         |                            | 9.72 years                                                         | -                             | -                                                                  |
|                            | <u>827,234</u>                |                            | <u>5.84 years</u>                                                  | <u>643,934</u>                | <u>5.33 years</u>                                                  |

For the years ended December 31, 2014 and 2013, share-based compensation expense applicable to the Plan was \$358 thousand and \$543 thousand, respectively.

As of December 31, 2014, unrecognized share-based compensation expense related to nonvested options amounted to \$502 thousand. This amount is expected to be recognized over a weighted-average period of 1.8 years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model. Following are the weighted average assumptions used to value options granted in 2014:

|                         | <b>2014</b> |
|-------------------------|-------------|
| Dividend yield          | 0.00%       |
| Expected life           | 7.50 years  |
| Expected volatility     | 30.00%      |
| Risk-free interest rate | 2.21%       |

The expected volatility is based on historical volatility of peer banks. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life is based on the average of the contractual life and vesting schedule. The dividend yield assumption is based on the Bank's history and expectation of dividend payouts.

## Notes to Financial Statements

### Note 17. Earnings Per Common Share

Earnings per common share was computed based on the following for the years ended December 31, 2014 and 2013:

|                                                                                 | <u>2014</u>      | <u>2013</u>      |
|---------------------------------------------------------------------------------|------------------|------------------|
| Average common shares outstanding                                               | 8,297,608        | 6,187,372        |
| Effect of dilutive options                                                      | <u>399,416</u>   | <u>124,123</u>   |
| Average common shares outstanding used<br>to compute diluted earnings per share | <u>8,697,024</u> | <u>6,311,495</u> |

Weighted average shares and per share amounts for all periods have been adjusted to reflect a 5 for 4 stock split in the form of a 25% stock dividend declared on June 18, 2013 and paid on July 22, 2013.

Potential common shares did not impact net income. Options totaling 26,250 and 13,125 were excluded from the calculation of diluted earnings per share for the years ended December 31, 2014 and 2013, respectively, because their impact would have been anti-dilutive.

### Note 18. 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 - possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Bank's 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 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.

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 to average assets (as defined). Management believes, as of December 31, 2014 and 2013, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2014, the most recent notification from the Federal Reserve Bank categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the 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 the notification that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios are also presented in the table.

## Notes to Financial Statements

|                                          | Actual     |       | Minimum<br>Capital<br>Requirement |       | Minimum<br>To Be Well<br>Capitalized Under<br>Prompt Corrective<br>Action Provisions |       |
|------------------------------------------|------------|-------|-----------------------------------|-------|--------------------------------------------------------------------------------------|-------|
|                                          | Amount     | Ratio | Amount                            | Ratio | Amount                                                                               | Ratio |
| (Dollars in thousands)                   |            |       |                                   |       |                                                                                      |       |
| As of December 31, 2014:                 |            |       |                                   |       |                                                                                      |       |
| Total Capital (to Risk Weighted Assets)  | \$ 106,518 | 14.0% | \$ 60,759                         | 8.0%  | \$ 75,948                                                                            | 10.0% |
| Tier 1 Capital (to Risk Weighted Assets) | \$ 99,836  | 13.2% | \$ 30,379                         | 4.0%  | \$ 45,569                                                                            | 6.0%  |
| Tier 1 Capital (to Average Assets)       | \$ 99,836  | 13.1% | \$ 30,548                         | 4.0%  | \$ 38,185                                                                            | 5.0%  |
| As of December 31, 2013:                 |            |       |                                   |       |                                                                                      |       |
| Total Capital (to Risk Weighted Assets)  | \$ 97,227  | 15.7% | \$ 49,470                         | 8.0%  | \$ 61,837                                                                            | 10.0% |
| Tier 1 Capital (to Risk Weighted Assets) | \$ 91,306  | 14.8% | \$ 24,735                         | 4.0%  | \$ 37,102                                                                            | 6.0%  |
| Tier 1 Capital (to Average Assets)       | \$ 91,306  | 14.1% | \$ 25,860                         | 4.0%  | \$ 32,325                                                                            | 5.0%  |

### Note 19. Restrictions on Dividends

The Bank is subject to certain restrictions on the amount of dividends that it may pay without prior regulatory approval.

### Note 20. 401(k) Plan

Effective August 1, 2006, the Bank adopted a contributory 401(k) savings plan (the Plan) covering substantially all employees. Eligible employees may elect to defer a portion of their compensation to the Plan. The Board of Directors may elect to match a portion of each employee's contribution. No contributions were made by the Bank for the years ended December 31, 2014 and 2013.

### Note 21. Subsequent Events

The Bank evaluates subsequent events that have occurred after the balance sheet date but before the financial statements are issued. There are two types of subsequent events: (1) recognized, or those that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements and (2) nonrecognized, or those that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Based on the evaluation, the Bank did not identify any recognized or unrecognized subsequent events that would have required adjustment to or disclosure in the financial statements. Subsequent events were evaluated through March 10, 2015.