

COMMUNITY FINANCIAL CORP /MD/  
Form 10-Q  
November 07, 2013

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

**x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended September 30, 2013

OR

**“ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-18279

**The Community Financial Corporation**

(Exact name of registrant as specified in its charter)

Maryland 52-1652138  
(State of other jurisdiction of (I.R.S. Employer

incorporation or organization) Identification No.)

3035 Leonardtown Road, Waldorf, Maryland 20601  
(Address of principal executive offices) (Zip Code)

(301) 645-5601

(Registrant's telephone number, including area code)

Not applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

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

|  |   |
|--|---|
| Large Accelerated Filer <input type="checkbox"/> | Accelerated Filer <input type="checkbox"/>                    |
| Non-accelerated Filer <input type="checkbox"/>   | Smaller Reporting Company <input checked="" type="checkbox"/> |

(Do not check if a smaller reporting company)

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

Yes  No

As of October 30, 2013, the registrant had 4,647,324 shares of common stock outstanding.

**THE COMMUNITY FINANCIAL CORPORATION**

**FORM 10-Q**

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**PART I FINANCIAL STATEMENTS****ITEM I. FINANCIAL STATEMENTS****THE COMMUNITY FINANCIAL CORPORATION****CONSOLIDATED BALANCE SHEETS SEPTEMBER 30, 2013 AND DECEMBER 31, 2012**

|   | September 30,<br>2013<br>(Unaudited) | December 31,<br>2012  |
|---|--------------------------------------|-----------------------|
| <b>Assets</b>   |                                      |                       |
| Cash and due from banks   | \$ 23,269,755                        | \$ 10,696,653         |
| Federal funds sold  | -                                    | 190,000               |
| Interest-bearing deposits with banks  | 3,626,750                            | 409,002               |
| Securities available for sale (AFS), at fair value  | 50,869,490                           | 47,205,663            |
| Securities held to maturity (HTM), at amortized cost  | 91,349,615                           | 112,619,434           |
| Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock -<br>at cost                                     | 5,593,100                            | 5,476,050             |
| Loans receivable - net of allowance for loan losses of \$8,079,277 and<br>\$8,246,957                               | 759,880,727                          | 747,640,752           |
| Premises and equipment, net   | 19,272,212                           | 19,782,236            |
| Other real estate owned (OREO)  | 7,058,504                            | 6,891,353             |
| Accrued interest receivable   | 2,850,066                            | 2,904,325             |
| Investment in bank owned life insurance   | 19,195,355                           | 18,730,580            |
| Other assets  | 9,938,081                            | 9,093,164             |
| <b>Total Assets</b>   | <b>\$ 992,903,655</b>                | <b>\$ 981,639,212</b> |
| <b>Liabilities and Stockholders' Equity</b>   |                                      |                       |
| <b>Liabilities</b>  |                                      |                       |
| <b>Deposits</b>   |                                      |                       |
| Non-interest-bearing deposits   | \$ 107,856,339                       | \$ 102,319,581        |
| Interest-bearing deposits   | 709,391,120                          | 717,910,707           |
| <b>Total deposits</b>   | <b>817,247,459</b>                   | <b>820,230,288</b>    |
| Short-term borrowings   | 2,640,000                            | 1,000,000             |
| Long-term debt  | 70,488,848                           | 60,527,208            |
| Guaranteed preferred beneficial interest in junior subordinated debentures<br>(TRUPs)                               | 12,000,000                           | 12,000,000            |
| Accrued expenses and other liabilities  | 8,379,012                            | 8,834,455             |
| <b>Total Liabilities</b>  | <b>910,755,319</b>                   | <b>902,591,951</b>    |
| <b>Stockholders' Equity</b>   |                                      |                       |
| Preferred Stock, Senior Non-Cumulative Perpetual, Series C - par value<br>\$1,000; authorized 20,000; issued 20,000 | 20,000,000                           | 20,000,000            |
|   | 30,484                               | 30,524                |

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|  |                |                |
|--|----------------|----------------|
| Common stock - par value \$.01; authorized - 15,000,000 shares; issued<br>3,048,439 and 3,052,416 shares, respectively |                |                |
| Additional paid in capital   | 18,275,729     | 17,873,560     |
| Retained earnings  | 45,626,970     | 41,986,633     |
| Accumulated other comprehensive gain (loss)  | (910,940       | ) 139,184      |
| Unearned ESOP shares   | (873,907       | ) (982,640     |
| Total Stockholders' Equity   | 82,148,336     | 79,047,261     |
| Total Liabilities and Stockholders' Equity   | \$ 992,903,655 | \$ 981,639,212 |

*See notes to Consolidated Financial Statements*

**THE COMMUNITY FINANCIAL CORPORATION****CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)****THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2013 AND 2012**

|   | Three Months Ended September 30, |              | Nine Months Ended September 30, |               |
|---|----------------------------------|--------------|---------------------------------|---------------|
|   | 2013                             | 2012         | 2013                            | 2012          |
| Interest and Dividend Income                            |                                  |              |                                 |               |
| Loans, including fees                                   | \$ 9,340,139                     | \$ 9,113,063 | \$ 27,703,885                   | \$ 27,624,323 |
| Taxable interest and dividends on investment securities | 631,652                          | 768,611      | 1,852,692                       | 2,465,529     |
| Interest on deposits with banks                         | 3,268                            | 4,982        | 8,552                           | 7,730         |
| Total Interest and Dividend Income                      | 9,975,059                        | 9,886,656    | 29,565,129                      | 30,097,582    |
| Interest Expense  |                                  |              |                                 |               |
| Deposits  | 1,335,916                        | 2,001,535    | 4,332,351                       | 6,630,820     |
| Short-term borrowings                                   | 4,237                            | 298          | 12,930                          | 12,483        |
| Long-term debt  | 532,833                          | 537,216      | 1,569,247                       | 1,684,772     |
| Total Interest Expense                                  | 1,872,986                        | 2,539,049    | 5,914,528                       | 8,328,075     |
| Net Interest Income                                     | 8,102,073                        | 7,347,607    | 23,650,601                      | 21,769,507    |
| Provision for loan losses                               | 285,610                          | 746,075      | 640,210                         | 1,523,580     |
| Net Interest Income After Provision For Loan Losses     | 7,816,463                        | 6,601,532    | 23,010,391                      | 20,245,927    |
| Noninterest Income                                      |                                  |              |                                 |               |
| Loan appraisal, credit, and miscellaneous charges       | 55,620                           | 280,456      | 374,769                         | 663,897       |
| Gain on sale of asset                                   | -                                | -            | 11,000                          | -             |
| Net gain (losses) on sale of OREO                       | 215,345                          | -            | 215,345                         | (96,917)      |
| Income from bank owned life insurance                   | 156,348                          | 157,177      | 464,775                         | 476,294       |
| Service charges   | 661,134                          | 528,420      | 1,764,314                       | 1,530,323     |
| Gain on sale of loans held for sale                     | 30,769                           | 336,384      | 546,819                         | 471,725       |
| Total Noninterest Income                                | 1,119,216                        | 1,302,437    | 3,377,022                       | 3,045,322     |
| Noninterest Expense                                     |                                  |              |                                 |               |
| Salary and employee benefits                            | 3,737,000                        | 3,492,524    | 10,883,606                      | 9,982,603     |
| Occupancy expense                                       | 504,627                          | 487,233      | 1,556,877                       | 1,389,024     |
| Advertising   | 118,421                          | 86,020       | 391,152                         | 345,111       |
| Data processing expense                                 | 237,054                          | 329,005      | 967,368                         | 1,118,598     |
| Professional fees                                       | 293,028                          | 177,818      | 754,719                         | 746,322       |
| Depreciation of furniture, fixtures, and equipment      | 191,320                          | 188,870      | 580,842                         | 486,159       |
| Telephone communications                                | 45,787                           | 45,563       | 148,516                         | 137,649       |



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|   |              |              |              |              |
|---|--------------|--------------|--------------|--------------|
| Office supplies   | 41,689       | 52,751       | 151,157      | 186,741      |
| FDIC Insurance  | 284,591      | 201,607      | 858,860      | 1,092,809    |
| Valuation allowance on OREO   | 170,560      | 31,050       | 500,536      | 657,226      |
| Other   | 621,650      | 508,343      | 1,701,338    | 1,719,647    |
| Total Noninterest Expense   | 6,245,727    | 5,600,784    | 18,494,971   | 17,861,889   |
| Income before income taxes  | 2,689,952    | 2,303,185    | 7,892,442    | 5,429,360    |
| Income tax expense  | 987,111      | 830,244      | 2,885,761    | 1,910,014    |
| Net Income  | \$ 1,702,841 | \$ 1,472,941 | \$ 5,006,681 | \$ 3,519,346 |
| Preferred stock dividends   | 50,000       | 50,000       | 150,000      | 150,000      |
| Net Income Available to Common Shareholders                             | \$ 1,652,841 | \$ 1,422,941 | \$ 4,856,681 | \$ 3,369,346 |
| Net Income  | \$ 1,702,841 | \$ 1,472,941 | \$ 5,006,681 | \$ 3,519,346 |
| Net unrealized holding gains (losses) arising during period, net of tax | (231,346 )   | 68,791       | (1,050,124 ) | 76,542       |
| Comprehensive Income  | \$ 1,471,495 | \$ 1,541,732 | \$ 3,956,557 | \$ 3,595,888 |
| Earnings Per Common Share   |              |              |              |              |
| Basic   | \$ 0.55      | \$ 0.47      | \$ 1.61      | \$ 1.11      |
| Diluted   | \$ 0.55      | \$ 0.47      | \$ 1.60      | \$ 1.10      |
| Cash dividends paid per common share                                    | \$ 0.10      | \$ -         | \$ 0.30      | \$ 0.40      |

*See notes to Consolidated Financial Statements*

**THE COMMUNITY FINANCIAL CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)****NINE MONTHS ENDED SEPTEMBER 30, 2013 AND 2012**

|  | Nine Months Ended<br>September 30, |               |
|--|------------------------------------|---------------|
|  | 2013                               | 2012          |
| <b>Cash Flows from Operating Activities</b>                                      |                                    |               |
| Net income   | \$5,006,681                        | \$3,519,346   |
| Adjustments to reconcile net income to net cash provided by operating activities |                                    |               |
| Provision for loan losses  | 640,210                            | 1,523,580     |
| Depreciation and amortization  | 965,380                            | 845,804       |
| Loans originated for resale  | (20,903,681 )                      | (9,987,050 )  |
| Proceeds from sale of loans originated for sale                                  | 21,326,491                         | 10,383,776    |
| Gain on sale of loans held for sale  | (546,819 )                         | (471,725 )    |
| Net (gains) losses on the sale of OREO   | (215,345 )                         | 96,917        |
| Gain on sale of asset  | (11,000 )                          | -             |
| Net amortization of premium/discount on investment securities                    | 440,932                            | 308,509       |
| Increase in OREO valuation allowance   | 500,536                            | 657,226       |
| Increase in cash surrender of bank owned life insurance                          | (464,775 )                         | (476,293 )    |
| Deferred income tax benefit  | (128,314 )                         | (773,527 )    |
| Decrease (Increase) in accrued interest receivable                               | 54,259                             | (39,413 )     |
| Stock based compensation   | 249,129                            | 263,088       |
| Decrease in deferred loan fees   | 215,478                            | 104,942       |
| (Decrease) Increase in accounts payable, accrued expenses and other liabilities  | (455,443 )                         | 441,789       |
| (Increase) Decrease in other assets  | (165,764 )                         | 2,411,207     |
| Net Cash Provided by Operating Activities  | 6,507,955                          | 8,808,176     |
| <b>Cash Flows from Investing Activities</b>                                      |                                    |               |
| Purchase of AFS investment securities  | (13,486,742 )                      | (10,101,789 ) |
| Proceeds from redemption or principal payments of AFS investment securities      | 8,091,820                          | 15,465,959    |
| Purchase of HTM investment securities  | (11,682,813 )                      | (11,249,535 ) |
| Proceeds from maturities or principal payments of HTM investment securities      | 32,651,698                         | 39,413,413    |
| Net (increase) decrease of FHLB and FRB stock                                    | (117,050 )                         | 155,250       |
| Loans originated or acquired   | (182,200,307)                      | (173,628,906) |
| Principal collected on loans   | 168,063,366                        | 147,989,755   |
| Purchase of premises and equipment   | (455,356 )                         | (4,253,518 )  |
| Proceeds from sale of OREO   | 712,945                            | 344,512       |
| Proceeds from disposal of asset  | 11,000                             | -             |
| Net Cash Provided by Investing Activities  | 1,588,561                          | 4,135,141     |



**THE COMMUNITY FINANCIAL CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)****NINE MONTHS ENDED SEPTEMBER 30, 2013 AND 2012 (continued)**

|   | Nine Months Ended<br>September 30, |                |
|---|------------------------------------|----------------|
|   | 2013                               | 2012           |
| <b>Cash Flows from Financing Activities</b>                   |                                    |                |
| Net decrease in deposits                                      | \$(2,982,829 )                     | \$(4,265,600 ) |
| Proceeds from long-term borrowings                            | 10,000,000                         | -              |
| Payments of long-term borrowings                              | (38,360 )                          | (36,854 )      |
| Net increase in short term borrowings                         | 1,640,000                          | -              |
| Exercise of stock options                                     | 125,222                            | 67,391         |
| Dividends Paid  | (1,063,992 )                       | (1,371,571 )   |
| Net change in unearned ESOP shares                            | 126,812                            | (1,942 )       |
| Redemption of common stock                                    | (302,519 )                         | (257,935 )     |
| Net Cash Provided by (Used in) Financing Activities           | 7,504,334                          | (5,866,511 )   |
| Increase in Cash and Cash Equivalents                         | \$ 15,600,850                      | \$ 7,076,806   |
| <br>  |                                    |                |
| Cash and Cash Equivalents - January 1                         | 11,295,655                         | 19,118,189     |
| Cash and Cash Equivalents - September 30                      | \$26,896,505                       | \$26,194,995   |
| <br>  |                                    |                |
| <b>Supplemental Disclosures of Cash Flow Information</b>      |                                    |                |
| Cash paid during the nine months for:                         |                                    |                |
| Interest  | \$5,856,848                        | \$8,340,170    |
| Income taxes  | \$3,164,596                        | \$1,470,590    |
| <br>  |                                    |                |
| <b>Supplemental Schedule of Non-Cash Operating Activities</b> |                                    |                |
| Issuance of common stock for payment of compensation          | \$249,129                          | \$263,088      |
| Transfer from loans to OREO                                   | \$1,390,286                        | \$2,165,376    |

*See notes to Consolidated Financial Statements*

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

**NINE MONTHS ENDED SEPTEMBER 30, 2013 AND 2012**

**1. BASIS OF PRESENTATION**

*General* - The consolidated financial statements of The Community Financial Corporation (formerly Tri-County Financial Corporation) (the “Company”) and its wholly owned subsidiary, Community Bank of the Chesapeake (formerly Community Bank of Tri-County) (the “Bank”), and the Bank’s wholly owned subsidiary, Community Mortgage Corporation of Tri-County, included herein are unaudited. The Bank conducts business through its main office in Waldorf, Maryland, and ten branch offices in Waldorf, Bryans Road, Dunkirk, Leonardtown, La Plata, Charlotte Hall, Prince Frederick, Lusby, California, Maryland; and Dahlgren, Virginia. Effective October 18, 2013, the Company changed its name from Tri-County Financial Corporation and the Bank changed its name from Community Bank of Tri-County. The new names reflect the Bank’s recent expansion into the Northern Neck of Virginia. The name of the holding company changed to better align the parent company name with that of the Bank.

The consolidated financial statements reflect all adjustments consisting only of normal recurring accruals that, in the opinion of management, are necessary to present fairly the Company’s financial condition, results of operations, and cash flows for the periods presented. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. The Company believes that the disclosures are adequate to make the information presented not misleading. The balances as of December 31, 2012 have been derived from audited financial statements. There have been no significant changes to the Company’s accounting policies as disclosed in the 2012 Annual Report. The results of operations for the three and nine months ended September 30, 2013 are not necessarily indicative of the results of operations to be expected for the remainder of the year or any other period. Certain previously reported amounts have been restated to conform to the 2013 presentation.

These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company’s 2012 Annual Report.

In October 2013, the Company completed a stock offering and issued 1,591,300 shares of common stock at a price of \$18.75 per share resulting in net proceeds of \$27.4 million after commissions and related offering expenses. The additional capital raise was completed in the fourth quarter 2013 and is not reflected in the financial statements as of September 30, 2013.

## **2. NATURE OF BUSINESS**

The Company provides a variety of financial services to individuals and businesses through its offices in Southern Maryland and King George, Virginia. Its primary deposit products are demand, savings and time deposits, and its primary lending products are commercial and residential mortgage loans, commercial loans, construction and land development loans, home equity and second mortgages and commercial equipment loans.

## **3. FAIR VALUE MEASUREMENTS**

The Company adopted FASB ASC Topic 820, “Fair Value Measurements” and FASB ASC Topic 825, “The Fair Value Option for Financial Assets and Financial Liabilities”, which provides a framework for measuring and disclosing fair value under generally accepted accounting principles. FASB ASC Topic 820 requires disclosures about the fair value of assets and liabilities recognized in the balance sheet in periods subsequent to initial recognition, whether the measurements are made on a recurring basis (for example, available for sale investment securities) or on a nonrecurring basis (for example, impaired loans).

FASB ASC Topic 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FASB ASC Topic 820 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

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

Under FASB ASC Topic 820, the Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine the fair value. These hierarchy levels are:

Level 1 inputs - Unadjusted quoted prices in active markets for identical assets or liabilities that the entity has the ability to access at the measurement date.

Level 2 inputs - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves that are observable at commonly quoted intervals.

Level 3 inputs - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Company's monthly or quarterly valuation process.

There were no transfers between levels of the fair value hierarchy and the Company had no Level 3 fair value assets or liabilities for the three and nine months ended September 30, 2013 and the year ended December 31, 2012, respectively.

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

***Securities Available for Sale***

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

### ***Loans Receivable***

The Company does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. Management estimates the fair value of impaired loans using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At September 30, 2013 and December 31, 2012, substantially all of the impaired loans were evaluated based upon the fair value of the collateral. In accordance with FASB ASC 820, impaired loans where an allowance is established based on the fair value of collateral (loans with impairment) require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the loan as nonrecurring Level 3.



**Other Real Estate Owned (“OREO”)**

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

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

The tables below present the recorded amount of assets as of September 30, 2013 and December 31, 2012 measured at fair value on a recurring basis.

| Description of Asset                         | September 30, 2013 |         |              |         |
|--|--------------------|---------|--------------|---------|
|  | Fair Value         | Level 1 | Level 2      | Level 3 |
| Available for sale securities                |                    |         |              |         |
| Asset-backed securities issued by GSEs       |                    |         |              |         |
| Collateralized Mortgage Obligations ("CMOs") | \$46,471,000       | \$ -    | \$46,471,000 | \$ -    |
| Mortgage Backed Securities ("MBS")           | 198,713            | -       | 198,713      | -       |
| Corporate equity securities                  | 38,698             | -       | 38,698       | -       |
| Bond mutual funds                            | 4,161,079          | -       | 4,161,079    | -       |
| Total available for sale securities          | \$50,869,490       | \$ -    | \$50,869,490 | \$ -    |

| Description of Asset                   | December 31, 2012 |         |              |         |
|--|-------------------|---------|--------------|---------|
|  | Fair Value        | Level 1 | Level 2      | Level 3 |
| Available for sale securities          |                   |         |              |         |
| Asset-backed securities issued by GSEs |                   |         |              |         |
| CMOs                                   | \$42,655,799      | \$ -    | \$42,655,799 | \$ -    |
| MBS                                    | 231,386           | -       | 231,386      | -       |
| Corporate equity securities            | 37,332            | -       | 37,332       | -       |
| Bond mutual funds                      | 4,281,146         | -       | 4,281,146    | -       |
| Total available for sale securities    | \$47,205,663      | \$ -    | \$47,205,663 | \$ -    |

**Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis**

The Company may be required from time to time to measure certain assets at fair value on a nonrecurring basis in accordance with U.S. GAAP. These include assets that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. Assets measured at fair value on a nonrecurring basis as of September 30, 2013 and December 31, 2012 are included in the tables below.

| Description of Asset        | September 30, 2013 |         |             |         |
|-----------------------------|--------------------|---------|-------------|---------|
|                             | Fair Value         | Level 1 | Level 2     | Level 3 |
| Loans with impairment       |                    |         |             |         |
| Commercial real estate      | \$3,411,781        | \$ -    | \$3,411,781 | \$ -    |
| Residential first mortgage  | 530,170            | -       | 530,170     | -       |
| Commercial loans            | 429,000            | -       | 429,000     | -       |
| Total loans with impairment | \$4,370,951        | \$ -    | \$4,370,951 | \$ -    |
| Other real estate owned     | \$7,058,504        | \$ -    | \$7,058,504 | \$ -    |

| Description of Asset        | December 31, 2012 |         |             |         |
|-----------------------------|-------------------|---------|-------------|---------|
|                             | Fair Value        | Level 1 | Level 2     | Level 3 |
| Loans with impairment       |                   |         |             |         |
| Commercial real estate      | \$2,028,534       | \$ -    | \$2,028,534 | \$ -    |
| Residential first mortgage  | 602,290           | -       | 602,290     | -       |
| Commercial loans            | 94,355            | -       | 94,355      | -       |
| Total loans with impairment | \$2,725,179       | \$ -    | \$2,725,179 | \$ -    |
| Other real estate owned     | \$6,891,353       | \$ -    | \$6,891,353 | \$ -    |

Loans with impairment have unpaid principal balances of \$5,415,721 and \$4,272,836 at September 30, 2013 and December 31, 2012, respectively, and include impaired loans with a specific allowance.

#### 4. INCOME TAXES

The Company files a consolidated federal income tax return with its subsidiaries. Deferred tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws and when it is considered more likely than not that deferred tax assets will be realized. It is the Company's policy to recognize accrued interest and penalties related to unrecognized tax benefits as a component of tax expense.

#### 5. EARNINGS PER COMMON SHARE (EPS)

Basic earnings per common share represent income available to common shareholders, divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate to outstanding stock options and are determined using the treasury stock method. As of September 30, 2013 and 2012, there were 101,549 and 187,367 shares, respectively, excluded from the diluted net income per share computation because the exercise price of the stock options were greater than the market price, and thus were anti-dilutive. Basic and diluted earnings per share have been computed based on weighted-average common and common equivalent shares outstanding as follows:

|   | Three Months Ended    |                       | Nine Months Ended     |                       |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
|   | September 30,<br>2013 | September 30,<br>2012 | September 30,<br>2013 | September 30,<br>2012 |
| Net Income  | \$1,702,841           | \$1,472,941           | \$5,006,681           | \$3,519,346           |
| Less: dividends paid and accrued on preferred stock | (50,000 )             | (50,000 )             | (150,000 )            | (150,000 )            |
| Net income available to common shareholders         | \$1,652,841           | \$1,422,941           | \$4,856,681           | \$3,369,346           |
| Average number of common shares outstanding         | 2,997,401             | 3,044,556             | 3,016,793             | 3,042,645             |

|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Effect of dilutive options                             | 24,981    | 8,693     | 25,295    | 13,026    |
| Average number of shares used to calculate diluted EPS | 3,022,382 | 3,053,249 | 3,042,088 | 3,055,671 |

## 6. STOCK-BASED COMPENSATION

The Company has stock option and incentive arrangements to attract and retain key personnel. In May 2005, the 2005 Equity Compensation Plan (the "Plan") was approved by the shareholders, which authorizes the issuance of restricted stock, stock appreciation rights, stock units and stock options to the Board of Directors and key employees. Compensation expense for service based awards is recognized over the vesting period. Performance based awards are recognized based on a vesting, if applicable, and the probability of achieving the goals.

Stock-based compensation expense totaled \$159,089 and \$91,826 for the nine months ended September 30, 2013 and 2012, respectively, which consisted of grants of restricted stock and restricted stock units. Stock-based compensation for the nine months ended September 30, 2013 and 2012 included director compensation of \$3,320 and \$18,128, respectively, for stock granted in lieu of cash compensation for board fees. All outstanding options are fully vested and the Company has not granted any stock options since 2007.

The fair value of the Company's outstanding employee stock options is estimated on the date of grant using the Black-Scholes option pricing model. The Company estimates expected market price volatility and expected term of the options based on historical data and other factors.

The exercise price for options granted is set at the discretion of the committee administering the Plan, but is not less than the market value of the shares as of the date of grant. An option's maximum term is 10 years and the options vest at the discretion of the committee.

The following tables below summarize outstanding and exercisable options at September 30, 2013 and December 31, 2012.

|                                   | Shares    | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value | Weighted-Average<br>Contractual Life<br>Remaining In<br>Years |
|-----------------------------------|-----------|--|---------------------------------|---|
| Outstanding at January 1, 2013    | 236,059   | \$ 18.49                                 | \$ 164,304                      |   |
| Granted at fair value             | -         | -  |                                 |   |
| Exercised                         | (16,009 ) | 13.63                                    | 73,518                          |   |
| Expired                           | -         |  |                                 |   |
| Forfeited                         | (2 )      | 13.05                                    |                                 |   |
| Outstanding at September 30, 2013 | 220,048   | \$ 18.84                                 | \$ 478,620                      | 0.8   |
| Exercisable at September 30, 2013 | 220,048   | \$ 18.84                                 | \$ 478,620                      | 0.8   |

|                                | Shares    | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value | Weighted-Average<br>Contractual Life<br>Remaining In<br>Years |
|--------------------------------|-----------|--|---------------------------------|---|
| Outstanding at January 1, 2012 | 264,156   | \$ 17.90                                 | \$ 175,911                      |   |
| Granted at fair value          | -         | -  |                                 |   |
| Exercised                      | (24,780 ) | 12.25                                    | 88,607                          |   |

|                                  |          |          |            |     |
|----------------------------------|----------|----------|------------|-----|
| Expired                          | -        |          |            |     |
| Forfeited                        | (3,317 ) | 18.25    |            |     |
| Outstanding at December 31, 2012 | 236,059  | \$ 18.49 | \$ 164,304 | 1.0 |
| Exercisable at December 31, 2012 | 236,059  | \$ 18.49 | \$ 164,304 | 1.0 |

Options outstanding are all currently exercisable and are summarized as follows:

| Shares Outstanding<br>September 30, 2013 | Weighted Average<br>Remaining Contractual Life | Weighted Average<br>Exercise Price |
|--|--|------------------------------------|
| 39,668                                   | 1 years  | \$ 12.97                           |
| 78,831                                   | 2 years  | 15.89                              |
| 80,138                                   | 3 years  | 22.29                              |
| 21,411                                   | 4 years  | 27.70                              |
| 220,048                                  |  | \$ 18.84                           |

The aggregate intrinsic value of outstanding stock options and exercisable stock options was \$478,620 and \$164,304 at September 30, 2013 and December 31, 2012, respectively. Aggregate intrinsic value represents the difference between the Company's closing stock price on the last trading day of the period, which was \$18.95 and \$15.98 per share at September 30, 2013 and December 31, 2012, respectively, and the exercise price multiplied by the number of options outstanding.

The Company has outstanding restricted stock and stock units granted in accordance with the Plan. The following tables summarize the unvested restricted stock awards and units outstanding at September 30, 2013 and December 31, 2012, respectively.

|                                 | Restricted Stock |  | Restricted Stock Units |            |
|---------------------------------|------------------|--|------------------------|------------|
|                                 | Number of Shares | Weighted Average Grant Date Fair Value | Number of Units        | Fair Value |
| Nonvested at December 31, 2012  | 23,569           | \$ 15.64                               | 5,211                  | \$ 15.98   |
| Granted                         | 13,656           | 18.00                                  | 2,105                  | 16.87      |
| Vested                          | (16,678 )        | 16.35                                  | (3,106 )               | 15.98      |
| Nonvested at September 30, 2013 | 20,547           | \$ 16.63                               | 4,210                  | \$ 18.95   |

|                                | Restricted Stock |  | Restricted Stock Units |            |
|--------------------------------|------------------|--|------------------------|------------|
|                                | Number of Shares | Weighted Average Grant Date Fair Value | Number of Units        | Fair Value |
| Nonvested at January 1, 2012   | 8,113            | \$ 16.47                               | 6,845                  | \$ 15.00   |
| Granted                        | 23,281           | 15.21                                  | 2,105                  | 15.98      |
| Vested                         | (7,825 )         | 15.20                                  | (3,739 )               | 14.80      |
| Nonvested at December 31, 2012 | 23,569           | \$ 15.64                               | 5,211                  | \$ 15.98   |

## **7. GUARANTEED PREFERRED BENEFICIAL INTEREST IN JUNIOR SUBORDINATED DEBENTURES (“TRUPS”)**

On June 15, 2005, Tri-County Capital Trust II (“Capital Trust II”), a Delaware business trust formed, funded and wholly owned by the Company, issued \$5,000,000 of variable-rate capital securities in a private pooled transaction. The variable rate is based on the 90-day LIBOR rate plus 1.70%. The Trust used the proceeds from this issuance, along with the \$155,000 for Capital Trust II's common securities, to purchase \$5,155,000 of the Company's junior subordinated debentures. The interest rate on the debentures and the trust preferred securities is variable and adjusts quarterly. These capital securities qualify as Tier I capital and are presented in the Consolidated Balance Sheets as “Guaranteed Preferred Beneficial Interests in Junior Subordinated Debentures.” Both the capital securities of Capital

Trust II and the junior subordinated debentures are scheduled to mature on June 15, 2035, unless called by the Company.

On July 22, 2004, Tri-County Capital Trust I (“Capital Trust I”), a Delaware business trust formed, funded and wholly owned by the Company, issued \$7,000,000 of variable-rate capital securities in a private pooled transaction. The variable rate is based on the 90-day LIBOR rate plus 2.60%. The Trust used the proceeds from this issuance, along with the Company’s \$217,000 capital contribution for Capital Trust I’s common securities, to purchase \$7,217,000 of the Company’s junior subordinated debentures. The interest rate on the debentures and the trust preferred securities is variable and adjusts quarterly. These debentures qualify as Tier I capital and are presented in the Consolidated Balance Sheets as “Guaranteed Preferred Beneficial Interests in Junior Subordinated Debentures.” Both the capital securities of Capital Trust I and the junior subordinated debentures are scheduled to mature on July 22, 2034, unless called by the Company.



## 8. PREFERRED STOCK

### *Small Business Lending Fund Preferred Stock*

On September 22, 2011, the Company entered into a Securities Purchase Agreement (the "Purchase Agreement") with the Secretary of the Treasury (the "Secretary"), pursuant to which the Company issued 20,000 shares of the Company's Senior Non-Cumulative Perpetual Preferred Stock, Series C (the "Series C Preferred Stock"), having a liquidation amount per share equal to \$1,000, for a total purchase price of \$20,000,000. The Purchase Agreement was entered into, and the Series C Preferred Stock was issued, as authorized by the Small Business Lending Fund program.

The Series C Preferred Stock is entitled to receive non-cumulative dividends, payable quarterly. The dividend rate can fluctuate on a quarterly basis during the first 10 quarters during which the Series C Preferred Stock is outstanding, based upon changes in the level of "Qualified Small Business Lending" or "QSBL" (as defined in the Purchase Agreement) by the Bank. Based upon the increase in the Bank's level of QSBL over the baseline level calculated under the terms of the Purchase Agreement, the dividend rate for the initial dividend period was set at one percent (1%). For the second through ninth calendar quarters, the dividend rate may be adjusted to between one percent (1%) and five percent (5%) per annum, to reflect the amount of change in the Bank's level of QSBL. If the level of the Bank's qualified small business loans declines so that the percentage increase in QSBL as compared to the baseline level is less than 10%, then the dividend rate payable on the Series C Preferred Stock would increase. For the tenth calendar quarter through four and one half years after issuance, the dividend rate will be fixed at between one percent (1%) and seven percent (7%) based upon the increase in QSBL as compared to the baseline. After four and one half years from issuance, the dividend rate will increase to nine percent (9%). In addition, beginning on January 1, 2014, and on all Series C Preferred Stock dividend payment dates thereafter ending on April 1, 2016, if the Company had not increased its QSBL from the baseline as of the quarter ending September 30, 2013, the Company would have been required to pay to the Secretary, on each share of Series C Preferred Stock, but only out of assets legally available, a fee equal to 0.5% of the liquidation amount per share of Series C Preferred Stock. At September 30, 2013, the Company had increased its QSBL from the baseline so that the dividend rate should remain at 1% through four and one half years from issuance.

The Series C Preferred Stock is non-voting, except in limited circumstances. If the Company misses five dividend payments, whether or not consecutive, the holder of the Series C Preferred Stock will have the right, but not the obligation, to appoint a representative as an observer on the Company's Board of Directors. The Series C Preferred Stock may be redeemed at any time at the Company's option, at a redemption price of 100% of the liquidation amount plus accrued but unpaid dividends to the date of redemption for the current period, subject to the approval of our federal banking regulator. The Company is permitted to repay its SBLF funding in increments of 25% or \$5.0 million, subject to the approval of its federal banking regulator.

The Series C Preferred Stock was issued in a private placement exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended. The Company has agreed to register the Series C Preferred Stock under certain circumstances set forth in Annex E to the Purchase Agreement. The Series C Preferred Stock is not subject to any contractual restrictions on transfer.

**9. OTHER REAL ESTATE OWNED (“OREO”)**

OREO assets are presented net of the allowance for losses. The Company considers OREO as classified assets for regulatory and financial reporting. An analysis of the activity follows.

|                                  | Nine Months Ended September 30, |              | Year Ended           |
|----------------------------------|---------------------------------|--------------|----------------------|
|                                  | 2013                            | 2012         | December 31,<br>2012 |
| Balance at beginning of year     | \$ 6,891,353                    | \$ 5,028,513 | \$ 5,028,513         |
| Additions of underlying property | 1,390,286                       | 2,165,375    | 4,020,494            |
| Disposals of underlying property | (722,599 )                      | (441,429 )   | (1,483,449 )         |
| Valuation allowance              | (500,536 )                      | (657,226 )   | (674,205 )           |
| Balance at end of period         | \$ 7,058,504                    | \$ 6,095,233 | \$ 6,891,353         |

During the nine months ended September 30, 2013, the Bank recognized \$215,345 in gains on the sale of OREO which consisted of the sale of four properties for net proceeds of \$712,944 and net losses of \$9,655 and the recognition of \$225,000 of previously deferred gain from the sale of an OREO property that the Bank financed during 2011 that did not initially qualify for full accrual sales treatment under ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition. During the nine months ended September 30, 2012, the Bank disposed of three OREO properties resulting in proceeds of \$344,512 and recognized net losses of \$96,917.

Expenses applicable to OREO assets include the following.

|                     | Three Months Ended September 30, |           | Nine Months Ended September 30, |            |
|---------------------|----------------------------------|-----------|---------------------------------|------------|
|                     | 2013                             | 2012      | 2013                            | 2012       |
| Valuation allowance | \$ 170,560                       | \$ 31,050 | \$ 500,536                      | \$ 657,226 |
| Operating expenses  | 41,080                           | 54,529    | 105,168                         | 85,374     |
|                     | \$ 211,640                       | \$ 85,579 | \$ 605,704                      | \$ 742,600 |

Operating expenses for the nine months ended September 30, 2012 included \$7,600 in deposits refunded on sold foreclosed real estate.

**10. SECURITIES**

|   | September 30, 2013 |                           |                            |                         |
|---|--------------------|---------------------------|----------------------------|-------------------------|
|   | Amortized<br>Cost  | Gross Unrealized<br>Gains | Gross Unrealized<br>Losses | Estimated<br>Fair Value |
| Securities available for sale (AFS)       |                    |                           |                            |                         |
| Asset-backed securities issued by GSEs    |                    |                           |                            |                         |
| Residential MBS                           | \$181,968          | \$ 16,745                 | \$ -                       | \$198,713               |
| Residential CMOs                          | 47,721,616         | 75,448                    | 1,326,064                  | 46,471,000              |
| Corporate equity securities               | 37,310             | 1,572                     | 184                        | 38,698                  |
| Bond mutual funds                         | 4,078,129          | 82,950                    | -                          | 4,161,079               |
| Total securities available for sale       | \$52,019,023       | \$ 176,715                | \$ 1,326,248               | \$50,869,490            |
| Securities held to maturity (HTM)         |                    |                           |                            |                         |
| Asset-backed securities issued by GSEs:   |                    |                           |                            |                         |
| Residential MBS                           | \$23,722,148       | \$ 684,723                | \$ 186,163                 | \$24,220,708            |
| Residential CMOs                          | 63,583,106         | 385,242                   | 864,471                    | 63,103,877              |
| Asset-backed securities issued by Others: |                    |                           |                            |                         |
| Residential CMOs                          | 3,294,474          | 100,907                   | 418,975                    | 2,976,406               |
| Total debt securities held to maturity    | 90,599,728         | 1,170,872                 | 1,469,609                  | 90,300,991              |
| U.S. government obligations               | 749,887            | 75                        | -                          | 749,962                 |
| Total securities held to maturity         | \$91,349,615       | \$ 1,170,947              | \$ 1,469,609               | \$91,050,953            |
|   | December 31, 2012  |                           |                            |                         |
|   | Amortized<br>Cost  | Gross Unrealized<br>Gains | Gross Unrealized<br>Losses | Estimated<br>Fair Value |
| Securities available for sale (AFS)       |                    |                           |                            |                         |
| Asset-backed securities issued by GSEs    |                    |                           |                            |                         |
| Residential MBS                           | \$198,400          | \$ 32,986                 | \$ -                       | \$231,386               |
| Residential CMOs                          | 42,507,542         | 266,775                   | 118,518                    | 42,655,799              |
| Corporate equity securities               | 37,310             | 306                       | 284                        | 37,332                  |
| Bond mutual funds                         | 4,012,609          | 268,537                   | -                          | 4,281,146               |
| Total securities available for sale       | \$46,755,861       | \$ 568,604                | \$ 118,802                 | \$47,205,663            |
| Securities held to maturity (HTM)         |                    |                           |                            |                         |
| Asset-backed securities issued by GSEs:   |                    |                           |                            |                         |
| Residential MBS                           | \$31,239,176       | \$ 1,237,277              | \$ -                       | \$32,476,453            |
| Residential CMOs                          | 76,191,199         | 715,620                   | 97,998                     | 76,808,821              |
| Asset-backed securities issued by Others: |                    |                           |                            |                         |
| Residential CMOs                          | 4,439,118          | 197,028                   | 484,343                    | 4,151,803               |
| Total debt securities held to maturity    | 111,869,493        | 2,149,925                 | 582,341                    | 113,437,077             |
| U.S. government obligations               | 749,941            | -                         | -                          | 749,941                 |
| Total securities held to maturity         | \$112,619,434      | \$ 2,149,925              | \$ 582,341                 | \$114,187,018           |

At September 30, 2013, certain asset-backed securities with an aggregate carrying value of \$36.7 million were pledged to secure certain deposits. At September 30, 2013, asset-backed securities with an aggregate carrying value of \$2.9 million were pledged as collateral for advances from the Federal Home Loan Bank of Atlanta.

At September 30, 2013, 98% of the asset-backed securities portfolio was rated AAA by Standard & Poor's or the equivalent credit rating from another major rating agency. AFS asset-backed securities issued by GSEs had an average life of 5.12 years and an average duration of 4.68 years and are guaranteed by their issuer as to credit risk. HTM asset-backed securities issued by GSEs had an average life of 5.54 years and an average duration of 5.14 years and are guaranteed by their issuer as to credit risk.

At December 31, 2012, 97% of the asset-backed securities portfolio was rated AAA by Standard & Poor's or the equivalent credit rating from another major rating agency. AFS asset-backed securities issued by GSEs had an average life of 3.43 years and average duration of 3.26 years and are guaranteed by their issuer as to credit risk. HTM asset-backed securities issued by GSEs had an average life of 3.43 years and average duration of 3.24 years and are guaranteed by their issuer as to credit risk.

We believe that AFS securities with unrealized losses will either recover in market value or be paid off as agreed. The Company intends to, and has the ability to, hold these securities to maturity. We believe that the losses are the result of general perceptions of safety and creditworthiness of the entire sector and a general disruption of orderly markets in the asset class.

Management has the ability and intent to hold the HTM securities with unrealized losses until they mature, at which time the Company will receive full value for the securities. Because our intention is not to sell the investments and it is not more likely than not that we will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, management considers the unrealized losses in the held-to-maturity portfolio to be temporary.

No charges related to other-than-temporary impairment were made during the three and nine months ended September 30, 2013 and for the year ended December 31, 2012. During the year ended December 31, 2009, the Company recorded a charge of \$148,000 related to other-than-temporary impairment on a single HTM CMO issue. At September 30, 2013, the CMO issue had a par value of \$889,000, a market fair value of \$611,000 and a carrying value of \$511,000.

During the fourth quarter of the year ended December 31, 2012, the Company recognized net losses on the sale of securities of \$3,736. The Company sold one AFS security with a carrying value of \$1,469,911 and three HTM securities with aggregate carrying values of \$3,796,011, recognizing a gain of \$153,417 and losses of \$157,153, respectively. The sale of HTM securities was permitted under ASC 320 "Investments - Debt and Equity Securities." ASC 320-10-25-6 permits the sale of HTM securities for certain changes in circumstances. The Company sold the HTM positions due to a significant deterioration in the issues' creditworthiness and the increase in regulatory risk weights mandated for risk-based capital purposes. There were no sales of AFS and HTM securities during the three and nine months ended September 30, 2013 and 2012, respectively.

**AFS Securities**

Gross unrealized losses and estimated fair value by length of time that the individual AFS securities have been in a continuous unrealized loss position at September 30, 2013 are as follows:

| September 30, 2013                     | Less Than 12 Months |                 | More Than 12 Months |                 | Total        |                   |
|--|---------------------|-----------------|---------------------|-----------------|--------------|-------------------|
|  | Fair Value          | Unrealized Loss | Fair Value          | Unrealized Loss | Fair Value   | Unrealized Losses |
| Asset-backed securities issued by GSEs | \$33,460,034        | \$1,098,769     | \$5,623,802         | \$227,295       | \$39,083,836 | \$1,326,064       |
| Corporate equity securities            | 126                 | 184             | -                   | -               | 126          | 184               |
|  | \$33,460,160        | \$1,098,953     | \$5,623,802         | \$227,295       | \$39,083,962 | \$1,326,248       |

At September 30, 2013, the AFS investment portfolio had an estimated fair value of \$50,869,490, of which \$39,083,962 or 77% of the securities had some unrealized losses from their amortized cost. The securities with unrealized losses are predominantly mortgage-backed securities issued by GSEs.

AFS securities issued by GSEs are guaranteed by the issuer. Total unrealized losses on the asset-backed securities issued by GSEs were \$1,326,064 or 2.77% of the portfolio amortized cost of \$47,903,584. AFS asset-backed securities issued by GSEs with unrealized losses have an average life of 5.22 years and an average duration of 4.74 years. We believe that the securities will either recover in market value or be paid off as agreed.

At December 31, 2012, the AFS investment portfolio had a fair value of \$47,205,663 with unrealized losses from their amortized cost of \$118,802. Asset-backed securities and corporate securities with unrealized losses had a fair value of \$11,956,182 and all unrealized losses were for less than twelve months.

### *HTM Securities*

Gross unrealized losses and estimated fair value by length of time that the individual HTM securities have been in a continuous unrealized loss position at September 30, 2013 are as follows:

| September 30, 2013                      | Less Than 12 Months |                 | More Than 12 Months |                 | Total        |                   |
|---|---------------------|-----------------|---------------------|-----------------|--------------|-------------------|
|   | Fair Value          | Unrealized Loss | Fair Value          | Unrealized Loss | Fair Value   | Unrealized Losses |
| Asset-backed securities issued by GSEs  | \$41,773,548        | \$1,029,248     | \$3,300,948         | \$21,386        | \$45,074,496 | \$1,050,634       |
| Asset-backed securities issued by other | -                   | -               | 2,258,562           | 418,975         | 2,258,562    | 418,975           |
|   | \$41,773,548        | \$1,029,248     | \$5,559,510         | \$440,362       | \$47,333,058 | \$1,469,609       |

At September 30, 2013, the HTM investment portfolio had an estimated fair value of \$91,050,953, of which \$47,333,058 or 52%, of the securities had some unrealized losses from their amortized cost. Of these securities, \$45,074,496 or 95%, are mortgage-backed securities issued by GSEs and the remaining \$2,258,562 or 5%, were asset-backed securities issued by others.

HTM securities issued by GSEs are guaranteed by the issuer. Total unrealized losses on the asset-backed securities issued by GSEs were \$1,050,634 or 1.20% of the portfolio amortized cost of \$87,305,254. HTM asset-backed securities issued by GSEs with unrealized losses have an average life of 6.02 years and an average duration of 5.56 years. We believe that the securities will either recover in market value or be paid off as agreed. The Company intends to, and has the ability to, hold these securities to maturity.

HTM asset-backed securities issued by others are collateralized mortgage obligation securities. All of the securities have credit support tranches that absorb losses prior to the tranches that the Company owns. The Company reviews credit support positions on its securities regularly. Total unrealized losses on the asset-backed securities issued by others were \$418,975, or 12.72% of the portfolio amortized cost of \$3,294,474. HTM asset-backed securities issued by others with unrealized losses have an average life of 4.24 years and an average duration of 3.27 years.



Gross unrealized losses and estimated fair value by length of time that the individual HTM securities have been in a continuous unrealized loss position at December 31, 2012 are as follows:

| December 31, 2012                       | Less Than 12 Months |                 | More Than 12 Months |                 | Total         |                   |
|---|---------------------|-----------------|---------------------|-----------------|---------------|-------------------|
|   | Fair Value          | Unrealized Loss | Fair Value          | Unrealized Loss | Fair Value    | Unrealized Losses |
| Asset-backed securities issued by GSEs  | \$ 14,253,558       | \$ 89,638       | \$ 6,132,036        | \$ 8,360        | \$ 20,385,594 | \$ 97,998         |
| Asset-backed securities issued by other | -                   | -               | 3,057,666           | 484,343         | 3,057,666     | 484,343           |
|   | \$ 14,253,558       | \$ 89,638       | \$ 9,189,702        | \$ 492,703      | \$ 23,443,260 | \$ 582,341        |

At December 31, 2012, the HTM investment portfolio had an estimated fair value of \$114,187,018, of which \$23,443,260, or 21% of the securities, had some unrealized losses from their amortized cost. Of these securities, \$20,385,594, or 87%, are mortgage-backed securities issued by GSEs and the remaining \$3,057,666, or 13%, were asset-backed securities issued by others.

HTM securities issued by GSEs are guaranteed by the issuer. Total unrealized losses on the asset-backed securities issued by GSEs were \$97,998 or 0.09% of the portfolio amortized cost of \$107,430,375. HTM asset-backed securities issued by GSEs with unrealized losses have an average life of 1.85 years and an average duration of 1.72 years. We believe that the securities will either recover in market value or be paid off as agreed. The Company intends to, and has the ability to, hold these securities to maturity.

HTM asset-backed securities issued by others are collateralized mortgage obligation securities. All of the securities have credit support tranches that absorb losses prior to the tranches that the Company owns. The Company reviews credit support positions on its securities regularly. Total unrealized losses on the asset-backed securities issued by others were \$484,343, or 10.91% of the portfolio amortized cost of \$4,439,118. HTM asset-backed securities issued by others with unrealized losses have an average life of 3.17 years and an average duration of 2.40 years.

### *Credit Quality of Asset-Backed Securities*

The tables below present the Standard & Poor's or equivalent credit rating from other major rating agencies for AFS and HTM asset-backed securities issued by GSEs and others at September 30, 2013 and December 31, 2012 by carrying value. The Company considers noninvestment grade securities rated BB+ or lower as classified assets for regulatory and financial reporting. GSE asset-backed security downgrades by Standard and Poor's were treated as AAA based on regulatory guidance.

| September 30, 2013 |               | December 31, 2012 |               |
|--------------------|---------------|-------------------|---------------|
| Credit Rating      | Amount        | Credit Rating     | Amount        |
| AAA                | \$133,974,968 | AAA               | \$150,317,560 |
| A+                 | -             | A+                | -             |
| A                  | -             | A                 | 110,780       |
| BBB                | 635,920       | BBB               | 978,043       |
| BBB-               | 106,045       | BBB-              | 322,329       |
| BB+                | -             | BB+               | -             |
| BB                 | 836,679       | BB                | 1,069,517     |
| BB-                | -             | BB-               | 68,604        |
| B+                 | 66,873        | B+                | 1,008,126     |
| CCC+               | 874,410       | CCC+              | -             |
| CCC                | 774,547       | CCC               | 881,719       |
| Total              | \$137,269,442 | Total             | \$154,756,678 |

**11. LOANS**

Loans consist of the following:

|                                   | September 30, 2013 | December 31, 2012 |
|-----------------------------------|--------------------|-------------------|
| Commercial real estate            | \$ 445,662,038     | \$ 419,667,312    |
| Residential first mortgages       | 161,861,710        | 177,663,354       |
| Construction and land development | 31,113,145         | 31,818,782        |
| Home equity and second mortgages  | 21,711,980         | 21,982,375        |
| Commercial loans                  | 86,504,220         | 88,157,606        |
| Consumer loans                    | 901,800            | 995,206           |
| Commercial equipment              | 21,085,197         | 16,267,684        |
|                                   | 768,840,090        | 756,552,319       |
| Less:                             |                    |                   |
| Deferred loan fees                | 880,086            | 664,610           |
| Allowance for loan loss           | 8,079,277          | 8,246,957         |
|                                   | 8,959,363          | 8,911,567         |
|                                   | \$ 759,880,727     | \$ 747,640,752    |

At September 30, 2013, the Bank's allowance for loan losses totaled \$8,079,277, or 1.05% of loan balances, as compared to \$8,246,957, or 1.09% of loan balances, at December 31, 2012. Management's determination of the adequacy of the allowance is based on a periodic evaluation of the portfolio with consideration given to the overall loss experience, current economic conditions, size, growth and composition of the loan portfolio, financial condition of the borrowers and other relevant factors that, in management's judgment, warrant recognition in providing an adequate allowance.

At December 31, 2012, gross loans included \$1,454,757 from the sales of OREO property that the Bank financed during 2011 that did not qualify for full accrual sales treatment under ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition". The deferred gain balance was \$225,000 at December 31, 2012. The Bank recognized the deferred gain of \$225,000 during the three months ended September 30, 2013 as the transaction qualified for full accrual sales treatment under ASC Topic 360-20-40.

***Risk Characteristics of Portfolio Segments***

The Company manages its credit products and exposure to credit losses (credit risk) by the following specific portfolio segments (classes), which are levels at which the Company develops and documents its allowance for loan loss methodology. These segments are:

***Commercial Real Estate ("CRE")***

Commercial and other real estate projects include office buildings, retail locations, churches, other special purpose buildings and commercial construction. Commercial construction balances were below 5% of the CRE portfolio at September 30, 2013 and December 31, 2012. The Bank offers both fixed-rate and adjustable-rate loans under these product lines. The primary security on a commercial real estate loan is the real property and the leases that produce income for the real property. The Bank generally limits its exposure to a single borrower to 15% of the Bank's capital. Loans secured by commercial real estate are generally limited to 80% of the lower of the appraised value or sales price at origination and have an initial contractual loan payment period ranging from three to 20 years.

Loans secured by commercial real estate are larger and involve greater risks than one-to-four family residential mortgage loans. Because payments on loans secured by such properties are often dependent on the successful operation or management of the properties, repayment of such loans may be subject to a greater extent to adverse conditions in the real estate market or the economy.

#### *Residential First Mortgages*

Residential first mortgage loans made by the Bank are generally long term loans, amortized on a monthly basis, with principal and interest due each month. The initial contractual loan payment period for residential loans typically ranges from ten to 30 years. The Bank's experience indicates that real estate loans remain outstanding for significantly shorter time periods than their contractual terms. Borrowers may refinance or prepay loans at their option, without penalty. The Bank originates both fixed-rate and adjustable-rate residential first mortgages.

The annual and lifetime limitations on interest rate adjustments may limit the increases in interest rates on these loans. There are also unquantifiable credit risks resulting from potential increased costs to the borrower as a result of repricing of adjustable-rate mortgage loans. During periods of rising interest rates, the risk of default on adjustable-rate mortgage loans may increase due to the upward adjustment of interest cost to the borrower.

#### *Construction and Land Development*

The Bank offers loans for the construction of one-to-four family dwellings. Generally, these loans are secured by the real estate under construction as well as by guarantees of the principals involved. In addition, the Bank offers loans to acquire and develop land, as well as loans on undeveloped, subdivided lots for home building by individuals.

A decline in demand for new housing might adversely affect the ability of borrowers to repay these loans. Construction and land development loans are inherently riskier than providing financing on owner-occupied real estate. The Bank's risk of loss is affected by the accuracy of the initial estimate of the market value of the completed project as well as the accuracy of the cost estimates made to complete the project. In addition, the volatility of the real estate market has made it increasingly difficult to ensure that the valuation of land associated with these loans is accurate. During the construction phase, a number of factors could result in delays and cost overruns. If the estimate of construction costs proves to be inaccurate, the Bank may be required to advance funds beyond the amount originally committed to permit completion of the development. If the estimate of value proves to be inaccurate, a project's value might be insufficient to assure full repayment. As a result of these factors, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the project rather than the ability of the borrower or guarantor to repay principal and interest. If the Bank forecloses on a project, there can be no assurance that the Bank will be able to recover all of the unpaid balance of, and accrued interest on, the loan as well as related foreclosure and holding costs.

#### *Home Equity and Second Mortgage Loans*

The Bank maintains a portfolio of home equity and second mortgage loans. These products contain a higher risk of default than residential first mortgages as in the event of foreclosure, the first mortgage would need to be paid off prior to collection of the second mortgage. This risk has been heightened as the market value of residential property has declined.

#### *Commercial Loans*

The Bank offers commercial loans to its business customers. The Bank offers a variety of commercial loan products including term loans and lines of credit. Such loans are generally made for terms of five years or less. The Bank offers both fixed-rate and adjustable-rate loans under these product lines. When making commercial business loans, the Bank considers the financial condition of the borrower, the borrower's payment history of both corporate and personal debt, the projected cash flows of the business, the viability of the industry in which the consumer operates, the value of the collateral, and the borrower's ability to service the debt from income. These loans are primarily secured by

equipment, real property, accounts receivable, or other security as determined by the Bank.

Commercial loans are made on the basis of the borrower's ability to make repayment from the cash flows of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself.

#### *Consumer Loans*

The Bank has developed a number of programs to serve the needs of its customers with primary emphasis upon loans secured by automobiles, boats, recreational vehicles and trucks. The Bank also makes home improvement loans and offers both secured and unsecured personal lines of credit. Consumer loans entail greater risk from other loan types due to being secured by rapidly depreciating assets or the reliance on the borrower's continuing financial stability.

#### *Commercial Equipment Loans*

These loans consist primarily of fixed-rate, short-term loans collateralized by a commercial customer's equipment. When making commercial equipment loans, the Bank considers the same factors it considers when underwriting a commercial business loan. Commercial loans are of higher risk and typically are made on the basis of the borrower's ability to make repayment from the cash flows of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself. In the case of business failure, collateral would need to be liquidated to provide repayment for the loan. In many cases, the highly specialized nature of collateral equipment would make full recovery from the sale of collateral problematic.

*Non-accrual and Past Due Loans*

Non-accrual loans as of September 30, 2013 and December 31, 2012 were as follows:

|                             | September 30, 2013                     |                    |                                    |                    |               |                             |
|-----------------------------|--|--------------------|------------------------------------|--------------------|---------------|-----------------------------|
|                             | 90 or<br>Greater<br>Days<br>Delinquent | Number<br>of Loans | Non-accrual<br>Performing<br>Loans | Number<br>of Loans | Total Dollars | Total<br>Number<br>of Loans |
| Commercial real estate      | \$2,947,607                            | 9                  | \$3,728,175                        | 2                  | \$6,675,782   | 11                          |
| Residential first mortgages | 2,155,122                              | 7                  | 565,802                            | 3                  | 2,720,924     | 10                          |
| Commercial loans            | 5,670,331                              | 10                 | -                                  | -                  | 5,670,331     | 10                          |
| Consumer loans              | -                                      | -                  | 31,935                             | 1                  | 31,935        | 1                           |
| Commercial equipment        | 316,662                                | 5                  | -                                  | -                  | 316,662       | 5                           |
|                             | \$11,089,722                           | 31                 | \$4,325,912                        | 6                  | \$15,415,634  | 37                          |

|                                  | December 31, 2012                      |                    |                                    |                    |               |                             |
|----------------------------------|--|--------------------|------------------------------------|--------------------|---------------|-----------------------------|
|                                  | 90 or<br>Greater<br>Days<br>Delinquent | Number<br>of Loans | Non-accrual<br>Performing<br>Loans | Number<br>of Loans | Total Dollars | Total<br>Number<br>of Loans |
| Commercial real estate           | \$1,527,844                            | 7                  | \$3,802,947                        | 2                  | \$5,330,791   | 9                           |
| Residential first mortgages      | 3,169,404                              | 10                 | 569,693                            | 3                  | 3,739,097     | 13                          |
| Home equity and second mortgages | 71,296                                 | 2                  | -                                  | -                  | 71,296        | 2                           |
| Commercial loans                 | 3,732,090                              | 11                 | -                                  | -                  | 3,732,090     | 11                          |
| Consumer loans                   | -                                      | -                  | 51,748                             | 1                  | 51,748        | 1                           |
| Commercial equipment             | 216,383                                | 4                  | -                                  | -                  | 216,383       | 4                           |
|                                  | \$8,717,017                            | 34                 | \$4,424,388                        | 6                  | \$13,141,405  | 40                          |

The Bank categorized six performing loans totaling \$4,325,912 and \$4,424,388 as non-accrual loans at September 30, 2013 and December 31, 2012, respectively. These six loans represent one well-secured commercial relationship with no specific reserves in the allowance due to the Bank's superior credit position with underlying collateral, which consists primarily of commercial real estate. As of September 30, 2013, the Bank had received all scheduled interest and principal payments on this relationship. It is management's belief that there is no current risk of loss to the Bank for this relationship. These loans were classified as non-accrual loans due to the customer's operating results. In accordance with the Company's policy, interest income is recognized on a cash-basis for these loans.

Non-accrual loans on which the recognition of interest has been discontinued, which did not have a specific allowance for impairment, amounted to \$12,932,327 and \$11,371,542 at September 30, 2013 and December 31, 2012, respectively. Interest due but not recognized on these balances at September 30, 2013 and December 31, 2012 was \$432,916 and \$443,856, respectively. Non-accrual loans with a specific allowance for impairment on which the recognition of interest has been discontinued amounted to \$2,483,307 and \$1,769,863 at September 30, 2013 and December 31, 2012, respectively. Interest due but not recognized on these balances at September 30, 2013 and December 31, 2012 was \$180,751 and \$182,106, respectively.



An analysis of past due loans as of September 30, 2013 and December 31, 2012 was as follows:

| September 30, 2013               | Current       | 31-60<br>Days | 61-89<br>Days | 90 or Greater<br>Days | Total<br>Past Due | Total<br>Loan<br>Receivables |
|----------------------------------|---------------|---------------|---------------|-----------------------|-------------------|------------------------------|
| Commercial real estate           | \$440,735,812 | \$-           | \$1,978,619   | \$2,947,607           | \$4,926,226       | \$445,662,038                |
| Residential first mortgages      | 159,568,816   | -             | 137,772       | 2,155,122             | 2,292,894         | 161,861,710                  |
| Construction and land dev.       | 30,786,474    | 326,671       | -             | -                     | 326,671           | 31,113,145                   |
| Home equity and second mortgages | 21,388,847    | 199,217       | 123,916       | -                     | 323,133           | 21,711,980                   |
| Commercial loans                 | 80,633,889    | 200,000       | -             | 5,670,331             | 5,870,331         | 86,504,220                   |
| Consumer loans                   | 898,574       | 3,226         | -             | -                     | 3,226             | 901,800                      |
| Commercial equipment             | 20,730,853    | 37,682        | -             | 316,662               | 354,344           | 21,085,197                   |
| Total                            | \$754,743,265 | \$766,796     | \$2,240,307   | \$11,089,722          | \$14,096,825      | \$768,840,090                |
| December 31, 2012                |               |               |               |                       |                   |                              |
| Commercial real estate           | \$416,721,658 | \$-           | \$1,417,810   | \$1,527,844           | \$2,945,654       | \$419,667,312                |
| Residential first mortgages      | 173,593,886   | 97,307        | 802,757       | 3,169,404             | 4,069,468         | 177,663,354                  |
| Construction and land dev.       | 31,818,782    | -             | -             | -                     | -                 | 31,818,782                   |
| Home equity and second mortgages | 21,499,018    | 350,715       | 61,346        | 71,296                | 483,357           | 21,982,375                   |
| Commercial loans                 | 84,384,426    | -             | 41,090        | 3,732,090             | 3,773,180         | 88,157,606                   |
| Consumer loans                   | 983,094       | 9,363         | 2,749         | -                     | 12,112            | 995,206                      |
| Commercial equipment             | 15,659,007    | 371,921       | 20,373        | 216,383               | 608,677           | 16,267,684                   |
| Total                            | \$744,659,871 | \$829,306     | \$2,346,125   | \$8,717,017           | \$11,892,448      | \$756,552,319                |

There were no accruing loans 90 days or greater past due at September 30, 2013 and December 31, 2012, respectively.

***Allowance for Loan Losses***

The following tables detail activity in the allowance for loan losses at and for the three and nine months ended September 30, 2013 and September 30, 2012, respectively, and the year ended December 31, 2012 and loan receivable balances at September 30, 2013 and September 30, 2012, respectively, and at December 31, 2012. An allocation of the allowance to one category of loans does not prevent the Company's ability to utilize the allowance to absorb losses in a different category. The loan receivables are disaggregated on the basis of the Company's impairment methodology.

|   | Commercial<br>Real Estate | Residential<br>First<br>Mortgage | Construction<br>and Land<br>Development | Home<br>Equity<br>and Second<br>Mtg. | Commercial<br>Loans | Consumer<br>Loans | Commercial<br>Equipment | Total      |
|---|---------------------------|----------------------------------|---|--------------------------------------|---------------------|-------------------|-------------------------|------------|
| At and For<br>the Three<br>Months<br>Ended<br>September<br>30, 2013<br>Allowance<br>for loan<br>losses: |                           |                                  |   |                                      |                     |                   |                         |            |
| Balance at<br>July 1,   | \$3,358,001               | \$1,960,882                      | \$600,525                               | \$364,281                            | \$1,519,332         | \$13,972          | \$216,560               | \$8,033,55 |
| Charge-offs   | (140,048 )                | (80,110 )                        | (50 )                                   | (155 )                               | (28,576 )           | (1,012 )          | (31 )                   | (249,982 ) |
| Recoveries  | -                         | 154                              | -                                       | -                                    | 168                 | 28                | 9,746                   | 10,096     |
| Provisions  | 311,035                   | (177,787 )                       | (131,581 )                              | (45,812 )                            | 272,009             | 1,539             | 56,207                  | 285,610    |
| Balance at<br>September<br>30,  | \$3,528,988               | \$1,703,139                      | \$468,894                               | \$318,314                            | \$1,762,933         | \$14,527          | \$282,482               | \$8,079,27 |
| At and For<br>the Nine<br>Months<br>Ended<br>September<br>30, 2013<br>Allowance<br>for loan<br>losses:  |                           |                                  |   |                                      |                     |                   |                         |            |
| Balance at<br>January 1,  | \$4,089,834               | \$1,083,228                      | \$533,430                               | \$279,819                            | \$1,949,024         | \$19,341          | \$292,281               | \$8,246,95 |
| Charge-offs   | (140,048 )                | (139,048 )                       | (36,012 )                               | (111,038 )                           | (434,149 )          | (10,003 )         | (22,008 )               | (892,306 ) |
| Recoveries  | -                         | 11,054                           | -                                       | -                                    | 12,059              | 2,010             | 59,293                  | 84,416     |
| Provisions  | (420,798 )                | 747,905                          | (28,524 )                               | 149,533                              | 235,999             | 3,179             | (47,084 )               | 640,210    |
| Balance at<br>September<br>30,  | \$3,528,988               | \$1,703,139                      | \$468,894                               | \$318,314                            | \$1,762,933         | \$14,527          | \$282,482               | \$8,079,27 |

|  |               |               |              |              |              |           |              |            |
|--|---------------|---------------|--------------|--------------|--------------|-----------|--------------|------------|
| Ending<br>balance:<br>individually<br>evaluated<br>for<br>impairment | \$559,333     | \$170,741     | \$-          | \$-          | \$291,821    | \$-       | \$22,875     | \$1,044,77 |
| Ending<br>balance:<br>collectively<br>evaluated<br>for<br>impairment | \$2,969,655   | \$1,532,398   | \$468,894    | \$318,314    | \$1,471,112  | \$14,527  | \$259,607    | \$7,034,50 |
| Loan<br>receivables:<br>Ending<br>balance                            | \$445,662,038 | \$161,861,710 | \$31,113,145 | \$21,711,980 | \$86,504,220 | \$901,800 | \$21,085,197 | \$768,840  |
| Ending<br>balance:<br>individually<br>evaluated<br>for<br>impairment | \$19,856,516  | \$3,882,548   | \$5,349,737  | \$58,000     | \$11,054,771 | \$31,935  | \$316,662    | \$40,550,1 |
| Ending<br>balance:<br>collectively<br>evaluated<br>for<br>impairment | \$425,805,522 | \$157,979,162 | \$25,763,408 | \$21,653,980 | \$75,449,449 | \$869,865 | \$20,768,535 | \$728,289  |

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|   | Commercial<br>Real Estate | Residential<br>First<br>Mortgage | Construction<br>and Land<br>Development | Home<br>Equity<br>and Second<br>Mtg. | Commercial<br>Loans | Consumer<br>Loans | Commercial<br>Equipment | Total      |
|---|---------------------------|----------------------------------|---|--------------------------------------|---------------------|-------------------|-------------------------|------------|
| At and For<br>the Year<br>Ended<br>December<br>31, 2012<br>Allowance<br>for loan<br>losses: |                           |                                  |   |                                      |                     |                   |                         |            |
| Balance at<br>January 1,  | \$2,525,199               | \$539,205                        | \$354,385                               | \$143,543                            | \$3,850,294         | \$19,119          | \$223,296               | \$7,655,04 |
| Charge-offs   | (486,431 )                | (10,987 )                        | (140,835 )                              | (210,753 )                           | (1,003,824 )        | (4,994 )          | (168,802 )              | (2,026,6   |
| Recoveries  | -                         | 37,524                           | -                                       | -                                    | 51,350              | 987               | -                       | 89,861     |
| Provisions  | 2,051,066                 | 517,486                          | 319,880                                 | 347,029                              | (948,796 )          | 4,229             | 237,787                 | 2,528,68   |
| Balance at<br>December<br>31,<br>Ending<br>balance:   | \$4,089,834               | \$1,083,228                      | \$533,430                               | \$279,819                            | \$1,949,024         | \$19,341          | \$292,281               | \$8,246,95 |
| individually<br>evaluated<br>for<br>impairment  | \$785,878                 | \$403,475                        | \$-                                     | \$-                                  | \$353,883           | \$-               | \$4,421                 | \$1,547,65 |
| Ending<br>balance:<br>collectively<br>evaluated<br>for<br>impairment                        | \$3,303,956               | \$679,753                        | \$533,430                               | \$279,819                            | \$1,595,141         | \$19,341          | \$287,860               | \$6,699,30 |
| Loan<br>receivables:  |                           |                                  |   |                                      |                     |                   |                         |            |
| Ending<br>balance   | \$419,667,312             | \$177,663,354                    | \$31,818,782                            | \$21,982,375                         | \$88,157,606        | \$995,206         | \$16,267,684            | \$756,552. |
| Ending<br>balance:<br>individually<br>evaluated<br>for<br>impairment                        | \$21,618,890              | \$3,367,827                      | \$4,877,868                             | \$291,000                            | \$8,778,681         | \$51,748          | \$4,421                 | \$38,990,4 |
| Ending<br>balance:<br>collectively<br>evaluated<br>for<br>impairment                        | \$398,048,422             | \$174,295,527                    | \$26,940,914                            | \$21,691,375                         | \$79,378,925        | \$943,458         | \$16,263,263            | \$717,561. |

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|   | Commercial<br>Real Estate | Residential<br>First<br>Mortgage | Construction<br>and Land<br>Development | Home<br>Equity<br>and Second<br>Mtg. | Commercial<br>Loans | Consumer<br>Loans | Commercial<br>Equipment | Total    |
|---|---------------------------|----------------------------------|---|--------------------------------------|---------------------|-------------------|-------------------------|----------|
| At and For<br>the Three<br>Months<br>Ended<br>September<br>30, 2012<br>Allowance<br>for loan<br>losses: |                           |                                  |   |                                      |                     |                   |                         |          |
| Balance at<br>July 1,   | \$3,478,458               | \$901,505                        | \$596,854                               | \$212,791                            | \$1,968,491         | \$18,316          | \$287,722               | \$7,464, |
| Charge-offs   | (50,034 )                 | (10,991 )                        | (5,995 )                                | (46,989 )                            | (413 )              | -                 | (90 )                   | (114,5   |
| Recoveries  | -                         | 429                              | -                                       | -                                    | 23                  | -                 | -                       | 452      |
| Provisions  | 683,311                   | (3,991 )                         | 40,378                                  | 18,402                               | (14,062 )           | 1,505             | 20,532                  | 746,07   |
| Balance at<br>September<br>30,  | \$4,111,735               | \$886,952                        | \$631,237                               | \$184,204                            | \$1,954,039         | \$19,821          | \$308,164               | \$8,096, |
| At and For<br>the Nine<br>Months<br>Ended<br>September<br>30, 2012<br>Allowance<br>for loan<br>losses:  |                           |                                  |   |                                      |                     |                   |                         |          |
| Balance at<br>January 1,  | \$2,525,199               | \$539,205                        | \$354,385                               | \$143,543                            | \$3,850,294         | \$19,119          | \$223,296               | \$7,655, |
| Charge-offs   | (171,867 )                | (10,991 )                        | (5,995 )                                | (88,931 )                            | (693,461 )          | (999 )            | (149,884 )              | (1,122,  |
| Recoveries  | -                         | 37,676                           | -                                       | -                                    | 1,983               | -                 | -                       | 39,659   |
| Provisions  | 1,758,403                 | 321,062                          | 282,847                                 | 129,592                              | (1,204,777 )        | 1,701             | 234,752                 | 1,523,   |
| Balance at<br>September<br>30,  | \$4,111,735               | \$886,952                        | \$631,237                               | \$184,204                            | \$1,954,039         | \$19,821          | \$308,164               | \$8,096, |
| Ending<br>balance:<br>individually<br>evaluated<br>for<br>impairment                                    | \$1,122,590               | \$247,541                        | \$134,500                               | \$21,855                             | \$499,654           | \$-               | \$4,715                 | \$2,030, |
| Ending<br>balance:<br>collectively<br>evaluated<br>for  | \$2,989,145               | \$639,411                        | \$496,737                               | \$162,349                            | \$1,454,385         | \$19,821          | \$303,449               | \$6,065, |

|  |               |               |              |              |              |             |              |           |  |
|--|---------------|---------------|--------------|--------------|--------------|-------------|--------------|-----------|--|
| impairment<br>Loan<br>receivables:                                   |               |               |              |              |              |             |              |           |  |
| Ending<br>balance  | \$406,261,770 | \$176,825,516 | \$31,639,206 | \$21,940,441 | \$86,057,488 | \$1,047,046 | \$17,246,112 | \$741,011 |  |
| Ending<br>balance:<br>individually<br>evaluated<br>for<br>impairment | \$23,039,920  | \$4,011,851   | \$5,217,025  | \$293,855    | \$12,972,808 | \$60,925    | \$4,715      | \$45,601  |  |
| Ending<br>balance:<br>collectively<br>evaluated<br>for<br>impairment | \$383,221,850 | \$172,813,665 | \$26,422,181 | \$21,646,586 | \$73,084,680 | \$986,121   | \$17,241,397 | \$695,410 |  |

### *Credit Quality Indicators*

A risk grading scale is used to assign grades to commercial real estate, construction and land development, commercial loans and commercial equipment loans. Loans are graded at inception, annually thereafter when financial statements are received and at other times when there is an indication that a credit may have weakened or improved. Only commercial loan relationships with an aggregate exposure to the Bank of \$750,000 or greater are subject to being risk rated.

Residential first mortgages, home equity and second mortgages and consumer loans are evaluated for creditworthiness in underwriting and are monitored based on borrower payment history. These loans are classified as unrated unless they are part of a larger commercial relationship that requires grading or are troubled debt restructures or nonperforming loans with an Other Assets Especially Mentioned (“OAEM”) or higher risk rating due to a delinquent payment history.

Management regularly reviews credit quality indicators as part of its individual loan reviews and on a monthly and quarterly basis. The overall quality of the Bank’s loan portfolio is assessed using the Bank’s risk grading scale, the level and trends of net charge-offs, nonperforming loans and delinquencies, the performance of troubled debt restructured loans and the general economic conditions in the Company’s geographical market. This review process is assisted by frequent internal reporting of loan production, loan quality, concentrations of credit, loan delinquencies and nonperforming and potential problem loans. Credit quality indicators and allowance factors are adjusted based on management’s judgment during the monthly and quarterly review process.

Loans subject to risk ratings are graded on a scale of one to ten. The Company considers loans classified substandard, doubtful and loss as classified assets for regulatory and financial reporting.

#### *Ratings 1 thru 6 - Pass*

Ratings 1 thru 6 have asset risks ranging from excellent low risk to adequate. The specific rating assigned considers customer history of earnings, cash flows, liquidity, leverage, capitalization, consistency of debt service coverage, the nature and extent of customer relationship and other relevant specific business factors such as the stability of the industry or market area, changes to management, litigation or unexpected events that could have an impact on risks.

#### *Rating 7 - OAEM (Other Assets Especially Mentioned) – Special Mention*

These credits, while protected by the financial strength of the borrowers, guarantors or collateral, have reduced quality due to economic conditions, less than adequate earnings performance or other factors which require the lending officer to direct more than normal attention to the credit. Financing alternatives may be limited and/or command higher risk interest rates. OAEM loans are the first adversely classified assets on our watch list. These relationships will be

reviewed at least quarterly.

*Rating 8 - Substandard*

Substandard assets are assets that are inadequately protected by the sound worth or paying capacity of the borrower or of the collateral pledged. These assets have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard assets, does not have to exist in individual assets classified substandard. The loans may have a delinquent history or combination of weak collateral, weak guarantor strength or operating losses. When a loan is assigned to this category the Bank may estimate a specific reserve in the loan loss allowance analysis. These assets listed may include assets with histories of repossessions or some that are non-performing bankruptcies. These relationships will be reviewed at least quarterly.

*Rating 9 - Doubtful*

Doubtful assets have many of the same characteristics of Substandard with the exception that the Bank has determined that loss is not only possible but is probable and the risk is close to certain that loss will occur. When a loan is assigned to this category the Bank will identify the probable loss and it will receive a specific reserve in the loan loss allowance analysis. These relationships will be reviewed at least quarterly.

*Rating 10 - Loss*

Once an asset is identified as a definite loss to the Bank, it will receive the classification of "loss". There may be some future potential recovery; however it is more practical to write off the loan at the time of classification. Losses will be taken in the period in which they are determined to be uncollectable.



Credit quality indicators as of September 30, 2013 and December 31, 2012 were as follows:

### Credit Risk Profile by Internally Assigned Grade

|                 | Commercial Real Estate |               | Construction and Land Dev. |              |
|-----------------|------------------------|---------------|----------------------------|--------------|
|                 | 9/30/2013              | 12/31/2012    | 9/30/2013                  | 12/31/2012   |
| Unrated         | \$63,842,162           | \$59,930,126  | \$4,339,477                | \$4,330,321  |
| Pass            | 351,452,830            | 329,882,941   | 18,631,753                 | 19,752,749   |
| Special mention | 5,790,532              | 4,880,758     | -                          | -            |
| Substandard     | 24,576,514             | 24,973,487    | 8,141,915                  | 7,735,712    |
| Doubtful        | -                      | -             | -                          | -            |
| Loss            | -                      | -             | -                          | -            |
| Total           | \$445,662,038          | \$419,667,312 | \$31,113,145               | \$31,818,782 |

|                 | Commercial Loans |              | Commercial Equipment |              |
|-----------------|------------------|--------------|----------------------|--------------|
|                 | 9/30/2013        | 12/31/2012   | 9/30/2013            | 12/31/2012   |
| Unrated         | \$11,401,481     | \$11,627,726 | \$5,938,295          | \$5,082,713  |
| Pass            | 60,365,389       | 64,436,809   | 15,121,129           | 11,180,550   |
| Special mention | 402,000          | -            | 2,898                | -            |
| Substandard     | 14,335,350       | 12,093,071   | 22,875               | 4,421        |
| Doubtful        | -                | -            | -                    | -            |
| Loss            | -                | -            | -                    | -            |
| Total           | \$86,504,220     | \$88,157,606 | \$21,085,197         | \$16,267,684 |

### Credit Risk Profile Based on Payment Activity

|               | Residential First Mortgages |               | Home Equity and Second Mtg. |              | Consumer Loans |            |
|---------------|-----------------------------|---------------|-----------------------------|--------------|----------------|------------|
|               | 9/30/2013                   | 12/31/2012    | 9/30/2013                   | 12/31/2012   | 9/30/2013      | 12/31/2012 |
| Performing    | \$159,706,588               | \$174,493,950 | \$21,711,980                | \$21,911,079 | \$901,800      | \$995,206  |
| Nonperforming | 2,155,122                   | 3,169,404     | -                           | 71,296       | -              | -          |
| Total         | \$161,861,710               | \$177,663,354 | \$21,711,980                | \$21,982,375 | \$901,800      | \$995,206  |

**Impaired Loans and Troubled Debt Restructures (“TDRs”)**

Impaired loans, including TDRs, at September 30, 2013 and September 30, 2012, respectively, and at December 31, 2012 were as follows:

| September 30, 2013          | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance | Recorded Investment With Allowance | Total Recorded Investment | Related Allowance | Three Month Average Recorded Investment | Three Month Interest Income Recognized | Nine Mo Average Recorded Investment |
|-----------------------------|--------------------------------------|---------------------------------------|------------------------------------|---------------------------|-------------------|---|--|-------------------------------------|
| Commercial real estate      | \$20,025,629                         | \$15,885,402                          | \$3,971,114                        | \$19,856,516              | \$559,333         | \$20,010,465                            | \$207,372                              | \$20,162,000                        |
| Residential first mortgages | 3,882,548                            | 3,181,637                             | 700,911                            | 3,882,548                 | 170,741           | 3,910,884                               | 30,371                                 | 3,919,600                           |
| Construction and land dev.  | 5,349,737                            | 5,349,737                             | -                                  | 5,349,737                 | -                 | 5,363,126                               | 77,157                                 | 5,311,700                           |
| Home equity and second mtg. | 58,000                               | 58,000                                | -                                  | 58,000                    | -                 | 120,000                                 | 1,486                                  | 216,550                             |
| Commercial loans            | 11,054,771                           | 10,333,950                            | 720,821                            | 11,054,771                | 291,821           | 11,028,319                              | 66,604                                 | 10,967,000                          |
| Consumer loans              | 31,935                               | 31,935                                | -                                  | 31,935                    | -                 | 36,393                                  | 1,112                                  | 43,199                              |
| Commercial equipment        | 335,563                              | 293,787                               | 22,875                             | 316,662                   | 22,875            | 336,106                                 | 1,238                                  | 350,880                             |
| Total                       | \$40,738,183                         | \$35,134,448                          | \$5,415,721                        | \$40,550,169              | \$1,044,770       | \$40,805,293                            | \$385,340                              | \$40,971,000                        |
| December 31, 2012           | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance | Recorded Investment With Allowance | Total Recorded Investment | Related Allowance | Average Recorded Investment             | Interest Income Recognized             |                                     |
| Commercial real estate      | \$21,618,890                         | \$18,804,478                          | \$2,814,412                        | \$21,618,890              | \$785,878         | \$22,501,842                            | \$1,119,715                            |                                     |
| Residential first mortgages | 3,367,827                            | 2,362,062                             | 1,005,765                          | 3,367,827                 | 403,475           | 3,388,867                               | 157,595                                |                                     |
| Construction and land dev.  | 4,877,868                            | 4,877,868                             | -                                  | 4,877,868                 | -                 | 4,792,982                               | 276,260                                |                                     |
| Home equity and second mtg. | 291,000                              | 291,000                               | -                                  | 291,000                   | -                 | 221,000                                 | 6,783                                  |                                     |
| Commercial loans            | 8,778,681                            | 8,330,442                             | 448,238                            | 8,778,681                 | 353,883           | 9,153,074                               | 284,095                                |                                     |
| Consumer loans              | 51,748                               | 51,748                                | -                                  | 51,748                    | -                 | 64,459                                  | 5,284                                  |                                     |
| Commercial equipment        | 4,421                                | -                                     | 4,421                              | 4,421                     | 4,421             | 5,112                                   | 318                                    |                                     |
| Total                       | \$38,990,435                         | \$34,717,598                          | \$4,272,836                        | \$38,990,435              | \$1,547,657       | \$40,127,336                            | \$1,850,050                            |                                     |
| September 30, 2012          | Unpaid Contractual                   | Recorded Investment                   | Recorded Investment                | Total Recorded            | Related Allowance | Three Month                             | Three Month                            | Nine Mo Average                     |

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|                             | Principal<br>Balance | With No<br>Allowance | With<br>Allowance | Investment   |             | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Recorded<br>Investment |
|-----------------------------|----------------------|----------------------|-------------------|--------------|-------------|-----------------------------------|----------------------------------|------------------------|
| Commercial real estate      | \$23,497,570         | \$19,699,656         | \$3,340,264       | \$23,039,920 | \$1,122,590 | \$23,128,253                      | \$282,740                        | \$23,257,000           |
| Residential first mortgages | 4,011,851            | 2,347,285            | 1,664,567         | 4,011,851    | 247,541     | 4,021,446                         | 35,750                           | 4,025,600              |
| Construction and land dev.  | 5,217,025            | 5,082,525            | 134,500           | 5,217,025    | 134,500     | 5,145,911                         | 90,653                           | 5,701,100              |
| Home equity and second mtg. | 293,855              | 272,000              | 21,855            | 293,855      | 21,855      | 246,399                           | 1,870                            | 220,570                |
| Commercial loans            | 13,572,808           | 12,196,993           | 775,815           | 12,972,808   | 499,654     | 13,486,660                        | 105,044                          | 13,871,000             |
| Consumer loans              | 60,925               | 60,925               | -                 | 60,925       | -           | 63,492                            | 1,557                            | 70,365                 |
| Commercial equipment        | 4,715                | -                    | 4,715             | 4,715        | 4,715       | 4,909                             | 83                               | 5,309                  |
| Total                       | \$46,658,749         | \$39,659,384         | \$5,941,716       | \$45,601,099 | \$2,030,855 | \$46,097,070                      | \$517,697                        | \$47,152,000           |

TDRs, included in the impaired loan schedules above, as of September 30, 2013 and December 31, 2012, respectively were as follows:

|                             | September 30, 2013 |                 | December 31, 2012 |                 |
|-----------------------------|--------------------|-----------------|-------------------|-----------------|
|                             | Dollars            | Number of Loans | Dollars           | Number of Loans |
| Commercial real estate      | \$ 3,152,197       | 8               | \$ 3,097,214      | 7               |
| Residential first mortgages | 1,485,600          | 4               | 1,418,229         | 3               |
|                             | \$ 4,637,797       | 12              | \$ 4,515,443      | 10              |

At December 31, 2012, all TDRs were performing according to the terms of their restructured agreements and there were no amounts specifically reserved for TDRs. At September 30, 2013, one TDR loan of \$323,976 was over 90 days past due and the specific reserve of the allowance for loan losses was \$12,000. Interest income in the amount of \$155,812 and \$220,326 was recognized on these loans for the nine months ended September 30, 2013 and the year ended December 31, 2012, respectively.

During the nine months ended September 30, 2013, the Bank entered into one TDR for \$77,165 for a residential first mortgage and one TDR for \$60,000 for a commercial real estate mortgage. TDR activity for the nine months ended September 30, 2013 included only two additions to the number of TDRs. During the year ended December 31, 2012, the Bank entered into TDRs for eight commercial real estate loans totaling \$3,212,894 and three residential first mortgages totaling \$1,419,657. For the year ended December 31, 2012, two commercial real estate TDR loans were charged-off in the amount of \$415,995. One of the two charged-off commercial real estate loans was transferred to OREO with a balance of \$382,500.

## 12. LOANS HELD FOR SALE

Residential mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value, in the aggregate. Fair value is derived from secondary market quotations for similar instruments. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income.

Residential mortgage loans held for sale are generally sold with the mortgage servicing rights retained by the Company. The carrying value of mortgage loans sold is reduced by the cost allocated to the associated servicing rights. Gains or losses on sales of mortgage loans are recognized based on the difference between the selling price and the carrying value of the related mortgage loans sold, using the specific identification method.

The Company enters into contractual commitments with potential borrowers, including loan commitments and rate-lock commitments for the origination of residential mortgage loans that will be held for sale in the secondary market. The period of time between issuance of a loan commitment and closing and sale of the loan generally ranges from 15 to 60 days. These commitments, which contain fixed expiration dates, offer the borrower an interest rate guarantee provided the loan meets underwriting guidelines and subsequently closes within the timeframe established by the Company.

The interest rate-lock commitments are derivative financial instruments. Interest rate risk arises on these commitments and subsequently closed loans held for sale if interest rates change between the time of interest rate-lock and the delivery of the loan to a secondary market investor. To mitigate interest rate risk, the Company sells certain loans forward into the secondary market at a specified price with a specified date on a best efforts basis. These forward sales, which are entered into as a result of an interest rate-lock commitment with the Bank's customer, are derivative financial instruments. The Company does not recognize gains or losses due to interest rate changes for loans sold forward on a best effort basis. The Bank had no loans held for sale at September 30, 2013 and 2012, respectively.

### **13. NEW ACCOUNTING STANDARDS**

Financial Accounting Standards Board ("FASB") Accounting Standards Update ("ASU") No. 2011-11; "*Balance Sheet (Topic 210) – Disclosures about Offsetting Assets and Liabilities*". ASU 2011-11 amends Topic 210 "Balance Sheet," to require an entity to disclose both gross and net information about financial instruments, such as sales and repurchase agreements, borrowing/lending arrangements and derivative instruments with a right of offset. ASU 2011-11 was effective for the Company beginning on January 1, 2013 and did have a material impact on the Company's consolidated financial statements.

ASU 2013-02 – *Comprehensive Income (Topic 220) – Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income.*” The new guidance requires the presentation of significant amounts reclassified in a separate footnote and cross referencing to related footnote disclosures, if applicable. ASU 2013-02 was effective for the Company prospectively beginning on January 1, 2013 and did not have a material impact on the Company’s consolidated financial statements.

#### 14. FAIR VALUE OF FINANCIAL INSTRUMENTS

The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. Therefore, any aggregate unrealized gains or losses should not be interpreted as a forecast of future earnings or cash flows. Furthermore, the fair values disclosed should not be interpreted as the aggregate current value of the Company.

| September 30, 2013                     |                 | Fair Value Measurements |   |                                   |                               |
|--|-----------------|-------------------------|---|-----------------------------------|-------------------------------|
| Description of Asset                   | Carrying Amount | Fair Value              | Quoted  | Significant                       | Significant                   |
|  |                 |                         | Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Unobservable Inputs (Level 3) |
| <b>Assets</b>                          |                 |                         |   |                                   |                               |
| Investment securities - AFS            | \$50,869,490    | \$50,869,490            | \$-   | \$50,869,490                      | \$ -                          |
| Investment securities - HTM            | 91,349,615      | 91,050,953              | 749,962   | 90,300,991                        | -                             |
| FHLB and FRB Stock                     | 5,593,100       | 6,198,000               | -   | 6,198,000                         | -                             |
| Loans                                  | 759,880,727     | 753,916,000             | -   | 753,916,000                       | -                             |
| Other real estate owned                | 7,058,504       | 7,058,504               | -   | 7,058,504                         | -                             |
| <b>Liabilities</b>                     |                 |                         |   |                                   |                               |
| Savings, NOW and money market accounts | \$432,564,049   | \$432,564,049           | \$-   | \$432,564,049                     | \$ -                          |
| Time deposits                          | 384,683,410     | 387,119,000             | -   | 387,119,000                       | -                             |
| Long-term debt                         | 70,488,848      | 71,382,000              | -   | 71,382,000                        | -                             |
| Short term borrowings                  | 2,640,000       | 2,640,000               | -   | 2,640,000                         | -                             |
| TRUPs                                  | 12,000,000      | 2,400,000               | -   | 2,400,000                         | -                             |

| At December 31, 2012 |                 | Fair Value Measurements |   |                                   |                               |
|----------------------|-----------------|-------------------------|---|-----------------------------------|-------------------------------|
| Description of Asset | Carrying Amount | Fair Value              | Quoted  | Significant                       | Significant                   |
|                      |                 |                         | Prices in Active Markets for Identical Assets (Level 1) | Other Observable Inputs (Level 2) | Unobservable Inputs (Level 3) |

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|  |               |               | Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Inputs<br>(Level 2) | (Level 3) |
|--|---------------|---------------|--|---------------------|-----------|
| <b>Assets</b>                          |               |               |  |                     |           |
| Investment securities - AFS            | \$47,205,663  | \$47,205,663  | \$-  | \$47,205,663        | \$ -      |
| Investment securities - HTM            | 112,619,434   | 114,187,018   | 749,941  | 113,437,077         | -         |
| FHLB and FR Stock                      | 5,476,050     | 5,469,000     | -  | 5,469,000           | -         |
| Loans                                  | 747,640,752   | 757,387,000   | -  | 757,387,000         | -         |
| Other real estate owned                | 6,891,353     | 6,891,353     | -  | 6,891,353           | -         |
| <b>Liabilities</b>                     |               |               |  |                     |           |
| Savings, NOW and money market accounts | \$414,776,285 | \$414,776,285 | \$-  | \$414,776,285       | \$ -      |
| Time deposits                          | 405,454,003   | 410,257,000   | -  | 410,257,000         | -         |
| Long-term debt                         | 60,527,208    | 64,252,000    | -  | 64,252,000          | -         |
| Short term borrowings                  | 1,000,000     | 1,000,000     | -  | 1,000,000           | -         |
| TRUPs                                  | 12,000,000    | 2,400,000     | -  | 2,400,000           | -         |

At September 30, 2013, the Company had outstanding loan commitments and standby letters of credit of \$25.8 million and \$24.7 million, respectively. Based on the short-term lives of these instruments, the Company does not believe that the fair value of these instruments differs significantly from their carrying values.

### **Valuation Methodology**

*Investment securities and FHLB and FRB stock* - Fair values are based on quoted market prices or dealer quotes. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

*Loans receivable* - For conforming residential first-mortgage loans, the market price for loans with similar coupons and maturities was used. For nonconforming loans with maturities similar to conforming loans, the coupon was adjusted for credit risk. Loans that did not have quoted market prices were priced using the discounted cash flow method. The discount rate used was the rate currently offered on similar products. Loans priced using the discounted cash flow method included residential construction loans, commercial real estate loans and consumer loans. The estimated fair value of loans held for sale is based on the terms of the related sale commitments.

*Other real estate owned* - Fair value is based upon independent market prices, appraised value of the collateral or management's estimation of the value of the collateral.

*Deposits* - The fair value of checking accounts, saving accounts and money market accounts were the amount payable on demand at the reporting date.

*Time certificates* - The fair value was determined using the discounted cash flow method. The discount rate was equal to the rate currently offered on similar products.

*Long-term debt and other borrowed funds* - These were valued using the discounted cash flow method. The discount rate was equal to the rate currently offered on similar borrowings.

*Guaranteed preferred beneficial interest in junior subordinated securities (TRUPs)* - These were valued using discounted cash flows. The discount rate was equal to the rate currently offered on similar borrowings.



*Off-balance sheet instruments* - The Company charges fees for commitments to extend credit. Interest rates on loans for which these commitments are extended are normally committed for periods of less than one month. Fees charged on standby letters of credit and other financial guarantees are deemed to be immaterial and these guarantees are expected to be settled at face amount or expire unused. It is impractical to assign any fair value to these commitments.

The fair value estimates presented herein are based on pertinent information available to management as of September 30, 2013 and December 31, 2012, respectively. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date and, therefore, current estimates of fair value may differ significantly from the amount presented herein..

**15. ACCUMULATED OTHER COMPREHENSIVE INCOME**

The following tables presents the components of comprehensive loss for securities for the three and nine months ended September 30, 2013 and 2012.

|  | Three Months Ended September 30,<br>2013 |               |               | Three Months Ended September 30,<br>2012 |            |            |
|--|--|---------------|---------------|--|------------|------------|
|  | Before Tax                               | Tax Effect    | Net of Tax    | Before Tax                               | Tax Effect | Net of Tax |
| Net unrealized holding gain (loss) arising during period | \$ (350,524 )                            | \$ (119,178 ) | \$ (231,346 ) | \$ 104,229                               | \$ 35,438  | \$ 68,791  |
| Reclassification adjustments                             | -  | -             | -             | -  | -          | -          |
| Other comprehensive gain (loss)                          | \$ (350,524 )                            | \$ (119,178 ) | \$ (231,346 ) | \$ 104,229                               | \$ 35,438  | \$ 68,791  |

  

|  | Nine Months Ended September 30, 2013 |               |                 | Nine Months Ended September 30,<br>2012 |            |            |
|--|--------------------------------------|---------------|-----------------|---|------------|------------|
|  | Before Tax                           | Tax Effect    | Net of Tax      | Before Tax                              | Tax Effect | Net of Tax |
| Net unrealized holding gain (loss) arising during period | \$ (1,591,096 )                      | \$ (540,972 ) | \$ (1,050,124 ) | \$ 115,973                              | \$ 39,431  | \$ 76,542  |
| Reclassification adjustments                             | -                                    | -             | -               | -                                       | -          | -          |
| Other comprehensive gain (loss)                          | \$ (1,591,096 )                      | \$ (540,972 ) | \$ (1,050,124 ) | \$ 115,973                              | \$ 39,431  | \$ 76,542  |

The following table presents the changes in each component of accumulated other comprehensive income for securities, net of tax, for the three and nine months ended September 30, 2013.

|  | Three Months<br>Ended<br>September 30, 2013<br>Net Unrealized Gains<br>And Losses | Nine Months<br>Ended<br>September 30, 2013<br>Net Unrealized Gains<br>And Losses |
|--|---|--|
| Beginning of period  | \$ (679,594 )   | \$ 139,184   |
| Other comprehensive loss before reclassifications                | (231,346 )  | (1,050,124 )   |
| Amounts reclassified from accumulated other comprehensive income | -   | -  |
| Net other comprehensive loss                                     | (231,346 )  | (1,050,124 )   |
| End of period  | \$ (910,940 )   | \$ (910,940 )  |

## ITEM 2

### MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This document may contain forward-looking statements that are based on assumptions and may describe future plans, strategies and expectations of The Community Financial Corporation (the "Company") and Community Bank of the Chesapeake (the "Bank"). These forward-looking statements are generally identified by use of the words "believe," "expect," "intend," "anticipate," "estimate," "project" or similar expressions.

The Company and the Bank's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors that could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in interest rates, national and regional economic conditions, legislative and regulatory changes, monetary and fiscal policies of the U.S. government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality and composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Company and the Bank's market area, changes in real estate market values in the Company and the Bank's market area and changes in relevant accounting principles and guidelines. Additional factors that may affect our results are discussed in Part I of the Company's Annual Report on Form 10-K for the year ended December 31, 2012 (the "Form 10-K") and in the prospectus, dated September 26, 2013, that we filed with the Securities and Exchange Commission. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Except as required by applicable law or regulation, the Company does not undertake, and specifically disclaims any obligation, to release publicly the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of the statements or to reflect the occurrence of anticipated or unanticipated events.

### GENERAL

The Company is a bank holding company organized in 1989 under the laws of the State of Maryland. It owns all the outstanding shares of capital stock of the Bank. The Company engages in no significant activity other than holding the stock of the Bank, paying its subordinated debt and preferred stock obligations, and directing the business of the Bank. Accordingly, the information set forth in this report, including financial statements and related data, relates primarily to the Company, the Bank and its subsidiaries.

In October 2013, the Company issued 1,591,300 shares of common stock at a price of \$18.75 per share resulting in net proceeds of \$27.4 million after commissions and related offering expenses. The additional capital raised was a fourth quarter 2013 event and was not reflected in the third quarter analysis below. In addition, the Company listed its stock on the NASDAQ Stock Exchange and began trading on September 27, 2013 under the ticker symbol "TCFC."

Effective October 18, 2013, Community Bank of Tri-County changed its name to Community Bank of the Chesapeake. This new name reflects the Bank's recent expansion into the Northern Neck of Virginia and Fredericksburg, Virginia. The name of the holding company changed from Tri-County Financial Corporation to The Community Financial Corporation, to better align the parent company name with that of the Bank.

The Bank has sought to increase assets through loan production. The Bank believes that its ability to offer fast, flexible, local decision-making will continue to attract significant new business relationships and enhance asset growth. The Bank's marketing is also directed towards increasing its balances of both consumer and business transaction deposit accounts. The Bank believes that increases in these account types will lessen the Bank's dependence on higher-cost funding, such as certificates of deposit and borrowings. Although management believes that this strategy will increase financial performance over time, increasing the balances of certain products, such as commercial lending and transaction accounts, may also increase the Bank's noninterest expense. It recognizes that certain lending and deposit products increase the possibility of losses from credit and other risks.

The Bank conducts business through its main office in Waldorf, Maryland, and ten branch offices in Waldorf, Bryans Road, Dunkirk, Leonardtown, La Plata, Charlotte Hall, Prince Frederick, Lusby, California, Maryland, and King George, Virginia. The Bank provides commercial lending services from its three loan production offices in La Plata and Prince Frederick, Maryland and Fredericksburg, Virginia.

The Company's results are influenced by local and national economic conditions. These conditions include the level of short-term interest rates such as the federal funds rate, the differences between short-term and long-term interest rates, the value of real estate in our markets, the prospects for economic growth or decline, and the rates of anticipated and current inflation. Local conditions, including employment growth or declines, may have direct or indirect effects on our borrowers' ability to meet their obligations.

The Bank continues to evaluate its allowance for loan losses and the associated provision to compensate for the inherent risk in the loan portfolio. Any evaluation of the allowance for loan losses is inherently subjective and reflects management's expectations as to future economic conditions in the region as well as individual borrowers' circumstances. Management believes that its allowance for loan losses is adequate. For further information on the Bank's allowance for loan losses see the discussion in the sections captioned "Financial Condition" and "Critical Accounting Policies" as well as the relevant discussions in the Form 10-K and Annual Report for the year ended December 31, 2012.

On September 23, 2011, the U.S. Department of Treasury purchased \$20.0 million in the Company's preferred stock under the Small Business Lending Fund (the "SBLF"). The SBLF is a program intended to encourage small business lending by providing capital to qualified community banks at favorable rates. SBLF dividend rates can fluctuate between 1% and 7% during the first four and one half years, depending on the level of the Bank's small business lending. As of September 30, 2013 and December 31, 2012, the Company's dividend rate on the SBLF funds was 1%. At September 30, 2013, the Company had increased its QSBL from the baseline so that the dividend rate should remain at 1% through four and one half years from issuance. For additional information regarding SBLF, refer to Note 8 in the Company's Form 10-Q for the nine months ended September 30, 2013 and Note 18 of the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2012.

#### SELECTED FINANCIAL DATA

|                                     | Three Months Ended<br>September 30, |             | Nine Months Ended<br>September 30, |              |
|-------------------------------------|-------------------------------------|-------------|------------------------------------|--------------|
|                                     | 2013                                | 2012        | 2013                               | 2012         |
| <b>Condensed Income Statement</b>   |                                     |             |                                    |              |
| Interest and Dividend Income        | \$9,975,059                         | \$9,886,656 | \$29,565,129                       | \$30,097,582 |
| Interest Expense                    | 1,872,986                           | 2,539,049   | 5,914,528                          | 8,328,075    |
| Net Interest Income                 | 8,102,073                           | 7,347,607   | 23,650,601                         | 21,769,507   |
| Provision for Loan Loss             | 285,610                             | 746,075     | 640,210                            | 1,523,580    |
| Noninterest Income                  | 1,119,216                           | 1,302,437   | 3,377,022                          | 3,045,322    |
| Noninterest Expense                 | 6,245,727                           | 5,600,784   | 18,494,971                         | 17,861,889   |
| Income Before Income Taxes          | 2,689,952                           | 2,303,185   | 7,892,442                          | 5,429,360    |
| Income Tax Expense                  | 987,111                             | 830,244     | 2,885,761                          | 1,910,014    |
| Net Income (NI)                     | 1,702,841                           | 1,472,941   | 5,006,681                          | 3,519,346    |
| Preferred Stock Dividends           | 50,000                              | 50,000      | 150,000                            | 150,000      |
| NI Available to Common Shareholders | 1,652,841                           | 1,422,941   | 4,856,681                          | 3,369,346    |
| Comprehensive Income                | 1,471,495                           | 1,541,732   | 3,956,557                          | 3,595,888    |
| <b>Per Common Share</b>             |                                     |             |                                    |              |
| Basic Earnings                      | \$0.55                              | \$0.47      | \$1.61                             | \$1.11       |
| Diluted Earnings                    | \$0.55                              | \$0.47      | \$1.60                             | \$1.10       |
| Cash Dividends Paid <sup>(1)</sup>  | \$0.10                              | \$-         | \$0.30                             | \$0.40       |
| Book Value                          | \$20.39                             | \$18.99     | \$20.39                            | \$18.99      |

|                                 |       |   |       |   |       |   |       |   |
|---------------------------------|-------|---|-------|---|-------|---|-------|---|
| Return On Average Assets        | 0.70  | % | 0.61  | % | 0.69  | % | 0.49  | % |
| Return On Average Common Equity | 10.63 | % | 9.85  | % | 10.52 | % | 7.84  | % |
| Return On Average Equity        | 8.29  | % | 7.58  | % | 8.19  | % | 6.07  | % |
| Interest Rate Spread            | 3.48  | % | 3.15  | % | 3.41  | % | 3.10  | % |
| Net Interest Margin             | 3.60  | % | 3.28  | % | 3.53  | % | 3.24  | % |
| Cost of Funds                   | 0.85  | % | 1.15  | % | 0.90  | % | 1.27  | % |
| Cost of Deposits                | 0.67  | % | 0.99  | % | 0.73  | % | 1.10  | % |
| Efficiency Ratio                | 67.73 | % | 64.75 | % | 68.43 | % | 71.98 | % |

<sup>(1)</sup> Beginning with the first quarter of 2013, the Company moved to paying a quarterly dividend in place of its annual dividend. The total dividends expected to be paid during 2013 are expected to remain at \$0.40 per share.

**RESULTS OF OPERATIONS – NINE MONTHS ENDED SEPTEMBER 30, 2013 AND SEPTEMBER 30, 2012**

Consolidated net income available to common shareholders for the nine months ended September 30, 2013 increased \$1,487,335, or 44.14%, to \$4,856,681, or \$1.60 per common share (fully diluted), compared to \$3,369,346, or \$1.10 per common share (fully diluted), for the nine months ended September 30, 2012. The increase of \$0.50 per share was attributable to increased net interest income of \$1,881,094 and noninterest income of \$331,700 and decreased provision for loan losses of \$883,370, partially offset by increased noninterest expense of \$633,082 and increased income tax expense of \$975,747.

|   | Nine Months Ended September 30, |                      |                     |                 |          |
|---|---------------------------------|----------------------|---------------------|-----------------|----------|
|   | 2013                            | 2012                 | \$ Change           | % Change        |          |
| <b>Interest and Dividend Income</b>                     |                                 |                      |                     |                 |          |
| Loans, including fees                                   | \$ 27,703,885                   | \$ 27,624,323        | \$79,562            | 0.29            | %        |
| Taxable interest and dividends on investment securities | 1,852,692                       | 2,465,529            | (612,837 )          | (24.86 )        | %        |
| Interest on deposits with banks                         | 8,552                           | 7,730                | 822                 | 10.63           | %        |
| <b>Total Interest and Dividend Income</b>               | <b>29,565,129</b>               | <b>30,097,582</b>    | <b>(532,453 )</b>   | <b>(1.77 )</b>  | <b>%</b> |
| <b>Interest Expenses</b>                                |                                 |                      |                     |                 |          |
| Deposits  | 4,332,351                       | 6,630,820            | (2,298,469 )        | (34.66 )        | %        |
| Short-term borrowings                                   | 12,930                          | 12,483               | 447                 | 3.58            | %        |
| Long-term debt  | 1,569,247                       | 1,684,772            | (115,525 )          | (6.86 )         | %        |
| <b>Total Interest Expenses</b>                          | <b>5,914,528</b>                | <b>8,328,075</b>     | <b>(2,413,547 )</b> | <b>(28.98 )</b> | <b>%</b> |
| <b>Net Interest Income (NII)</b>                        | <b>23,650,601</b>               | <b>21,769,507</b>    | <b>1,881,094</b>    | <b>8.64</b>     | <b>%</b> |
| Provision for loan losses                               | 640,210                         | 1,523,580            | (883,370 )          | (57.98 )        | %        |
| <b>NII After Provision For Loan Losses</b>              | <b>\$ 23,010,391</b>            | <b>\$ 20,245,927</b> | <b>\$2,764,464</b>  | <b>13.65</b>    | <b>%</b> |

Net interest income increased from the comparable nine months in 2012 due primarily to reduced funding costs and the Company's ability to maintain loan yields. An important component of lowering the Company's cost of funds was the increase in average noninterest-bearing deposits of \$15.9 million for the first nine months of 2013 to \$86.8 million compared to \$70.9 million for the first nine months of 2012. The Company's 2013 year to date cost of funds, which includes debt and interest and non-interest bearing deposits, decreased 37 basis points to 0.90% from 1.27% for the nine months ended September 30, 2012. During the same comparable period average loan yields decreased 10 basis points from 5.14% for the nine months ended September 30, 2012 to 5.04% for the nine months ended September 30, 2013.

Net interest income increased to \$23,650,601 for the nine months ended September 30, 2013 compared to \$21,769,507 for the nine months ended September 30, 2012. The net interest margin was 3.53% for the nine months ended September 30, 2013, a 29 basis point increase from 3.24% for the nine months ended September 30, 2012. The increase was largely the result of a rapid decrease in the Company's cost of funds that began during 2012 as certificates of deposit re-priced and rates declined on money market accounts. The average cost of total interest-bearing liabilities

decreased 38 basis points from 1.38% for the first nine months of 2012 to 1.00% for the first nine months of 2013.

Interest and dividend income decreased by \$532,453 to \$29,565,129 for the nine months ended September 30, 2013 compared to \$30,097,582 for the nine months ended September 30, 2012. Decreases in yields on loans and investments were partially offset by the growth in the average balance of loans. A reduction in average yields on interest-earning assets resulted in a decrease in interest income of \$931,044 as rates decreased from 4.47% for the nine months ended September 30, 2012 to 4.41% for the nine months ended September 30, 2013. The Company has been successful over the last several years in mitigating the effect of the lower interest rate environment on loan rates through pricing and interest rate floors. Interest and dividend income was further reduced \$231,762 as average interest-earning investment balances decreased \$20.0 million from \$180.3 million for the nine months ended September 30, 2012 to \$160.3 million for the nine months ended September 30, 2013. These reductions were partially offset by an increase in interest income of \$630,353 due to growth of \$16.7 million in the average balance of loans from \$716.6 million to \$733.3 million.



Interest expense decreased \$2,413,547 to \$5,914,528 for the nine months ended September 30, 2013 compared to \$8,328,075 for the nine months ended September 30, 2012 due primarily to a reduction in the average cost of funds on interest-bearing liabilities as interest expense decreased \$2,221,583 due to a decrease in rates. This was principally achieved by a decrease in the average rates paid on certificates of deposits and money market accounts, which declined from 1.64% and 0.62%, respectively, for the nine months ended September 30, 2012 to 1.22% and 0.34%, respectively, for the nine months ended September 30, 2013. The Company has been successful in increasing its core deposits and reducing its cost of funds in the low interest rate environment over the last several years. In addition, the average rate paid on long-term debt decreased from 3.17% to 2.58% for the comparable period. Interest expense also decreased \$361,932 due to a decline in average interest-bearing deposit balances of \$29.2 million from \$729.4 million for the nine months ended September 30, 2012 to \$700.2 million for the nine months ended September 30, 2013. These reductions in interest expense were partially offset by a \$169,968 increase in interest expense due to a \$9.2 million increase in average debt balances.

The provision for loan losses decreased \$883,370 from \$1,523,580 for the comparable period in 2012 to \$640,210 for the nine months ended September 30, 2013 and reflected a decrease in the allowance for specific nonperforming loans and a decrease in net-charge-offs offset by increasing average loan balances, economic conditions that affected the loss factors used to compute the allowance and an increase in the level of delinquencies. The specific allowance is based on management's estimate of realizable value. Net charge-offs decreased \$274,578 from \$1,082,469 for the nine months ended September 30, 2012 to \$807,891 for the nine months ended September 30, 2013. The general allowance as a percentage of gross loans increased during the nine months ended September 30, 2013 as average loans increased from the comparable period. Overall delinquency, which included all loans greater than 30 days past due, increased from 1.57% at December 31, 2012 to 1.83% at September 30, 2013. Nonperforming loans as a percentage of total loans were 1.44% at September 30, 2013 compared to 1.15% at December 31, 2012.

The following table presents information on the average balances of the Company's interest-earning assets and interest-bearing liabilities and interest earned or paid thereon for the nine months ended September 30, 2013 and 2012, respectively. There are no tax equivalency adjustments.

|  | For the Nine Months Ended September 30, |          |                        |   |                 |          |                        |   |
|--|---|----------|------------------------|---|-----------------|----------|------------------------|---|
|  | 2013                                    |          |                        |   | 2012            |          |                        |   |
| dollars in thousands   | Average Balance                         | Interest | Average Yield/<br>Cost |   | Average Balance | Interest | Average Yield/<br>Cost |   |
| Assets   |   |          |                        |   |                 |          |                        |   |
| Interest-earning assets:   |   |          |                        |   |                 |          |                        |   |
| Loan portfolio (1)   | \$733,275                               | \$27,704 | 5.04                   | % | \$716,566       | \$27,624 | 5.14                   | % |
| Investment securities, federal funds sold and interest-bearing deposits          | 160,317                                 | 1,861    | 1.55                   | % | 180,263         | 2,474    | 1.83                   | % |
| Total Interest-Earning Assets  | 893,592                                 | 29,565   | 4.41                   | % | 896,829         | 30,098   | 4.47                   | % |
| Cash and cash equivalents  | 11,766                                  |          |                        |   | 10,837          |          |                        |   |
| Other assets   | 57,294                                  |          |                        |   | 54,428          |          |                        |   |
| Total Assets   | \$962,652                               |          |                        |   | \$962,094       |          |                        |   |
| Liabilities and Stockholders' Equity   |   |          |                        |   |                 |          |                        |   |
| Interest-bearing liabilities:  |   |          |                        |   |                 |          |                        |   |
| Savings  | \$37,237                                | \$28     | 0.10                   | % | \$32,260        | \$46     | 0.19                   | % |
| Interest-bearing demand and money market accounts                                | 266,966                                 | 672      | 0.34                   | % | 259,057         | 1,203    | 0.62                   | % |
| Certificates of deposit  | 395,974                                 | 3,632    | 1.22                   | % | 438,070         | 5,382    | 1.64                   | % |
| Long-term debt   | 68,807                                  | 1,333    | 2.58                   | % | 60,097          | 1,430    | 3.17                   | % |
| Short-term debt  | 5,357                                   | 13       | 0.32                   | % | 4,836           | 12       | 0.33                   | % |
| Guaranteed preferred beneficial interest in junior subordinated debentures       | 12,000                                  | 236      | 2.62                   | % | 12,000          | 255      | 2.83                   | % |
| Total Interest-Bearing Liabilities   | 786,341                                 | 5,914    | 1.00                   | % | 806,320         | 8,328    | 1.38                   | % |
| Noninterest-bearing demand deposits  | 86,762                                  |          |                        |   | 70,897          |          |                        |   |
| Other liabilities  | 8,013                                   |          |                        |   | 7,589           |          |                        |   |
| Stockholders' equity   | 81,536                                  |          |                        |   | 77,288          |          |                        |   |
| Total Liabilities and Stockholders' Equity                                       | \$962,652                               |          |                        |   | \$962,094       |          |                        |   |
| Net interest income  |   | \$23,651 |                        |   |                 | \$21,770 |                        |   |
| Interest rate spread   |   |          | 3.41                   | % |                 |          | 3.10                   | % |
| Net yield on interest-earning assets   |   |          | 3.53                   | % |                 |          | 3.24                   | % |
| Ratio of average interest-earning assets to average interest bearing liabilities |   |          | 113.64                 | % |                 |          | 111.22                 | % |
| Cost of funds  |   |          | 0.90                   | % |                 |          | 1.27                   | % |
| Cost of deposits   |   |          | 0.73                   | % |                 |          | 1.10                   | % |

(1) Average balance includes non-accrual loans

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The table below sets forth certain information regarding changes in interest income and interest expense of the Bank for the periods indicated. For each category of interest earning asset and interest bearing liability, information is provided on changes attributable to (1) changes in volume (changes in volume multiplied by old rate); and (2) changes in rate (changes in rate multiplied by old volume). Changes in rate volume (changes in rate multiplied by the change in volume) have been allocated to changes due to volume.

| dollars in thousands   | Nine Months Ended September 30, 2013<br>compared to Nine Months Ended<br>September 30, 2012 |                |             |
|--|---|----------------|-------------|
|  | Volume  | Due to<br>Rate | Total       |
| <b>Interest income:</b>  |   |                |             |
| Loan portfolio (1)   | \$ 631  | \$ (551 )      | \$ 80       |
| Investment securities, federal funds sold and interest bearing deposits    | (232 )  | (381 )         | (613 )      |
| Total interest-earning assets  | \$ 399  | \$ (932 )      | \$ (533 )   |
| <b>Interest-bearing liabilities:</b>                                       |   |                |             |
| Savings  | 4   | (22 )          | (18 )       |
| Interest-bearing demand and money market accounts                          | 20  | (551 )         | (531 )      |
| Certificates of deposit  | (386 )  | (1,364 )       | (1,750 )    |
| Long-term debt   | 169   | (266 )         | (97 )       |
| Short-term debt  | 1   | -              | 1           |
| Guaranteed preferred beneficial interest in junior subordinated debentures | -   | (19 )          | (19 )       |
| Total interest-bearing liabilities   | \$ (192 )   | \$ (2,222 )    | \$ (2,414 ) |
| Net change in net interest income  | \$ 591  | \$ 1,290       | \$ 1,881    |

(1) Average balance includes non-accrual loans

The following table shows the components of noninterest income and the dollar and percentage changes for the periods presented.

|   | Nine Months Ended September 30, |              | \$ Change    | % Change   |
|---|---------------------------------|--------------|--------------|------------|
|   | 2013                            | 2012         |              |            |
| <b>Noninterest Income</b>                         |                                 |              |              |            |
| Loan appraisal, credit, and miscellaneous charges | \$ 374,769                      | \$ 663,897   | \$ (289,128) | (43.55 )%  |
| Gain on sale of asset                             | 11,000                          | -            | 11,000       | n/a        |
| Net gains (losses) on sale of OREO                | 215,345                         | (96,917 )    | 312,262      | (322.20 )% |
| Income from bank owned life insurance             | 464,775                         | 476,294      | (11,519 )    | (2.42 )%   |
| Service charges                                   | 1,764,314                       | 1,530,323    | 233,991      | 15.29 %    |
| Gain on sale of loans held for sale               | 546,819                         | 471,725      | 75,094       | 15.92 %    |
| Total Noninterest Income                          | \$ 3,377,022                    | \$ 3,045,322 | \$ 331,700   | 10.89 %    |

Gains on loan sales were impacted during the third quarter by a reduction in residential mortgage refinancing activity due to rising interest rates. For the nine months ended September 30, 2013 gains on loan sales increased to \$546,819 on sales of \$20,903,681 compared to \$471,725 on sales of \$9,972,254 for the same period in 2012.

During the nine months ended September 30, 2013, the Bank recognized \$215,345 in gains on the sale of OREO which consisted of the sale of four properties for net proceeds of \$712,944 and net losses of \$9,655 and the recognition of \$225,000 of previously deferred gain from the sale of an OREO property that the Bank financed during 2011 that did not initially qualify for full accrual sales treatment under ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition. During the nine months ended September 30, 2012, the Bank disposed of three OREO properties resulting in proceeds of \$344,512 and recognized net losses of \$96,917.

The increase in service charge income for the nine months ended September 30, 2013 was principally the result of increased revenue from the Bank's sale of investment products and services of \$209,769. Additionally, bank account fees increased \$73,897 compared with the same period in 2012, but were also impacted by the Company's waiver of certain service charge fees during its conversion to a new data processing system during the second quarter of 2012. These increases to service charge income were offset by a decrease of \$49,675 for miscellaneous service charges.

The following table shows the components of noninterest expense and the dollar percentage changes for the periods presented.

|  | Nine Months Ended September 30, |               | \$ Change | % Change |    |
|--|---------------------------------|---------------|-----------|----------|----|
|  | 2013                            | 2012          |           |          |    |
| Noninterest Expense                                |                                 |               |           |          |    |
| Salary and employee benefits                       | \$ 10,883,606                   | \$ 9,982,603  | \$901,003 | 9.03     | %  |
| Occupancy expense                                  | 1,556,877                       | 1,389,024     | 167,853   | 12.08    | %  |
| Advertising  | 391,152                         | 345,111       | 46,041    | 13.34    | %  |
| Data processing expense                            | 967,368                         | 1,118,598     | (151,230) | (13.52)  | )% |
| Professional fees                                  | 754,719                         | 746,322       | 8,397     | 1.13     | %  |
| Depreciation of furniture, fixtures, and equipment | 580,842                         | 486,159       | 94,683    | 19.48    | %  |
| Telephone communications                           | 148,516                         | 137,649       | 10,867    | 7.89     | %  |
| Office supplies                                    | 151,157                         | 186,741       | (35,584 ) | (19.06)  | )% |
| FDIC Insurance                                     | 858,860                         | 1,092,809     | (233,949) | (21.41)  | )% |
| Valuation allowance on OREO                        | 500,536                         | 657,226       | (156,690) | (23.84)  | )% |
| Other  | 1,701,338                       | 1,719,647     | (18,309 ) | (1.06)   | )% |
| Total Noninterest Expense                          | \$ 18,494,971                   | \$ 17,861,889 | \$633,082 | 3.54     | %  |

|                                       | Nine Months Ended  |                    |           |            |
|---------------------------------------|--------------------|--------------------|-----------|------------|
|                                       | September 30, 2013 | September 30, 2012 | Variance  | % Variance |
| Compensation and Benefits             | \$10,883,606       | \$ 9,982,603       | \$901,003 | 9.03 %     |
| OREO Valuation Allowance and Expenses | 605,704            | 742,600            | (136,896) | (18.43)%   |
| Other Operating Expenses              | 7,005,661          | 7,136,686          | (131,025) | (1.84)%    |
| Total Noninterest Expense             | \$18,494,971       | \$ 17,861,889      | \$633,082 | 3.54 %     |

For the nine months ended September 30, 2013, noninterest expense increased 3.54% or \$633,082 to \$18,494,971 from \$17,861,889 for the comparable period in 2012. Year to date increases in compensation and benefits were offset by decreases in OREO expenses and other operating expenses. Other operating expenses decreased due to one-time costs for conversion of the Bank's data processing system in 2012 and reductions in the cost of FDIC insurance. Depreciation and occupancy expense increased primarily due to the opening of a new operations center in Waldorf, Maryland and its 11th branch in King George, Virginia in the second half of 2012. We also opened a loan production office in Fredericksburg, Virginia in August 2013. Increased revenues and a moderate increase in noninterest expense have improved the Company's efficiency ratio to 68.43% for the nine months ended September 30, 2013 from 71.98% for the nine months ended September 30, 2012.

The Company recorded income tax expense of \$2,885,761 or 36.56%, of pretax earnings of \$7,892,442, for the nine months ended September 30, 2013 compared with \$1,910,014 or 35.18%, of pretax earnings of \$5,429,360, for the nine months ended September 30, 2012. The increase in the effective tax rate was the result of tax exempt income being relatively lower to total income in 2013 than the comparable period in 2012.

**RESULTS OF OPERATIONS – THREE MONTHS ENDED SEPTEMBER 30, 2013 AND SEPTEMBER 30, 2012**

Consolidated net income available to common shareholders for the three months ended September 30, 2013 increased 16.16%, or \$229,900, to \$1,652,841, or \$0.55 per common share (fully diluted) compared to \$1,422,941, or \$0.47, per common share (fully diluted) for the three months ended September 30, 2012. The increase of \$0.08 per share was attributable to increased net interest income of \$754,466 and decreased provision for loan losses of \$460,465 partially offset by decreased noninterest income of \$183,221 and increased noninterest expense of \$644,943 and income tax expense of \$156,867.

|   | Three Months Ended September |              |              |          |   |
|---|------------------------------|--------------|--------------|----------|---|
|   | 2013                         | 2012         | \$ Change    | % Change |   |
| Interest and Dividend Income                            |                              |              |              |          |   |
| Loans, including fees                                   | \$ 9,340,139                 | \$ 9,113,063 | \$227,076    | 2.49     | % |
| Taxable interest and dividends on investment securities | 631,652                      | 768,611      | (136,959 )   | (17.82 ) | % |
| Interest on deposits with banks                         | 3,268                        | 4,982        | (1,714 )     | (34.40 ) | % |
| Total Interest and Dividend Income                      | 9,975,059                    | 9,886,656    | 88,403       | 0.89     | % |
| Interest Expenses                                       |                              |              |              |          |   |
| Deposits  | 1,335,916                    | 2,001,535    | (665,619 )   | (33.26 ) | % |
| Short-term borrowings                                   | 4,237                        | 298          | 3,939        | 1321.81  | % |
| Long-term debt  | 532,833                      | 537,216      | (4,383 )     | (0.82 )  | % |
| Total Interest Expenses                                 | 1,872,986                    | 2,539,049    | (666,063 )   | (26.23 ) | % |
| Net Interest Income (NII)                               | 8,102,073                    | 7,347,607    | 754,466      | 10.27    | % |
| Provision for loan losses                               | 285,610                      | 746,075      | (460,465 )   | (61.72 ) | % |
| NII After Provision For Loan Losses                     | \$ 7,816,463                 | \$ 6,601,532 | \$ 1,214,931 | 18.40    | % |

Net interest income increased from the comparable three months in 2012 due primarily to reduced funding costs and the Company's ability to maintain loan yields. An important component of lowering the Company's cost of funds was the increase in average noninterest-bearing deposits of \$16.2 million for the third quarter of 2013 to \$93.9 million compared to \$77.7 million for the third quarter of 2012. The Company's 2013 third quarter cost of funds, which includes debt and interest and non-interest bearing deposits, decreased 30 basis points to 0.85% for the three months ended September 30, 2013 from 1.15% for the three months ended September 30, 2012. During the same comparable period, average loan yields decreased one basis point from 5.03% for the three months ended September 30, 2012 to 5.02% for the three months ended September 30, 2013.

Net interest income increased to \$8,102,073 for the three months ended September 30, 2013 compared to \$7,347,607 for the three months ended September 30, 2012. The net interest margin was 3.60% for the three months ended September 30, 2013, a 32 basis point increase from 3.28% for the three months ended September 30, 2012. The



increase was largely the result of a rapid decrease in the Company's cost of funds that began during 2012 as certificates of deposit re-priced and rates declined on money market accounts. The average cost of total interest-bearing liabilities decreased 31 basis points from 1.26% for the third quarter of 2012 to 0.95% for the third quarter of 2013. Deposit costs decreased 32 basis points from 0.99% to 0.67% for the comparable period.

Interest and dividend income increased by \$88,403 to \$9,975,059 for the three months ended September 30, 2013 compared to \$9,886,656 for the three months ended September 30, 2012. The growth in the average balance of loans was partially offset by decreases in investment average balances and yields on loans and investments. Interest and dividend income increased \$249,136 due to growth of \$19.8 million in the average balance of loans from \$724.4 million to \$744.2 million. This increase was partially offset by a reduction in average yields on investment and loan yields, which resulted in a decrease in interest income of \$100,458. The Company has been successful over the last several years in limiting the effect of the lower interest rate environment on loan rates through pricing and interest rate floors. Interest and dividend income was further reduced \$60,275 as average interest-earning investment balances decreased \$14.9 million from \$171.9 million for the three months ended September 30, 2012 to \$157.0 million for the three months ended September 30, 2013.

Interest expense decreased \$666,063 to \$1,872,986 for the three months ended September 30, 2013 compared to \$2,539,049 for the three months ended September 30, 2012 due primarily to a reduction in the average cost of funds on interest-bearing liabilities as interest expense decreased \$629,060 due to a decrease in rates. This was principally achieved by a decrease in the average rates paid on certificates of deposits and money market accounts, which declined from 1.56% and 0.47%, respectively, for the three months ended September 30, 2012 to 1.14% and 0.33%, respectively, for the three months ended September 30, 2013. The Company has been successful in increasing its core deposits and reducing its cost of funds in the low interest rate environment over the last several years. In addition, the average rate paid on long-term debt decreased from 2.99% to 2.54% for the comparable period. Interest expense was also reduced \$111,011 due to a decline in average interest-bearing deposit balances of \$32.9 million from \$732.1 million for the three months ended September 30, 2012 to \$699.2 million for the three months ended September 30, 2013. These reductions in interest expense were partially offset by a \$74,008 increase in interest expense due to a \$16.0 million increase in average debt balances.

The provision for loan losses decreased \$460,465 from \$746,075 for the comparable period in 2012 to \$285,610 for the three months ended September 30, 2013 and reflected a decrease in the allowance for specific nonperforming loans, offset by an increase in net charge-offs. The specific allowance is based on management's estimate of realizable value. Net charge-offs increased \$125,827 from \$114,060 for the three months ended September 30, 2012 to \$239,887 for the three months ended September 30, 2013.

The following table presents information on the average balances of the Company's interest-earning assets and interest-bearing liabilities and interest earned or paid thereon for the three months ended September 30, 2013 and 2012, respectively. There are no tax equivalency adjustments.

|  | For the Three Months Ended September 30, |                |                        |          |                  |                |                        |          |
|--|--|----------------|------------------------|----------|------------------|----------------|------------------------|----------|
|  | 2013                                     |                |                        | 2012     |                  |                |                        |          |
| dollars in thousands   | Average Balance                          | Interest       | Average Yield/<br>Cost |          | Average Balance  | Interest       | Average Yield/<br>Cost |          |
| <b>Assets</b>  |  |                |                        |          |                  |                |                        |          |
| <b>Interest-earning assets:</b>  |  |                |                        |          |                  |                |                        |          |
| Loan portfolio (1)   | \$744,180                                | \$9,340        | 5.02                   | %        | \$724,416        | \$9,113        | 5.03                   | %        |
| Investment securities, federal funds sold and interest-bearing deposits          | 157,045                                  | 635            | 1.62                   | %        | 171,926          | 774            | 1.80                   | %        |
| <b>Total Interest-Earning Assets</b>   | <b>901,225</b>                           | <b>9,975</b>   | <b>4.43</b>            | <b>%</b> | <b>896,342</b>   | <b>9,887</b>   | <b>4.41</b>            | <b>%</b> |
| Cash and cash equivalents  | 13,398                                   |                |                        |          | 15,672           |                |                        |          |
| Other assets   | 57,732                                   |                |                        |          | 56,137           |                |                        |          |
| <b>Total Assets</b>  | <b>\$972,355</b>                         |                |                        |          | <b>\$968,151</b> |                |                        |          |
| <b>Liabilities and Stockholders' Equity</b>                                      |  |                |                        |          |                  |                |                        |          |
| <b>Interest-bearing liabilities:</b>   |  |                |                        |          |                  |                |                        |          |
| Savings  | \$37,975                                 | \$10           | 0.11                   | %        | \$33,337         | \$9            | 0.11                   | %        |
| Interest-bearing demand and money market accounts                                | 273,750                                  | 224            | 0.33                   | %        | 271,260          | 322            | 0.47                   | %        |
| Certificates of deposit  | 387,480                                  | 1,102          | 1.14                   | %        | 427,476          | 1,671          | 1.56                   | %        |
| Long-term debt   | 71,526                                   | 454            | 2.54                   | %        | 60,544           | 452            | 2.99                   | %        |
| Short-term debt  | 5,156                                    | 4              | 0.31                   | %        | 102              | -              | 0.00                   | %        |
| Guaranteed preferred beneficial interest in junior subordinated debentures       | 12,000                                   | 79             | 2.63                   | %        | 12,000           | 85             | 2.83                   | %        |
| <b>Total Interest-Bearing Liabilities</b>  | <b>787,887</b>                           | <b>1,873</b>   | <b>0.95</b>            | <b>%</b> | <b>804,719</b>   | <b>2,539</b>   | <b>1.26</b>            | <b>%</b> |
| Noninterest-bearing demand deposits  | 93,902                                   |                |                        |          | 77,749           |                |                        |          |
| Other liabilities  | 8,368                                    |                |                        |          | 7,920            |                |                        |          |
| Stockholders' equity   | 82,198                                   |                |                        |          | 77,763           |                |                        |          |
| <b>Total Liabilities and Stockholders' Equity</b>                                | <b>\$972,355</b>                         |                |                        |          | <b>\$968,151</b> |                |                        |          |
| <b>Net interest income</b>   |  | <b>\$8,102</b> |                        |          |                  | <b>\$7,348</b> |                        |          |
| Interest rate spread   |  |                | 3.48                   | %        |                  |                | 3.15                   | %        |
| Net yield on interest-earning assets   |  |                | 3.60                   | %        |                  |                | 3.28                   | %        |
| Ratio of average interest-earning assets to average interest bearing liabilities |  |                | 114.39                 | %        |                  |                | 111.39                 | %        |
| Cost of funds  |  |                | 0.85                   | %        |                  |                | 1.15                   | %        |
| Cost of deposits   |  |                | 0.67                   | %        |                  |                | 0.99                   | %        |

(1) Average balance includes non-accrual loans

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The table below sets forth certain information regarding changes in interest income and interest expense of the Bank for the periods indicated. For each category of interest earning asset and interest bearing liability, information is provided on changes attributable to (1) changes in volume (changes in volume multiplied by old rate); and (2) changes in rate (changes in rate multiplied by old volume). Changes in rate volume (changes in rate multiplied by the change in volume) have been allocated to changes due to volume.

| dollars in thousands   | Three Months Ended September 30, 2013<br>compared to Three Months Ended<br>September 30, 2012 |                |           |
|--|---|----------------|-----------|
|  | Volume  | Due to<br>Rate | Total     |
| Interest income:   |   |                |           |
| Loan portfolio (1)   | \$ 248  | \$ (21 )       | \$ 227    |
| Investment securities, federal funds sold and interest bearing deposits    | (60 )   | (79 )          | (139 )    |
| Total interest-earning assets  | \$ 188  | \$ (100 )      | \$ 88     |
| Interest-bearing liabilities:  |   |                |           |
| Savings  | 1   | -              | 1         |
| Interest-bearing demand and money market accounts                          | 2   | (100 )         | (98 )     |
| Certificates of deposit  | (114 )  | (455 )         | (569 )    |
| Long-term debt   | 70  | (68 )          | 2         |
| Short-term debt  | 4   | -              | 4         |
| Guaranteed preferred beneficial interest in junior subordinated debentures | -   | (6 )           | (6 )      |
| Total interest-bearing liabilities   | \$ (37 )  | \$ (629 )      | \$ (666 ) |
| Net change in net interest income  | \$ 225  | \$ 529         | \$ 754    |

(1) Average balance includes non-accrual loans

The following table shows the components of noninterest income and the dollar and percentage changes for the periods presented.

|   | Three Months Ended September 30, |              | \$ Change    | % Change  |
|---|----------------------------------|--------------|--------------|-----------|
|   | 2013                             | 2012         |              |           |
| Noninterest Income                                |                                  |              |              |           |
| Loan appraisal, credit, and miscellaneous charges | \$ 55,620                        | \$ 280,456   | \$ (224,836) | (80.17 )% |
| Net gains on sale of OREO                         | 215,345                          | -            | 215,345      | n/a       |
| Income from bank owned life insurance             | 156,348                          | 157,177      | (829 )       | (0.53 )%  |
| Service charges                                   | 661,134                          | 528,420      | 132,714      | 25.12 %   |
| Gain on sale of loans held for sale               | 30,769                           | 336,384      | (305,615)    | (90.85 )% |
| Total Noninterest Income                          | \$ 1,119,216                     | \$ 1,302,437 | \$ (183,221) | (14.07 )% |

Gains on loan sales were impacted during the third quarter by a reduction in residential mortgage refinancing activity due to rising interest rates. For the three months ended September 30, 2013, gains on loan sales decreased to \$30,769 on sales of \$3,353,424 compared to \$336,384 on sales of \$6,686,204 for the same period in 2012. The increase in service charge income for the three months ended September 30, 2013 was principally the result of increased revenue from the Bank's investment products and services and bank account fees.

During the three months ended September 30, 2013, the Bank recognized \$215,345 in gains on the sale of OREO which consisted of the sale of four properties for net proceeds of \$712,944 and net losses of \$9,655 and the recognition of \$225,000 of previously deferred gain from the sale of an OREO property that the Bank financed during 2011 that did not initially qualify for full accrual sales treatment under ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition. During the three months ended September 30, 2012, there were no sales of OREO properties,

The following table shows the components of noninterest expense and the dollar percentage changes for the periods presented.

|  | Three Months Ended September 30, |              | \$ Change | % Change |    |
|--|----------------------------------|--------------|-----------|----------|----|
|  | 2013                             | 2012         |           |          |    |
| Noninterest Expense                                |                                  |              |           |          |    |
| Salary and employee benefits                       | \$ 3,737,000                     | \$ 3,492,524 | \$244,476 | 7.00     | %  |
| Occupancy expense                                  | 504,627                          | 487,233      | 17,394    | 3.57     | %  |
| Advertising  | 118,421                          | 86,020       | 32,401    | 37.67    | %  |
| Data processing expense                            | 237,054                          | 329,005      | (91,951 ) | (27.95)  | )% |
| Professional fees                                  | 293,028                          | 177,818      | 115,210   | 64.79    | %  |
| Depreciation of furniture, fixtures, and equipment | 191,320                          | 188,870      | 2,450     | 1.30     | %  |
| Telephone communications                           | 45,787                           | 45,563       | 224       | 0.49     | %  |
| Office supplies                                    | 41,689                           | 52,751       | (11,062 ) | (20.97)  | )% |
| FDIC Insurance                                     | 284,591                          | 201,607      | 82,984    | 41.16    | %  |
| Valuation allowance on OREO                        | 170,560                          | 31,050       | 139,510   | 449.31   | %  |
| Other  | 621,650                          | 508,343      | 113,307   | 22.29    | %  |
| Total Noninterest Expense                          | \$ 6,245,727                     | \$ 5,600,784 | \$644,943 | 11.52    | %  |

|                                       | Three Months Ended |                    | Variance  | % Variance |   |
|---------------------------------------|--------------------|--------------------|-----------|------------|---|
|                                       | September 30, 2013 | September 30, 2012 |           |            |   |
| Compensation and Benefits             | \$3,737,000        | \$ 3,492,524       | \$244,476 | 7.00       | % |
| OREO Valuation Allowance and Expenses | 211,640            | 85,579             | 126,061   | 147.30     | % |
| Other Operating Expenses              | 2,297,087          | 2,022,681          | 274,406   | 13.57      | % |
| Total Noninterest Expense             | \$6,245,727        | \$ 5,600,784       | \$644,943 | 11.52      | % |

For the three months ended September 30, 2013, noninterest expense increased 11.52% or \$644,943, to \$6,245,727 from \$5,600,784 for the comparable period in 2012. Employee compensation and other operating expenses continue to be impacted by greater regulatory compliance costs for legacy regulations and the impact of the Dodd-Frank Act.

The efficiency ratio of 67.73% for the three months ended September 30, 2013 was higher than the comparable three months of 2012 of 64.75%, but was in line with year to date trends (68.43% for the nine months ended September 30,

2013).

The Company recorded income tax expense of \$987,111 or 36.70%, of pretax earnings of \$2,689,952, for the three months ended September 30, 2013 compared with \$830,244 or 36.05%, of pretax earnings of \$2,303,185, for the three months ended September 30, 2012. The increase in the effective tax rate was the result of tax exempt income being relatively lower to total income in 2013 than the comparable period in 2012.

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**FINANCIAL CONDITION – SEPTEMBER 30, 2013 AND DECEMBER 31, 2012**

|   | September 30,<br>2013<br>(Unaudited) | December 31,<br>2012 | \$ Change     | %<br>Change |   |
|---|--------------------------------------|----------------------|---------------|-------------|---|
| Assets  |                                      |                      |               |             |   |
| Cash and due from banks                                       | \$ 23,269,755                        | \$ 10,696,653        | \$12,573,102  | 117.54      | % |
| Federal funds sold  | -                                    | 190,000              | (190,000 )    | (100.00)    | % |
| Interest-bearing deposits with banks                          | 3,626,750                            | 409,002              | 3,217,748     | 786.73      | % |
| Securities available for sale (AFS), at fair value            | 50,869,490                           | 47,205,663           | 3,663,827     | 7.76        | % |
| Securities held to maturity (HTM), at amortized cost          | 91,349,615                           | 112,619,434          | (21,269,819)  | (18.89)     | % |
| FHLB and FRB stock - at cost                                  | 5,593,100                            | 5,476,050            | 117,050       | 2.14        | % |
| Loans receivable - net of ALLL of \$8,079,277 and \$8,246,957 | 759,880,727                          | 747,640,752          | 12,239,975    | 1.64        | % |
| Premises and equipment, net                                   | 19,272,212                           | 19,782,236           | (510,024 )    | (2.58)      | % |
| Other real estate owned (OREO)                                | 7,058,504                            | 6,891,353            | 167,151       | 2.43        | % |
| Accrued interest receivable                                   | 2,850,066                            | 2,904,325            | (54,259 )     | (1.87)      | % |
| Investment in bank owned life insurance                       | 19,195,355                           | 18,730,580           | 464,775       | 2.48        | % |
| Other assets  | 9,938,081                            | 9,093,164            | 844,917       | 9.29        | % |
| Total Assets  | \$ 992,903,655                       | \$ 981,639,212       | \$ 11,264,443 | 1.15        | % |

Total assets at September 30, 2013 of \$992,903,655 increased by \$11,264,443 compared to total assets of \$981,639,212 at December 31, 2012. The increase in total assets was primarily attributable to an increase in the loan portfolio and cash and cash equivalents, offset by a decrease in investment securities. The differences in allocations between the different cash and investment categories reflect operational needs.

Details of the Bank's loan portfolio are presented below:

|                                   | September 30, 2013 | %        | December 31, 2012 | %        |
|-----------------------------------|--------------------|----------|-------------------|----------|
| Commercial real estate            | \$ 445,662,038     | 57.97 %  | \$ 419,667,312    | 55.47 %  |
| Residential first mortgages       | 161,861,710        | 21.05 %  | 177,663,354       | 23.48 %  |
| Construction and land development | 31,113,145         | 4.05 %   | 31,818,782        | 4.21 %   |
| Home equity and second mortgage   | 21,711,980         | 2.82 %   | 21,982,375        | 2.91 %   |
| Commercial loans                  | 86,504,220         | 11.25 %  | 88,157,606        | 11.65 %  |
| Consumer loans                    | 901,800            | 0.12 %   | 995,206           | 0.13 %   |
| Commercial equipment              | 21,085,197         | 2.74 %   | 16,267,684        | 2.15 %   |
|                                   | 768,840,090        | 100.00 % | 756,552,319       | 100.00 % |
| Less:                             |                    |          |                   |          |
| Deferred loan fees                | 880,086            | 0.11 %   | 664,610           | 0.09 %   |
| Allowance for loan loss           | 8,079,277          | 1.05 %   | 8,246,957         | 1.09 %   |

|                |                |
|----------------|----------------|
| 8,959,363      | 8,911,567      |
| \$ 759,880,727 | \$ 747,640,752 |

Loans increased \$12,239,975 from \$747,640,752 at December 31, 2012 to \$759,880,727 at September 30, 2013, due primarily to increases in loans for commercial real estate and commercial equipment partially offset by decreases in residential mortgages and commercial loans. First and second quarter 2013 residential loan production was focused on loans originated for sale in the secondary market.

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| Asset Quality  | September 30,<br>2013 | December 31,<br>2012 | \$ Change     | %<br>Change |    |
|--|-----------------------|----------------------|---------------|-------------|----|
| Gross Loans  | \$ 768,840,090        | \$ 756,552,319       | \$ 12,287,771 | 1.62        | %  |
| Allowance for loan loss (ALLL)   | 8,079,277             | 8,246,957            | (167,680 )    | (2.03       | )% |
| Foreclosed real estate (OREO)  | 7,058,504             | 6,891,353            | 167,151       | 2.43        | %  |
| Past due loans (PDLs) 31-89 days   | 3,007,103             | 3,175,431            | (168,328 )    | (5.30       | )% |
| Nonperforming loans >= 90 days Delinquent (NPLs)                             | 11,089,722            | 8,717,018            | 2,372,704     | 27.22       | %  |
| Nonperforming assets (NPLs + OREO)   | 18,148,226            | 15,608,371           | 2,539,855     | 16.27       | %  |
| Performing non-accrual loans   | 4,325,912             | 4,424,388            | (98,476 )     | (2.23       | )% |
| Troubled debt restructures (TDRs)  | 4,637,797             | 4,515,443            | 122,354       | 2.71        | %  |
| Allowance for loan losses (ALLL) to total loans                              | 1.05                  | % 1.09               | %             |             |    |
| Past due loans to total loans  | 0.39                  | % 0.42               | %             |             |    |
| Nonperforming loans to total loans   | 1.44                  | % 1.15               | %             |             |    |
| Loan delinquency (PDLs + NPLs) to total loans                                | 1.83                  | % 1.57               | %             |             |    |
| NPLs and performing non-accrual loans to total loans                         | 2.01                  | % 1.74               | %             |             |    |
| NPLs, performing non-accrual loans and TDRs to total loans (a)               | 2.57                  | % 2.33               | %             |             |    |
| Allowance to nonperforming loans   | 72.85                 | % 94.61              | %             |             |    |
| Nonperforming assets to total assets   | 1.83                  | % 1.59               | %             |             |    |
| Nonperforming assets, performing nonaccrual loans + TDRs to total assets (a) | 2.70                  | % 2.50               | %             |             |    |

(a) Ratio was adjusted to remove duplication of loans that are both nonperforming and troubled debt restructures.

The allowance for loan losses decreased from 1.09% of loans at December 31, 2012 to 1.05% of loans at September 30, 2013 due to changes to certain general allowance factors that reflect changes in historical loss and delinquency rates and general economic conditions and a reduction in specific reserves on impaired loans. Management's determination of the adequacy of the allowance is based on a periodic evaluation of the portfolio with consideration given to: the overall loss experience; current economic conditions; size, growth and composition of the loan portfolio; financial condition of the borrowers; current appraised values of underlying collateral; and other relevant factors that, in management's judgment, warrant recognition in providing an adequate allowance. Management believes that the allowance is adequate.

The allowance for loan losses decreased \$167,680 from \$8,246,957 at December 31, 2012 to \$8,079,277 at September 30, 2013. The decrease in the allowance reflects an overall reduction in lower specific reserves partially offset by a dollar and percentage increase in the general allowance.

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|                    | September 30, 2013 | % of Gross<br>Loans | December 31, 2012 | % of Gross<br>Loans |
|--------------------|--------------------|---------------------|-------------------|---------------------|
| General Allowance  | \$ 7,034,507       | 0.91                | % \$ 6,699,300    | 0.89 %              |
| Specific Allowance | 1,044,770          | 0.14                | % 1,547,657       | 0.20 %              |
| Total Allowance    | \$ 8,079,277       | 1.05                | % \$ 8,246,957    | 1.09 %              |

The specific allowance has decreased principally due to a trend in the overall improvement in asset quality over the past two years in the Bank's commercial portfolios, which include commercial real estate, commercial loans, commercial equipment and construction and land development. Classified loans in these portfolios decreased from \$62,843,351 at December 31, 2011 compared to \$44,806,691 at December 31, 2012 and \$47,076,654 at September 30, 2013 (See Note 11 of the Consolidated Financial Statements). The \$2,269,963 increase since December 31, 2012 in classified loans in the Bank's commercial portfolios primarily related to a line of credit on one well-secured stalled development project.

Nonperforming loans (90 days or greater delinquent) were \$11,089,722 or 1.44% of total loans at September 30, 2013 compared to \$8,717,018 or 1.15% of total loans at December 31, 2012. The Bank considers all nonperforming loans 90 days or greater delinquent to be non-accrual loans and in accordance with the Company's policy all interest accrued but not collected from loans that are placed on non-accrual 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.

The Bank had 31 nonperforming loans at September 30, 2013 compared to 34 nonperforming loans at December 31, 2012. The net increase of \$2,372,704 was due to increases of 90 days or greater delinquency in commercial real estate of \$1,419,763, commercial loans of \$1,938,241 and commercial equipment loans of \$100,279 partially offset by reductions in nonperforming residential first mortgages of \$1,014,282 and home equity and second mortgages of \$71,297. Nonperforming loans at September 30, 2013 included \$6,704,665 or 60%, of nonperforming loans attributed to four well-secured customer relationships, of which \$3,308,407 related to a line of credit on a stalled development project that the Bank expects to be current by the end of the year. The increase in nonperforming loans from December 31, 2012 was due primarily to the line of credit on the stalled development project. Nonperforming loans at September 30, 2013 decreased \$1,214,483 from the June 30, 2013 balance of \$12,304,205 or 1.63% of total loans.

The Bank categorized six performing loans totaling \$4,325,912 and \$4,424,388 as nonaccrual loans at September 30, 2013 and December 31, 2012, respectively. These six loans represent one well-secured commercial relationship with no specific reserves in the allowance due to the Bank's superior credit position with underlying collateral, which consists primarily of commercial real estate. As of September 30, 2013, the Bank had received all scheduled interest and principal payments on this relationship. It is management's belief that there is no current risk of loss to the Bank for this relationship. These loans were classified as nonaccrual loans due to the customer's operating results. In accordance with the Company's policy, interest income is recognized on a cash-basis for these loans

Non-accrual loans on which the recognition of interest has been discontinued, which did not have a specific allowance for impairment, amounted to \$12,932,327 and \$11,371,542 at September 30, 2013 and December 31, 2012, respectively. Interest due but not recognized on these balances at September 30, 2013 and December 31, 2012 was \$432,916 and \$443,856, respectively. Non-accrual loans with a specific allowance for impairment on which the recognition of interest has been discontinued amounted to \$2,483,307 and \$1,769,863 at September 30, 2013 and December 31, 2012, respectively. Interest due but not recognized on these balances at September 30, 2013 and December 31, 2012 was \$180,751 and \$182,106, respectively. Specific allowances on these balances at September 30, 2013 and December 31, 2012 were \$952,674 and \$732,189, respectively, and are based on management's evaluation of the underlying collateral and utilization of the Bank's credit evaluation criteria.

The overall delinquency rate (loans past due 31-89 days and 90 days or greater) improved 43 basis points from 2.26% at March 31, 2013 to 1.83% at September 30, 2013 and was 26 basis points higher than the December 31, 2012 delinquency rate of 1.57%.

At September 30, 2013, the Bank had 12 TDRs totaling \$4,637,797 compared to 10 TDRs totaling \$4,515,443 as of December 31, 2012. At December 31, 2012, all TDRs were performing according to the terms of their restructured agreements and there were no amounts specifically reserved for TDRs. At September 30, 2013 one TDR loan of \$323,976 was over 90 days past due and the specific reserve of the allowance for loan losses was \$12,000. Interest income in the amount of \$155,812 and \$220,326 was recognized on these loans for the nine months ended September 30, 2013 and the year ended December 31, 2012, respectively.

Management continues to monitor nonperforming and TDR loans and is working to resolve these loans in a manner that will preserve the most value for the Company. Additional loan information is presented in this Quarterly Report on Form 10-Q under Note 11 and for prior years is presented in the Company's Form 10-K for the year ended December 31, 2012.

The OREO balance was \$7,058,504 at September 30, 2013 an increase of \$167,151 compared to \$6,891,353 at December 31, 2012. This increase consisted of additions of \$1,390,286 offset by disposals of \$722,599 and valuation allowances of \$500,536 to adjust properties to current appraised values less the estimated cost to sell. OREO carrying amounts reflect management's estimate of the realizable value of these properties incorporating current appraised values, local real estate market conditions and related costs. During the nine months ended September 30, 2013, the Bank recognized \$215,345 in gains on the sale of OREO which consisted of the sale of four properties for net proceeds of \$712,944 and net losses of \$9,655 and the recognition of \$225,000 of a previously deferred gain from the sale of an OREO property that the Bank financed during 2011 that did not initially qualify for full accrual sales treatment under ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition. During the nine months ended September 30, 2012, the Bank disposed of three OREO properties resulting in proceeds of \$344,512 and recognized net losses of \$96,917.

At September 30, 2013, 98%, or \$133,974,968, of the asset-backed securities portfolio was rated AAA by Standard & Poor's or an equivalent credit rating from another major rating agency compared to 97%, or \$150,317,560, at December 31, 2012. Debt securities are evaluated quarterly to determine whether a decline in their value is other-than-temporary ("OTTI"). No OTTI charges were recorded for the three and nine months ended September 30, 2013 and the year ended December 31, 2012, respectively. Classified securities decreased \$475,457 to \$2,552,509 at September 30, 2013 from \$3,027,966 at December 31, 2012.

The Bank's asset quality trends have been generally improving over the last two years. Loans classified as substandard, doubtful or loss, OREO assets and classified securities, have decreased \$22,293,455 from \$81,909,520 at September 30, 2011 to \$59,616,065 at September 30, 2013. Since December 31, 2012, classified assets have increased \$1,020,716 from \$58,595,349. Current year 2013 positive trends were offset by a substandard classification of \$3,308,407 related to a line of credit on a stalled development project. The Bank expects this relationship to be current by the end of the year.

|  | September 30,<br>2013<br>(Unaudited) | December 31,<br>2012 | \$ Change   | %<br>Change |    |
|--|--------------------------------------|----------------------|-------------|-------------|----|
| Liabilities  |                                      |                      |             |             |    |
| Deposits   |                                      |                      |             |             |    |
| Non-interest-bearing deposits  | \$ 107,856,339                       | \$ 102,319,581       | \$5,536,758 | 5.41        | %  |
| Interest-bearing deposits  | 709,391,120                          | 717,910,707          | (8,519,587) | (1.19)      | )% |
| Total deposits   | 817,247,459                          | 820,230,288          | (2,982,829) | (0.36)      | )% |
| Short-term borrowings  | 2,640,000                            | 1,000,000            | 1,640,000   | 164.00      | %  |
| Long-term debt   | 70,488,848                           | 60,527,208           | 9,961,640   | 16.46       | %  |
| Guaranteed preferred beneficial interest in junior subordinated debentures (TRUPs) | 12,000,000                           | 12,000,000           | -           | 0.00        | %  |
| Accrued expenses and other liabilities   | 8,379,012                            | 8,834,455            | (455,443)   | (5.16)      | )% |
| Total Liabilities  | \$ 910,755,319                       | \$ 902,591,951       | \$8,163,368 | 0.90        | %  |

Total liabilities increased \$8,163,368 or 0.90%, primarily due to an increase in borrowings partially offset by a small increase in deposits.

Details of the Bank's deposit portfolio are presented below:

|                            | September 30, 2013 | %       | December 31, 2012 | %       |
|----------------------------|--------------------|---------|-------------------|---------|
| Noninterest-bearing demand | \$ 107,856,339     | 13.20 % | \$ 102,319,581    | 12.47 % |
| Interest-bearing:          |                    |         |                   |         |
| Demand                     | 86,009,278         | 10.52 % | 67,351,757        | 8.21 %  |
| Money market deposits      | 200,947,770        | 24.59 % | 209,813,301       | 25.58 % |

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|                         |                |          |                |          |
|-------------------------|----------------|----------|----------------|----------|
| Savings                 | 37,750,662     | 4.62 %   | 35,291,646     | 4.30 %   |
| Certificates of deposit | 384,683,410    | 47.07 %  | 405,454,003    | 49.43 %  |
| Total interest-bearing  | 709,391,120    | 86.80 %  | 717,910,707    | 87.53 %  |
| Total deposits          | \$ 817,247,459 | 100.00 % | \$ 820,230,288 | 100.00 % |

Deposits decreased \$2,982,829 or 0.36%, to \$817,247,459 at September 30, 2013 compared to \$820,230,288 at December 31, 2012. During the last two years, the Bank's focus has been on increasing transaction deposits, especially noninterest bearing deposits, to lower its overall cost of funds. As of September 30, 2013, the Bank's deposit funding consisted of 52.93% transaction accounts, an increase of 2.36% from 50.57% at December 31, 2012 and an increase of 4.35% from 48.58% at September 30, 2012. Average noninterest bearing deposits increased \$15.9 million for the first nine months of 2013 to \$86.8 million from \$70.9 million for the first nine months of 2012. During the same time frame, average time deposits decreased \$42.1 million from \$438.1 million to \$396.0 million. Long-term debt increased \$9,961,640 from \$60,527,208 at December 31, 2012 to \$70,488,848 at September 30, 2013. During the first quarter of 2013, the Company added \$10 million in Federal Home Loan Bank advances at 0.87% for four years.



| Stockholders' Equity                           | September 30, 2013<br>(Unaudited) | December 31, 2012 | \$ Change   | % Change   |
|--|-----------------------------------|-------------------|-------------|------------|
| Preferred Stock at par of \$1,000              | \$ 20,000,000                     | \$ 20,000,000     | \$-         | 0.00 %     |
| Common Stock at par of \$0.01                  | 30,484                            | 30,524            | (40 )       | (0.13 )%   |
| Additional paid in capital                     | 18,275,729                        | 17,873,560        | 402,169     | 2.25 %     |
| Retained earnings                              | 45,626,970                        | 41,986,633        | 3,640,337   | 8.67 %     |
| Accumulated other comprehensive gain<br>(loss) | (910,940 )                        | 139,184           | (1,050,124) | (754.49 )% |
| Unearned ESOP shares                           | (873,907 )                        | (982,640 )        | 108,733     | (11.07 )%  |
| Total Stockholders' Equity                     | \$ 82,148,336                     | \$ 79,047,261     | \$3,101,075 | 3.92 %     |

During the nine months ended September 30, 2013, stockholders' equity increased \$3,101,075 to \$82,148,336. The increase in stockholders' equity was due to net income of \$5,006,681 and net stock related activities of \$208,510 partially offset by quarterly common dividends paid of \$913,992, quarterly preferred stock dividends of \$150,000 and a decrease to accumulated other comprehensive income of \$1,050,124. Accumulated other comprehensive losses increased during the second and third quarters primarily due to market valuation adjustments of the Company's AFS asset-backed securities portfolio as a result of increases in long-term interest rates. The Company believes that AFS securities with unrealized losses will either recover in market value or be paid off as agreed. The Company intends to and has the ability to hold these securities to maturity. Common stockholders' equity at \$82,148,336 as of September 30, 2013 resulted in a book value of \$20.39 per common share. The Company remains well-capitalized at September 30, 2013 with a Tier 1 capital to average asset ratio of 9.76%. As indicated above, the additional \$27.4 million of capital raised in October 2013 was a fourth quarter 2013 event and was not reflected in the third quarter analysis above.

The Company had paid annual cash dividends on common stock since 1994. During the first quarter of 2013, the Board of Directors announced a change to a quarterly dividend in place of its previous annual dividend and that the expected total dividend to be paid in 2013 will be \$0.40 per share.

## LIQUIDITY AND CAPITAL RESOURCES

The Company has no business other than holding the stock of the Bank and does not currently have any material funding requirements, except for the payment of dividends on preferred and common stock, and the payment of interest on subordinated debentures.

The Company's principal sources of liquidity are cash on hand and dividends received from the Bank. The Bank is subject to various regulatory restrictions on the payment of dividends.

The Bank's principal sources of funds for investment and operations are net income, deposits, sales of loans, borrowings, principal and interest payments on loans, principal and interest received on investment securities and proceeds from the maturity and sale of investment securities. Its principal funding commitments are for the origination or purchase of loans, the purchase of securities and the payment of maturing deposits. Deposits are considered the primary source of funds supporting the Bank's lending and investment activities. The Bank also uses borrowings from the Federal Home Loan Bank (FHLB) of Atlanta to supplement deposits. The amount of FHLB advances available to the Bank is limited to the lower of 30% of Bank assets or the amount supportable by eligible collateral including FHLB stock, loans and securities. In addition, the Bank has established lines of credit with the Federal Reserve Bank and commercial banks.

For additional information regarding these arrangements, including collateral, refer to Note 10 of the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2012.

The Bank's most liquid assets are cash, cash equivalents and federal funds sold. The levels of such assets are dependent on the Bank's operating, financing and investment activities at any given time. The variations in levels of cash and cash equivalents are influenced by deposit flows and anticipated future deposit flows.

Cash, federal funds sold, and interest-bearing deposits with banks as of September 30, 2013 totaled \$26,896,505, an increase of \$15,600,850 or 138%, from the December 31, 2012 total of \$11,295,655. The increase in cash was primarily due to cash generated from net income, net proceeds received from maturing investment securities, and increases in short-term and long-term borrowings. These increases to cash were partially offset by an excess of loan originations over principal collected and a decrease in deposits.

During the first nine months of 2013, all financing activities provided \$7,504,334 in cash compared to \$5,866,511 in cash used for the same period in 2012. The Bank provided \$13,370,845 more cash for financing activities in the nine months ended September 30, 2013 compared to the nine months ended September 30, 2012, primarily due to an increase in borrowings and a reduction in the net decrease in deposits. The Bank borrowed a net of \$11,638,494 for the nine months ended September 30, 2013 compared to no borrowings for the nine months ended September 30, 2012. Customer deposits for the nine months ended September 30, 2013 decreased \$2,982,829 compared to a decrease in deposits of \$4,265,600 for the nine months ended September 30, 2012. The Company moved to a quarterly dividend in 2013 and as a result used \$307,579 less cash to pay dividends of \$1,063,992 during the nine months ended September 30, 2013 compared to \$1,371,571 for the nine months ended September 30, 2012. Other financing activities increased cash provided \$142,001.

Operating activities provided cash of \$6,507,955 for nine months ended September 30, 2013 compared to \$8,808,176 of cash provided in the same period of 2012, a decrease in cash of \$2,300,221 from the comparable period in 2012. Cash decreased primarily due to decreases in other assets and the provision for loan losses and a decrease in accrued expenses partially offset by an increase in net income.

Investing activities provided cash of \$1,588,561 for nine months ended September 30, 2013 compared to \$4,135,141 of cash provided for the same period of 2012. The decrease in cash of \$2,546,580 was primarily due to a decrease in net cash provided from investment transactions from \$33,683,298 of cash provided for the nine months ended September 30, 2012 to \$15,456,913 of cash provided for the nine months ended September 30, 2013. Additionally, cash was reduced \$8,571,401 due to increased loans originated from \$173,628,906 for the nine months ended September 30, 2012 to \$182,200,307 for the nine months ended September 30, 2013. These decreases to cash provided were partially offset by increased cash provided due to growth in principal payments collected, decreased premises and equipment purchases and increased proceeds from the sale of OREO and other assets. Principal payments collected increased cash provided by \$20,073,611 increasing from \$147,989,755 for the nine months ended September 30, 2012 to \$168,063,366 for the nine months ended September 30, 2013. Net cash provided also increased \$3,798,162 for the nine months ended September 30, 2013, as 2012 incurred costs were expended in 2012 for premises and equipment related to acquisition and construction costs for the operations center in Waldorf, Maryland and the King George, Virginia branch. Additionally, cash increased \$379,433 due to an increase in net proceeds from sales of OREO and asset disposals.

**REGULATORY MATTERS**

The Bank is subject to Federal Reserve Board capital requirements as well as statutory capital requirements imposed under Maryland law. To be categorized as well-capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the table. The Company's and the Bank's actual capital amounts and ratios at September 30, 2013 and December 31, 2012, respectively are presented in the following tables.

| At September 30, 2013                    | Actual     |        | Required for Capital Adequacy Purposes |      | To be Considered Well Capitalized Under Prompt Corrective Action |           |         |
|--|------------|--------|--|------|--|-----------|---------|
| (in thousands)                           |            |        |  |      |  |           |         |
| Total Capital (to risk weighted assets)  |            |        |  |      |  |           |         |
| The Company                              | \$ 103,176 | 12.79% | \$ 64,545                              | 8.00 | %  |           |         |
| The Bank                                 | \$ 102,137 | 12.68% | \$ 64,425                              | 8.00 | %  | \$ 80,531 | 10.00 % |
| Tier 1 Capital (to risk weighted assets) |            |        |  |      |  |           |         |
| The Company                              | \$ 95,059  | 11.78% | \$ 32,272                              | 4.00 | %  |           |         |
| The Bank                                 | \$ 94,020  | 11.67% | \$ 32,212                              | 4.00 | %  | \$ 48,319 | 6.00 %  |
| Tier 1 Capital (to average assets)       |            |        |  |      |  |           |         |
| The Company                              | \$ 95,059  | 9.76 % | \$ 38,956                              | 4.00 | %  |           |         |
| The Bank                                 | \$ 94,020  | 9.67 % | \$ 38,896                              | 4.00 | %  | \$ 48,620 | 5.00 %  |
|  |            |        |  |      |  |           |         |
| At December 31, 2012                     | Actual     |        | Required for Capital Adequacy Purposes |      | To be Considered Well Capitalized Under Prompt Corrective Action |           |         |
| (in thousands)                           |            |        |  |      |  |           |         |
| Total Capital (to risk weighted assets)  |            |        |  |      |  |           |         |
| The Company                              | \$ 99,280  | 12.84% | \$ 61,842                              | 8.00 | %  |           |         |
| The Bank                                 | \$ 96,600  | 12.55% | \$ 61,586                              | 8.00 | %  | \$ 76,983 | 10.00 % |
| Tier 1 Capital (to risk weighted assets) |            |        |  |      |  |           |         |
| The Company                              | \$ 90,908  | 11.76% | \$ 30,921                              | 4.00 | %  |           |         |
| The Bank                                 | \$ 88,228  | 11.46% | \$ 30,793                              | 4.00 | %  | \$ 46,190 | 6.00 %  |
| Tier 1 Capital (to average assets)       |            |        |  |      |  |           |         |
| The Company                              | \$ 90,908  | 9.39 % | \$ 38,723                              | 4.00 | %  |           |         |
| The Bank                                 | \$ 88,228  | 9.14 % | \$ 38,595                              | 4.00 | %  | \$ 48,244 | 5.00 %  |

**CRITICAL ACCOUNTING POLICIES**

Critical accounting policies are defined as those that involve significant judgments and uncertainties and could potentially result in materially different results under different assumptions and conditions. The Company considers its determination of the allowance for loan losses, the determination of other-than-temporarily impaired securities, the

valuation of foreclosed real estate and the valuation of deferred tax assets to be critical accounting policies.

The Company's Consolidated Financial Statements are prepared in accordance with accounting principles generally accepted in the United States of America and the general practices of the United States banking industry. Application of these principles requires management to make estimates, assumptions and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions and judgments are based on information available as of the date of the financial statements. Accordingly, as this information changes, the financial statements could reflect different estimates, assumptions and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments and, as such, have a greater possibility of producing results that could be materially different than originally reported.

Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value, when a decline in the value of an asset not carried on the financial statements at fair value warrants an impairment write-down or valuation reserve to be established or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and the information used to record valuation adjustments for certain assets and liabilities are based either on quoted market prices or are provided by other third-party sources, when available. When these sources are not available, management makes estimates based upon what it considers to be the best available information.

#### *Allowance for Loan Losses*

The allowance for loan losses is an estimate of the losses that exist in the loan portfolio. The allowance is based on two principles of accounting: (1) Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 450 "Contingencies," which requires that losses be accrued when they are probable of occurring and are estimable and (2) FASB ASC 310 "Receivables," which requires that losses be accrued when it is probable that the Company will not collect all principal and interest payments according to the contractual terms of the loan. The loss, if any, is determined by the difference between the loan balance and the value of collateral, the present value of expected future cash flows and values observable in the secondary markets.

The allowance for loan loss balance is an estimate based upon management's evaluation of the loan portfolio. The allowance is comprised of a specific and a general component. The specific component consists of management's evaluation of certain classified impaired and non-accrual loans and their underlying collateral. Management assesses the ability of the borrower to repay the loan based upon all information available. Loans are examined to determine a specific allowance based upon the borrower's payment history, economic conditions specific to the loan or borrower and other factors that would impact the borrower's ability to repay the loan on its contractual basis. Depending on the assessment of the borrower's ability to pay and the type, condition and value of collateral, management will establish an allowance amount specific to the loan.

Management utilizes a risk scale to assign grades to commercial real estate, construction and land development, commercial loans and commercial equipment loans. Commercial loan relationships with an aggregate exposure to the Bank of \$750,000 or greater are risk rated. Residential first mortgages, home equity and second mortgages and

consumer loans are evaluated for creditworthiness in underwriting and are monitored on an ongoing basis based on borrower payment history. Consumer loans and residential real estate loans are classified as unrated unless they are part of a larger commercial relationship that requires grading or are troubled debt restructures or nonperforming loans with an Other Assets Especially Mentioned or higher risk rating due to a delinquent payment history.

The Bank's commercial loan portfolio is periodically reviewed by regulators and independent consultants engaged by management. These reviews validate the Bank's asset classifications and may result in adjustments to provisions based on the field examination team's assessment of information available at the time of the examination.

In establishing the general component of the allowance, management analyzes non-impaired loans in the portfolio including changes in the amount and type of loans. Management also examines historical loss experience (charge-offs and recoveries) within each loan category. The state of the local and national economy is also considered. Based upon these factors, the Bank's loan portfolio is categorized and a loss factor is applied to each category. Based upon these factors, the Bank will adjust the loan loss allowance by increasing or decreasing the provision for loan losses.

Management has significant discretion in making the judgments inherent in the determination of the allowance for loan losses, including in connection with the valuation of collateral, a borrower's prospects of repayment and in establishing loss factors on the general component of the allowance. Changes in loss factors will have a direct impact on the amount of the provision and a corresponding effect on net income. Errors in management's perception and assessment of the global factors and their impact on the portfolio could result in the allowance not being adequate to cover losses in the portfolio, and may result in additional provisions or charge-offs. An increase or decrease in the allowance could result in a charge or credit to income before income taxes that materially impacts earnings.

For additional information regarding the allowance for loan losses, refer to Notes 1 and 5 of the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2012.

***Other-Than-Temporary-Impairment (“OTTI”)***

Debt securities are evaluated quarterly to determine whether a decline in their value is other-than-temporary. The term “other-than-temporary” is not necessarily intended to indicate a permanent decline in value. It means that the prospects for near-term recovery of value are not necessarily favorable, or that there is a lack of evidence to support fair values equal to, or greater than, the carrying value of the investment. Under the revised guidance, for recognition and presentation of other-than-temporary impairments the amount of other-than-temporary impairment that is recognized through earnings for debt securities is determined by comparing the present value of the expected cash flows to the amortized cost of the security. The discount rate used to determine the credit loss is the expected book yield on the security.

For additional information regarding the evaluation of OTTI, refer to Notes 4 of the Consolidated Financial Statements as presented in the Company’s Form 10-K for the year ended December 31, 2012.

***Other Real Estate Owned (“OREO”)***

The Company maintains a valuation allowance on its other real estate owned. As with the allowance for loan losses, the valuation allowance on OREO is based on FASB ASC 450 “Contingencies,” as well as the accounting guidance on impairment of long-lived assets. These statements require that the Company establish a valuation allowance when it has determined that the carrying amount of a foreclosed asset exceeds its fair value. Fair value of a foreclosed asset is measured by the cash flows expected to be realized from its subsequent disposition. These cash flows are reduced for the costs of selling or otherwise disposing of the asset.

In estimating the cash flows from the sale of OREO, management must make significant assumptions regarding the timing and amount of cash flows. For example, in cases where the real estate acquired is undeveloped land, management must gather the best available evidence regarding the market value of the property, including appraisals, cost estimates of development and broker opinions. Due to the highly subjective nature of this evidence, as well as the limited market, long time periods involved and substantial risks, cash flow estimates are highly subjective and subject to change. Errors regarding any aspect of the costs or proceeds of developing, selling or otherwise disposing of foreclosed real estate could result in the allowance being inadequate to reduce carrying costs to fair value and may require an additional provision for valuation allowances.

For additional information regarding foreclosed real estate, refer to Notes 1 and 7 of the Consolidated Financial Statements as presented in the Company’s Form 10-K for the year ended December 31, 2012.

***Deferred Tax Assets***



The Company accounts for income taxes in accordance with FASB ASC 740, "Income Taxes," which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the book and tax bases of recorded assets and liabilities. FASB ASC 740 requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or the entire deferred tax asset will not be realized.

The Company periodically evaluates the ability of the Company to realize the value of its deferred tax assets. If the Company were to determine that it was not more likely than not that the Company would realize the full amount of the deferred tax assets, it would establish a valuation allowance to reduce the carrying value of the deferred tax asset to the amount it believes would be realized. The factors used to assess the likelihood of realization are the Company's forecast of future taxable income, future expected tax rates and available tax-planning strategies that could be implemented to realize the net deferred tax assets.

Failure to achieve forecasted taxable income might affect the ultimate realization of the net deferred tax assets. Factors that may affect the Company's ability to achieve sufficient forecasted taxable income include, but are not limited to, the following: increased competition, a decline in net interest margin, a loss of market share, decreased demand for financial services and national and regional economic conditions.

The Company's provision for income taxes and the determination of the resulting deferred tax assets and liabilities involve a significant amount of management judgment and are based on the best information available at the time. The Company operates within federal and state taxing jurisdictions and is subject to audit in these jurisdictions.

For additional information regarding the deferred tax assets, refer to Note 11 in the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2012.

### **ITEM 3. Quantitative and qualitative Disclosure about Market Risk**

Not applicable as the Company is a smaller reporting company.

### **ITEM 4. CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, management of the Company carried out an evaluation, under the supervision and with the participation of the Company's principal executive officer and principal financial officer, of the effectiveness of the Company's disclosure controls and procedures. Based on this evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934, as amended, (1) is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and (2) is accumulated and communicated to the Company's management, including its principal executive and financial officers as appropriate to allow timely decisions regarding required disclosure. It should be noted that the design of the Company's disclosure controls and procedures is based in part upon certain reasonable assumptions about the likelihood of future events, and there can be no reasonable assurance that any design of disclosure controls and procedures will succeed in achieving its stated goals under all potential future conditions, regardless of how remote, but the Company's principal executive and financial officers have concluded that the Company's disclosure controls and procedures are, in fact, effective at a reasonable assurance level. There were no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2013 that have materially affected, or are reasonable likely to materially affect, the Company's internal control over financial reporting.

### **PART II - OTHER INFORMATION**

Item 1 - Legal Proceedings – The Company is not involved in any pending legal proceedings. The Bank is not involved in any pending legal proceedings other than routine legal proceedings occurring in the ordinary course of business. Such routine legal proceedings, in the aggregate, are believed by management to be immaterial to the financial condition and results of operations of the Company.

Item 1A - Risk Factors - In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A- Risk Factors" in the Form 10-K and in the prospectus, dated September 26, 2013, that we filed with the Securities and Exchange Commission, which could materially affect our business, financial condition or future results. The risks described are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds

(a) Not applicable

(b) Not applicable

On September 25, 2008, the Company announced a repurchase program under which it would repurchase up to 5% of its outstanding common stock or approximately 147,435 shares. The program will continue until it is (c) completed or terminated by the Company's Board of Directors. As of September 30, 2013, 79,824 shares were available to be repurchased under the repurchase program. The following schedule provides repurchases for the three months ended September 30, 2013.

| Period               | (a)<br>Total<br>Number of<br>Shares<br>Purchased | (b)<br>Average<br>Price Paid<br>per Share | (c)<br>Total Number<br>of Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced Plans<br>or<br>Programs | (d)<br>Maximum<br>Number of Shares<br>that May Yet Be<br>Purchased Under<br>the Plans or<br>Programs |
|----------------------|--|---|--|--|
| July 1-31, 2013      | 250  | \$ 18.86                                  | 250  | 79,824   |
| August 1-31, 2013    | -  | -   | -  | 79,824   |
| September 1-30, 2013 | -  | -   | -  | 79,824   |
| Total                | 250  | \$ 18.86                                  | 250  | 79,824   |

Item 3 - Default Upon Senior Securities - None

Item 4 – Mine Safety Disclosures – Not Applicable

Item 5 - Other Information - None

Item 6 - Exhibits

Exhibit 1.1 – Underwriting Agreement, dated September 26, 2013, among Tri-County Financial Corporation, Community Bank of Tri-County and Keefe, Bruyette & Woods, Inc., as representative of the underwriters\*

Exhibit 31 - Rule 13a-14(a) Certifications

Exhibit 32 - Section 1350 Certifications

Exhibit 101.0 - The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2013, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income and Comprehensive Income, (iii) the Consolidated Statements of Cash Flows; and (iv) the Notes to the Consolidated Financial Statements.

\*Incorporated herein by reference to the Form 8-K as filed with the Securities and Exchange Commission on September 27, 2013.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**THE COMMUNITY FINANCIAL  
CORPORATION**

Date: November 7, 2013 By: /s/ Michael L. Middleton  
Michael L. Middleton  
Chief Executive Officer

Date: November 7, 2013 By: /s/ William J. Pasenelli  
William J. Pasenelli  
President and Chief Financial Officer