

COMMUNITY FINANCIAL CORP /MD/  
Form 10-Q  
May 06, 2014

**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 March 31, 2014

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

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(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  Accelerated Filer   
Non-accelerated Filer  Smaller Reporting Company   
(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 April 30, 2014, the registrant had 4,686,391 shares of common stock outstanding.

**THE COMMUNITY FINANCIAL CORPORATION**

**FORM 10-Q**

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**PART 1 - FINANCIAL INFORMATION****ITEM 1 – FINANCIAL STATEMENTS****CONSOLIDATED BALANCE SHEETS**

| (dollars in thousands)  | March 31,<br>2014<br>(Unaudited) | December 31,<br>2013 |
|---|----------------------------------|----------------------|
| <b>Assets</b>   |                                  |                      |
| Cash and due from banks   | \$ 13,237                        | \$ 11,408            |
| Federal funds sold  | 2,205                            | 8,275                |
| Interest-bearing deposits with banks  | 734                              | 4,836                |
| Securities available for sale (AFS), at fair value  | 43,446                           | 48,247               |
| Securities held to maturity (HTM), at amortized cost  | 80,902                           | 86,401               |
| Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stock - at cost  | 6,380                            | 5,593                |
| Loans receivable - net of allowance for loan losses of \$8,197 and \$8,138  | 810,484                          | 799,130              |
| Premises and equipment, net   | 19,776                           | 19,543               |
| Other real estate owned (OREO)  | 7,454                            | 6,797                |
| Accrued interest receivable   | 2,992                            | 2,974                |
| Investment in bank owned life insurance   | 19,501                           | 19,350               |
| Other assets  | 9,827                            | 11,270               |
| <b>Total Assets</b>   | <b>\$ 1,016,938</b>              | <b>\$ 1,023,824</b>  |
| <b>Liabilities and Stockholders' Equity</b>   |                                  |                      |
| <b>Liabilities</b>  |                                  |                      |
| <b>Deposits</b>   |                                  |                      |
| Non-interest-bearing deposits   | \$ 103,235                       | \$ 103,882           |
| Interest-bearing deposits   | 705,884                          | 717,413              |
| <b>Total deposits</b>   | <b>809,119</b>                   | <b>821,295</b>       |
| Long-term debt  | 75,463                           | 70,476               |
| Guaranteed preferred beneficial interest in junior subordinated debentures (TRUPs)                                  | 12,000                           | 12,000               |
| Accrued expenses and other liabilities  | 8,223                            | 9,323                |
| <b>Total Liabilities</b>  | <b>904,805</b>                   | <b>913,094</b>       |
| <b>Stockholders' Equity</b>   |                                  |                      |
| Preferred Stock, Senior Non-Cumulative Perpetual, Series C - par value \$1,000; authorized 20,000; issued 20,000    | 20,000                           | 20,000               |
| Common stock - par value \$.01; authorized - 15,000,000 shares; issued 4,686,157 and 4,647,407 shares, respectively | 47                               | 46                   |

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|  |              |   |              |   |
|--|--------------|---|--------------|---|
| Additional paid in capital                 | 46,160       |   | 45,881       |   |
| Retained earnings                          | 47,728       |   | 46,523       |   |
| Accumulated other comprehensive loss       | (1,139       | ) | (1,057       | ) |
| Unearned ESOP shares                       | (663         | ) | (663         | ) |
| Total Stockholders' Equity                 | 112,133      |   | 110,730      |   |
| Total Liabilities and Stockholders' Equity | \$ 1,016,938 |   | \$ 1,023,824 |   |

*See notes to Consolidated Financial Statements*

**CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (Unaudited)**

| (dollars in thousands, except per share amounts )       | Three Months Ended March |          |
|---|--------------------------|----------|
|   | 2014                     | 2013     |
| Interest and Dividend Income                            |                          |          |
| Loans, including fees                                   | \$ 9,583                 | \$ 9,247 |
| Taxable interest and dividends on investment securities | 590                      | 590      |
| Interest on deposits with banks                         | 2                        | 3        |
| Total Interest and Dividend Income                      | 10,175                   | 9,840    |
| Interest Expense  |                          |          |
| Deposits  | 1,208                    | 1,551    |
| Short-term borrowings                                   | 6                        | 4        |
| Long-term debt  | 527                      | 468      |
| Total Interest Expense                                  | 1,741                    | 2,023    |
| Net Interest Income                                     | 8,434                    | 7,817    |
| Provision for loan losses                               | 203                      | 155      |
| Net Interest Income After Provision For Loan Losses     | 8,231                    | 7,662    |
| Noninterest Income                                      |                          |          |
| Loan appraisal, credit, and miscellaneous charges       | 100                      | 188      |
| Net gains on sale of investment securities              | 24                       | -        |
| Income from bank owned life insurance                   | 151                      | 151      |
| Service charges   | 552                      | 471      |
| Gain on sale of loans held for sale                     | 68                       | 379      |
| Total Noninterest Income                                | 895                      | 1,189    |
| Noninterest Expense                                     |                          |          |
| Salary and employee benefits                            | 4,029                    | 3,557    |
| Occupancy expense                                       | 565                      | 483      |
| Advertising   | 122                      | 104      |
| Data processing expense                                 | 271                      | 364      |
| Professional fees                                       | 230                      | 197      |
| Depreciation of furniture, fixtures, and equipment      | 185                      | 192      |
| Telephone communications                                | 50                       | 49       |
| Office supplies   | 80                       | 63       |
| FDIC Insurance  | 139                      | 301      |
| Valuation allowance on OREO                             | 82                       | 311      |
| Other   | 578                      | 522      |
| Total Noninterest Expense                               | 6,331                    | 6,143    |
| Income before income taxes                              | 2,795                    | 2,708    |
| Income tax expense                                      | 1,074                    | 990      |
| Net Income  | \$ 1,721                 | \$ 1,718 |
| Preferred stock dividends                               | 50                       | 50       |
| Net Income Available to Common Shareholders             | \$ 1,671                 | \$ 1,668 |

|   |          |   |          |
|---|----------|---|----------|
| Net Income  | \$ 1,721 |   | \$ 1,718 |
| Net unrealized holding losses arising during period, net of tax of \$(39) and \$(40), respectively      | (77      | ) | (75 )    |
| Reclassification adjustment for gains included in net income, net of tax of \$(3) and \$0, respectively | (5       | ) | -        |
| Comprehensive Income  | \$ 1,639 |   | \$ 1,643 |
| Earnings Per Common Share   |          |   |          |
| Basic   | \$ 0.36  |   | \$ 0.55  |
| Diluted   | \$ 0.36  |   | \$ 0.54  |
| Cash dividends paid per common share  | \$ 0.10  |   | \$ 0.10  |

*See notes to Consolidated Financial Statements*



**CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)**

| (dollars in thousands)   | Three Months Ended March 31, |               |
|--|------------------------------|---------------|
|  | 2014                         | 2013          |
| <b>Cash Flows from Operating Activities</b>                                      |                              |               |
| Net income   | \$ 1,721                     | \$ 1,718      |
| Adjustments to reconcile net income to net cash provided by operating activities |                              |               |
| Provision for loan losses  | 203                          | 155           |
| Depreciation and amortization  | 312                          | 323           |
| Loans originated for resale  | (2,769)                      | (12,610)      |
| Proceeds from sale of loans originated for sale                                  | 2,367                        | 12,905        |
| Gain on sale of loans held for sale  | (68)                         | (379)         |
| Gains on sales of HTM investment securities                                      | (16)                         | -             |
| Gains on sales of AFS investment securities                                      | (8)                          | -             |
| Net amortization of premium/discount on investment securities                    | 68                           | 184           |
| OREO valuation allowance   | 82                           | 311           |
| Increase in cash surrender of bank owned life insurance                          | (151)                        | (151)         |
| Decrease (increase) in deferred income tax benefit                               | 709                          | (166)         |
| Increase in accrued interest receivable  | (18)                         | (124)         |
| Stock based compensation   | 136                          | 134           |
| Increase (decrease) in deferred loan fees  | 31                           | (2)           |
| Decrease in accrued expenses and other liabilities                               | (1,099)                      | (1,699)       |
| Decrease in other assets   | 834                          | 1,002         |
| <b>Net Cash Provided by Operating Activities</b>                                 | <b>2,334</b>                 | <b>1,601</b>  |
| <b>Cash Flows from Investing Activities</b>                                      |                              |               |
| Purchase of AFS investment securities  | (22)                         | (22)          |
| Proceeds from redemption or principal payments of AFS investment securities      | 2,621                        | 2,520         |
| Purchase of HTM investment securities  | (750)                        | (10,933)      |
| Proceeds from maturities or principal payments of HTM investment securities      | 3,048                        | 12,659        |
| Net increase of FHLB and FRB stock   | (787)                        | (153)         |
| Loans originated or acquired   | (58,172)                     | (37,457)      |
| Principal collected on loans   | 46,315                       | 49,739        |
| Purchase of premises and equipment   | (545)                        | (57)          |
| Proceeds from sale of HTM investment securities                                  | 3,179                        | -             |
| Proceeds from sale of AFS investment securities                                  | 2,056                        | -             |
| <b>Net Cash (Used in) Provided by Investing Activities</b>                       | <b>(3,057)</b>               | <b>16,296</b> |

**CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)****(continued)**

| (dollars in thousands)  | Three Months Ended March 31, |              |
|---|------------------------------|--------------|
|   | 2014                         | 2013         |
| <b>Cash Flows from Financing Activities</b>                   |                              |              |
| Net decrease in deposits                                      | \$ (12,176 )                 | \$ (21,377 ) |
| Proceeds from long-term borrowings                            | 5,000                        | 10,000       |
| Payments of long-term borrowings                              | (13 )                        | (13 )        |
| Net decrease in short term borrowings                         | -                            | (1,000 )     |
| Exercise of stock options                                     | 85                           | 33           |
| Dividends Paid  | (516 )                       | (354 )       |
| Net change in unearned ESOP shares                            | -                            | 177          |
| Repurchase of common stock                                    | -                            | (112 )       |
| Net Cash Used in Financing Activities                         | (7,620 )                     | (12,646 )    |
| (Decrease) Increase in Cash and Cash Equivalents              | \$ (8,343 )                  | \$ 5,251     |
| Cash and Cash Equivalents - January 1                         | 24,519                       | 11,296       |
| Cash and Cash Equivalents - March 31                          | \$ 16,176                    | \$ 16,547    |
| <b>Supplemental Disclosures of Cash Flow Information</b>      |                              |              |
| Cash paid during the period for                               |                              |              |
| Interest  | \$ 1,754                     | \$ 2,083     |
| Income taxes  | \$ 125                       | \$ 200       |
| <b>Supplemental Schedule of Non-Cash Operating Activities</b> |                              |              |
| Issuance of common stock for payment of compensation          | \$ 182                       | \$ 249       |
| Transfer from loans to OREO                                   | \$ 739                       | \$ 371       |

*See notes to Consolidated Financial Statements*

## **NOTE 1 – BASIS OF PRESENTATION**

General - The consolidated financial statements of The Community Financial Corporation (the “Company”) and its wholly owned subsidiary, Community Bank of the Chesapeake (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, 2013 have been derived from audited financial statements. There have been no significant changes to the Company’s accounting policies as disclosed in the 2013 Annual Report. The results of operations for the three months ended March 31, 2014 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 2014 presentation.

These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company’s 2013 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 of 2013.

## **NOTE 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 and Fredericksburg, 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.

## **NOTE 3 – 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. The Company's income tax returns for the past three years are subject to examinations by tax authorities, and may change upon examination.

**NOTE 4 - ACCUMULATED OTHER COMPREHENSIVE INCOME**

The following table presents the components of comprehensive loss for the three months ended March 31, 2014 and 2013. The Company's comprehensive losses were solely for securities for the three months ended March 31, 2014 and 2013.

| (dollars in thousands)                              | Three Months Ended March 31,<br>2014 |               |               | Three Months Ended March 31,<br>2013 |               |               |
|---|--------------------------------------|---------------|---------------|--------------------------------------|---------------|---------------|
|   | Before<br>Tax                        | Tax<br>Effect | Net of<br>Tax | Before<br>Tax                        | Tax<br>Effect | Net of<br>Tax |
| Net unrealized holding losses arising during period | \$ (116 )                            | \$ (39 )      | \$ (77 )      | \$ (115 )                            | \$ (40 )      | \$ (75 )      |
| Reclassification adjustments                        | (8 )                                 | (3 )          | (5 )          | -                                    | -             | -             |
| Other comprehensive loss                            | \$ (124 )                            | \$ (42 )      | \$ (82 )      | \$ (115 )                            | \$ (40 )      | \$ (75 )      |

The following table presents the changes in each component of accumulated other comprehensive income, net of tax, for the three months ended March 31, 2014 and 2013.

| (dollars in thousands)   | Three Months<br>Ended<br>March 31, 2014 | Three Months<br>Ended<br>March 31, 2013 |
|--|---|---|
|  | Net Unrealized Gains<br>And Losses      | Net Unrealized Gains<br>And Losses      |
| Beginning of period  | \$ (1,057 )                             | \$ 139 )                                |
| Other comprehensive loss before reclassifications                | (77 )                                   | (75 )                                   |
| Amounts reclassified from accumulated other comprehensive income | (5 )                                    | - )                                     |
| Net other comprehensive loss                                     | (82 )                                   | (75 )                                   |
| End of period  | \$ (1,139 )                             | \$ 64 )                                 |

**NOTE 5 - EARNINGS PER 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 March 31, 2014 and 2013, there were 87,435 and 101,549 options, respectively, which were excluded from the calculation as their effect would be anti-dilutive, because the exercise price of the options were greater than the average market price of the common shares. Basic and diluted earnings per share have been computed based on weighted-average common and common equivalent shares outstanding as follows:

| (dollars in thousands)                                 | Three Months Ended |           |
|--|--------------------|-----------|
|  | March 31,          |           |
|  | 2014               | 2013      |
| Net Income   | \$1,721            | \$1,718   |
| Less: dividends paid and accrued on preferred stock    | (50 )              | (50 )     |
| Net income available to common shareholders            | \$1,671            | \$1,668   |
| <br>   |                    |           |
| Average number of common shares outstanding            | 4,642,064          | 3,053,204 |
| Effect of dilutive options                             | 16,465             | 21,283    |
| Average number of shares used to calculate diluted EPS | 4,658,529          | 3,074,487 |

**NOTE 6 - STOCK-BASED COMPENSATION**

The Company has stock-based incentive arrangements to attract and retain key personnel. In May 2005, the 2005 Equity Compensation Plan (the "Plan") was approved by 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 schedule, if applicable, and the probability of achieving the goals.

Stock-based compensation expense totaled \$136,000 and \$134,000 for the three months ended March 31, 2014 and 2013, respectively, which consisted of grants of restricted stock and restricted stock units. Stock-based compensation for the three months ended March 31, 2013 included director compensation of \$3,000 for stock granted in lieu of cash compensation. All outstanding options were 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 March 31, 2014 and December 31, 2013.

| (dollars in thousands, except per share amounts) | 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, 2014                   | 159,517  | \$ 20.12                                 | \$ 347                          |   |
| Exercised  | (5,290 ) | 15.89                                    | 26                              |   |
| Outstanding at March 31, 2014                    | 154,227  | \$ 20.26                                 | \$ 341                          | 0.7   |
| Exercisable at March 31, 2014                    | 154,227  | \$ 20.26                                 | \$ 341                          | 0.7   |
|  |          | Weighted                                 |                                 | Weighted-Average  |

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| (dollars in thousands, except per share amounts) | Shares    | Average Exercise Price | Aggregate Intrinsic Value | Contractual Life Remaining In Years |
|--|-----------|------------------------|---------------------------|-------------------------------------|
| Outstanding at January 1, 2013                   | 236,059   | \$ 18.49               | \$ 164                    |                                     |
| Exercised  | (55,672 ) | 13.16                  | 310                       |                                     |
| Forfeited  | (20,870 ) | 20.27                  |                           |                                     |
| Outstanding at December 31, 2013                 | 159,517   | \$ 20.12               | \$ 347                    | 1.0                                 |
| Exercisable at December 31, 2013                 | 159,517   | \$ 20.12               | \$ 347                    | 1.0                                 |

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

| Shares Outstanding<br>March 31, 2014 | Weighted Average<br>Remaining Contractual Life | Weighted Average<br>Exercise Price |
|--------------------------------------|--|------------------------------------|
| 66,792                               | 1 years  | \$ 15.89                           |
| 66,224                               | 2 years  | 22.29                              |
| 21,211                               | 4 years  | 27.70                              |
| 154,227                              |  | \$ 20.26                           |



The aggregate intrinsic value of outstanding stock options and exercisable stock options was \$341,000 and \$347,000 at March 31, 2014 and December 31, 2013, respectively. Aggregate intrinsic value represents the difference between the Company's closing stock price on the last trading day of the period, which was \$21.00 and \$20.71 per share at March 31, 2014 and December 31, 2013, respectively, and the exercise price multiplied by the number of in the money options outstanding.

The Company has outstanding restricted stock and stock units granted in accordance with the Plan. The vesting period for granted restricted stock is between three and five years. As of March 31, 2014, unrecognized stock compensation expense was \$573,000. The following tables summarize the unvested restricted stock awards and units outstanding at March 31, 2014 and December 31, 2013, respectively.

|                              | Restricted Stock |  | Restricted Stock Units |            |
|------------------------------|------------------|--|------------------------|------------|
|                              | Number of Shares | Weighted Average Grant Date Fair Value | Number of Units        | Fair Value |
| Nonvested at January 1, 2014 | 16,832           | \$ 17.86                               | 4,210                  | \$ 20.71   |
| Granted                      | 33,460           | 21.35                                  | -                      | -          |
| Vested                       | (17,105)         | 15.39                                  | (2,105 )               | 20.29      |
| Nonvested at March 31, 2014  | 33,187           | \$ 20.90                               | 2,105                  | \$ 21.00   |

|                                | Restricted Stock |  | Restricted Stock Units |            |
|--------------------------------|------------------|--|------------------------|------------|
|                                | Number of Shares | Weighted Average Grant Date Fair Value | Number of Units        | Fair Value |
| Nonvested at January 1, 2013   | 23,569           | \$ 15.64                               | 5,211                  | \$ 15.98   |
| Granted                        | 13,656           | 18.00                                  | 2,105                  | 20.71      |
| Vested                         | (20,393)         | 18.79                                  | (3,106 )               | 15.98      |
| Nonvested at December 31, 2013 | 16,832           | \$ 17.86                               | 4,210                  | \$ 20.71   |

#### **NOTE 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 \$5.0 million 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 \$5.2 million 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 \$7.0 million 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 \$7.2 million 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.

## NOTE 8 - PREFERRED STOCK

### *Small Business Lending Fund Preferred Stock*

On September 22, 2011, 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 to the Department of the Treasury for \$20.0 million under the Small Business Lending Fund program.

The Series C Preferred Stock receives non-cumulative dividends, payable quarterly. The dividend rate fluctuates quarterly 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. 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 Department of the Treasury, 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 regulatory approval. The Company is permitted to repay its SBLF funding in increments of 25% or \$5.0 million, subject to regulatory approval.

## NOTE 9 - OTHER REAL ESTATE OWNED ("OREO")

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

| Three Months Ended | Year Ended   |
|--------------------|--------------|
|                    | December 31, |

| (dollars in thousands)           | 2014     | 2013     | 2013     |
|----------------------------------|----------|----------|----------|
| Balance at beginning of year     | \$ 6,797 | \$ 6,891 | \$ 6,891 |
| Additions of underlying property | 739      | 372      | 1,853    |
| Disposals of underlying property | -        | -        | (1,346 ) |
| Valuation allowance              | (82 )    | (311 )   | (601 )   |
| Balance at end of period         | \$ 7,454 | \$ 6,952 | \$ 6,797 |

During the three months ended March 31, 2014 additions of \$739,000 consisted of a residential property of \$99,000 and a commercial building of \$640,000 compared to \$372,000 of additions for a residential property for the three months ended March 31, 2013. There were no disposals of OREO during the three months ended March 31, 2014 and 2013, respectively. Additions were offset by valuation allowances of \$82,000 and \$311,000 to adjust properties to current appraised values for the three months ended March 31, 2014 and 2013, respectively. 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.

Expenses applicable to OREO assets include the following.

|                        | Three Months Ended March 31, |        |
|------------------------|------------------------------|--------|
| (dollars in thousands) | 2014                         | 2013   |
| Valuation allowance    | \$ 82                        | \$ 311 |
| Operating expenses     | 47                           | 40     |
|                        | \$ 129                       | \$ 351 |

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**NOTE 10 – SECURITIES**

| (dollars in thousands)                                   | March 31, 2014    |                              | Gross<br>Unrealized<br>Losses | Estimated<br>Fair Value |
|--|-------------------|------------------------------|-------------------------------|-------------------------|
|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains |                               |                         |
| Securities available for sale (AFS)                      |                   |                              |                               |                         |
| Asset-backed securities issued by GSEs                   |                   |                              |                               |                         |
| Residential Mortgage Backed Securities ("MBS")           | \$48              | \$ 5                         | \$ -                          | \$ 53                   |
| Residential Collateralized Mortgage Obligations ("CMOs") | 40,733            | 24                           | 1,581                         | 39,176                  |
| Corporate equity securities                              | 37                | 5                            | -                             | 42                      |
| Bond mutual funds  | 4,130             | 45                           | -                             | 4,175                   |
| Total securities available for sale                      | \$44,948          | \$ 79                        | \$ 1,581                      | \$ 43,446               |
| Securities held to maturity (HTM)                        |                   |                              |                               |                         |
| Asset-backed securities issued by GSEs:                  |                   |                              |                               |                         |
| Residential MBS  | \$21,983          | \$ 690                       | \$ 141                        | \$ 22,532               |
| Residential CMOs   | 55,576            | 247                          | 917                           | 54,906                  |
| Asset-backed securities issued by Others:                |                   |                              |                               |                         |
| Residential CMOs   | 2,593             | 129                          | 116                           | 2,606                   |
| Total debt securities held to maturity                   | 80,152            | 1,066                        | 1,174                         | 80,044                  |
| U.S. government obligations                              | 750               | -                            | -                             | 750                     |
| Total securities held to maturity                        | \$80,902          | \$ 1,066                     | \$ 1,174                      | \$ 80,794               |

| (dollars in thousands)                    | December 31, 2013 |                              | Gross Unrealized<br>Losses | Estimated<br>Fair Value |
|---|-------------------|------------------------------|----------------------------|-------------------------|
|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains |                            |                         |
| Securities available for sale (AFS)       |                   |                              |                            |                         |
| Asset-backed securities issued by GSEs    |                   |                              |                            |                         |
| Residential MBS                           | \$176             | \$ 17                        | \$ -                       | \$ 193                  |
| Residential CMOs                          | 45,299            | 63                           | 1,479                      | 43,883                  |
| Corporate equity securities               | 37                | 4                            | -                          | 41                      |
| Bond mutual funds                         | 4,108             | 22                           | -                          | 4,130                   |
| Total securities available for sale       | \$49,620          | \$ 106                       | \$ 1,479                   | \$ 48,247               |
| Securities held to maturity (HTM)         |                   |                              |                            |                         |
| Asset-backed securities issued by GSEs:   |                   |                              |                            |                         |
| Residential MBS                           | \$22,662          | \$ 625                       | \$ 214                     | \$ 23,073               |
| Residential CMOs                          | 59,869            | 265                          | 943                        | 59,191                  |
| Asset-backed securities issued by Others: |                   |                              |                            |                         |
| Residential CMOs                          | 3,120             | 114                          | 157                        | 3,077                   |

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|  |          |          |          |           |
|--|----------|----------|----------|-----------|
| Total debt securities held to maturity | 85,651   | 1,004    | 1,314    | 85,341    |
| U.S. government obligations            | 750      | -        | -        | 750       |
| Total securities held to maturity      | \$86,401 | \$ 1,004 | \$ 1,314 | \$ 86,091 |

At March 31, 2014, certain asset-backed securities with an amortized cost of \$13.7 million were pledged to secure certain deposits. At March 31, 2014, asset-backed securities with an amortized cost of \$2.6 million were pledged as collateral for advances from the Federal Home Loan Bank (“FHLB”) of Atlanta.

At March 31, 2014, 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 4.44 years and an average duration of 4.04 years and are guaranteed by their issuer as to credit risk. HTM asset-backed securities issued by GSEs had an average life of 4.51 years and an average duration of 4.19 years and are guaranteed by their issuer as to credit risk.

At December 31, 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 4.45 years and average duration of 4.45 years and are guaranteed by their issuer as to credit risk. HTM asset-backed securities issued by GSEs had an average life of 4.49 years and average duration of 4.16 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 until recovery of the market value which may be the 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 months ended March 31, 2014 and 2013. 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 March 31, 2014, the CMO issue had a par value of \$836,000, a market fair value of \$592,000 and a carrying value of \$463,000.

During the three months ended March 31, 2014, the Company recognized net gains on the sale of securities of \$24,000. The Company sold five AFS securities with a carrying value of \$2.1 million and ten HTM securities with aggregate carrying values of \$3.2 million, recognizing gains of \$8,000 and \$16,000, respectively. The sale of HTM securities was permitted under ASC 320 "Investments - Debt and Equity Securities." ASC 320 permits the sale of HTM securities for certain changes in circumstances. The Company sold the HTM positions utilizing the safe harbor rule that allows for the sale of HTM securities that have principal payments paid down to less than 15% of original purchased par. ASC 320 10-25-15 indicates that a sale of a debt security after a substantial portion of the principal has been collected is equivalent to holding the security to maturity. There were no sales of AFS and HTM securities during the three months ended March 31, 2013.

### *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 March 31, 2014 were as follows:



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| March 31, 2014<br><br>(dollars in thousands) | Less Than 12<br>Months |            | More Than 12<br>Months |            | Total    |            |
|--|------------------------|------------|------------------------|------------|----------|------------|
|  | Fair                   | Unrealized | Fair                   | Unrealized | Fair     | Unrealized |
|  | Value                  | Loss       | Value                  | Loss       | Value    | Losses     |
| Asset-backed securities issued by GSEs       | \$19,256               | \$ 933     | \$11,603               | \$ 648     | \$30,859 | \$ 1,581   |

At March 31, 2014, the AFS investment portfolio had an estimated fair value of \$43.4 million, of which \$30.9 million or 71% of the securities had some unrealized losses from their amortized cost. The securities with unrealized losses are predominantly CMOs 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 \$1.6 million or 3.88% of the portfolio amortized cost of \$40.8 million. AFS asset-backed securities issued by GSEs with unrealized losses had an average life of 4.07 years and an average duration of 4.55 years. We believe that the securities will either recover in market value or be paid off as agreed.

| December 31, 2013<br><br>(dollars in thousands) | Less Than 12<br>Months                 |                    | More Than 12<br>Months |                    | Total         |                      |
|---|--|--------------------|------------------------|--------------------|---------------|----------------------|
|   | Fair<br>Value                          | Unrealized<br>Loss | Fair<br>Value          | Unrealized<br>Loss | Fair<br>Value | Unrealized<br>Losses |
|   | Asset-backed securities issued by GSEs | \$28,669           | \$ 1,016               | \$8,352            | \$ 463        | \$37,021             |

At December 31, 2013, the AFS investment portfolio had an estimated fair value of \$48.2 million, of which \$37.0 million or 77% of the securities had some unrealized losses from their amortized cost. The securities with unrealized losses are predominantly CMOs 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 \$1.5 million or 3.25% of the portfolio amortized cost of \$45.5 million. AFS asset-backed securities issued by GSEs with unrealized losses had an average life of 4.71 years and an average duration of 4.25 years.

### *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 March 31, 2014 are as follows:

| March 31, 2014<br><br>(dollars in thousands) | Less Than 12<br>Months                 |                    | More Than 12<br>Months |                    | Total         |                      |
|--|--|--------------------|------------------------|--------------------|---------------|----------------------|
|  | Fair<br>Value                          | Unrealized<br>Loss | Fair<br>Value          | Unrealized<br>Loss | Fair<br>Value | Unrealized<br>Losses |
|  | Asset-backed securities issued by GSEs | \$18,660           | \$ 590                 | \$15,184           | \$ 469        | \$33,844             |
| Asset-backed securities issued by other      | -                                      | -                  | 1,915                  | 115                | 1,915         | 115                  |
|  | \$18,660                               | \$ 590             | \$17,099               | \$ 584             | \$35,759      | \$ 1,174             |

At March 31, 2014, the HTM investment portfolio had an estimated fair value of \$80.0 million, of which \$35.8 million or 44%, of the securities had some unrealized losses from their amortized cost. Of these securities, \$33.8 million or 95%, were asset-backed securities issued by GSEs and the remaining \$2.0 million 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 \$1.1 million or 1.36% of the portfolio amortized cost of \$77.6 million. HTM asset-backed securities issued by GSEs with unrealized losses had an average life of 5.41 years and an average duration of 4.92 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 \$116,000 or 4.47% of the portfolio amortized cost of \$2.6 million. HTM asset-backed securities issued by others with unrealized losses have an average life of 4.03 years and an average duration of 3.47 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, 2013 are as follows:

| December 31, 2013<br><br>(dollars in thousands) | Less Than 12<br>Months                 |                    | More Than 12<br>Months |                    | Total         |                      |
|---|--|--------------------|------------------------|--------------------|---------------|----------------------|
|   | Fair<br>Value                          | Unrealized<br>Loss | Fair<br>Value          | Unrealized<br>Loss | Fair<br>Value | Unrealized<br>Losses |
|   | Asset-backed securities issued by GSEs | \$36,705           | \$ 1,000               | \$6,832            | \$ 157        | \$43,537             |
| Asset-backed securities issued by other         | 97                                     | -                  | 2,399                  | 157                | 2,496         | 157                  |
|   | \$36,802                               | \$ 1,000           | \$9,231                | \$ 314             | \$46,033      | \$ 1,314             |

At December 31, 2013, the HTM investment portfolio had an estimated fair value of \$86.1 million, of which \$46.0 million, or 53% of the securities, had some unrealized losses from their amortized cost. Of these securities, \$43.5 million, or 95%, are mortgage-backed securities issued by GSEs and the remaining \$2.5 million, 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 \$1.2 million or 1.40% of the portfolio amortized cost of \$82.5 million. HTM asset-backed securities issued by GSEs with unrealized losses had an average life of 5.24 years and an average duration of 4.80 years.

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 \$157,000, or 5.02% of the portfolio amortized cost of \$3.1 million. HTM asset-backed securities issued by others with unrealized losses had an average life of 5.17 years and an average duration of 4.73 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 March 31, 2014 and December 31, 2013 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.

| March 31, 2014         |           | December 31, 2013 |           |
|------------------------|-----------|-------------------|-----------|
| Credit Rating          | Amount    | Credit Rating     | Amount    |
| (dollars in thousands) |           |                   |           |
| AAA                    | \$116,789 | AAA               | \$126,607 |
| BBB                    | 543       | BBB               | 584       |
| BBB-                   | -         | BBB-              | 98        |
| BB                     | 791       | BB                | 813       |

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|       |           |       |           |
|-------|-----------|-------|-----------|
| B+    | -         | B+    | 66        |
| CCC+  | 795       | CCC+  | 1,092     |
| CCC   | 463       | CCC   | 467       |
| Total | \$119,381 | Total | \$129,727 |

**NOTE 11 - LOANS**

Loans consist of the following:

| (dollars in thousands)            | March 31, 2014 | December 31, 2013 |
|-----------------------------------|----------------|-------------------|
| Commercial real estate            | \$ 504,564     | \$ 476,648        |
| Residential first mortgages       | 158,080        | 159,147           |
| Construction and land development | 30,611         | 32,001            |
| Home equity and second mortgages  | 21,699         | 21,692            |
| Commercial loans                  | 80,297         | 94,176            |
| Consumer loans                    | 691            | 838               |
| Commercial equipment              | 23,741         | 23,738            |
|                                   | 819,683        | 808,240           |
| Less:                             |                |                   |
| Deferred loan fees                | 1,002          | 972               |
| Allowance for loan loss           | 8,197          | 8,138             |
|                                   | 9,199          | 9,110             |
|                                   | \$ 810,484     | \$ 799,130        |

At March 31, 2014, the Bank's allowance for loan losses totaled \$8.2 million, or 1.00% of loan balances, as compared to \$8.1 million, or 1.01% of loan balances, at December 31, 2013. 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.

***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 March 31, 2014 and December 31, 2013. 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. 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 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 March 31, 2014 and December 31, 2013 were as follows:

| (dollars in thousands)            | March 31, 2014                         |                    | Non-accrual<br>Only Loans | Number<br>of Loans | Total<br>Non-accrual<br>Loans | Total<br>Number<br>of Loans |
|-----------------------------------|--|--------------------|---------------------------|--------------------|-------------------------------|-----------------------------|
|                                   | 90 or<br>Greater<br>Days<br>Delinquent | Number<br>of Loans |                           |                    |                               |                             |
| Commercial real estate            | \$5,056                                | 13                 | \$ 3,662                  | 2                  | \$ 8,718                      | 15                          |
| Residential first mortgages       | 1,015                                  | 4                  | 556                       | 3                  | 1,571                         | 7                           |
| Construction and land development | 3,627                                  | 2                  | -                         | -                  | 3,627                         | 2                           |
| Home equity and second mortgages  | 205                                    | 4                  | -                         | -                  | 205                           | 4                           |
| Commercial loans                  | 2,502                                  | 9                  | -                         | -                  | 2,502                         | 9                           |
| Consumer loans                    | -                                      | -                  | 15                        | 1                  | 15                            | 1                           |
| Commercial equipment              | 239                                    | 4                  | -                         | -                  | 239                           | 4                           |
|                                   | \$12,644                               | 36                 | \$ 4,233                  | 6                  | \$ 16,877                     | 42                          |

| (dollars in thousands)            | December 31, 2013                      |                    | Non-accrual<br>Only Loans | Number<br>of Loans | Total<br>Non-accrual<br>Loans | Total<br>Number<br>of Loans |
|-----------------------------------|--|--------------------|---------------------------|--------------------|-------------------------------|-----------------------------|
|                                   | 90 or<br>Greater<br>Days<br>Delinquent | Number<br>of Loans |                           |                    |                               |                             |
| Commercial real estate            | \$4,235                                | 10                 | \$ 3,695                  | 2                  | \$ 7,930                      | 12                          |
| Residential first mortgages       | 1,683                                  | 6                  | 562                       | 3                  | 2,245                         | 9                           |
| Construction and land development | 2,968                                  | 1                  | -                         | -                  | 2,968                         | 1                           |
| Home equity and second mortgages  | 115                                    | 3                  | -                         | -                  | 115                           | 3                           |
| Commercial loans                  | 1,935                                  | 6                  | -                         | -                  | 1,935                         | 6                           |
| Consumer loans                    | -                                      | -                  | 24                        | 1                  | 24                            | 1                           |
| Commercial equipment              | 234                                    | 2                  | -                         | -                  | 234                           | 2                           |
|                                   | \$11,170                               | 28                 | \$ 4,281                  | 6                  | \$ 15,451                     | 34                          |

The Bank categorized six performing loans totaling \$4.2 million and \$4.3 million as non-accrual only loans at March 31, 2014 and December 31, 2013, respectively. These six loans represent one well-secured commercial loan 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 March 31, 2014 and December 31, 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 and cash flow coverage. In accordance with the Company's policy, interest income is recognized on a cash basis for these loans if the loans are not impaired or there is no impairment.

Non-accrual loans on which the recognition of interest has been discontinued, which did not have a specific allowance for impairment, amounted to \$10.6 million and \$9.1 million at March 31, 2014 and December 31, 2013, respectively. Interest due but not recognized on these balances at March 31, 2014 and December 31, 2013 was \$330,000 and \$304,000, respectively. Non-accrual loans with a specific allowance for impairment on which the recognition of interest has been discontinued amounted to \$6.3 million and \$6.4 million at March 31, 2014 and December 31, 2013, respectively. Interest due but not recognized on these balances at March 31, 2014 and December 31, 2013 was \$314,000 and \$295,000, respectively.

An analysis of past due loans as of March 31, 2014 and December 31, 2013 was as follows:

| (dollars in thousands)      | March 31, 2014 |               |               |                       |           | Total<br>Past Due | Total<br>Loan<br>Receivables |
|-----------------------------|----------------|---------------|---------------|-----------------------|-----------|-------------------|------------------------------|
|                             | Current        | 31-60<br>Days | 61-89<br>Days | 90 or Greater<br>Days |           |                   |                              |
| Commercial real estate      | \$498,173      | \$1,335       | \$-           | \$ 5,056              | \$ 6,391  | \$ 504,564        |                              |
| Residential first mortgages | 156,716        | 342           | 7             | 1,015                 | 1,364     | 158,080           |                              |
| Construction and land dev.  | 26,984         | -             | -             | 3,627                 | 3,627     | 30,611            |                              |
| Home equity and second mtg. | 20,869         | 490           | 135           | 205                   | 830       | 21,699            |                              |
| Commercial loans            | 74,247         | 3,521         | 27            | 2,502                 | 6,050     | 80,297            |                              |
| Consumer loans              | 687            | -             | 4             | -                     | 4         | 691               |                              |
| Commercial equipment        | 23,409         | 79            | 14            | 239                   | 332       | 23,741            |                              |
| Total                       | \$801,085      | \$5,767       | \$ 187        | \$ 12,644             | \$ 18,598 | \$ 819,683        |                              |

| (dollars in thousands)      | December 31, 2013 |               |               |                       |           | Total<br>Past Due | Total<br>Loan<br>Receivables |
|-----------------------------|-------------------|---------------|---------------|-----------------------|-----------|-------------------|------------------------------|
|                             | Current           | 31-60<br>Days | 61-89<br>Days | 90 or Greater<br>Days |           |                   |                              |
| Commercial real estate      | \$469,182         | \$58          | \$3,173       | \$ 4,235              | \$ 7,466  | \$ 476,648        |                              |
| Residential first mortgages | 157,043           | 8             | 413           | 1,683                 | 2,104     | 159,147           |                              |
| Construction and land dev.  | 28,525            | -             | 508           | 2,968                 | 3,476     | 32,001            |                              |
| Home equity and second mtg. | 21,183            | 121           | 273           | 115                   | 509       | 21,692            |                              |
| Commercial loans            | 88,812            | 3,111         | 318           | 1,935                 | 5,364     | 94,176            |                              |
| Consumer loans              | 830               | 8             | -             | -                     | 8         | 838               |                              |
| Commercial equipment        | 23,435            | 26            | 43            | 234                   | 303       | 23,738            |                              |
| Total                       | \$789,010         | \$3,332       | \$4,728       | \$ 11,170             | \$ 19,230 | \$ 808,240        |                              |

There were no loans greater than 90 days still accruing interest at March 31, 2014 and at December 31, 2013.

#### ***Impaired Loans and Troubled Debt Restructures ("TDRs")***

Impaired loans, including TDRs, at March 31, 2014 and 2013 and at December 31, 2013 were as follows:

| (dollars in thousands) | March 31, 2014                                |  |   |  | Total<br>Recorded<br>Investment | Related<br>Allowance | Three Month<br>Average<br>Recorded<br>Investment | Three Month<br>Interest<br>Income<br>Recognized |
|------------------------|---|--|---|--|---------------------------------|----------------------|--|---|
|                        | Unpaid<br>Contractual<br>Principal<br>Balance | Recorded<br>Investment<br>With No<br>Allowance | Recorded<br>Investment<br>With<br>Allowance |  |                                 |                      |  |   |

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|                             |          |           |           |           |          |           |        |
|-----------------------------|----------|-----------|-----------|-----------|----------|-----------|--------|
| Commercial real estate      | \$19,389 | \$ 15,216 | \$ 4,144  | \$ 19,360 | \$ 332   | \$ 19,405 | \$ 180 |
| Residential first mortgages | 3,572    | 2,705     | 867       | 3,572     | 98       | 3,597     | 37     |
| Construction and land dev.  | 5,866    | 1,664     | 4,202     | 5,866     | 81       | 5,818     | 27     |
| Home equity and second mtg. | 381      | 308       | 73        | 381       | 33       | 333       | 1      |
| Commercial loans            | 6,800    | 2,681     | 4,118     | 6,799     | 763      | 6,780     | 62     |
| Consumer loans              | 15       | 15        | -         | 15        | -        | 17        | -      |
| Commercial equipment        | 339      | 227       | 80        | 307       | 80       | 310       | 3      |
| Total                       | \$36,362 | \$ 22,816 | \$ 13,484 | \$ 36,300 | \$ 1,387 | \$ 36,260 | \$ 310 |

| (dollars in thousands)      | December 31, 2013                    |                                       |                                    |                           |                   |                             |                            |
|-----------------------------|--------------------------------------|---------------------------------------|------------------------------------|---------------------------|-------------------|-----------------------------|----------------------------|
|                             | 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      | \$18,342                             | \$ 14,274                             | \$ 3,899                           | \$ 18,173                 | \$ 372            | \$ 18,473                   | \$ 770                     |
| Residential first mortgages | 3,401                                | 2,695                                 | 706                                | 3,401                     | 171               | 3,392                       | 125                        |
| Construction and land dev.  | 5,666                                | 1,489                                 | 4,177                              | 5,666                     | 55                | 5,386                       | 252                        |
| Home equity and second mtg. | 207                                  | 207                                   | -                                  | 207                       | -                 | 297                         | 12                         |
| Commercial loans            | 10,218                               | 9,297                                 | 921                                | 10,218                    | 304               | 10,600                      | 432                        |
| Consumer loans              | 24                                   | 24                                    | -                                  | 24                        | -                 | 39                          | 3                          |
| Commercial equipment        | 335                                  | 234                                   | 83                                 | 317                       | 83                | 367                         | 13                         |
| Total                       | \$38,193                             | \$ 28,220                             | \$ 9,786                           | \$ 38,006                 | \$ 985            | \$ 38,554                   | \$ 1,607                   |

| (dollars in thousands)      | March 31, 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 |
| Commercial real estate      | \$22,599                             | \$ 19,762                             | \$ 2,837                           | \$ 22,599                 | \$ 767            | \$ 21,640                               | \$ 251                                 |
| Residential first mortgages | 5,138                                | 4,225                                 | 913                                | 5,138                     | 444               | 5,180                                   | 52                                     |
| Construction and land dev.  | 4,627                                | 4,622                                 | -                                  | 4,622                     | -                 | 4,469                                   | 68                                     |
| Home equity and second mtg. | 483                                  | 443                                   | 40                                 | 483                       | 40                | 485                                     | 3                                      |
| Commercial loans            | 9,107                                | 8,797                                 | 310                                | 9,107                     | 308               | 8,941                                   | 78                                     |
| Consumer loans              | 47                                   | 47                                    | -                                  | 47                        | -                 | 49                                      | 1                                      |
| Commercial equipment        | 239                                  | 195                                   | 25                                 | 220                       | 25                | 240                                     | -                                      |
| Total                       | \$42,240                             | \$ 38,091                             | \$ 4,125                           | \$ 42,216                 | \$ 1,584          | \$ 41,004                               | \$ 453                                 |

TDRs, included in the impaired loan schedules above, as of March 31, 2014 and December 31, 2013 were as follows:

| (dollars in thousands)      | March 31, 2014 |                 | December 31, 2013 |                 |
|-----------------------------|----------------|-----------------|-------------------|-----------------|
|                             | Dollars        | Number of Loans | Dollars           | Number of Loans |
| Commercial real estate      | \$ 3,129       | 8               | \$ 3,141          | 8               |
| Residential first mortgages | 2,001          | 5               | 1,485             | 4               |
| Commercial equipment        | 66             | 1               | 67                | 1               |
| Total                       | \$ 5,196       | 14              | \$ 4,693          | 13              |

At March 31, 2014, all TDRs were performing according to the terms of their restructured agreements. At December 31, 2013, one TDR loan of \$329,000 was over 90 days past due. Except as noted, all TDRs were performing according to the terms of their restructured agreements. The Bank had specific reserves in the allowance for loan losses of \$154,000 on three TDRs at March 31, 2014 and \$79,000 on two TDRs totaling \$1.8 million at December 31, 2013. Interest income in the amount of \$62,000 and \$214,000 was recognized on these loans for the three months ended March 31, 2014 and the year ended December 31, 2013, respectively.

The Bank added one TDR of \$526,000, a residential first mortgage, during the three months ended March 31, 2014. There were no dispositions of TDRs during the first quarter of 2014. TDR activity for the year ended December 31, 2013 included three additions to the number of TDRs. During the year ended December 31, 2013, the Bank entered into one TDR for \$77,000 for a residential first mortgage, one TDR for \$60,000 for a commercial real estate mortgage and one TDR for \$67,000 for a commercial equipment loan. There were no other TDR transactions for the year ended December 31, 2013.

### *Allowance for Loan Losses*

The following tables detail activity in the allowance for loan losses at and for the three months ended March 31, 2014 and 2013, respectively, and for the year ended December 31, 2013 and loan receivable balances at March 31, 2014 and 2013, respectively, and at December 31, 2013. 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.

| (dollars in thousands)                           | Commercial<br>Real Estate | Residential<br>First<br>Mortgage | Construction<br>and Land<br>Development | Home<br>Equity and<br>Second Mtg. | Commercial<br>Loans | Consumer<br>Loans | Commercial<br>Equipment | Total      |
|--|---------------------------|----------------------------------|---|-----------------------------------|---------------------|-------------------|-------------------------|------------|
| At and For the Three Months Ended March 31, 2014 |                           |                                  |   |                                   |                     |                   |                         |            |
| Allowance for loan losses:                       |                           |                                  |   |                                   |                     |                   |                         |            |
| Balance at January 1,                            | \$ 3,525                  | \$ 1,401                         | \$ 584                                  | \$ 249                            | \$ 1,916            | \$ 10             | \$ 453                  | \$ 8,138   |
| Charge-offs                                      | (21 )                     | (94 )                            | -                                       | -                                 | (35 )               | -                 | -                       | (150 )     |
| Recoveries                                       | 5                         | -                                | -                                       | -                                 | 1                   | -                 | -                       | 6          |
| Provisions                                       | 101                       | (35 )                            | (23 )                                   | 91                                | 233                 | (4 )              | (160 )                  | 203        |
| Balance at March 31,                             | \$ 3,610                  | \$ 1,272                         | \$ 561                                  | \$ 340                            | \$ 2,115            | \$ 6              | \$ 293                  | \$ 8,197   |
| Ending balance:                                  |                           |                                  |   |                                   |                     |                   |                         |            |
| individually evaluated for impairment            | \$ 332                    | \$ 98                            | \$ 81                                   | \$ 33                             | \$ 763              | \$ -              | \$ 80                   | \$ 1,387   |
| Ending balance:                                  |                           |                                  |   |                                   |                     |                   |                         |            |
| collectively evaluated for impairment            | \$ 3,278                  | \$ 1,174                         | \$ 480                                  | \$ 307                            | \$ 1,352            | \$ 6              | \$ 213                  | \$ 6,810   |
| Loan receivables:                                |                           |                                  |   |                                   |                     |                   |                         |            |
| Ending balance                                   | \$ 504,564                | \$ 158,080                       | \$ 30,611                               | \$ 21,699                         | \$ 80,297           | \$ 691            | \$ 23,741               | \$ 819,683 |
| Ending balance:                                  |                           |                                  |   |                                   |                     |                   |                         |            |
| individually evaluated for impairment            | \$ 19,360                 | \$ 3,572                         | \$ 5,866                                | \$ 381                            | \$ 6,799            | \$ 15             | \$ 307                  | \$ 36,300  |
| Ending balance:                                  |                           |                                  |   |                                   |                     |                   |                         |            |
| collectively evaluated for impairment            | \$ 485,204                | \$ 154,508                       | \$ 24,745                               | \$ 21,318                         | \$ 73,498           | \$ 676            | \$ 23,434               | \$ 783,383 |
| (dollars in thousands)                           |                           |                                  |   |                                   |                     |                   |                         | Total      |



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|  |                           |                                  |   |                                   |                     |                   |                         |  |
|--|---------------------------|----------------------------------|---|-----------------------------------|---------------------|-------------------|-------------------------|--|
|  | Commercial<br>Real Estate | Residential<br>First<br>Mortgage | Construction<br>and Land<br>Development | Home<br>Equity and<br>Second Mtg. | Commercial<br>Loans | Consumer<br>Loans | Commercial<br>Equipment |  |
|--|---------------------------|----------------------------------|---|-----------------------------------|---------------------|-------------------|-------------------------|--|

At and For the Year Ended December 31, 2013

Allowance for loan

losses:

|   |            |            |           |           |           |        |           |            |
|---|------------|------------|-----------|-----------|-----------|--------|-----------|------------|
| Balance at January 1,                                       | \$ 4,092   | \$ 1,083   | \$ 533    | \$ 280    | \$ 1,948  | \$ 19  | \$ 292    | \$ 8,247   |
| Charge-offs   | (140 )     | (348 )     | (36 )     | (111 )    | (480 )    | (12 )  | (35 )     | (1,162 )   |
| Recoveries  | -          | 11         | 1         | 17        | 23        | 3      | 58        | 113        |
| Provisions  | (427 )     | 655        | 86        | 63        | 425       | -      | 138       | 940        |
| Balance at December 31,                                     | \$ 3,525   | \$ 1,401   | \$ 584    | \$ 249    | \$ 1,916  | \$ 10  | \$ 453    | \$ 8,138   |
| Ending balance:   |            |            |           |           |           |        |           |            |
| individually evaluated<br>for impairment                    | \$ 372     | \$ 171     | \$ 55     | \$ -      | \$ 304    | \$ -   | \$ 83     | \$ 985     |
| Ending balance:<br>collectively evaluated for<br>impairment | \$ 3,153   | \$ 1,230   | \$ 529    | \$ 249    | \$ 1,612  | \$ 10  | \$ 370    | \$ 7,153   |
| Loan receivables:   |            |            |           |           |           |        |           |            |
| Ending balance  | \$ 476,648 | \$ 159,147 | \$ 32,001 | \$ 21,692 | \$ 94,176 | \$ 838 | \$ 23,738 | \$ 808,240 |
| Ending balance:<br>individually evaluated<br>for impairment | \$ 18,173  | \$ 3,401   | \$ 5,666  | \$ 207    | \$ 10,218 | \$ 24  | \$ 317    | \$ 38,006  |
| Ending balance:<br>collectively evaluated for<br>impairment | \$ 458,475 | \$ 155,746 | \$ 26,335 | \$ 21,485 | \$ 83,958 | \$ 814 | \$ 23,421 | \$ 770,234 |

| (dollars in thousands)                              | Commercial<br>Real Estate | Residential<br>First<br>Mortgage | Construction<br>and Land<br>Development | Home<br>Equity and<br>Second Mtg. | Commercial<br>Loans | Consumer<br>Loans | Commercial<br>Equipment | Total     |
|---|---------------------------|----------------------------------|---|-----------------------------------|---------------------|-------------------|-------------------------|-----------|
| At and For the Three Months Ended March 31,<br>2013 |                           |                                  |   |                                   |                     |                   |                         |           |
| Allowance for loan<br>losses:                       |                           |                                  |   |                                   |                     |                   |                         |           |
| Balance at January 1,                               | \$4,092                   | \$1,083                          | \$533                                   | \$280                             | \$1,948             | \$19              | \$292                   | \$8,247   |
| Charge-offs   | -                         | (59)                             | (36)                                    | -                                 | -                   | (9)               | -                       | (104)     |
| Recoveries  | -                         | 1                                | -                                       | -                                 | -                   | 1                 | 50                      | 52        |
| Provisions  | (552)                     | 960                              | -                                       | 38                                | (124)               | 6                 | (173)                   | 155       |
| Balance at March 31,                                | \$3,540                   | \$1,985                          | \$497                                   | \$318                             | \$1,824             | \$17              | \$169                   | \$8,350   |
| Ending balance:                                     |                           |                                  |   |                                   |                     |                   |                         |           |
| individually evaluated<br>for impairment            | \$767                     | \$444                            | \$-                                     | \$40                              | \$308               | \$-               | \$25                    | \$1,584   |
| Ending balance:                                     |                           |                                  |   |                                   |                     |                   |                         |           |
| collectively evaluated<br>for impairment            | \$2,773                   | \$1,541                          | \$497                                   | \$278                             | \$1,516             | \$17              | \$144                   | \$6,766   |
| Loan receivables:                                   |                           |                                  |   |                                   |                     |                   |                         |           |
| Ending balance                                      | \$417,405                 | \$169,089                        | \$31,063                                | \$21,579                          | \$88,045            | \$1,023           | \$15,728                | \$743,932 |
| Ending balance:                                     |                           |                                  |   |                                   |                     |                   |                         |           |
| individually evaluated<br>for impairment            | \$22,599                  | \$5,138                          | \$4,622                                 | \$483                             | \$9,107             | \$47              | \$220                   | \$42,216  |
| Ending balance:                                     |                           |                                  |   |                                   |                     |                   |                         |           |
| collectively evaluated<br>for impairment            | \$394,806                 | \$163,951                        | \$26,441                                | \$21,096                          | \$78,938            | \$976             | \$15,508                | \$701,716 |

### ***Credit Quality Indicators***

Credit quality indicators as of March 31, 2014 and December 31, 2013 were as follows:

### **Credit Risk Profile by Internally Assigned Grade**

| (dollars in thousands) | Commercial Real Estate |            | Construction and Land Dev. |            |
|------------------------|------------------------|------------|----------------------------|------------|
|                        | 3/31/2014              | 12/31/2013 | 3/31/2014                  | 12/31/2013 |
| Unrated                | \$67,404               | \$66,481   | \$4,296                    | \$5,782    |
| Pass                   | 410,609                | 380,124    | 17,474                     | 17,628     |
| Special mention        | 3,139                  | 7,084      | -                          | -          |
| Substandard            | 23,412                 | 22,959     | 8,841                      | 8,591      |
| Doubtful               | -                      | -          | -                          | -          |
| Loss                   | -                      | -          | -                          | -          |

Total \$ 504,564 \$ 476,648 \$ 30,611 \$ 32,001

| (dollars in thousands) | Commercial Loans |            | Commercial Equipment |            |
|------------------------|------------------|------------|----------------------|------------|
|                        | 3/31/2014        | 12/31/2013 | 3/31/2014            | 12/31/2013 |
| Unrated                | \$ 11,558        | \$ 12,873  | \$ 6,380             | \$ 6,137   |
| Pass                   | 56,218           | 67,354     | 17,281               | 17,516     |
| Special mention        | 2,607            | 402        | -                    | 2          |
| Substandard            | 9,914            | 13,547     | 80                   | 83         |
| Doubtful               | -                | -          | -                    | -          |
| Loss                   | -                | -          | -                    | -          |
| Total                  | \$ 80,297        | \$ 94,176  | \$ 23,741            | \$ 23,738  |

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**Credit Risk Profile Based on Payment Activity**

| (dollars in thousands) | Residential First Mortgages |            | Home Equity and Second Mtg. |            | Consumer Loans |            |
|------------------------|-----------------------------|------------|-----------------------------|------------|----------------|------------|
|                        | 3/31/2014                   | 12/31/2013 | 3/31/2014                   | 12/31/2013 | 3/31/2014      | 12/31/2013 |
| Performing             | \$ 157,065                  | \$ 157,464 | \$ 21,494                   | \$ 21,577  | \$ 691         | \$ 838     |
| Nonperforming          | 1,015                       | 1,683      | 205                         | 115        | -              | -          |
| Total                  | \$ 158,080                  | \$ 159,147 | \$ 21,699                   | \$ 21,692  | \$ 691         | \$ 838     |

**Summary of Total Classified Loans**

| (dollars in thousands)       | 3/31/2014 | 12/31/2013 |
|------------------------------|-----------|------------|
| By Internally Assigned Grade | \$ 42,247 | \$ 45,181  |
| By Payment Activity          | 3,306     | 2,464      |
| Total Classified             | \$ 45,553 | \$ 47,645  |

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 the loan 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.

**NOTE 12 - REGULATORY MATTERS**

The Company and the Bank are subject to various regulatory capital requirements administered by the federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of tangible and core capital (as defined in the regulations) to total adjusted assets (as defined) and of risk-based capital (as defined) to risk-weighted assets (as defined). Management believes, as of March 31, 2014 and December 31, 2013, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of March 31, 2014 and December 31, 2013, the Bank was well-capitalized under the regulatory framework for prompt corrective action (as defined). 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. There are no conditions or events that management believes have changed the Company's or the Bank's category. The Company's and the Bank's actual regulatory capital amounts and ratios are presented in the following tables.

| (dollars in thousands)                   | At March 31, 2014 |         |  |        | To be Considered Well Capitalized Under Prompt Corrective Action |         |  |
|--|-------------------|---------|--|--------|--|---------|--|
|  | Actual            |         | Required for Capital Adequacy Purposes |        |  |         |  |
| Total Capital (to risk weighted assets)  |                   |         |  |        |  |         |  |
| The Company                              | \$ 133,488        | 15.75 % | \$ 67,814                              | 8.00 % |  |         |  |
| The Bank                                 | \$ 132,424        | 15.66 % | \$ 67,668                              | 8.00 % | \$ 84,585  | 10.00 % |  |
| Tier 1 Capital (to risk weighted assets) |                   |         |  |        |  |         |  |
| The Company                              | \$ 125,271        | 14.78 % | \$ 33,907                              | 4.00 % |  |         |  |
| The Bank                                 | \$ 124,207        | 14.68 % | \$ 33,834                              | 4.00 % | \$ 50,751  | 6.00 %  |  |
| Tier 1 Capital (to average assets)       |                   |         |  |        |  |         |  |
| The Company                              | \$ 125,271        | 12.46 % | \$ 40,218                              | 4.00 % |  |         |  |
| The Bank                                 | \$ 124,207        | 12.37 % | \$ 40,158                              | 4.00 % | \$ 50,198  | 5.00 %  |  |

| (dollars in thousands)                   | At December 31, 2013 |         |  |        |  |         |
|--|----------------------|---------|--|--------|--|---------|
|  | Actual               |         | Required for Capital Adequacy Purposes |        | To be Considered Well Capitalized Under Prompt Corrective Action |         |
| Total Capital (to risk weighted assets)  |                      |         |  |        |  |         |
| The Company                              | \$ 131,936           | 15.62 % | \$ 67,561                              | 8.00 % |  |         |
| The Bank                                 | \$ 131,216           | 15.57 % | \$ 67,433                              | 8.00 % | \$ 84,292  | 10.00 % |
| Tier 1 Capital (to risk weighted assets) |                      |         |  |        |  |         |
| The Company                              | \$ 123,787           | 14.66 % | \$ 33,781                              | 4.00 % |  |         |
| The Bank                                 | \$ 123,067           | 14.60 % | \$ 33,717                              | 4.00 % | \$ 50,575  | 6.00 %  |
| Tier 1 Capital (to average assets)       |                      |         |  |        |  |         |
| The Company                              | \$ 123,787           | 12.50 % | \$ 39,597                              | 4.00 % |  |         |
| The Bank                                 | \$ 123,067           | 12.45 % | \$ 39,537                              | 4.00 % | \$ 49,422  | 5.00 %  |

In October 2013, the Company added \$27.4 million in additional common capital after commissions and related offering expenses and immediately downstreamed \$27.2 million of the net proceeds raised to the Bank.

### NOTE 13 - 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 months ended March 31, 2014 and the year ended December 31, 2013, 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 March 31, 2014 and December 31, 2013, 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 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 March 31, 2014 and December 31, 2013 measured at fair value on a recurring basis.

| (dollars in thousands)                 | March 31, 2014 |         |          |         |
|--|----------------|---------|----------|---------|
|  | Fair Value     | Level 1 | Level 2  | Level 3 |
| Description of Asset                   |                |         |          |         |
| Available for sale securities          |                |         |          |         |
| Asset-backed securities issued by GSEs |                |         |          |         |
| CMOs                                   | \$39,176       | \$ -    | \$39,176 | \$ -    |
| MBS                                    | 53             | -       | 53       | -       |
| Corporate equity securities            | 42             | -       | 42       | -       |
| Bond mutual funds                      | 4,175          | -       | 4,175    | -       |
| Total available for sale securities    | \$43,446       | \$ -    | \$43,446 | \$ -    |

| (dollars in thousands)                 | December 31, 2013 |         |          |         |
|--|-------------------|---------|----------|---------|
| Description of Asset                   | Fair Value        | Level 1 | Level 2  | Level 3 |
| Available for sale securities          |                   |         |          |         |
| Asset-backed securities issued by GSEs |                   |         |          |         |
| CMOs                                   | \$43,883          | \$ -    | \$43,883 | \$ -    |
| MBS                                    | 193               | -       | 193      | -       |
| Corporate equity securities            | 41                | -       | 41       | -       |
| Bond mutual funds                      | 4,130             | -       | 4,130    | -       |
| Total available for sale securities    | \$48,247          | \$ -    | \$48,247 | \$ -    |

***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 March 31, 2014 and December 31, 2013 are included in the tables below.

| (dollars in thousands)            | March 31, 2014 |         |          |         |
|-----------------------------------|----------------|---------|----------|---------|
| Description of Asset              | Fair Value     | Level 1 | Level 2  | Level 3 |
| Loans with impairment             |                |         |          |         |
| Commercial real estate            | \$3,812        | \$ -    | \$3,812  | \$ -    |
| Residential first mortgage        | 768            | -       | 768      | -       |
| Construction and land development | 4,122          | -       | 4,122    | -       |
| Home equity and second mortgage   | 40             | -       | 40       | -       |
| Commercial loans                  | 3,355          | -       | 3,355    | -       |
| Total loans with impairment       | \$12,097       | \$ -    | \$12,097 | \$ -    |
| Other real estate owned           | \$7,454        | \$ -    | \$7,454  | \$ -    |

| (dollars in thousands)            | December 31, 2013 |         |         |         |
|-----------------------------------|-------------------|---------|---------|---------|
| Description of Asset              | Fair Value        | Level 1 | Level 2 | Level 3 |
| Loans with impairment             |                   |         |         |         |
| Commercial real estate            | \$3,527           | \$ -    | \$3,527 | \$ -    |
| Residential first mortgage        | 535               | -       | 535     | -       |
| Construction and land development | 4,122             | -       | 4,122   | -       |
| Commercial loans                  | 617               | -       | 617     | -       |
| Total loans with impairment       | \$8,801           | \$ -    | \$8,801 | \$ -    |
| Other real estate owned           | \$6,797           | \$ -    | \$6,797 | \$ -    |

Loans with impairment have unpaid principal balances of \$13.5 million and \$9.8 million at March 31, 2014 and December 31, 2013, respectively, and include impaired loans with a specific allowance.

**NOTE 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.

## **Valuation Methodology**

*Investment securities* - 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.

*FHLB and FRB stock* - Fair values are at cost, which is the carrying value of the 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 Company's estimated fair values of financial instruments are presented in the following tables.

| March 31, 2014<br>Description of Asset<br>(dollars in thousands) | Carrying<br>Amount | Fair Value | Fair Value Measurements |            |         |
|--|--------------------|------------|-------------------------|------------|---------|
|  |                    |            | Level<br>1              | Level 2    | Level 3 |
| <b>Assets</b>  |                    |            |                         |            |         |
| Investment securities - AFS                                      | \$43,446           | \$43,446   | \$ -                    | \$ 43,446  | \$ -    |
| Investment securities - HTM                                      | 80,902             | 80,794     | 750                     | 80,044     | -       |
| FHLB and FRB Stock   | 6,380              | 6,380      | -                       | 6,380      | -       |
| Loans  | 810,484            | 805,278    | -                       | 805,278    | -       |
| OREO   | 7,454              | 7,454      | -                       | 7,454      | -       |
| <b>Liabilities</b>   |                    |            |                         |            |         |
| Savings, NOW and money market accounts                           | \$415,957          | \$415,957  | \$ -                    | \$ 415,957 | \$ -    |
| Time deposits  | 393,162            | 395,661    | -                       | 395,661    | -       |
| Long-term debt   | 75,463             | 77,029     | -                       | 77,029     | -       |
| TRUPs  | 12,000             | 7,400      | -                       | 7,400      | -       |

| December 31, 2013<br>Description of Asset<br>(dollars in thousands) | Carrying<br>Amount | Fair Value | Fair Value Measurements |            |         |
|---|--------------------|------------|-------------------------|------------|---------|
|   |                    |            | Level<br>1              | Level 2    | Level 3 |
| <b>Assets</b>   |                    |            |                         |            |         |
| Investment securities - AFS   | \$48,247           | \$48,247   | \$ -                    | \$ 48,247  | \$ -    |
| Investment securities - HTM   | 86,401             | 86,091     | 750                     | 85,341     | -       |
| FHLB and FRB Stock  | 5,593              | 6,178      | -                       | 6,178      | -       |
| Loans   | 799,130            | 793,449    | -                       | 793,449    | -       |
| OREO  | 6,797              | 6,797      | -                       | 6,797      | -       |
| <b>Liabilities</b>  |                    |            |                         |            |         |
| Savings, NOW and money market accounts                              | \$433,984          | \$433,984  | \$ -                    | \$ 433,984 | \$ -    |
| Time deposits   | 387,311            | 389,705    | -                       | 389,705    | -       |
| Long-term debt  | 70,476             | 71,960     | -                       | 71,960     | -       |
| Short term borrowings   | -                  | -          | -                       | -          | -       |
| TRUPs   | 12,000             | 2,400      | -                       | 2,400      | -       |

At March 31, 2014, the Company had outstanding loan commitments and standby letters of credit of \$20.8 million and \$16.9 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.

The fair value estimates presented herein are based on pertinent information available to management as of March 31, 2014 and December 31, 2013, 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.

#### **NOTE 15 – NEW ACCOUNTING STANDARDS**

Financial Accounting Standards Board (“FASB”) Accounting Standards Update (“ASU”) No. 2013-12 - *Definition of a Public Business Entity - An Addition to the Master Glossary*. ASU 2013-12 amends the Master Glossary of the FASB Accounting Standards Codification to include one definition of public business entity for future use in U.S. GAAP and identifies the types of business entities that are excluded from the scope of the Private Company Decision-Making Framework: A Guide for Evaluating Financial Accounting and Reporting for Private Companies. ASU 2013-12 did not have a material impact on the Company’s consolidated financial statements.

ASU No. 2014-04 - *Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40) - Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*. The amendments clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest



in the residential real estate to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate that are in the process of foreclosure according to local requirements of the applicable jurisdiction. ASU 2014-04 is effective for interim and annual periods beginning after December 15, 2014. Adoption of ASU 2014-04 is not expected to have a material impact on the Company's consolidated financial statements.

Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations

**FORWARD-LOOKING STATEMENTS**

This report contains 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, 2013 (the “Form 10-K”) 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.

**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 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 uses 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 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 Company's commercial loan portfolio is periodically reviewed by regulators and independent consultants engaged by management.

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. This analysis reviews trends by portfolio segment in charge-offs, delinquency, classified loans, loan concentrations and the rate of portfolio segment growth. Qualitative factors also include an assessment of the current regulatory environment, the quality of credit administration and loan portfolio management and national and local economic trends. Based upon this analysis a loss factor is applied to each loan category and the Bank adjusts 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 the valuation of collateral, assessing a borrower's prospects of repayment and in establishing loss factors on the general component of the allowance. Changes in loss factors have a direct impact on the amount of the provision and on net income. Errors in management's assessment of the allowance 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. 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 6 of the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2013 and the discussion under the caption "Provision for Loan Losses" below.

#### ***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. Accounting guidance indicates that 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 1 and 5 of the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2013.

### ***Other Real Estate Owned***

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 OREO, refer to Notes 1 and 8 of the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2013.

### ***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 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 12 in the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2013.

## **OVERVIEW**

Community Bank of the Chesapeake (the "Bank") is headquartered in Southern Maryland with branches located throughout the Chesapeake region. The Bank is a wholly owned subsidiary of The Community Financial Corporation. The Bank conducts business through its 11 branch locations including its main office in Waldorf, Maryland, and branch offices in Waldorf, Bryans Road, Dunkirk, Leonardtown, La Plata, Charlotte Hall, Prince Frederick, Lusby and

California, Maryland and King George, Virginia. In addition, Community Bank originates loans through loan production offices in La Plata, Leonardtown and Prince Frederick, Maryland and Fredericksburg, Virginia.

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. 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. The Bank focuses its commercial business generation efforts on targeting small and medium sized businesses with revenues between \$5.0 million and \$35.0 million. 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. The Bank recognizes that certain lending and deposit products increase the possibility of losses from credit and other risks.

During the fourth quarter of 2013, the Company began to leverage the \$27.4 million in additional capital from the October 2013 capital raise to increase interest-earning assets. The Bank successfully grew its loan portfolio \$39.3 million from \$768.9 million at September 30, 2013 to \$808.2 million at December 31, 2013. The positive loan growth trend continued during the first quarter of 2014 as the Bank increased its loan portfolio \$11.5 million to \$819.7 million by the end of the quarter. Average loan balances increased \$30.3 million from the fourth quarter of 2013 to the first quarter of 2014.

The Bank opened a commercial loan production office (“LPO”) in Fredericksburg, Virginia during August 2013. Investments in people and infrastructure made during the second half of 2013 to capitalize on market expansion opportunities in the Fredericksburg Virginia area are yielding results. The Fredericksburg Virginia area market is comparable in size to our legacy Southern Maryland footprint. We are optimistic that our returns on these investments will continue to increase shareholder value during 2014.

In February 2014, the Bank announced its intention to open two full-service bank branches in Fredericksburg over the next 18 months.

### ***Economy***

The U.S. economy continued to experience slow growth throughout 2013. Locally, real estate values appear to have stabilized and there were positive trends in housing during 2012 and 2013. However, uncertainty for small and medium size businesses lessened the demand for lending. The impact on the Southern Maryland economy has been moderated by the presence of federal government agencies and defense facilities, but the ongoing possibility of large cuts to the defense budget hampered economic expansion. Even through the difficult economic environment, the Bank’s capital levels and asset quality remained strong.

For additional information regarding the local economy and its impact on the Company’s business refer to the Business Section in the Company’s Form 10-K for the year ended December 31, 2013 under the caption “Market Area” (*Part I. Item 1. Business Section – Market Area*).



**SELECTED FINANCIAL DATA**

| (dollars in thousands, except per share amounts ) | Three Months Ended |          |       |   |
|---|--------------------|----------|-------|---|
|   | March 31,          |          |       |   |
|   | 2014               | 2013     |       |   |
| <b>Condensed Income Statement</b>                 |                    |          |       |   |
| Interest and Dividend Income                      | \$ 10,175          | \$ 9,840 |       |   |
| Interest Expense                                  | 1,741              | 2,023    |       |   |
| Net Interest Income                               | 8,434              | 7,817    |       |   |
| Provision for Loan Loss                           | 203                | 155      |       |   |
| Noninterest Income                                | 895                | 1,189    |       |   |
| Noninterest Expense                               | 6,331              | 6,143    |       |   |
| Income Before Income Taxes                        | 2,795              | 2,708    |       |   |
| Income Tax Expense                                | 1,074              | 990      |       |   |
| Net Income (NI)                                   | 1,721              | 1,718    |       |   |
| Preferred Stock Dividends                         | 50                 | 50       |       |   |
| NI Available to Common Shareholders               | \$ 1,671           | \$ 1,668 |       |   |
| Comprehensive Income                              | \$ 1,639           | \$ 1,643 |       |   |
| <b>Per Common Share</b>                           |                    |          |       |   |
| Basic Earnings                                    | \$ 0.36            | \$ 0.55  |       |   |
| Diluted Earnings                                  | \$ 0.36            | \$ 0.54  |       |   |
| Cash Dividends Paid                               | \$ 0.10            | \$ 0.10  |       |   |
| Book Value  | \$ 19.66           | \$ 19.89 |       |   |
| Return On Average Assets                          | 0.69               | %        | 0.72  | % |
| Return On Average Common Equity                   | 7.24               | %        | 11.03 | % |
| Return On Average Equity                          | 6.13               | %        | 8.54  | % |
| Interest Rate Spread                              | 3.46               | %        | 3.40  | % |
| Net Interest Margin                               | 3.60               | %        | 3.52  | % |
| Cost of Funds                                     | 0.79               | %        | 0.93  | % |
| Cost of Deposits                                  | 0.61               | %        | 0.79  | % |
| Efficiency Ratio                                  | 67.86              | %        | 68.21 | % |
| Net Charge-offs to Average Loans                  | 0.07               | %        | 0.03  | % |

**COMPARISON OF RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED MARCH 31, 2014 AND 2013*****Earnings Summary***

Net income available to common shareholders of \$1.7 million for the three months ended March 31, 2014 was equal to the comparable quarter of 2013. This was attributable to increased net interest income of \$617,000 offset by an increased provision for loan losses of \$48,000, decreased noninterest income of \$294,000, increased noninterest

expense of \$188,000 and income tax expense of \$84,000. Diluted earnings per share were \$0.36 for the three months ended March 31, 2014 compared to diluted earnings per share of \$0.54 for the three months ended March 31, 2013.

The Company's return on average assets was 0.69% for the three months ended March 31, 2014 compared to 0.72% for the three months ended March 31, 2013. The Company's return on average common stockholders' equity was 7.24% compared to 11.03% for the same comparative period.

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 shares outstanding impacted year to year comparability of per share amounts beginning with the fourth quarter of 2013.

**Net Interest Income**

The primary component of the Company's net income is its net interest income, which is the difference between income earned on assets and interest paid on the deposits and borrowings used to fund them. Net interest income is affected by the difference between the yields earned on the Company's interest-earning assets and the rates paid on interest-bearing liabilities, as well as the relative amounts of such assets and liabilities. Net interest income, divided by average interest-earning assets, represents the Company's net interest margin.

Net interest income increased \$617,000 to \$8.4 million for the three months ended March 31, 2014 compared to \$7.8 million for the three months ended March 31, 2013. The net interest margin was 3.60% for the three months ended March 31, 2014, an eight basis point increase from 3.52% for the three months ended March 31, 2013. The increase was largely the result of a decrease in the cost of funds and an increase in the average balance of loans. These increases were partially offset by a reduction in loan yields.

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

| (dollars in thousands )                                 | Three Months Ended March 31, |          | \$ Change | % Change |    |
|---|------------------------------|----------|-----------|----------|----|
|   | 2014                         | 2013     |           |          |    |
| Interest and Dividend Income                            |                              |          |           |          |    |
| Loans, including fees                                   | \$ 9,583                     | \$ 9,247 | \$ 336    | 3.6      | %  |
| Taxable interest and dividends on investment securities | 590                          | 590      | -         | 0.0      | %  |
| Interest on deposits with banks                         | 2                            | 3        | (1 )      | (33.3    | )% |
| Total Interest and Dividend Income                      | 10,175                       | 9,840    | 335       | 3.4      | %  |
| Interest Expenses                                       |                              |          |           |          |    |
| Deposits  | 1,208                        | 1,551    | (343 )    | (22.1    | )% |
| Short-term borrowings                                   | 6                            | 4        | 2         | 50.0     | %  |
| Long-term debt  | 527                          | 468      | 59        | 12.6     | %  |
| Total Interest Expenses                                 | 1,741                        | 2,023    | (282 )    | (13.9    | )% |
| Net Interest Income (NII)                               | \$ 8,434                     | \$ 7,817 | \$ 617    | 7.9      | %  |

Interest and dividend income increased by \$335,000 to \$10.2 million for the three months ended March 31, 2014 compared to \$9.8 million for the three months ended March 31, 2013. Interest and dividend income increased due to the growth in the average balance of loans and higher investment yields. These increases were partially offset by decreased interest and dividend income from lower loan yields and lower investment average balances. Interest and dividend income increased \$810,000 due to growth of \$67.3 million in the average balance of loans from \$728.4 million to \$795.7 million and \$79,000 due to higher investment yields. This increase was partially offset by a decrease of \$475,000 in interest income as a result of a reduction in loan yields. Average loan yields declined 26 basis points from 5.08% for the three months ended March 31, 2013 to 4.82% for the three months ended March 31, 2014. Interest

and dividend income was further reduced \$79,000 as average interest-earning investment balances decreased \$18.8 million from \$160.1 million for the three months ended March 31, 2013 to \$141.3 million for the three months ended March 31, 2014.

The Company's cost of funds decreased as certificates of deposit re-priced and rates declined on money market accounts. The average cost of total interest-bearing liabilities decreased 15 basis points from 1.03% for the first quarter of 2013 to 0.88% for the first quarter of 2014. Deposit costs decreased 18 basis points from 0.79% to 0.61% for the comparable period in 2014. Additionally, the increase of noninterest bearing demand deposits for the first quarter of 2014 contributed to the decline in funding costs with average balances increasing \$8.2 million from \$82.5 million for the three months ended March 31, 2013 to \$90.7 million for the three months ended March 31, 2014.

Interest expense decreased \$282,000 to \$1.7 million for the three months ended March 31, 2014 compared to \$2.0 million for the three months ended March 31, 2013 due primarily to a reduction in the average cost of funds on interest-bearing liabilities; interest expense decreased \$311,000 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 1.30% and 0.35%, respectively, for the three months ended March 31, 2013 to 1.03% and 0.30%, respectively, for the three months ended March 31, 2014. 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 and short-term borrowings decreased from 2.28% to 2.24% for the comparable period. Interest expense was also reduced \$32,000 due to a decline in average interest-bearing deposit balances of \$6.2 million from \$703.3 million for the three months ended March 31, 2013 to \$697.1 million for the three months ended March 31, 2014. These reductions in interest expense were partially offset by a \$61,000 increase in interest expense due to a \$12.3 million increase in average debt balances.

The following table presents information on average balances and rates for deposits.

| (dollars in thousands)                            | For the Three Months Ended<br>March 31, |                 |                    |                 |
|---|---|-----------------|--------------------|-----------------|
|   | 2014                                    |                 | 2013               |                 |
|   | Average<br>Balance                      | Average<br>Rate | Average<br>Balance | Average<br>Rate |
| Savings   | \$38,940                                | 0.10 %          | \$36,175           | 0.11 %          |
| Interest-bearing demand and money market accounts | 271,035                                 | 0.30 %          | 265,797            | 0.35 %          |
| Certificates of deposit                           | 387,108                                 | 1.03 %          | 401,358            | 1.30 %          |
| Total interest-bearing deposits                   | 697,083                                 | 0.69 %          | 703,330            | 0.88 %          |
| Noninterest-bearing demand deposits               | 90,664                                  |                 | 82,507             |                 |
|   | \$787,747                               | 0.61 %          | \$785,837          | 0.79 %          |

The following table 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 March 31, 2014<br>compared to Three Months Ended<br>March 31, 2013 |                |           |
|--|---|----------------|-----------|
|  | Volume  | Due to<br>Rate | Total     |
| <b>Interest income:</b>  |   |                |           |
| Loan portfolio (1)   | \$ 810  | \$ (475 )      | \$ 335    |
| Investment securities, federal funds sold and interest bearing deposits    | (79 )   | 79             | -         |
| Total interest-earning assets  | \$ 731  | \$ (396 )      | \$ 335    |
| <b>Interest-bearing liabilities:</b>                                       |   |                |           |
| Savings  | 1   | (1 )           | -         |
| Interest-bearing demand and money market accounts                          | 4   | (35 )          | (31 )     |
| Certificates of deposit  | (37 )   | (275 )         | (312 )    |
| Long-term debt   | 59  | (6 )           | 53        |
| Short-term debt  | 2   | -              | 2         |
| Guaranteed preferred beneficial interest in junior subordinated debentures | -   | 6              | 6         |
| Total interest-bearing liabilities   | \$ 29   | \$ (311 )      | \$ (282 ) |
| Net change in net interest income  | \$ 702  | \$ (85 )       | \$ 617    |

(1) Average balance includes non-accrual loans



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 March 31, 2014 and 2013, respectively. There are no tax equivalency adjustments.

|  | For the Three Months Ended March 31, |                |                        |                  |                |                        |  |  |
|--|--------------------------------------|----------------|------------------------|------------------|----------------|------------------------|--|--|
|  | 2014                                 |                |                        | 2013             |                |                        |  |  |
| 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)   | \$795,690                            | \$9,583        | 4.82 %                 | \$728,411        | \$9,248        | 5.08 %                 |  |  |
| Investment securities, federal funds sold and interest-bearing deposits          | 141,262                              | 592            | 1.68 %                 | 160,065          | 592            | 1.48 %                 |  |  |
| <b>Total Interest-Earning Assets</b>   | <b>936,952</b>                       | <b>10,175</b>  | <b>4.34 %</b>          | <b>888,476</b>   | <b>9,840</b>   | <b>4.43 %</b>          |  |  |
| Cash and cash equivalents  | 8,159                                |                |                        | 11,539           |                |                        |  |  |
| Other assets   | 58,657                               |                |                        | 56,967           |                |                        |  |  |
| <b>Total Assets</b>  | <b>\$1,003,768</b>                   |                |                        | <b>\$956,982</b> |                |                        |  |  |
| <b>Liabilities and Stockholders' Equity</b>                                      |                                      |                |                        |                  |                |                        |  |  |
| <b>Interest-bearing liabilities:</b>   |                                      |                |                        |                  |                |                        |  |  |
| Savings  | \$38,940                             | \$10           | 0.10 %                 | \$36,175         | \$10           | 0.11 %                 |  |  |
| Interest-bearing demand and money market accounts                                | 271,035                              | 201            | 0.30 %                 | 265,797          | 232            | 0.35 %                 |  |  |
| Certificates of deposit  | 387,108                              | 997            | 1.03 %                 | 401,358          | 1,309          | 1.30 %                 |  |  |
| Long-term debt   | 74,212                               | 442            | 2.38 %                 | 64,308           | 389            | 2.42 %                 |  |  |
| Short-term debt  | 8,906                                | 6              | 0.27 %                 | 6,480            | 4              | 0.25 %                 |  |  |
| Guaranteed preferred beneficial interest in junior subordinated debentures       | 12,000                               | 85             | 2.83 %                 | 12,000           | 79             | 2.63 %                 |  |  |
| <b>Total Interest-Bearing Liabilities</b>  | <b>792,201</b>                       | <b>1,741</b>   | <b>0.88 %</b>          | <b>786,118</b>   | <b>2,023</b>   | <b>1.03 %</b>          |  |  |
| Noninterest-bearing demand deposits  | 90,664                               |                |                        | 82,507           |                |                        |  |  |
| Other liabilities  | 8,643                                |                |                        | 7,880            |                |                        |  |  |
| Stockholders' equity   | 112,260                              |                |                        | 80,477           |                |                        |  |  |
| <b>Total Liabilities and Stockholders' Equity</b>                                | <b>\$1,003,768</b>                   |                |                        | <b>\$956,982</b> |                |                        |  |  |
| <b>Net interest income</b>   |                                      | <b>\$8,434</b> |                        |                  | <b>\$7,817</b> |                        |  |  |
| Interest rate spread   |                                      |                | 3.46 %                 |                  |                | 3.40 %                 |  |  |
| Net yield on interest-earning assets   |                                      |                | 3.60 %                 |                  |                | 3.52 %                 |  |  |
| Ratio of average interest-earning assets to average interest bearing liabilities |                                      |                | 118.27 %               |                  |                | 113.02 %               |  |  |
| Cost of funds  |                                      |                | 0.79 %                 |                  |                | 0.93 %                 |  |  |
| Cost of deposits   |                                      |                | 0.61 %                 |                  |                | 0.79 %                 |  |  |

(1) Average balance includes non-accrual loans

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***Provision for Loan Losses***

The following table shows the dollar and percentage changes for the provision for loan losses for the periods presented.

| (dollars in thousands )   | Three Months Ended March 31, |        |           |          |
|---------------------------|------------------------------|--------|-----------|----------|
|                           | 2014                         | 2013   | \$ Change | % Change |
| Provision for loan losses | \$ 203                       | \$ 155 | \$ 48     | 31.0 %   |

The provision for loan losses increased \$48,000 from \$155,000 for the three months ended March 31, 2013 to \$203,000 for the three months ended March 31, 2014 and reflected an increase in the allowance for specific nonperforming loans and an increase in net charge-offs. The specific allowance is based on management's estimate of realizable value for particular loans. Net charge-offs increased \$93,000 from \$51,000 for the three months ended March 31, 2013 to \$144,000 for the three months ended March 31, 2014. See further discussion of the provision under the caption "Asset Quality and the Allowance for Loan Losses" in the Comparison of Financial Condition section of Management's Discussion and Analysis.

***Noninterest Income***

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

| (dollars in thousands )                           | Three Months Ended March 31, |          |           |          |
|---|------------------------------|----------|-----------|----------|
|   | 2014                         | 2013     | \$ Change | % Change |
| Noninterest Income                                |                              |          |           |          |
| Loan appraisal, credit, and miscellaneous charges | \$ 100                       | \$ 188   | \$ (88 )  | (46.8 )% |
| Net gains on sale of investment securities        | 24                           | -        | 24        | n/a      |
| Income from bank owned life insurance             | 151                          | 151      | -         | 0.0 %    |
| Service charges                                   | 552                          | 471      | 81        | 17.2 %   |
| Gain on sale of loans held for sale               | 68                           | 379      | (311 )    | (82.1 )% |
| Total Noninterest Income                          | \$ 895                       | \$ 1,189 | \$ (294 ) | (24.7 )% |

The decrease in noninterest income was principally due to a reduction in gains on the sale of loans held for sale and a reduction in other fees and miscellaneous charges. Secondary market sales slowed during the third quarter of 2013 due to rising residential mortgage interest rates. These decreases were partially offset by increased service charge income, which increased \$81,000 or 17.2% from \$471,000 for the three months ended March 31, 2013 to \$552,000 for the three months ended March 31, 2014. Service charge income includes fees and commissions from wealth and cash management products and services, bank account service charges, interchange fees, bank overdrafts and various transaction initiated fees. Service charge income increased from the comparable period primarily due to increased

revenues of \$119,000 from wealth and cash management products and services from \$220,000 for the three months ended March 31, 2013 to \$339,000 for the three months ended March 31, 2014. These increases to service charge income were partially offset by decreases in revenue streams impacted by new regulations, such as fees for interchange and bank overdrafts.

In addition, the Company recognized a net gain of \$24,000 on the sale of investment securities during the first quarter of 2014 with \$5.2 million in carrying value.

**Noninterest Expense**

The following tables show the components of noninterest expense and the dollar and percentage changes for the periods presented.

| (dollars in thousands )                            | Three Months Ended March 31, |          | \$ Change | % Change |    |
|--|------------------------------|----------|-----------|----------|----|
|  | 2014                         | 2013     |           |          |    |
| Noninterest Expense                                |                              |          |           |          |    |
| Salary and employee benefits                       | \$ 4,029                     | \$ 3,557 | \$ 472    | 13.3     | %  |
| Occupancy expense                                  | 565                          | 483      | 82        | 17.0     | %  |
| Advertising  | 122                          | 104      | 18        | 17.3     | %  |
| Data processing expense                            | 271                          | 364      | (93 )     | (25.5)   | )% |
| Professional fees                                  | 230                          | 197      | 33        | 16.8     | %  |
| Depreciation of furniture, fixtures, and equipment | 185                          | 192      | (7 )      | (3.6)    | )% |
| Telephone communications                           | 50                           | 49       | 1         | 2.0      | %  |
| Office supplies                                    | 80                           | 63       | 17        | 27.0     | %  |
| FDIC Insurance                                     | 139                          | 301      | (162 )    | (53.8)   | )% |
| Valuation allowance on OREO                        | 82                           | 311      | (229 )    | (73.6)   | )% |
| Other  | 578                          | 522      | 56        | 10.7     | %  |
| Total Noninterest Expense                          | \$ 6,331                     | \$ 6,143 | \$ 188    | 3.1      | %  |

| (dollars in thousands)                | Three Months Ended March 31, |          | \$ Change | % Change |    |
|---------------------------------------|------------------------------|----------|-----------|----------|----|
|                                       | 2014                         | 2013     |           |          |    |
| Compensation and Benefits             | \$ 4,029                     | \$ 3,557 | \$ 472    | 13.3     | %  |
| OREO Valuation Allowance and Expenses | 129                          | 351      | (222 )    | (63.2)   | )% |
| Other Operating Expenses              | 2,173                        | 2,235    | (62 )     | (2.8)    | )% |
| Total Noninterest Expense             | \$ 6,331                     | \$ 6,143 | \$ 188    | 3.1      | %  |

For the three months ended March 31, 2014, noninterest expense increased 3.1%, or \$188,000, to \$6.3 million from \$6.1 million for the comparable period in 2013. The increase was primarily due to growth in employee compensation of \$472,000 to \$4.0 million as the Bank added employees in the fourth quarter of 2013 and first quarter of 2014 to support its expansion in Virginia. Increased revenues and a moderate increase in noninterest expense have improved the Company's efficiency ratio to 67.86% for the three months ended March 31, 2014 from 68.21% for the three months ended March 31, 2013.

**Income Tax Expense**

For the three months ended March 31, 2014, the Company recorded income tax expense of \$1.1 million compared to \$990,000 in the prior year. The Company's effective tax rates for the three months ended March 31, 2014 and 2013 were 38.42% and 36.56%, respectively. The increase in the effective tax rate was the result of tax-exempt income being relatively lower to total income for the three months ended March 31, 2014 compared to the three months ended March 31, 2013.



**COMPARISON OF FINANCIAL CONDITON AT MARCH 31, 2014 AND DECEMBER 31, 2013*****Assets***

Total assets at March 31, 2014 of \$1.02 billion decreased \$6.9 million compared to total assets at December 31, 2013. The decrease in total assets was attributable to seasonal declines in customer deposits and a net decrease in cash and securities. The following table shows the Company's assets and the dollar and percentage changes for the periods presented.

| (dollars in thousands)                                | March 31, 2014<br>(Unaudited) | December 31, 2013 | \$ Change   | % Change |    |
|---|-------------------------------|-------------------|-------------|----------|----|
| Cash and due from banks                               | \$ 13,237                     | \$ 11,408         | \$ 1,829    | 16.0     | %  |
| Federal funds sold                                    | 2,205                         | 8,275             | (6,070 )    | (73.4    | )% |
| Interest-bearing deposits with banks                  | 734                           | 4,836             | (4,102 )    | (84.8    | )% |
| Securities available for sale (AFS), at fair value    | 43,446                        | 48,247            | (4,801 )    | (10.0    | )% |
| Securities held to maturity (HTM), at amortized cost  | 80,902                        | 86,401            | (5,499 )    | (6.4     | )% |
| FHLB and FRB stock - at cost                          | 6,380                         | 5,593             | 787         | 14.1     | %  |
| Loans receivable - net of ALLL of \$8,197 and \$8,138 | 810,484                       | 799,130           | 11,354      | 1.4      | %  |
| Premises and equipment, net                           | 19,776                        | 19,543            | 233         | 1.2      | %  |
| Other real estate owned (OREO)                        | 7,454                         | 6,797             | 657         | 9.7      | %  |
| Accrued interest receivable                           | 2,992                         | 2,974             | 18          | 0.6      | %  |
| Investment in bank owned life insurance               | 19,501                        | 19,350            | 151         | 0.8      | %  |
| Other assets  | 9,827                         | 11,270            | (1,443 )    | (12.8    | )% |
| Total Assets  | \$ 1,016,938                  | \$ 1,023,824      | \$ (6,886 ) | (0.7     | )% |

The differences in allocations between the cash and investment categories reflect operational needs. The AFS and HTM securities portfolio decreased a net of \$10.3 million during the first quarter of 2014 due to principal repayments and the sale of \$5.2 million in securities recognizing a gain of \$24,000. The Company sold five AFS securities with a carrying value of \$2.1 million and ten HTM securities with aggregate carrying values of \$3.2 million, recognizing gains of \$8,000 and \$16,000, respectively. The sale of HTM securities was permitted under ASC 320 "Investments - Debt and Equity Securities." The Company sold the HTM positions utilizing the safe harbor rule that allows for the sale of HTM securities that have principal payments paid down to less than 15% of original purchased par. There were no sales of AFS and HTM securities during the three months ended March 31, 2013.

Net loans increased \$11.4 million from \$799.1 million at December 31, 2013 to \$810.5 million at March 31, 2014, due primarily to increases in loans for commercial real estate partially offset by decreases in commercial loans. The following is a breakdown of the Company's loan portfolio at March 31, 2014 and December 31, 2013:

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| (dollars in thousands)            | March 31, 2014 | %        | December 31, 2013 | %        |
|-----------------------------------|----------------|----------|-------------------|----------|
| Commercial real estate            | \$ 504,564     | 61.56 %  | \$ 476,648        | 58.97 %  |
| Residential first mortgages       | 158,080        | 19.29 %  | 159,147           | 19.69 %  |
| Construction and land development | 30,611         | 3.73 %   | 32,001            | 3.96 %   |
| Home equity and second mortgages  | 21,699         | 2.65 %   | 21,692            | 2.68 %   |
| Commercial loans                  | 80,297         | 9.80 %   | 94,176            | 11.65 %  |
| Consumer loans                    | 691            | 0.08 %   | 838               | 0.10 %   |
| Commercial equipment              | 23,741         | 2.90 %   | 23,738            | 2.94 %   |
|                                   | 819,683        | 100.00 % | 808,240           | 100.00 % |
| Less:                             |                |          |                   |          |
| Deferred loan fees                | 1,002          | 0.12 %   | 972               | 0.12 %   |
| Allowance for loan loss           | 8,197          | 1.00 %   | 8,138             | 1.01 %   |
|                                   | 9,199          |          | 9,110             |          |
|                                   | \$ 810,484     |          | \$ 799,130        |          |

*Asset Quality and the Allowance for Loan Losses*The Allowance for Loan Losses

The allowance for loan losses decreased from 1.01% of gross loans at December 31, 2013 to 1.00% of gross loans at March 31, 2014 due to changes to general allowance factors that reflect changes in historical loss, delinquency rates and general economic conditions. The historical loss experience factor is tracked over various time horizons for each portfolio segment. It is weighted as the most important factor of the general component of the allowance and has decreased as the Bank's charge-off history has improved. The reduction in the general allowance was partially offset by the increase in specific reserves on impaired loans. The majority of the increase in specific reserves at March 31, 2014 compared to December 31, 2013 was due to a \$500,000 specific reserve on a \$3.2 million classified loan on an acquisition and development project. Management's determination of the adequacy of the allowance is based on a periodic evaluation of the portfolio with consideration given to: 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 determining an adequate allowance. The specific allowance is based on management's estimate of realizable value for particular loans. Management believes that the allowance is adequate.

The allowance for loan losses increased \$59,000 from \$8.1 million at December 31, 2013 to \$8.2 million at March 31, 2014. The increase in the allowance reflects an increase in specific reserves of \$402,000 partially offset by an decrease in the general allowance of \$343,000. The general allowance as a percentage of gross loans decreased from 0.89% at December 31, 2013 to 0.83% at March 31, 2014.

| (dollar in thousands) | March 31, 2014 | % of Gross<br>Loans | December 31, 2013 | % of Gross<br>Loans |
|-----------------------|----------------|---------------------|-------------------|---------------------|
| General Allowance     | \$ 6,810       | 0.83                | % \$ 7,153        | 0.89 %              |
| Specific Allowance    | 1,387          | 0.17                | % 985             | 0.12 %              |
| Total Allowance       | \$ 8,197       | 1.00                | % \$ 8,138        | 1.01 %              |

The provision for loan losses increased \$48,000 from the comparable period in 2013 to \$203,000 for the three months ended March 31, 2014 and reflected an increase in the allowance for specific nonperforming loans and an increase in net charge-offs. The specific allowance is based on management's estimate of realizable value for particular loans. Net charge-offs increased \$93,000 from \$51,000 for the three months ended March 31, 2013 to \$144,000 for the three months ended March 31, 2014.

Although loan balances have grown in 2013 and 2014, the credit quality of our loan portfolio improved, with a slightly better economic climate, low levels of net charge-offs, and a trend of lower levels of classified loans. Non-performing loans have been resolved with workouts, charge-offs and transfers to OREO. Net charge-offs have

fallen significantly over the last two years and have returned to pre-financial crisis levels.



Asset Quality

The following tables show selected asset quality ratios at March 31, 2014 and December 31, 2013.

| (dollars in thousands)  | March 31, 2014 |                   | \$ Change   | % Change |   |
|---|----------------|-------------------|-------------|----------|---|
|   | (Unaudited)    | December 31, 2013 |             |          |   |
| Total assets  | \$ 1,016,938   | \$ 1,023,824      | \$ (6,886 ) | (0.7 )   | % |
| Gross loans   | 819,683        | 808,240           | 11,443      | 1.4      | % |
| Allowance for loan loss (ALLL)                                  | 8,197          | 8,138             | 59          | 0.7      | % |
| Foreclosed real estate (OREO)                                   | 7,454          | 6,797             | 657         | 9.7      | % |
| Past due loans (PDLs) 31-89 days                                | 5,954          | 8,060             | (2,106 )    | (26.1 )  | % |
| Nonperforming loans >= 90 days Delinquent (NPLs)                | 12,644         | 11,170            | 1,474       | 13.2     | % |
| Non-accrual only loans <sup>(A)</sup>                           | 4,233          | 4,281             | (48 )       | (1.1 )   | % |
| Non-accrual loans (NPLs + Non-accrual only loans)               | 16,877         | 15,451            | 1,426       | 9.2      | % |
| Troubled debt restructures (TDRs)                               | 5,196          | 4,693             | 503         | 10.7     | % |
| Allowance for loan losses (ALLL) to total loans                 | 1.00           | % 1.01            | %           |          |   |
| Past due loans to total loans                                   | 0.73           | % 1.00            | %           |          |   |
| Nonperforming loans to total loans                              | 1.54           | % 1.38            | %           |          |   |
| Loan delinquency (PDLs + NPLs) to total loans                   | 2.27           | % 2.38            | %           |          |   |
| Non-accrual loans to total loans                                | 2.06           | % 1.91            | %           |          |   |
| Non-accrual loans and TDRs to total loans <sup>(B)</sup>        | 2.69           | % 2.45            | %           |          |   |
| Allowance to nonperforming loans                                | 64.83          | % 72.86           | %           |          |   |
| Non-accrual loans and OREO to total assets                      | 2.39           | % 2.17            | %           |          |   |
| Non-accrual loans, OREO and TDRs to total assets <sup>(B)</sup> | 2.90           | % 2.60            | %           |          |   |

<sup>(A)</sup> Non-accrual only loans are loans classified as non-accrual loans due to customer operating results or cash flows. Non-accrual loans can include loans that are current with all loan payments. Interest and principal are recognized on a cash basis in accordance with the Bank's policy if the loans are not impaired or there is no impairment.

<sup>(B)</sup> Ratio was adjusted at December 31, 2013 to remove \$329,000 for loans that were classified as both nonperforming and troubled debt restructures.

The Bank's past due loans (loans 31-89 days past due) decreased \$2.1 million from \$8.1 million at December 31, 2013 to \$6.0 million at March 31, 2014. The Bank had 31 past due loans at December 31, 2013 compared to 29 past due loans at March 31, 2014.

Nonperforming loans (“NPLs”) (90 days or greater delinquent) were \$12.6 million or 1.54% of total loans at March 31, 2014 compared to \$11.1 million or 1.38% of total loans at December 31, 2013. The Bank had 36 nonperforming loans at March 31, 2014 compared to 28 nonperforming loans at December 31, 2013. The net increase of \$1.5 million was due to increases of 90 days or greater delinquency in commercial real estate loans of \$822,000, construction and land development loans of \$659,000, commercial loans of \$567,000 and other loans of \$95,000 partially offset by a reduction in nonperforming residential first mortgages of \$668,000. Nonperforming loans at March 31, 2014 included \$10.0 million or 79% of nonperforming loans attributed to 13 loans representing five customer relationships. These 13 loans had specific reserves of \$494,000, which represented 88% of total specific reserves of \$562,000 on nonperforming loans.

Total non-accrual loans at March 31, 2014 were \$16.9 million, which included \$12.6 million of 90 day delinquent loans and non-accrual only loans totaling \$4.2 million compared to \$15.5 million in non-accrual loans at December 31, 2013, which included \$11.2 million in 90 day delinquent loans and non-accrual only loans totaling \$4.3 million. Non-accrual only loans are comprised of six loans representing 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 March 31, 2014, 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.

At March 31, 2014, the Bank had 14 TDRs totaling \$5.2 million compared to 13 TDRs totaling \$4.7 million as of December 31, 2013. At March 31, 2014, all TDRs were performing according to the terms of their restructured agreements. At December 31, 2013, one TDR loan of \$329,000 was over 90 days past due. The Bank had specific reserves in the allowance for loan losses of \$154,000 on three TDRs at March 31, 2014 and \$79,000 on two TDRs totaling \$1.8 million at December 31, 2013. The Bank added one TDR of \$526,000, a residential first mortgage during the three months ended March 31, 2014. There were no dispositions of TDRs during the first quarter of 2014.

The OREO balance was \$7.5 million at March 31, 2014, an increase of \$657,000, compared to \$6.8 million at December 31, 2013. This increase consisted of \$739,000 in additions related to a residential property of \$99,000 and a commercial building of \$640,000. Additions were offset by valuation allowances of \$82,000 to adjust properties to current appraised values. There were no disposals during the three months ended March 31, 2014. 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.

At March 31, 2014, 98%, or \$116.8 million of the asset-backed securities portfolio was rated AAA by Standard & Poor's or the equivalent credit rating from another major rating agency compared to 98% or \$126.6 million at December 31, 2013. Debt securities are evaluated quarterly to determine whether a decline in their value is OTTI. No OTTI charge was recorded for the three months ended March 31, 2014 and the year ended December 31, 2013. Classified securities decreased \$388,000 from \$2.4 million at December 31, 2013 to \$2.1 million at March 31, 2014.

Management considers classified assets to be an important measure of asset quality. Classified assets have been trending down from a high point of \$81.9 million at September 30, 2011. The following is a breakdown of the Company's classified and special mention assets at March 31, 2014 and December 31, 2013, 2012 and 2011, respectively:

#### Classified Assets and Special Mention Assets

| (dollars in thousands)                     | As of<br>March 31, 2014 | As of<br>December 31, 2013 | As of<br>December 31, 2012 | As of<br>December 31, 2011 |
|--|-------------------------|----------------------------|----------------------------|----------------------------|
| Classified loans                           |                         |                            |                            |                            |
| Substandard                                | \$ 45,553               | \$ 47,645                  | \$ 48,676                  | \$ 68,515                  |
| Doubtful                                   | -                       | -                          | -                          | -                          |
| Loss                                       | -                       | -                          | -                          | 37                         |
| Total classified loans                     | 45,553                  | 47,645                     | 48,676                     | 68,552                     |
| Special mention loans                      | 6,288                   | 9,246                      | 6,092                      | -                          |
| Total classified and special mention loans | \$ 51,841               | \$ 56,891                  | \$ 54,768                  | \$ 68,552                  |
| Classified loans                           | 45,553                  | 47,645                     | 48,676                     | 68,552                     |
| Classified securities                      | 2,050                   | 2,438                      | 3,028                      | 6,057                      |

|                         |           |           |           |           |
|-------------------------|-----------|-----------|-----------|-----------|
| Other real estate owned | 7,454     | 6,797     | 6,891     | 5,029     |
| Total classified assets | \$ 55,057 | \$ 56,880 | \$ 58,595 | \$ 79,638 |

Gross unrealized losses on HTM and AFS were \$2.8 million at March 31, 2014 and December 31, 2013. (see Note 10 in Consolidated Financial Statements). Gross unrealized losses at March 31, 2014 for HTM securities were \$1.2 million or 3.12% of the book value of \$36.9 million. Gross unrealized losses at December 31, 2013 for HTM securities were \$1.3 million or 2.75% of the book value of \$47.3 million. Gross unrealized losses at March 31, 2014 for AFS securities were \$1.6 million or 4.87% of the book value of \$32.4 million. Gross unrealized losses at December 31, 2013 for AFS securities were \$1.5 million or 3.90% of the book value of \$38.5 million. Unrealized losses increased during the second half of 2013 as a result of increases in long-term interest rates and not the result of a deterioration in credit risk. The Bank holds 95% of its AFS and HTM securities as asset-backed securities of GSEs or U.S. government obligations. The Company intends to, and has the ability to, hold both AFS and HTM securities with unrealized losses until they mature, at which time the Company will receive full value for the securities. The Company believes that the AFS and HTM securities with unrealized losses will either recover in market value or be paid off as agreed.

***Liabilities***

The following table shows the Company's liabilities and the dollar and percentage changes for the periods presented.

| (dollars in thousands)   | March 31, 2014<br>(Unaudited) | December 31, 2013 | \$ Change  | % Change |
|--|-------------------------------|-------------------|------------|----------|
| Deposits   |                               |                   |            |          |
| Non-interest-bearing deposits  | \$ 103,235                    | \$ 103,882        | \$(647 )   | (0.6 )%  |
| Interest-bearing deposits  | 705,884                       | 717,413           | (11,529 )  | (1.6 )%  |
| Total deposits   | 809,119                       | 821,295           | (12,176 )  | (1.5 )%  |
| Long-term debt   | 75,463                        | 70,476            | 4,987      | 7.1 %    |
| Guaranteed preferred beneficial interest in junior subordinated debentures (TRUPs) | 12,000                        | 12,000            | -          | 0.0 %    |
| Accrued expenses and other liabilities   | 8,223                         | 9,323             | (1,100 )   | (11.8 )% |
| Total Liabilities  | \$ 904,805                    | \$ 913,094        | \$(8,289 ) | (0.9 )%  |

***Deposits and Borrowings***

Deposits decreased during the first quarter driven primarily by seasonal customer deposit activity. Total deposits decreased by 1.5%, or \$12.2 million, to \$809.1 million at March 31, 2014 compared to \$821.3 million at December 31, 2013. During 2012 and 2013, the Bank increased transaction deposits, especially noninterest bearing deposits, to lower its overall cost of funds. Transaction deposits have increased from 44.9% at December 31, 2011 to 51.4% at March 31, 2014. Details of the Company's deposit portfolio at March 31, 2014 and December 31, 2013 are presented below:

| (dollars in thousands)     | March 31, 2014 |          |  | December 31, 2013 |          |  |
|----------------------------|----------------|----------|--|-------------------|----------|--|
|                            | Balance        | %        |  | Balance           | %        |  |
| Noninterest-bearing demand | \$ 103,235     | 12.76 %  |  | \$ 103,882        | 12.65 %  |  |
| Interest-bearing:          |                |          |  |                   |          |  |
| Demand                     | 71,389         | 8.82 %   |  | 86,954            | 10.59 %  |  |
| Money market deposits      | 202,120        | 24.98 %  |  | 204,032           | 24.84 %  |  |
| Savings                    | 39,213         | 4.85 %   |  | 39,116            | 4.76 %   |  |
| Certificates of deposit    | 393,162        | 48.59 %  |  | 387,311           | 47.16 %  |  |
| Total interest-bearing     | 705,884        | 87.24 %  |  | 717,413           | 87.35 %  |  |
| Total Deposits             | \$ 809,119     | 100.00 % |  | \$ 821,295        | 100.00 % |  |
| Transaction accounts       | \$ 415,957     | 51.41 %  |  | \$ 433,984        | 52.84 %  |  |

The Bank will be opening its first Fredericksburg, Virginia branch in July 2014 and intends to open a second branch in the area during 2015.

The Bank uses both traditional brokered deposits and reciprocal brokered deposits. The reciprocal brokered deposits have many characteristics of core deposits and are used to maximize FDIC insurance available to our customers. Brokered deposits at March 31, 2014 and December 31, 2013 were \$63.4 million and \$56.4 million, respectively, of which \$28.3 million and \$29.4 million, respectively, were reciprocal deposits. The Bank uses the Promontory Network for reciprocal brokered deposits to participate in the Certificate of Deposit Account Registry Service (“CDARS”) and the Insured Cash Sweep product (“ICS”). Long-term debt increased \$5.0 million from \$70.5 million at December 31, 2013 to \$75.5 million at March 31, 2014. During the first quarter of 2014, the Company added \$5.0 million in Federal Home Loan Bank advances at 0.52% for two years. The Bank uses brokered deposits and other wholesale funding to supplement funding when loan growth exceeds core deposit growth. The Bank may increase its level of brokered and wholesale funding during 2014 to fund loan growth.

**Stockholders' Equity**

The following table shows the Company's equity and the dollar and percentage changes for the periods presented.

| (dollars in thousands)               | March 31, 2014<br>(Unaudited) | <b>December 31, 2013</b> | \$ Change | % Change |   |
|--------------------------------------|-------------------------------|--------------------------|-----------|----------|---|
| Preferred Stock at par of \$1,000    | \$ 20,000                     | \$ 20,000                | \$ -      | 0.0      | % |
| Common Stock at par of \$0.01        | 47                            | 46                       | 1         | 2.2      | % |
| Additional paid in capital           | 46,160                        | 45,881                   | 279       | 0.6      | % |
| Retained earnings                    | 47,728                        | 46,523                   | 1,205     | 2.6      | % |
| Accumulated other comprehensive loss | (1,139 )                      | (1,057 )                 | (82 )     | 7.8      | % |
| Unearned ESOP shares                 | (663 )                        | (663 )                   | -         | 0.0      | % |
| Total Stockholders' Equity           | \$ 112,133                    | \$ 110,730               | \$ 1,403  | 1.3      | % |

During the three months ended March 31, 2014, stockholders' equity increased \$1.4 million to \$112.1 million. The increase in stockholders' equity was due to net income of \$1.7 million and net stock related activities related to stock-based compensation and the exercise of options of \$279,000. These increases to capital were partially offset by quarterly common dividends paid of \$466,000, quarterly preferred stock dividends of \$50,000 and adjustments to accumulated other comprehensive loss of \$82,000. Increases in common stockholders' equity to \$92.1 million at March 31, 2014 have resulted in a book value of \$19.66 per common share. The Company remains well-capitalized at March 31, 2014 with a Tier 1 capital to average assets ratio of 12.46%.

Accumulated other comprehensive losses increased during the second half of 2013 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.

**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 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 on these agreements, including collateral, see Note 11 of the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2013.

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 and cash equivalents as of March 31, 2014 totaled \$16.2 million, a decrease of \$8.3 million, or 34.0%, from the December 31, 2013 total of \$24.5 million. The decrease in cash was primarily due to an excess of loan originations over principal collected and a net decrease in deposits. These decreases to cash were partially offset by increases in total borrowings, net proceeds from maturing principal and proceeds from the sale of investment securities, and net income. Changes to the level of cash and cash equivalents have minimal impact on operational needs as the Bank has substantial sources of funds available from other sources.



During the three months ended March 31, 2014, all financing activities used \$7.6 million in cash compared to \$12.6 million in cash used for the same period in 2013. The Bank used \$5.0 million less cash for financing activities in the three months ended March 31, 2014 compared to the three months ended March 31, 2013 primarily due to a reduction in the decrease in deposits from \$21.4 million for the three months ended March 31, 2013 to \$12.2 million for the three months ended March 31, 2014. These decreases in the use of cash were partially offset by increased common stock dividends of \$162,000 due to more outstanding shares and increased other stock activities of \$13,000 and a reduction in net borrowings of \$4.0 million.

During the three months ended March 31, 2014, all investing activities used \$3.1 million in cash compared to \$16.3 million in cash provided for the same period in 2013. The primary reason for the reduction in cash of \$19.4 million was an increase in first quarter 2014 loan volume compared to the first quarter of 2013. Cash was used to fund additional loans as loans originated or acquired increased \$20.7 million from \$37.5 million for the three months ended March 31, 2013 to \$58.2 million for the three months ended March 31, 2014. Additionally, a decrease of \$3.4 million in cash resulted from a reduction in the amount of principal collected on loans from \$49.7 million for the three months ended March 31, 2013 to \$46.3 million for the three months ended March 31, 2014. Cash used also increased \$488,000 due to premise and equipment purchases. These decreases to cash were partially offset by net proceeds received from the sale of securities of \$5.2 million.

Operating activities provided cash of \$2.3 million for the three months ended March 31, 2014 compared to \$1.6 million of cash provided for the same period of 2013. Cash increased by \$732,000 primarily due to a decrease in deferred tax assets and a reduction in the decrease of accrued expenses and other liabilities for the three months ended March 31, 2014 compared with the three months ended March 31, 2013. These increases in cash were partially offset by a reduction in net proceeds from the sale of loans held for sale during the first quarter of 2014 compared to the same period in 2013.

### **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 March 31, 2014 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 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 March 31, 2014, 66,046 shares were available to be repurchased under the repurchase program. There were no repurchases for the three months ended March 31, 2014.

Item 3 - Default Upon Senior Securities - None

Item 4 – Mine Safety Disclosures – Not Applicable

Item 5 - Other Information - None

Item 6 - Exhibits

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 March 31, 2014, 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.

**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: May 6, 2014      By: /s/ Michael L. Middleton  
Michael L. Middleton  
Chief Executive Officer

Date: May 6, 2014 By: /s/ William J. Pasenelli  
William J. Pasenelli  
President and Chief Financial  
Officer