# Carolina ALLIANCE BANK™

2014 Annual Report

**CAROLINA ALLIANCE BANK AND SUBSIDIARY**
**2014 ANNUAL REPORT**
**Index**

Carolina
ALLIANCE BANK™

March 30, 2015

Dear Fellow Shareholders:

I take great pleasure in sharing this annual report which presents our financial position at December 31, 2014, as well as the operating results for the year. This has been the most exciting year in our young bank's history. Of course the highlight of the year was the completion of the merger with Forest Commercial Bank at the beginning of the second quarter. The third quarter also was eventful with the addition of the operations of Dave McBride Leasing, LLC to our existing leasing operation, which operates from our Charlotte, North Carolina office, and the issuance of the bank's first stock dividend to our loyal shareholders later in the third quarter.

While we are very pleased with the bank's status at this time, our endeavors for quality development on all fronts are ongoing. The Board and senior staff continue to work hard on strategic planning initiatives to chart a path for growth, high performance, and increased value of our shareholders' investment. Our recently announced merger agreement with Pinnacle Bank of South Carolina is the most recent example of an undertaking in furtherance of our long-term strategy to enhance performance and our potential for success.

Let me highlight some of our 2014 financial results:

The bank concluded 2014 with net income available to common shareholders for the year of approximately $6.1 million, compared to $1.0 million in the prior year. This $5.1 million increase in earnings was largely attributable to the increase in earning assets from the merger with Forest Commercial and the impact of merger-related accounting, particularly the non-operating after-tax bargain purchase gain of $3.7 million related to mark-to-market adjustments to the Forest Commercial balance sheet as of the merger date of April 5, 2014. Partially offsetting these increases were increased operating expenses from the addition of Forest Commercial's operations and non-operating after-tax expenses of approximately $0.7 million for merger costs and start-up costs associated with the bank's branches in Seneca and Anderson, South Carolina, both of which opened for business in 2014.

Gross loans and leases increased by $152.4 million to $335.2 million on December 31, 2014 from $182.8 million on December 31, 2013. Of the increase, $121.7 million is attributable to Forest Commercial loans and leases added as of the merger date. Total assets increased by $170.6 million to $418.0 million at December 31, 2014 from $247.4 million at December 31, 2013. Forest Commercial's assets totaled $156.2 million as of the merger date. Total deposits increased to $338.4 million on December 31, 2014 from $203.5 million on December 31, 2013, an increase of $134.9 million. Forest Commercial's deposits totaled $129.0 million as of the merger date. Total shareholders' equity was $52.3 million at December 31, 2014, or 12.5% of total assets, compared to $32.0 million, or 12.9% of total assets, at December 31, 2013. Book value per common share was $10.36 as of December 31, 2014 compared to $9.76 as of December 31, 2013 (adjusted for 10% stock dividend). Non-performing assets at December 31, 2014 increased $2.3 million from a year prior, in part due to real estate acquired in settlement of loans of $0.7 million absorbed in the merger. A detailed analysis of our non-performing assets is included in the notes to the financial statements.

It is our belief that a key role of our community bank is to support the communities in which we operate. In addition to the excellent work of our staff in a very demanding year, we are grateful for their commitment to their communities and their level of service in 2014.

We sincerely thank you, our loyal shareholders, for your continuing support of our bank.

Yours truly,

John S. Poole
Chief Executive Officer

John D. Kimberly
President

elliott davis decosimo

## Independent Auditor's Report

To the Board of Directors
Carolina Alliance Bank and Subsidiary
Spartanburg, South Carolina

**Report on the Financial Statements**

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

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

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

**Auditor's Responsibility**

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

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

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

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**Opinion**

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Carolina Alliance Bank and Subsidiary as of December 31, 2014 and 2013, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Elliott Davis Decosimo, LLC

Columbia, South Carolina
March 30, 2015

## CAROLINA ALLIANCE BANK AND SUBSIDIARY

Consolidated Balance Sheets

December 31, 2014 and 2013

| | **2014** | 2013 |
|---|---|---|
| **Assets:** | | |
| Cash and due from banks | **$ 6,698,634** | $ 5,692,846 |
| Federal funds sold and interest bearing bank balances | **722,691** | 855,115 |
| Total cash and cash equivalents | **7,421,325** | 6,547,961 |
| Bank term deposits | **4,731,000** | 6,723,000 |
| Investment securities, available for sale | **60,776,574** | 44,547,635 |
| Other investments | **1,262,500** | 389,000 |
| Loans and finance leases, net | **326,872,734** | 179,330,714 |
| Property and equipment, net | **7,165,761** | 6,699,194 |
| Leased assets, net | **3,648,196** | - |
| Deferred tax asset | **905,332** | 1,048,465 |
| Core deposit intangible | **947,704** | - |
| Accrued interest | **1,111,812** | 705,547 |
| Other assets | **2,956,561** | 1,393,097 |
| Total assets | **$ 417,799,499** | $ 247,384,613 |
| **Liabilities and Shareholders' Equity:** | | |
| Liabilities: | | |
| Deposits | **$ 338,391,498** | $ 203,499,827 |
| Securities sold under agreements to repurchase | **5,992,085** | 10,142,253 |
| Advances from FHLB of Atlanta | **19,600,000** | 1,000,000 |
| Accrued interest | **59,050** | 44,428 |
| Other liabilities | **1,487,422** | 720,233 |
| Total liabilities | **365,530,055** | 215,406,741 |
| Commitments and contingencies (Notes 11, 12 and 20) | | |
| Shareholders' Equity: | | |
| Preferred stock, $1.00 par value, 10,000,000 shares authorized; 5,000 shares issued and outstanding at December 31, 2014 and 2013, respectively | **5,000** | 5,000 |
| Common stock, $1.00 par value, 10,000,000 shares authorized; 4,560,660 and 2,511,959 issued and outstanding at December 31, 2014 and 2013, respectively | **4,560,733** | 2,511,959 |
| Additional paid-in capital | **44,531,008** | 28,969,360 |
| Retained earnings | **2,841,532** | 643,204 |
| Accumulated other comprehensive income (loss) | **331,171** | (151,651) |
| Total shareholders' equity | **52,269,444** | 31,977,872 |
| Total liabilities and shareholders' equity | **$ 417,799,499** | $ 247,384,613 |

*The accompanying notes are an integral part of these consolidated financial statements. Paid in capital, retained earnings, and common shares outstanding have been adjusted to reflect the 10 percent stock dividend in 2014.*

## CAROLINA ALLIANCE BANK AND SUBSIDIARY

Consolidated Statements of Income

For the Years Ended December 31, 2014 and 2013

| | **2014** | 2013 |
|---|---|---|
| **Interest Income:** | | |
| Interest and fees on loans and finance leases | **$ 14,334,373** | $ 8,581,012 |
| Investment securities | **1,314,717** | 983,687 |
| Federal funds sold and interest bearing bank deposits | **69,013** | 53,346 |
| Total interest income | **15,718,103** | 9,618,045 |
| **Interest Expense:** | | |
| Deposits | **939,570** | 732,496 |
| Other | **102,917** | 88,442 |
| Total interest expense | **1,042,487** | 820,938 |
| **Net Interest Income** | **14,675,616** | 8,797,107 |
| **Provision for Loan and Lease Losses** | **1,098,129** | 475,000 |
| **Net Interest Income After Provision for Loan and Lease Losses** | **13,577,487** | 8,322,107 |
| **Non-Interest Income:** | | |
| Operating lease income | **1,117,046** | - |
| Service fees on deposit accounts | **289,106** | 238,247 |
| Mortgage brokerage income | **121,894** | 60,677 |
| Other income | **241,131** | 185,071 |
| Gain on sale of securities available for sale | **15,776** | 6,619 |
| Gain (loss) on other real estate owned and repossessed assets | **15,310** | (122,872) |
| Gain on sale of Small Business Administration loans | **120,515** | - |
| Bargain purchase gain on merger transaction | **3,817,576** | - |
| Total non-interest income | **5,738,354** | 367,742 |
| **Non-Interest Expense:** | | |
| Salaries and benefits | **6,661,847** | 4,045,119 |
| Occupancy, furniture, and equipment | **1,011,788** | 542,310 |
| Operating lease expense | **992,192** | - |
| Data processing and computer network | **958,444** | 581,750 |
| Marketing | **262,732** | 179,639 |
| Printing, supplies, and postage | **134,822** | 90,165 |
| Core deposit intangible amortization | **177,787** | - |
| Merger-related expenses | **579,720** | 373,956 |
| Other operating | **1,336,555** | 1,004,715 |
| Total non-interest expense | **12,115,887** | 6,817,654 |
| **Income Before Income Taxes** | **7,199,954** | 1,872,195 |
| **Income Tax Expense** | **1,095,054** | 789,402 |
| **Net Income** | **6,104,900** | 1,082,793 |
| **Dividends on Preferred Shares** | **50,000** | 50,000 |
| **Net Income Available to Common Shareholders** | **$ 6,054,900** | $ 1,032,793 |
| **Basic Income per Common Share** | **$ 1.48** | $ 0.37 |
| **Diluted Income per Common Share** | **$ 1.45** | $ 0.37 |
| **Weighted Average Common Shares Outstanding:** | | |
| **Basic** | **4,101,338** | 2,756,916 |
| **Diluted** | **4,170,562** | 2,759,946 |

*The accompanying notes are an integral part of these consolidated financial statements. Earnings per share and weighted average common shares outstanding have been adjusted to reflect the 10 percent stock dividend in 2014.*

## CAROLINA ALLIANCE BANK AND SUBSIDIARY

Consolidated Statements of Comprehensive Income

For the Years Ended December 31, 2014 and 2013

| | 2014 | | 2013 | |
|---|---|---|---|---|
| **Net Income** | | **$ 6,104,900** | | $ 1,082,793 |
| **Other Comprehensive Income (Loss):** | | | | |
| Unrealized gains (losses) on investment securities available for sale, pretax | **$ 832,687** | | $ (1,644,898) | |
| Income tax effect | **(340,538)** | **492,149** | 629,065 | (1,015,833) |
| Reclassification of gain on sale of investment securities included in net income, pretax | **(15,776)** | | (6,619) | |
| Income tax effect | **6,449** | **(9,327)** | 2,707 | (3,912) |
| Total other comprehensive income (loss) | | **482,822** | | (1,019,745) |
| **Comprehensive Income** | | **$ 6,587,722** | | $ 63,048 |

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

**CAROLINA ALLIANCE BANK AND SUBSIDIARY**

Consolidated Statements of Changes in Shareholders' Equity

For the Years Ended December 31, 2014 and 2013

| | Preferred Stock | | Common Stock | | | | Accumulated Other Comprehensive | |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Additional Paid-in Capital | Retained (Deficit) Earnings | Accumulated Other Comprehensive Income (Loss) | Total Shareholders' Equity |
| **Balance, December 31, 2012** | 5,000 | $ 5,000 | 2,500,000 | $ 2,500,000 | $28,775,231 | $ (389,589) | $ 868,094 | $31,758,736 |
| Stock transactions: | | | | | | | | |
| For stock-based compensation | - | - | - | - | 95,736 | - | - | 95,736 |
| For directors' compensation | | | 11,959 | 11,959 | 98,393 | | | 110,352 |
| Preferred stock dividends | - | - | - | - | - | (50,000) | - | (50,000) |
| Net income | - | - | - | - | - | 1,082,793 | - | 1,082,793 |
| Other comprehensive loss | - | - | - | - | - | - | (1,019,745) | (1,019,745) |
| **Balance, December 31, 2013** | **5,000** | **5,000** | **2,511,959** | **2,511,959** | **28,969,360** | **643,204** | **(151,651)** | **31,977,872** |
| Stock transactions: | | | | | | | | |
| For stock-based compensation | **-** | **-** | **-** | **-** | **108,243** | **-** | **-** | **108,243** |
| For directors' compensation | **-** | **-** | **11,416** | **11,416** | **94,443** | **-** | **-** | **105,859** |
| In connection with merger transaction | **-** | **-** | **1,622,746** | **1,622,746** | **11,918,050** | **-** | **-** | **13,540,796** |
| Cash paid in lieu of fractional shares in connection with merger | **-** | **-** | **-** | **-** | **(368)** | **-** | **-** | **(368)** |
| 10% common stock dividend, net of 73 fractional shares | **-** | **-** | **414,539** | **414,539** | **3,441,280** | **(3,855,892)** | **-** | **-** |
| Cash paid in lieu of fractional shares for 10% stock dividend | **-** | **-** | **-** | **-** | **-** | **(680)** | **-** | **(680)** |
| Preferred stock dividends | | | | | | **(50,000)** | **-** | **(50,000)** |
| Net income | **-** | **-** | **-** | **-** | **-** | **6,104,900** | **-** | **6,104,900** |
| Other comprehensive income | **-** | **-** | **-** | **-** | **-** | **-** | **482,822** | **482,822** |
| **Balance, December 31, 2014** | **5,000** | **$ 5,000** | **4,560,660** | **$ 4,560,733** | **$44,531,008** | **$ 2,841,532** | **$ 331,171** | **$52,269,444** |

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

**CAROLINA ALLIANCE BANK AND SUBSIDIARY**

Consolidated Statements of Cash Flows

For the Years Ended December 31, 2014 and 2013

| | **2014** | 2013 |
|---|---|---|
| **Operating Activities:** | | |
| Net income | **$ 6,104,900** | $ 1,082,793 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan and lease losses | **1,098,129** | 475,000 |
| Accretion on acquired loans and deposits, net | **(1,411,029)** | - |
| Depreciation | **1,475,024** | 344,128 |
| Stock compensation | **108,243** | 95,736 |
| Deferred income tax expense | **1,005,513** | 14,430 |
| Amortization of premiums on investment securities, net | **388,654** | 361,593 |
| Gain on sale of investment securities available for sale | **(15,776)** | (6,619) |
| Net (gain) loss on other real estate owned | **(15,310)** | 122,872 |
| Gain on sale of Small Business Administration loans | **(120,515)** | - |
| Proceeds from sale of Small Business Administration loans | **1,789,658** | - |
| Bargain purchase gain on merger transaction | **(3,817,576)** | - |
| Decrease in other assets | **651,808** | 149,583 |
| Increase in other liabilities | **212,939** | 177,531 |
| Net cash provided by operating activities | **7,454,662** | 2,817,047 |
| **Investing Activities:** | | |
| Increase in loans and finance leases, net | **(28,258,027)** | (8,232,002) |
| Purchase of investments: | | |
| Investment securities available for sale | **(7,220,949)** | (11,527,866) |
| Bank term deposits | **(1,743,000)** | (3,984,000) |
| Other investments | **(477,000)** | - |
| Purchase of property and equipment | **(548,262)** | (178,354) |
| Purchase of leased assets | **(1,165,833)** | - |
| Proceeds from investment transactions: | | |
| Principal payments on investment securities available for sale | **8,156,051** | 10,288,174 |
| Maturities and calls of investment securities available for sale | **1,552,300** | - |
| Sales of investment securities available for sale | **2,075,100** | 1,587,881 |
| Maturity of bank term deposits | **3,735,000** | 2,241,000 |
| Redemption of other investments | **188,700** | 59,400 |
| Net cash received from merger | **3,955,731** | - |
| Proceeds from sale of other real estate owned | **472,103** | 378,324 |
| Net cash used for investing activities | **(19,278,086)** | (9,367,443) |
| **Financing Activities:** | | |
| Net increase (decrease) in deposits | **6,192,145** | (5,854,124) |
| Issuance of common stock and cash in lieu | **104,811** | 110,352 |
| Dividends paid on preferred stock | **(50,000)** | (50,000) |
| Borrowings from FHLB of Atlanta | **11,600,000** | - |
| Repayment of borrowings from FHLB of Atlanta | **(1,000,000)** | (1,000,000) |
| Net (decrease) increase in securities sold under agreements to repurchase | **(4,150,168)** | 4,830,725 |
| Net cash provided by (used for) financing activities | **12,696,788** | (1,963,047) |
| **Net Increase (Decrease) in Cash and Cash Equivalents** | **873,364** | (8,513,443) |
| **Cash and Cash Equivalents, Beginning of Period** | **6,547,961** | 15,061,404 |
| **Cash and Cash Equivalents, End of Period** | **$ 7,421,325** | $ 6,547,961 |

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

## CAROLINA ALLIANCE BANK AND SUBSIDIARY *(Continued)*

Consolidated Statements of Cash Flows

For the Years Ended December 31, 2014 and 2013

| | 2014 | 2013 |
|---|---|---|
| **Supplemental Disclosures of Cash Flow Information:** | | |
| Cash paid for interest | **$ 1,027,865** | $ 837,047 |
| Income taxes paid | **$ 934,031** | $ 751,679 |
| Non-cash transactions: | | |
| Loans transferred to other real estate owned | **$ 1,032,163** | $ 621,842 |
| Loans transferred to repossessed collateral | **$ -** | $ 88,000 |
| Unrealized gains (losses) on investment securities | **$ 832,687** | $ (1,644,898) |
| Deferred income taxes on unrealized securities losses and gains | **$ 340,538** | $ 629,065 |
| Reclassification of gain on sale of investment securities included in net income | **$ (15,776)** | $ (6,619) |
| Deferred income taxes on securities gains reclassified | **$ 6,449** | $ 2,707 |

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

## ***NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES***

***Organization -*** Carolina Alliance Bank (the "Bank") was incorporated and began operations in January 2007 and provides a broad array of commercial banking services to its customers. The Bank is subject to regulation of the South Carolina State Board of Financial Institutions and the Federal Deposit Insurance Corporation.

On April 5, 2014, Forest Commercial Bank ("Forest Commercial") was merged with and into the Bank (the "Merger"), with the Bank as the surviving legal entity, in accordance with an Agreement and Plan of Merger dated as of August 7, 2013. See Note 2 – *BUSINESS COMBINATIONS* for complete details on this transaction.

On August 4, 2014, the Bank acquired the commercial leasing operations of Dave McBride Leasing, LLC. See Note 2 – *BUSINESS COMBINATIONS* for complete details on this transaction.

***Basis of Presentation -*** The consolidated financial statements include the accounts of the Bank and its wholly-owned subsidiary, NSCB 2, LLC (whose only business activity is the holding of title to certain operating real estate). Significant intercompany balances and transactions have been eliminated. The accounting policies and reporting practices conform to accounting principles generally accepted in the United States of America ("GAAP") and to general practices in the banking industry.

***Use of Estimates -*** The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amount of income and expenses during the reporting periods. Actual results could differ from those estimates.

***Nature of Operations and Concentrations of Credit Risk -*** The Bank is engaged in the business of accepting demand and time deposits and providing loans to individuals and businesses. The Bank's business is limited primarily to Spartanburg and adjacent counties in the northwestern area of South Carolina. The Bank has a diversified loan portfolio and the borrowers' ability to repay their loans is not dependent upon any specific economic sector.

***Disclosure Regarding Segments -*** The Bank reports as one operating segment, as the chief operating decision-maker reviews the results of operations of the Bank as a single enterprise.

***Reclassifications -*** Certain amounts previously reported have been reclassified to conform to the current presentation of these consolidated financial statements. These reclassifications had no effect on previously reported net income or shareholders' equity.

***Business Combinations and Method of Accounting for Loans Acquired -*** Acquisitions are accounted for under the acquisition method of accounting. A business combination occurs when the Bank acquires net assets that constitute a business, or acquires equity interests in one or more other entities that are businesses and obtains control over those entities. Business combinations are effected through the transfer of consideration consisting of cash and/or common stock. The assets and liabilities of the acquired entity are recorded at their respective fair values as of the acquisition date. When the fair value of the assets purchased exceeds the fair value of liabilities assumed, it results in a "bargain purchase gain." If the consideration given exceeds the fair value of the net assets received, goodwill is recognized.

***NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)***

Determining the fair value of assets and liabilities, especially the loan portfolio, is a complicated process involving significant judgment regarding methods and assumptions used to calculate estimated fair values. Fair values are preliminary and subject to refinement for up to one year after the acquisition date, as relevant information becomes available. The results of operations of acquired entities are included in the Bank's consolidated results from the acquisition date, and prior periods are not restated. No allowance for loan and lease losses related to the acquired loans is recorded on the acquisition date because the fair value of the loans acquired incorporates assumptions regarding future credit losses. The fair value estimates associated with the acquired loans include estimates related to expected prepayments and the amount and timing of expected principal, interest and other cash flows.

***Subsequent Events -*** Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Non-recognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through March 30, 2015 the date the financial statements were issued, and determined that no subsequent events have occurred requiring accrual or disclosure, except as disclosed in Note 20.

***Cash and Cash Equivalents -*** For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, short-term interest bearing deposits and federal funds sold. Cash and cash equivalents have an original maturity of three months or less. Bank term deposits, consisting of FDIC-insured certificates of deposits with original maturities in excess of three months, are not included in cash and cash equivalents.

***Investment Securities -*** Investments in debt and equity securities are required to be classified into one of three categories: "trading," "held to maturity," or "available for sale." During the reporting periods, the Bank held no trading or held to maturity securities. Available for sale securities are debt and equity securities which are not classified as either trading or as held to maturity securities. These securities are reported at fair market value. Net unrealized gains and losses are reported as a separate component of shareholders' equity.

Gains or losses on dispositions of investment securities are determined on a trade date basis and are based on the difference between the net proceeds and the adjusted carrying amount of the securities sold, using the specific identification method. Premiums and discounts are amortized or accreted into interest income by a method that approximates a level yield.

***NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)***

The Bank periodically evaluates its investment securities portfolio for "other-than-temporary impairment." If a security is considered to be other-than-temporarily impaired, the related unrealized loss is charged to income, and a new cost basis is established. Factors considered include the reasons for the impairment; the severity and duration of the impairment; changes in value subsequent to period-end; and forecasted performance of the security issuer. Impairment is considered other-than-temporary unless the Bank has both the intent and ability to hold the security for a sufficient period of time to allow the fair market value to recover and evidence supporting the recovery outweighs evidence to the contrary.

***Other Investments -*** Other investments consists of stock in the Federal Home Loan Bank of Atlanta ("FHLB") which the Bank is required to own as a member institution. Transfer of the stock is restricted, no ready market exists, and it has no quoted market value. However, redemption of the stock historically has been at par value; therefore it is stated at the Bank's cost basis.

***Loans, Interest, and Fee Income on Loans and Leases -*** Loans and finance leases are stated at the principal balance outstanding and reduced by the allowance for loan and lease losses. Loan and lease origination fees and certain direct loan origination costs are deferred and the net amount is accreted or amortized as an adjustment of the related yield over the contractual life of the loan or lease. Loan and lease origination fees and costs are netted and the net amount either reduces or increases net loans and leases outstanding. Interest income is recognized over the term of the loan or lease based on the contractual interest rate and the principal balance outstanding.

*Purchased Credit-Impaired ("PCI") Loans* - Purchased loans acquired in a business combination, which include loans purchased in the Merger, are recorded at estimated fair value on the date of acquisition without the carryover of the related allowance for loan and lease losses. PCI loans are accounted for under the "Receivables" topic of the ASC when the loans have evidence of credit deterioration since origination and it is probable at the date of acquisition that the Bank will not collect all contractually required principal and interest payments. Purchased impaired loans generally meet the Bank's definition for nonaccrual status. The Merger with Forest Commercial included only two PCI loans, whose combined book balance totaled less than $100 thousand at December 31, 2014.

*Purchased Performing Loans* - The Bank accounts for performing loans acquired in business combinations using the contractual cash flows method of recognizing discount accretion based on the acquired loans' contractual cash flows. Purchased performing loans are recorded at fair value, including a credit discount. The fair value discount is accreted as an adjustment to yield over the estimated lives of the loans. There is no allowance for loan and lease losses established at the acquisition date for purchased performing loans. A provision for loan and lease losses is recorded for any further deterioration in these loans subsequent to the acquisition.

Loans generally are placed on non-accrual status when principal or interest becomes 90 days past due, or when payment in full is not anticipated. Interest payments received after a loan is placed in non-accrual status are applied as principal reductions until such time as the loan is returned to accrual status. Generally, a loan is returned to accrual status when the loan is brought current and the collectability of principal and interest is no longer in doubt.

***Allowance for Loan and Lease Losses -*** The Bank provides for loan and lease losses using the allowance method. Provisions for loan and lease losses are added to the allowance through charges to operating expenses. Loans and leases which are determined to be uncollectible are charged against the allowance and recoveries on loans and leases previously charged off are added to the allowance. The provision for loan and lease losses charged to operations is an amount sufficient to bring the allowance for loan and lease losses to an estimated balance considered adequate to absorb losses inherent in the portfolio.

***NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)***

Management's determination of the adequacy of the allowance is based on an evaluation of the portfolio, current economic conditions, historical loan and lease loss experience, and other risk factors. While management uses the best information available to make evaluations, future adjustments may be necessary if economic and other conditions differ substantially from the assumptions used. The allowance for loan and lease losses is subject to periodic evaluation by various regulatory authorities and may be subject to adjustment upon their examination.

A loan is considered to be impaired when full payment according to the terms of the loan agreement is not probable or when the terms of a loan are modified in a troubled debt restructuring ("TDR"). The fair value of impaired loans may be determined based upon the present value of expected cash flows discounted at the loan's effective interest rate, the market price of the loan, if available, or, if the loan is collateral-dependent, the value of the underlying collateral, less estimated selling costs when foreclosure is imminent.

The treatment of the loan impairment is based on the status of the borrower and the underlying collateral. In general, the impairment is charged-off for collateral-dependent loans and consumer loans. For all other loans, a portion of the allowance for loan and lease losses is allocated specifically to each impaired loan. When the ultimate collectability of an impaired loan's principal is in doubt, wholly or partially, all cash receipts are applied to principal. Once payments equal to the outstanding principal balance have been received, further cash receipts are applied to interest income, to the extent that any interest has been foregone.

***Property and Equipment -*** Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets. Building and fixtures have estimated useful lives of 10 to 40 years and furniture and equipment have estimated useful lives of 3 to 15 years. Maintenance and repairs are charged to operations, while major improvements are capitalized. Upon retirement, sale, or other disposition of property and equipment, the cost and accumulated depreciation are eliminated from the accounts and the gain or loss is included in income from operations.

***Leased Assets -*** The Bank has purchased construction and athletic equipment that it leases to customers under operation lease agreements with varying terms. The value of the lease asset (or lease or rental equipment) is recorded at cost and depreciated on the straight-line bases over the estimated useful life (3 to 5 years), after the date the equipment is put in service, and depreciated down to their estimated residual values. The Bank periodically reviews the residual values of leased assets for impairment using various factors, including the practices and benchmarks of the larger competitors in the particular industry.

Costs incurred on leased equipment subsequent to initial acquisition are capitalized when it is probable that future economic benefits in excess of the originally assessed performance will result; otherwise, they are expensed as incurred.

***NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)***

***Other Real Estate Owned and Repossessed Assets -*** Other real estate owned is comprised of real property acquired through a foreclosure proceeding or acceptance of a deed-in-lieu of foreclosure. Repossessed assets include personal property acquired through conveyance in satisfaction of debts. Other real estate owned and repossessed assets are recorded at the lower of the recorded investment in the loan at the time of acquisition or the fair value of the underlying property collateral, less estimated selling costs. Any write-down in the carrying value of a property at the time of acquisition is charged to the allowance for loan and lease losses. Any subsequent write-downs to reflect current fair market value, as well as gains and losses on disposition and revenues and expenses incurred in maintaining such properties, are treated as period costs. Other real estate owned and repossessed assets are included in "Other assets" in the balance sheet and balances are summarized in Note 4.

***Intangible Assets -*** Intangible assets are substantially all comprised of the core deposit intangible that resulted from the merger with Forest Commercial. Core deposit intangibles represent the value of long-term deposit relationships acquired in a business combination. The core deposit intangible is being amortized over seven years using the 150% declining balance method. This amortization method is used to match the recognition of the cost of the asset to the estimated lives of the underlying deposit relationships. These estimated useful lives are periodically reviewed for reasonableness.

***Advertising -*** Advertising, promotional, and other business development costs generally are expensed as incurred. External costs incurred in producing media advertising are expensed the first time the advertising takes place. External costs relating to direct mailing costs are expensed in the period in which the direct mailings are sent.

***Stock Dividend -*** On September 5, 2014 the board of directors declared a ten percent stock dividend of the Bank's common shares, distributed on October 7, 2014. All references to share and per share amounts in the statements of operations and accompanying notes to the financial statements have been retroactively restated to reflect the ten percent stock dividend.

***Stock-Based Compensation -*** The Bank adopted a stock option plan on May 21, 2007. The fair value of the stock options issued under the plan is expensed over the vesting period of each option grant. Further information about the plan and the methodology to determine the fair value of stock options is detailed in Note 15.

***Income Taxes -*** The asset and liability approach is utilized to account for income taxes, which requires recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the financial statement carrying values and the tax bases of assets and liabilities, as well as net operating loss carry forwards. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be realized or settled. A current tax asset or liability is recognized for taxes that are presently payable and included in "Other assets" in the balance sheet.

The Bank has analyzed its filing positions in the federal and state jurisdictions where it is required to file income tax returns, as well as all open tax years in these jurisdictions. The Bank believes that income tax filing positions taken or expected to be taken in its tax returns will more likely than not be sustained upon audit by the taxing authorities and does not anticipate any adjustments that will result in a material adverse impact on the Bank's financial condition, results of operations, or cash flows. Therefore, no reserves for uncertain income tax positions have been recorded.

***NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)***

***Earnings Per Share -*** Basic earnings per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income available to common shareholders by the weighted average number of common shares and potential common shares outstanding during the period. Potential common shares consist solely of dilutive stock options determined by the treasury stock method using the average market price of the shares during the period. The dilutive effect of stock options outstanding on earnings per share at December 31, 2014 and 2013 was either insignificant or non-existent. All earnings per share amounts have been restated to reflect the ten percent stock dividend issued in October 2014.

***Sales of Loans –*** Gains and losses on the sales of loans are accounted for as the difference between the proceeds received and the carrying value of the loans. Such gains or losses are recognized in the financial statements at the time of the sale.

***Comprehensive Income -*** Comprehensive income consists of net income and net unrealized gains and losses on investment securities available for sale and is presented in the Consolidated Statements of Changes in Shareholders' Equity and in the separate Consolidated Statements of Comprehensive Income.

***Fair Value Measurements -*** Fair value is 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. Fair values are determined under a hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs in the measurement process. There are three levels of inputs that may be used to measure fair value:

*Level 1:* These inputs principally consist of quoted prices in active markets for identical assets or liabilities. (The Bank has no assets or liabilities measured by the use of Level 1 inputs.)

*Level 2:* Observable inputs such as quoted prices for similar assets or liabilities or other inputs that are observable or can be corroborated by observable market data are the primary types of measurements that comprise Level 2.

*Level 3:* Unobservable inputs that are supported by little or no market activity or that may involve using pricing models, discounted cash flow methodologies, or similar techniques are included in this level. The determination of values also may require significant management judgment or estimation.

***NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)***

***Recently Issued Accounting Standards -*** In February 2013, the Financial Accounting Standards Board ("FASB") amended the Liabilities topic of the Accounting Standards Codification to address obligations resulting from joint and several liability arrangements. The guidance addresses recognition of financial commitments arising from joint and several liability arrangements. Specifically, the amendments require recognition of financial commitments arising from loans, contracts, and legal rulings if the Bank can be held liable for the entire claim. The amendments were effective for the Bank for reporting periods ending after December 15, 2014. The Bank does not expect these amendments to have a material effect on its consolidated financial statements.

In January 2014, the FASB amended Receivables topic of the Accounting Standards Codification. The amendments are intended to resolve diversity in practice with respect to when a creditor should reclassify a collateralized consumer mortgage loan to other real estate owned ("OREO"). In addition, the amendments require a creditor reclassify a collateralized consumer mortgage loan to OREO upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. The amendments will be effective for the Bank for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015, with early implementation of the guidance permitted. In implementing this guidance, assets that are reclassified from real estate to loans are measured at the carrying value of the real estate at the date of adoption. Assets reclassified from loans to real estate are measured at the lower of the net amount of the loan receivable or the fair value of the real estate less costs to sell at the date of adoption. The Bank will apply the amendments prospectively. The Bank does not expect these amendments to have a material effect on its consolidated financial statements.

## ***NOTE 2 - BUSINESS COMBINATIONS***

On August 1, 2014, the Bank acquired substantially all assets and assumed substantially all liabilities of the commercial leasing operations of Dave McBride Leasing, LLC ("DML"). The acquisition was a significant addition to the Bank's existing commercial leasing line of business, which had been concentrated geographically in North Carolina. The following table presents the consideration paid by the Bank and the assets acquired and liabilities assumed as of August 1, 2014:

| | As Recorded by DML | Fair Value and Other Merger Related Adjustments | As Recorded by the Bank |
|---|---|---|---|
| **Consideration paid:** | | | |
| Cancellation of the Bank's loan to DML | | | $ 1,766,810 |
| Cash | | | 733,440 |
| Installments due seller | | | 282,347 |
| Total consideration | | | 2,782,597 |
| **Assets:** | | | |
| Leases receivable (net of unearned income) | $ 5,753,507 | $ 371,782 | 6,125,289 |
| Other assets | 24,062 | 110,565 | 134,627 |
| Total assets acquired | 5,777,569 | 482,347 | 6,259,916 |
| **Liabilities:** | | | |
| Third-party bank notes payable | 3,477,319 | - | 3,477,319 |
| Carolina Alliance notes payable | 1,766,810 | (1,766,810) | - |
| Total liabilities assumed | 5,244,129 | (1,766,810) | 3,477,319 |
| Net identifiable assets acquired over liabilities assumed | $ 533,440 | $ 2,249,157 | $ 2,782,597 |

Since the net assets acquired represent less than one percent of total assets, the acquisition did not have a material effect on revenue or net income in 2014 or on a proforma basis if the transaction had been consummated on January 1, 2013.

On April 5, 2014, the Bank completed its merger with Forest Commercial Bank, a North Carolina state-chartered bank with its principal office in Asheville, North Carolina ("Forest Commercial"). Under terms of the Agreement and Plan of Merger (the "Merger Agreement") dated August 7, 2013, each outstanding share of the common stock of Forest Commercial was exchanged for 0.755 shares of Carolina Alliance common stock, and Forest Commercial merged with and into the Bank. Merger consideration consisted of 1,622,746 shares of common stock, cash aggregating to $205,856 for payments to dissenting shareholders, and cash paid in lieu of fractional shares. The shares issued and the cash paid were based on a value of $8.35 per share, which was the volume weighted average trading price of a share of Carolina Alliance common stock on the OTCBB, as reported by Bloomberg, for the 30 days prior to the closing date. The total value of consideration to Forest Commercial shareholders was $13,755,785.

Forest Commercial operated two full-service offices located in Asheville and Hendersonville, North Carolina and a loan production office located in Charlotte, North Carolina. The merger with Forest Commercial was undertaken in the execution of the Bank's business plan which in part sought a merger partner for the acceleration of growth and geographic diversification.

***NOTE 2 - BUSINESS COMBINATIONS (Contiued)***

The following table presents the consideration paid by the Bank in the acquisition of Forest Commercial and the assets acquired and liabilities assumed as of April 5, 2014:

| | As Recorded by Forest Commercial | Fair Value and Other Merger Related Adjustments | As Recorded by the Bank |
|---|---|---|---|
| **Consideration paid:** | | | |
| Common shares issued (1,622,746 shares) | | | $ 13,540,796 |
| Cash | | | 214,989 |
| Total consideration | | | 13,755,785 |
| **Assets:** | | | |
| Cash and cash equivalents | $ 5,252,375 | $ - | 5,252,375 |
| Investment securities, available for sale | 20,389,455 | - | 20,389,455 |
| Other investments | 1,167,650 | - | 1,167,650 |
| Loans and finance leases, net | 124,107,107 | (2,357,214) | 121,749,893 |
| Property and equipment, net | 3,868,071 | - | 3,868,071 |
| Accrued interest | 345,359 | - | 345,359 |
| Core deposit intangibles | - | 1,125,940 | 1,125,940 |
| Other assets | 1,568,765 | 721,701 | 2,290,466 |
| Total assets acquired | 156,698,782 | (509,573) | 156,189,209 |
| **Liabilities:** | | | |
| Deposits | 128,593,780 | 418,196 | 129,011,976 |
| Other borrowings | 9,144,998 | - | 9,144,998 |
| Other liabilities | 458,874 | - | 458,874 |
| Total liabilities assumed | 138,197,652 | 418,196 | 138,615,848 |
| **Net identifiable assets acquired over liabilities assumed** | $ 18, 501,130 | $ (927,769) | $ 17,573,361 |
| **Bargain purchase gain** | | | $ 3,817,576 |

Fair value and other merger related adjustments include decreases in the historical cost of loans and leases for current market interest rates in excess of contractual rates in the amount of $2,231,519 and net adjustment for potential loan and lease losses in excess of the recorded allowance for loan and lease losses in the amount of $125,695. An intangible asset in the amount of $1,125,940 for the fair value of long-term deposit relationships was recorded and an increase in the stated value of certificates of deposits in the amount of $418,196 was recorded to reflect contractual rates in excess of current market interest rates. An increase of $721,701 in Forest Commercial's deferred tax asset was recorded to reflect the tax effect of these adjustments.

The following table discloses certain pro forma information reflecting the impact of the merger with Forest Commercial during the period April 4, 2014 through December 31, 2014 as well for the years ended December 31, 2014 and 2013 as if the merger had occurred January 1, 2013.

***NOTE 2 - BUSINESS COMBINATIONS (Contiued)***

These results combine the historical results of Forest Commercial in the Consolidated Statements of Income and, while certain adjustments were made for the estimated impact of certain fair value adjustments and other merger-related activity, they are not indicative of what would have occurred had the merger taken place on January 1, 2013.

| | Inception to December 31, 2014 | Year Ended December 31, 2014 | Year Ended December 31, 2013 |
|---|---|---|---|
| Net interest income plus other income | **$ 13,113,363** | **$ 15,009,101** | **$ 15,787,079** |
| Net income | **1,805,883** | **1,767,873** | **1,892,156** |
| Acquisition costs | **401,697** | **493,412** | **747,760** |

***NOTE 3 - INVESTMENT SECURITIES***

The amortized cost and fair value of investment securities available for sale at December 31, 2014 and 2013 are as follows:

| 2014 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| U.S. government agency and sponsored enterprises | **$ 14,784,022** | **$ 101,125** | **$ (166,937)** | **$ 14,718,210** |
| Agency mortgage-backed securities | **20,493,045** | **463,238** | **(13,827)** | **20,942,456** |
| Agency collateralized mortgage obligations | **13,228,670** | **149,958** | **(86,843)** | **13,291,785** |
| Corporate securities | **1,000,630** | **-** | **(220)** | **1,000,410** |
| Municipal securities | **10,709,882** | **120,099** | **(6,268)** | **10,823,713** |
| Total available for sale | **$ 60,216,249** | **$ 834,420** | **$ (274,095)** | **$60,776,574** |

| 2013 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| U.S. government agency and sponsored enterprises | $ 11,186,620 | $ 6,111 | $ (597,635) | $ 10,595,096 |
| Agency mortgage-backed securities | 18,267,967 | 398,711 | (33,143) | 18,633,535 |
| Agency collateralized mortgage obligations | 6,335,751 | 49,686 | (99,815) | 6,285,622 |
| Municipal securities | 9,013,883 | 72,550 | (53,051) | 9,033,382 |
| Total available for sale | $ 44,804,221 | $ 527,058 | $ (783,644) | $ 44,547,635 |

In the year ended December 31, 2014, there was one sale of an investment security available for sale at a gain; there were two sales at a loss. The gross proceeds and gross gains realized are reflected in the Consolidated Statements of Cash Flows. In the year ended December 31, 2013, there were five sales of investment securities available for sale at a gain; there were no sales at a loss. The gross proceeds and gross gains realized are reflected in the Consolidated Statements of Cash Flows.

***NOTE 3 - INVESTMENT SECURITIES (Continued)***

For investment securities which had been in an unrealized loss position for less than 12 months, the number of securities, the fair value, and the gross unrealized losses for each investment security category at December 31, 2014 and 2013 are as follows.

| | 2014 | | | 2013 | | |
|---|---|---|---|---|---|---|
| | # | Fair Value | Unrealized Losses | # | Fair Value | Unrealized Losses |
| U.S. government agency and sponsored enterprises | **3** | **$ 926,225** | **$ (2,110)** | 23 | $ 9,317,014 | $ (533,470) |
| Agency mortgage-backed securities | **9** | **1,170,212** | **(11,915)** | 10 | 4,896,276 | (33,143) |
| Agency collateralized mortgage obligations | **5** | **3,878,733** | **(58,077)** | 7 | 2,934,536 | (55,633) |
| Corporate securities | **1** | **1,000,410** | **(220)** | - | - | - |
| Municipal securities | **4** | **1,443,452** | **(6,268)** | 6 | 1,737,203 | (22,758) |
| Total temporarily impaired securities | **22** | **$ 8,419,032** | **$ (78,590)** | 46 | $18,885,029 | $ (645,004) |

There were twenty-one investment securities which had been in an unrealized loss position for greater than 12 months at December 31, 2014 versus five at December 31, 2013. The number of securities, the fair value, and the gross unrealized losses for each investment security category at December 31, 2014 and 2013 are as follows.

| | 2014 | | | 2013 | | |
|---|---|---|---|---|---|---|
| | # | Fair Value | Unrealized Losses | # | Fair Value | Unrealized Losses |
| U.S. government agency and sponsored enterprises | **17** | **$ 7,006,099** | **$ (164,827)** | 1 | $ 652,943 | $ (64,165) |
| Agency mortgage-backed securities | **1** | **316,872** | **(1,912)** | - | - | - |
| Agency collateralized mortgage obligations | **3** | **1,186,436** | **(28,766)** | 2 | 871,195 | (44,182) |
| Municipal securities | **-** | **-** | **-** | 2 | 503,358 | (30,293) |
| Total temporarily impaired securities | **21** | **$ 8,509,407** | **$ (195,505)** | 5 | $ 2,027,496 | $ (138,640) |

Based on its other-than-temporary impairment analysis at December 31, 2014, management concluded that the unrealized losses reflected in the preceding summaries were not other-than-temporarily impaired as of that date. Management believes the decline in value to be solely the result of changes in interest rates and not from deterioration in the securities' quality. The Bank has the intention and ability to hold these securities for a period of time sufficient to allow for their recovery in value or maturity.

***NOTE 3 - INVESTMENT SECURITIES (continued)***

Investment securities at December 31, 2014 and 2013 were pledged as collateral for the following purposes (at fair value):

| | 2014 | 2013 |
|---|---|---|
| FHLB advances | **$ -** | $ 2,017,327 |
| Customer repurchase agreements | **7,857,903** | 10,688,146 |
| Public entity deposits | **9,480,106** | 8,383,825 |
| Total | **$ 17,338,009** | $ 21,089,298 |

Amortized cost and fair value of securities available for sale at December 31, 2014, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Mortgage-backed securities and collateralized mortgage obligations are shown separately since they are not due at a single maturity date.

| | Amortized Cost | Fair Value |
|---|---|---|
| Due within one year or less | **$ 3,539,613** | $ 3,542,825 |
| Due after one through five years | **10,569,043** | 10,658,362 |
| Due after five through ten years | **12,010,267** | 11,937,563 |
| Due after ten years | **375,611** | 403,583 |
| No contractual maturity | **33,721,715** | 34,234,241 |
| Total investment securities | **$ 60,216,249** | $ 60,776,574 |

***NOTE 4 – LOANS AND FINANCE LEASES***

Loans and leases receivable at December 31, 2014 and 2013 consisted of the following:

| | 2014 | 2013 |
|---|---|---|
| Commercial | **$ 50,570,533** | $ 35,646,157 |
| Real estate: | | |
| Commercial | **197,039,075** | 115,018,431 |
| Residential | **51,376,996** | 26,464,575 |
| Construction | **11,811,205** | 1,742,417 |
| Consumer | **4,326,335** | 3,857,454 |
| Gross loans | **315,124,144** | 182,729,034 |
| Finance leases | **20,031,638** | - |
| Gross loans and finance leases | **335,155,782** | 182,729,034 |
| Allowance for loan and lease losses | **(3,946,405)** | (3,515,034) |
| Fair value adjustments on acquired loans and leases | **(2,613,584)** | - |
| Deferred fees and costs, net | **(1,723,059)** | 116,714 |
| Net loans and finance leases | **$ 326,872,734** | $ 179,330,714 |

***NOTE 4 - LOANS (Continued)***

At December 31, 2014, substantially all of the Bank's residential mortgage loans were pledged as collateral for advances from the FHLB under the borrowing facility described in Note 9.

A summary of changes in the allowance for loan and lease losses is as follows for the years ended December 31, 2014 and 2013:

| | **2014** | 2013 |
|---|---|---|
| Balance, beginning of period | **$ 3,515,034** | $ 3,082,443 |
| Provision for loan and lease losses | **1,098,129** | 475,000 |
| Loans charged off | **(700,928)** | (205,558) |
| Loan recoveries | **34,170** | 163,149 |
| Balance, end of period | **$ 3,946,405** | $ 3,515,034 |

The Bank makes loans to individuals and small- to mid-sized businesses for various personal and commercial purposes primarily in the upstate region of South Carolina and western North Carolina. Credit concentrations can exist in relation to individual or groups of borrowers, industry segments, geographic regions and collateral characteristics. Credit risk associated with these concentrations could arise when a significant amount of loans sharing similar characteristics are simultaneously impacted by economic or other conditions which adversely affect their collectability. The Bank regularly monitors its credit concentrations. The Bank's loan portfolio is not concentrated in loans to any single borrower or a relatively small number of borrowers. The largest component of the loan portfolio is loans secured by real estate mortgages which were comprised of the following at December 31, 2014 (construction loans have been allocated to commercial and residential categories as appropriate):

***NOTE 4 - LOANS (Continued)***

| | Amount | % of Real Estate Loans |
|---|---|---|
| Commercial real estate : | | |
| Owner-occupied | $ 94,077,571 | 36.2% |
| Other | 110,094,770 | 42.3% |
| Total commercial real estate | 204,172,341 | 78.5% |
| Residential real estate | 56,054,935 | 21.5% |
| Total real estate loans | $ 260,227,276 | 100.0% |
| % of gross loans | 82.6% | |

In addition to monitoring potential concentrations described above, management monitors exposure to credit risk that could arise from potential concentrations of lending products and practices, such as loans that subject borrowers to substantial payment increases (e.g. principal deferral periods, loans with initial interest-only periods, etc.) and loans with high loan-to-value ratios. At December 31, 2014, approximately $9.5 million, or 3.0% of gross loans, were identified as having high loan-to-value ratios. The largest component comprising these loans was commercial real estate loans of approximately $6.0 million which was below the aggregate supervisory loan-to-value limit of 30% of capital for this type of loan by approximately $9.9 million.

The remainder of the balance of high loan-to-value loans, $3.5 million, was also well below supervisory limits. Additionally, there are industry practices that could subject the Bank to increased credit risk should economic conditions change over the course of a loan's life. For example, the Bank makes variable rate loans and fixed rate principal-amortizing loans with maturities prior to the loan being fully paid (i.e. balloon payment loans). These loans are underwritten and monitored to manage the associated risks. Management has determined that there is no concentration of credit risk associated with its lending policies or practices.

***NOTE 4 - LOANS (Continued)***

Credit quality of individual residential loans and consumer loans is monitored principally through review of delinquency measures and non-accrual levels on a portfolio-level basis. The Bank uses an internal loan grading system to classify and monitor the credit quality of all commercial loans. Loan risk grades are based on a graduated scale representing increasing likelihood of loss. The originating loan officers are responsible for the assignment of risk grades to commercial loans, subject to verification by an approving officer or the Management Loan Committee. In addition, the Credit Policy Officer is responsible for confirming loan grades and, along with the Management Loan Committee, has final authority over loan grading. Loan gradings also are reviewed on a regular basis by an independent third-party loan review firm. Individual loan officers also are responsible for ensuring that loan grades are updated as needed over the life of the loan. Loan grade descriptions and a summary of the grading of the Bank's loan portfolio by segment at December 31, 2014 are as follows:

***Grade 1 -*** Credits in this category are virtually risk-free and are well-collateralized by cash-equivalent instruments. The repayment program is well-defined and achievable. Repayment sources are numerous. No material documentation deficiencies or exceptions exist.

***Grade 2 -*** This grade is reserved for loans secured by readily marketable collateral, or loans within guidelines to borrowers with liquid financial statements. A liquid financial statement is a financial statement with substantial liquid assets relative to debts. These loans have excellent sources of repayment, with no significant identifiable risk of collection, and conform in all respects to Bank policy, guidelines, underwriting standards, and Federal and State regulations (no exceptions of any kind).

***Grade 3 -*** This grade is reserved for the Bank's top quality loans. These loans have excellent sources of repayment, with no significant identifiable risk of collection. Generally, loans assigned this risk grade will demonstrate the following characteristics:

- No exceptions of any kind.
- Documented historical cash flow that meets or exceeds required minimum Bank guidelines, or that can be supplemented with verifiable cash flow from other sources.
- Adequate secondary sources to liquidate the debt.

***Grade 4 -*** This grade is given to acceptable loans. These loans have adequate sources of repayment, with little identifiable risk of collection. Loans assigned this risk grade will demonstrate the following characteristics:

- Limited exceptions - any exceptions that are identified during the underwriting and approval process have been adequately mitigated by other factors.
- Documented historical cash flow that meets or exceeds required minimum Bank guidelines, or that can be supplemented with verifiable cash flow from other sources.
- Adequate secondary sources to liquidate the debt.

***NOTE 4 - LOANS (Continued)***

***Grade 5 -*** This grade is given to acceptable loans that show signs of weakness in either adequate sources of repayment or collateral, but have demonstrated mitigating factors that minimize the risk of delinquency or loss. Loans assigned this grade may demonstrate some or all of the following characteristics:

- Additional exceptions to the Bank's policy requirements, product guidelines, or underwriting standards that present a higher degree of risk to the Bank. Although the combination and/or severity of identified exceptions is greater, all exceptions have been properly mitigated by other factors.
- Unproved, insufficient or marginal primary sources of repayment that appear sufficient to service the debt at this time.
- Marginal or unproven secondary sources to liquidate the debt.

***Grade 6 -*** Watch List or **Special Mention** loans include the following characteristics:

- Loans with underwriting guideline tolerances and/or exceptions and with no mitigating factors.
- Extending loans that are currently performing satisfactorily but with potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Bank's position at some future date.
- Loans where adverse economic conditions that develop subsequent to the loan origination that don't jeopardize liquidation of the debt but do substantially increase the level of risk may also warrant this rating.

***Grade 7 -*** A **substandard** loan is inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as substandard must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt; they are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. Loans consistently not meeting the repayment schedule should be downgraded to substandard. Loans in this category are characterized by deterioration in quality exhibited by any number of well-defined weaknesses requiring corrective action. Such loans are no longer considered to be adequately protected due to the borrower's declining net worth, lack of earnings capacity, declining collateral margins and/or unperfected collateral positions. A possibility of loss of a portion of the loan balance cannot be ruled out. The repayment ability of the borrower is marginal or weak and the loan may have exhibited excessive overdue status or extensions and/or renewals.

***Grade 8 -*** Loans classified **Doubtful** have all the weaknesses inherent in loans classified Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. However, these loans are not yet rated as loss because certain events may occur which would salvage the debt. The ability of the borrower to service the debt is extremely weak, overdue status is constant, the debt has been placed on non-accrual status, and no definite repayment schedule exists. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off.

***Grade 9-*** Loans classified **Loss** are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this worthless loan even though partial recovery may be effected in the future.

***Not Graded-*** Primarily consists of individual residential or consumer loans not assigned a risk grade, in accordance with the Bank’s credit policy. Also, not graded may be commercial loans for which a grade is pending because the loan is under review.

***NOTE 4 - LOANS (Continued)***

The composition of the loan portfolio by segment and grade at December 31, 2014 is as follows:

| | | Real Estate | | | | |
|---|---|---|---|---|---|---|
| | **Commercial** | **Commercial** | **Residential** | **Construction** | **Consumer** | **Total** |
| Grade 1 | **$ 3,932,940** | **$ -** | **$ -** | **$ -** | **$ -** | **$ 3,932,940** |
| Grade 2 | **3,498,054** | **304,802** | **-** | **-** | **-** | **3,802,856** |
| Grade 3 | **10,532,152** | **58,665,480** | **60,294** | **2,804,271** | **-** | **72,062,197** |
| Grade 4 | **26,220,695** | **88,684,682** | **350,686** | **5,881,784** | **-** | **121,137,847** |
| Grade 5 | **5,276,432** | **37,014,079** | **72,620** | **1,267,329** | **386** | **43,630,846** |
| Grade 6 | **288,866** | **3,385,931** | **357,557** | **-** | **9,171** | **4,041,525** |
| Grade 7 | **124,069** | **8,261,583** | **985,314** | **-** | **14,350** | **9,385,316** |
| Grade 8 | **-** | **441,881** | **115,525** | **-** | **-** | **557,406** |
| Not graded | **697,325** | **280,637** | **49,435,000** | **1,857,821** | **4,302,428** | **56,573,211** |
| Gross loans | **$50,570,533** | **$197,039,075** | **$ 51,376,996** | **$ 11,811,205** | **$ 4,326,335** | **$315,124,144** |

Loan grade descriptions and a summary of the grading of the Bank's loan portfolio by segment at December 31, 2013 are as follows:

***Grade 1 -*** High Liquidity; Minimal Risk - Grade is based on highest quality liquid collateral, minimum risk, and excellent ratios.

***Grade 2 -*** Strong Liquidity; Low Risk - Borrower has strong financial statements, or loan is secured by marketable securities without impairment to liquidation. Although one measure removed from Grade 1, any unfavorable factor is outweighed by other positive considerations.

***Grade 3 -*** Normal Liquidity; Average Risk - Reasonable and satisfactory risk exists in these loans to borrowers with good financial strength. The loan's purpose becomes a more significant factor at this level.

***Grade 4 -*** Pass/Watch; Marginal Liquidity; Average Risk - Includes borrowers with generally acceptable credit strength, but with manageable weaknesses or uncertainty evident in one or more factors.

***Grade 5 -*** Special Mention/Potential Problem; Uncertain Liquidity; More than Normal Risk - Loans with potential weaknesses that deserve management's close attention are included. If left uncorrected, these potential weaknesses may result in deterioration of repayment prospects.

***Grade 6 -*** Substandard/Problem Loan; Minimal Liquidity; Abnormal Risk (Unacceptable) - The Bank is inadequately protected by the current sound worth and paying capacity of the borrower or of any pledged collateral. Well-defined weakness or weaknesses that jeopardize the liquidation of the debt is present. The loan is characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

***Grade 7 -*** Doubtful; Loss Potential; Absence of Liquidity - These loans exhibit all the weaknesses inherent in Grade 6 with the added characteristic that the weaknesses make collection in full highly questionable and improbable.

***NOTE 4 - LOANS (Continued)***

***Grade 8 -*** Loss/Charge-Off - Considered uncollectible; some recovery potential may exist, but the probability of such recovery does not support continued reflection of the loan as an asset.

***Not Graded -*** Primarily consists of individual residential or consumer loans not assigned a risk grade, in accordance with the Bank's credit policy. Also not graded may be commercial loans for which a grade is pending because the loan is under review.

The composition of the loan portfolio by segment and grade at December 31, 2013 is as follows:

| | | Real Estate | | | | |
|---|---|---|---|---|---|---|
| | **Commercial** | **Commercial** | **Residential** | **Construction** | **Consumer** | **Total** |
| Grade 1 | $ 813,020 | $ - | $ - | $ - | $ - | $ 813,020 |
| Grade 2 | 1,779,549 | - | - | - | - | 1,779,549 |
| Grade 3 | 10,223,584 | 37,180,323 | - | 322,865 | - | 47,726,772 |
| Grade 4 | 21,766,550 | 69,265,065 | 693,758 | - | - | 91,725,373 |
| Grade 5 | 524,979 | 3,690,023 | 253,600 | - | 1,000 | 4,469,602 |
| Grade 6 | 27,080 | 4,882,570 | 322,414 | 550,953 | 10,941 | 5,793,958 |
| Grades 7, 8 | - | - | - | - | - | - |
| Not graded | 511,395 | 450 | 25,194,803 | 868,599 | 3,845,513 | 30,420,760 |
| Gross loans | $35,646,157 | $115,018,431 | $26,464,575 | $ 1,742,417 | $ 3,857,454 | $182,729,034 |

The composition of non-performing assets at December 31, 2014 and 2013 is as follows:

| | **2014** | **2013** |
|---|---|---|
| Non-accrual loans: | | |
| Commercial | **$ 29,710** | $ 4,697 |
| Real estate: | | |
| Commercial | **2,229,043** | 665,377 |
| Residential | **115,526** | - |
| Construction | **-** | - |
| Consumer | **-** | - |
| Total non-accrual loans | **2,374,279** | 670,074 |
| Other real estate owned | **1,684,101** | 1,108,731 |
| Non-performing assets | **$ 4,058,380** | $ 1,778,805 |
| Loans past due 90 days or more still accruing interest | **$ -** | $ - |

***NOTE 4 - LOANS (Continued)***

The composition of past due loans by portfolio segment at December 31, 2014 is as follows:

| | 30-59 Days | 60-89 Days | Greater than 90 Days and on Nonaccrual | Total Past Due | Current | Total Loans |
|---|---|---|---|---|---|---|
| Commercial | $ 887 | $ - | $ 29,710 | $ 30,597 | $ 50,539,936 | $ 50,570,533 |
| Real estate: | | | | | | |
| Commercial | - | - | 2,229,043 | 2,229,043 | 194,810,032 | 197,039,075 |
| Residential | 673,762 | - | 115,525 | 789,287 | 50,587,709 | 51,376,996 |
| Construction | - | - | - | - | 11,811,205 | 11,811,205 |
| Consumer | - | - | - | - | 4,326,335 | 4,326,335 |
| Gross loans | $ 674,649 | $ - | $ 2,374,278 | $ 3,048,927 | $312,075,217 | $315,124,144 |

The composition of past due loans by portfolio segment at December 31, 2013 is as follows:

| | 30-59 Days | 60-89 Days | Greater than 90 Days | Total Past Due | Current | Total Loans |
|---|---|---|---|---|---|---|
| Commercial | $ - | $ 11,331 | $ 4,697 | $ 16,028 | $ 35,630,129 | $ 35,646,157 |
| Real estate: | | | | | | |
| Commercial | 497,044 | 453,126 | 665,377 | 1,615,547 | 113,402,884 | 115,018,431 |
| Residential | 107,336 | - | - | 107,336 | 26,357,239 | 26,464,575 |
| Construction | - | - | - | - | 1,742,417 | 1,742,417 |
| Consumer | - | - | - | - | 3,857,454 | 3,857,454 |
| Gross loans | $ 604,380 | $ 464,457 | $ 670,074 | $ 1,738,911 | $180,990,123 | $182,729,034 |

***NOTE 4 - LOANS (Continued)***

The following tables summarize information relative to impaired loans by portfolio segment.

| | December 31, 2014 | | | | |
|---|---|---|---|---|---|
| | **Recorded Investment** | **Unpaid Principal Balance** | **Related Allowance** | **Average Recorded Investment** | **Interest Income Recognized** |
| With no related allowance: | | | | | |
| Commercial | $ 29,710 | $ 30,758 | $ - | $ 89,826 | $ 6,348 |
| Real estate: | | | | | |
| Commercial | 4,542,070 | 4,633,533 | - | 5,195,702 | 253,246 |
| Residential | 574,070 | 587,913 | - | 778,101 | 33,012 |
| Construction | - | - | - | - | - |
| Consumer | 13,042 | 13,042 | - | 15,476 | 1,556 |
| | 5,158,892 | 5,265,246 | - | 6,079,105 | 294,162 |
| With a related allowance: | | | | | |
| Commercial | - | - | - | - | - |
| Real estate: | | | | | |
| Commercial | 2,754,305 | 2,754,305 | 554,000 | 2,762,579 | 114,565 |
| Residential | - | - | - | - | - |
| Construction | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| | 2,754,305 | 2,754,305 | 554,000 | 2,762,579 | 114,565 |
| Total impaired loans: | | | | | |
| Commercial | 29,710 | 30,758 | - | 89,826 | 6,348 |
| Real estate: | | | | | |
| Commercial | 7,296,375 | 7,387,838 | 554,000 | 7,958,281 | 367,811 |
| Residential | 574,070 | 587,913 | - | 778,101 | 33,012 |
| Construction | - | - | - | - | - |
| Consumer | 13,042 | 13,042 | - | 15,476 | 1,556 |
| | $ 7,913,197 | $ 8,019,551 | $ 554,000 | $ 8,841,684 | $ 408,727 |
| Troubled debt restructurings included in impaired loans: | | | | | |
| Accruing | $ 5,071,654 | $ 5,071,654 | $ 554,000 | $ 5,125,153 | $ 238,607 |
| Non-accrual | 1,104,883 | 1,104,883 | - | 1,713,153 | 92,248 |
| | $ 6,176,537 | $ 6,176,537 | $ 554,000 | $ 6,838,306 | $ 330,855 |

***NOTE 4 - LOANS (Continued)***

| | December 31, 2013 | | | | |
|---|---|---|---|---|---|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
| With no related allowance: | | | | | |
| Commercial | $ 312 | $ 4,325 | $ - | $ 40,202 | $ 4,013 |
| Real estate: | | | | | |
| Commercial | 2,424,135 | 2,444,877 | - | 2,492,134 | 135,059 |
| Residential | 376,409 | 376,409 | - | 387,278 | 9,585 |
| Construction | - | - | - | - | - |
| Consumer | 10,822 | 10,822 | - | 11,809 | 1,063 |
| | 2,811,678 | 2,836,433 | - | 2,931,423 | 149,720 |
| With a related allowance: | | | | | |
| Commercial | - | - | - | - | - |
| Real estate | | | | | |
| Commercial | 2,771,657 | 2,771,657 | 554,000 | 2,779,329 | 115,629 |
| Residential | - | - | - | - | - |
| Construction | 550,953 | 550,953 | 189,000 | 563,293 | 28,556 |
| Consumer | - | - | - | - | - |
| | 3,322,610 | 3,322,610 | 743,000 | 3,342,622 | 144,185 |
| Total impaired loans: | | | | | |
| Commercial | 312 | 4,325 | - | 40,202 | 4,013 |
| Real estate: | | | | | |
| Commercial | 5,195,792 | 5,216,534 | 554,000 | 5,271,463 | 250,688 |
| Residential | 376,409 | 376,409 | - | 387,278 | 9,585 |
| Construction | 550,953 | 550,953 | 189,000 | 563,293 | 28,556 |
| Consumer | 10,822 | 10,822 | - | 11,809 | 1,063 |
| | $ 6,134,288 | $ 6,159,043 | $ 743,000 | $ 6,274,045 | $ 293,905 |
| Troubled debt restructurings included in impaired loans: | | | | | |
| Accruing | $ 5,015,473 | $ 5,015,473 | $ 743,000 | $ 5,067,627 | $ 236,460 |
| Non-accrual | 329,141 | 349,816 | - | 383,539 | 16,392 |
| | $ 5,344,614 | $ 5,365,289 | $ 743,000 | $ 5,451,166 | $ 252,852 |

***NOTE 4 - LOANS (Continued)***

At December 31, 2014, the outstanding recorded investment in loans which had been determined in prior years to be impaired under ASC 310-10-35 was $4,682,189, and there was $554,000 in related allowance for loan and lease losses associated with those loans. Following is a summary of loans determined to be TDRs during the years ended December 31, 2014 and 2013:

| | 2014 | | | 2013 | | |
|---|---|---|---|---|---|---|
| | Number | Amount | | Number | Amount | |
| | of Loans | Pre-Modification | Post-Modification | of Loans | Pre-Modification | Post-Modification |
| Commercial | **-** | **$ -** | **$ -** | - | $ - | $ - |
| Real estate: | | | | | | |
| Commercial | **6** | **1,212,482** | **1,212,482** | 5 | 404,096 | 404,096 |
| Residential | **2** | **275,288** | **275,288** | 1 | 93,491 | 93,491 |
| Construction | **-** | **-** | **-** | - | - | - |
| Consumer | **1** | **6,578** | **6,578** | 1 | 10,822 | 10,822 |
| | **9** | **$ 1,494,348** | **$ 1,494,348** | 7 | $ 508,409 | $ 508,409 |

Of the loans that were identified as TDRs during the year ended December 31, 2014, all nine involved financial difficulty with renewal terms that did not mitigate the increased potential risk. During the year ended December 31, 2014, no loans that had been previously restructured had payment defaults. During the year ended December 31, 2013, one loan that had been previously restructured defaulted. The recorded investment at the loan's default was $100,000. During the year ended December 31, 2014, there were no loans that had been previously restructured removed from this classification (except by pay-offs). During the year ended December 31, 2013, there were two loans that had been previously restructured removed from this classification. One was paid off by the borrower, and the second was charged off due to a consistently poor payment pattern. The recorded investment at the loan's charge-off was approximately $8,000.

The following tables summarize activity related to the allowance for loan and lease losses by portfolio segment and finance leases for the year ended December 31, 2014:

| | Balance Beginning of Year | Provision for Losses | Loan Charge Offs | Loan Recoveries | Balance End of Period |
|---|---|---|---|---|---|
| Commercial | **$ 469,087** | **$ 79,826** | **$ (15,752)** | **$ 22,461** | **$ 555,622** |
| Real estate: | | | | | |
| Commercial | **1,704,954** | **677,906** | **(500,743)** | **2,760** | **1,884,877** |
| Residential | **338,009** | **420,854** | **(184,433)** | **925** | **575,355** |
| Construction | **857,256** | **(215,884)** | **-** | **-** | **641,372** |
| Consumer | **145,728** | **49,215** | **-** | **8,024** | **202,967** |
| Finance leases | **-** | **86,212** | **-** | **-** | **86,212** |
| Total | **$3,515,034** | **$1,098,129** | **$ (700,928)** | **$ 34,170** | **$3,946,405** |

***NOTE 4 - LOANS (Continued)***

The following table summarizes activity related to the allowance for loan and lease losses for the year ended December 31, 2013 by portfolio segment:

| | Balance Beginning of Year | Provision for Losses | Loan Charge Offs | Loan Recoveries | Balance End of Year |
|---|---|---|---|---|---|
| Commercial | $ 442,399 | $ 13,273 | $ (11,812) | $ 25,227 | $ 469,087 |
| Real estate: | | | | | |
| Commercial | 1,214,502 | 494,263 | (130,000) | 126,189 | 1,704,954 |
| Residential | 370,126 | (11,235) | (29,542) | 8,660 | 338,009 |
| Construction | 896,129 | (38,873) | - | - | 857,256 |
| Consumer | 159,287 | 17,572 | (34,204) | 3,073 | 145,728 |
| Total | $3,082,443 | $ 475,000 | $ (205,558) | $ 163,149 | $3,515,034 |

The following table presents the basis upon which loans in each portfolio segment and finance leases were reviewed for impairment, with the related allowance for loan and lease losses broken out on the same basis, at December 31, 2014 and 2013:

| | **2014** | | | | | |
|---|---|---|---|---|---|---|
| | **Gross Loan and Leases** | | | **Allowance for Loan and Lease Losses** | | |
| | **Basis of Review** | | | **Basis of Review** | | |
| | **Individual** | **Collective** | **Total** | **Individual** | **Collective** | **Total** |
| Commercial | **$ 29,710** | **$ 50,540,823** | **$ 50,570,533** | **$ -** | **$ 555,622** | **$ 555,622** |
| Real estate: | | | | | | |
| Commercial | **7,296,375** | **189,742,700** | **197,039,075** | **554,000** | **1,330,877** | **1,884,877** |
| Residential | **574,070** | **50,802,926** | **51,376,996** | **-** | **575,355** | **575,355** |
| Construction | **-** | **11,811,205** | **11,811,205** | **-** | **641,372** | **641,372** |
| Consumer | **13,042** | **4,313,293** | **4,326,335** | **-** | **202,967** | **202,967** |
| Finance leases | **-** | **20,031,638** | **20,031,638** | **-** | **86,212** | **86,212** |
| Total | **$7,913,197** | **$327,242,585** | **$335,155,782** | **$ 554,000** | **$ 3,392,405** | **$3,946,405** |

| | **2013** | | | | | |
|---|---|---|---|---|---|---|
| | **Gross Loans** | | | **Allowance for Loan Losses** | | |
| | **Basis of Review** | | | **Basis of Review** | | |
| | **Individual** | **Collective** | **Total** | **Individual** | **Collective** | **Total** |
| Commercial | $ 312 | $ 35,645,845 | $ 35,646,157 | $ - | $ 469,087 | $ 469,087 |
| Real estate: | | | | | | |
| Commercial | 5,195,792 | 109,822,639 | 115,018,431 | 554,000 | 1,150,954 | 1,704,954 |
| Residential | 376,409 | 26,088,166 | 26,464,575 | - | 338,009 | 338,009 |
| Construction | 550,953 | 1,191,464 | 1,742,417 | 189,000 | 668,256 | 857,256 |
| Consumer | 10,822 | 3,846,632 | 3,857,454 | - | 145,728 | 145,728 |
| Total | $6,134,288 | $176,594,746 | $182,729,034 | $ 743,000 | $ 2,772,034 | $3,515,034 |

Loans and finance leases totaling approximately $130.0 million were acquired during 2014, and credit related adjustments of approximately $1.1 million were included for these loans at December 31, 2014.

***NOTE 5 - PROPERTY AND EQUIPMENT***

Property and equipment at December 31, 2014 and 2013 are summarized as follows:

| | 2014 | 2013 |
|---|---|---|
| Land | **$ 1,115,352** | $ 1,115,352 |
| Building | **5,356,495** | 5,356,495 |
| Furniture and equipment | **3,010,705** | 2,199,775 |
| Leasehold improvements | **180,300** | - |
| | **9,662,852** | 8,671,622 |
| Less accumulated depreciation | **2,497,091** | 1,972,428 |
| Property and equipment, net | **$ 7,165,761** | $ 6,699,194 |

Depreciation expense for the years ended December 31, 2014 and 2013 was $485,722 and $344,128, respectively. During the year ended December 31, 2013, fully depreciated computer equipment with total original book value of $62,494 was retired.

***NOTE 6 – LEASED ASSETS***

As part of the merger, the Bank absorbed Forest Commercial's leasing division. Leased assets at December 31, 2014 are summarized as follows:

| | 2014 |
|---|---|
| Equipment | **$ 6,122,539** |
| Less accumulated depreciation | **2,474,343** |
| Leased assets, net | **$ 3,648,196** |

Depreciation expense on leased assets for the year ended December 31, 2014 was $989,302. The estimated residual at the end of the lease term is $1,118,816 at December 31, 2014. Minimum future lease receipts under these leases are as follows at December 31, 2014:

| | |
|---|---|
| 2015 | **$ 1,352,891** |
| 2016 | **953,578** |
| 2017 | **503,426** |
| 2018 | **44,767** |
| 2019 | **3,447** |
| Total | **$ 2,858,109** |

## *NOTE 7 – CORE DEPOSIT INTANGIBLE*

The core deposit intangible asset is amortized over the estimated life of the asset. At December 31, 2014, intangible assets consisted of a core deposit premium, net of accumulated amortization, and amounted to approximately $948,000. The amount of core deposit premium recorded as a result of the merger with Forest Commercial was $1,126,000. Amortization expense related to the core deposit premium was approximately $178,000 for the year ended December 31, 2014.

Amortization of the core deposit intangible asset is computed using the 150% declining balance method over an amortization period of seven years. Estimated future amortization expense is as follows at December 31, 2014:

| | |
|---|---|
| 2015 | **$ 205,205** |
| 2016 | **167,984** |
| 2017 | **160,849** |
| 2018 | **160,849** |
| 2019 | **160,849** |
| 2020 | **92,417** |
| Total | **$ 948,153** |

## *NOTE 8 - DEPOSITS*

Deposit accounts at December 31, 2014 and 2013 are summarized as follows:

| | **2014** | **2013** |
|---|---|---|
| Non-interest bearing deposits | **$ 57,751,335** | $ 28,602,201 |
| Interest bearing deposits: | | |
| Interest checking | **25,222,359** | 18,944,242 |
| Money market | **130,009,839** | 95,201,054 |
| Savings | **35,921,385** | 3,794,519 |
| Time deposits | **89,486,580** | 56,957,811 |
| Total deposits | **$ 338,391,498** | $ 203,499,827 |

At December 31, 2014 and 2013 there were deposits amounting to approximately $16.8 million and $4.2 million, respectively, obtained from outside the Bank's market area through the internet and deposit brokers. At December 31, 2014, time deposits greater than $250,000 totaled $26,675,212.

At December 31, 2014 the scheduled maturities of time deposits were as follows:

| | |
|---|---|
| 2015 | **$ 51,828,220** |
| 2016 | **21,770,195** |
| 2017 | **11,280,802** |
| 2018 | **4,278,443** |
| 2019 | **328,920** |
| Total time deposits | **$ 89,486,580** |

## *NOTE 9 - OTHER BORROWINGS*

***Repurchase Agreements -*** All of the Bank's repurchase agreements are with its commercial deposit customers. At December 31, 2014 and 2013, respectively, balances of $5,992,085 and $10,142,253 were outstanding at rates of 0.30% for both period ends.

***Federal Funds Lines of Credit -*** The Bank maintains federal funds lines of credit with correspondent banks to meet short-term liquidity needs. Advances under these agreements are unsecured and are limited to terms ranging from seven to 15 days. These banks have reserved the right to withdraw these lines at their option. At December 31, 2014, the Bank had credit availability of $29.8 million under these lines with no advances outstanding.

***FHLB Line of Credit -*** The Bank has an approved credit line with the FHLB of approximately $41.8 million, subject to the Bank's ability to pledge qualifying collateral. Advances totaled $19.6 million and $1.0 million at December 31, 2014 and 2013, respectively.

The advances are at fixed rates with interest paid monthly and principal paid at maturity. The following table summarizes the FHLB borrowings at December 31, 2014:

| Maturity Date | Balance | Interest Rate |
|---|---|---|
| January 23, 2015 | $ 1,000,000 | 0.25 % |
| April 16, 2015 | 2,000,000 | 0.29 % |
| April 27, 2015 | 3,500,000 | 0.38 % |
| July 21, 2015 | 1,500,000 | 0.30 % |
| December 21, 2015 | 6,600,000 | 0.37 % |
| October 18, 2016 | 2,000,000 | 0.76 % |
| May 23, 2017 | 1,500,000 | 1.23 % |
| May 23, 2018 | 1,500,000 | 1.49 % |
| | $19,600,000 | |

***Federal Reserve Bank Credit Facility -*** The Bank is eligible to borrow through the Federal Reserve Bank's ("FRB") "Discount Window" program. Any borrowings under this program must be secured by eligible collateral and are limited to very short terms, typically overnight. The FRB has indicated that though institutions are not required to seek funding elsewhere before requesting credit, they expect that institutions will use the Discount Window as a backup rather than a regular source of funding. The Bank has never used this funding source, but maintains it as a part of its contingency funding plan. The Bank estimates that credit availability under this program was approximately $101.0 million at December 31, 2014.

## *NOTE 10 - INCOME TAXES*

The income tax effects of temporary differences between financial statement carrying values and the tax bases of assets and liabilities, as well as net operating loss carryforwards at December 31, 2014 and 2013 are as follows:

| | 2014 | 2013 |
|---|---|---|
| Deferred tax assets: | | |
| Allowance for loan and lease losses | **$ 1,092,602** | $ 948,952 |
| Acquisition accounting adjustments | **1,046,318** | - |
| Net operating losses | **813,770** | - |
| Organization and start-up costs | **361,317** | 126,094 |
| Other real estate owned | **252,411** | 245,716 |
| Non-qualified stock options | **336,290** | 169,158 |
| Other | **204,721** | 86,107 |
| Unrealized losses on securities available for sale | **-** | 104,935 |
| Total deferred tax assets | **4,107,429** | 1,680,962 |
| Deferred tax liabilities: | | |
| Leased assets | **1,907,631** | - |
| Property and equipment | **546,222** | 388,661 |
| Loan origination costs | **126,350** | 85,389 |
| Unrealized gains on securities available for sale | **229,153** | - |
| Other | **392,741** | 163,447 |
| Total deferred tax liabilities | **3,202,097** | 637,497 |
| Net deferred tax asset | **$ 905,332** | $ 1,043,465 |

Deferred tax assets represent the future tax benefit of deductible differences and, if it is more likely than not that a tax asset will not be realized, a valuation allowance is required to reduce the recorded deferred tax assets to net realizable value. At December 31, 2014 and 2013, management determined that no valuation allowance was necessary.

The components of the change in the net deferred tax assets are as follows:

| | 2014 |
|---|---|
| Total change in net deferred tax assets | **$ 138,133** |
| Less: | |
| Change in unrealized gains on securities available for sale | **(334,088)** |
| Initial acquisition accounting deferred tax assets recorded | **1,201,468** |
| Change in operating deferred tax assets | **$ 1,005,513** |

The Bank has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions.

The Bank’s federal and state income tax returns are open and subject to examination from the 2011 tax return year and forward. The Bank's federal net operating loss is $2,162,096 as of December 31, 2014 and will expire 2034.

***NOTE 10 - INCOME TAXES (Continued)***

The income tax expense for the years ended December 31, 2014 and 2013 is summarized as follows:

| | 2014 | 2013 |
|---|---|---|
| Income taxes currently payable | **$ 89,541** | $ 774,972 |
| Net deferred income tax (benefit) expense | **1,005,513** | 14,430 |
| Income tax expense | **$ 1,095,054** | $ 789,402 |

The income tax expense for the years ended December 31, 2014 and 2013 is reconciled to the amount of income tax computed at the federal statutory rate of 34% on income before income taxes as follows:

| | 2014 | 2013 |
|---|---|---|
| Tax expense at statutory rate | **$ 2,447,984** | $ 636,546 |
| Increase (decrease) in taxes resulting from: | | |
| Bargain purchase gain | **(1,297,976)** | - |
| Non-deductible merger costs | **31,183** | 105,956 |
| Stock option compensation | **25,786** | 7,166 |
| State income taxes, net of federal benefit | **60,953** | 16,080 |
| Tax- exempt interest income | **(50,263)** | (31,911) |
| Other, net | **(122,613)** | 55,565 |
| Income tax expense | **$ 1,095,054** | $ 789,402 |

***NOTE 11 - COMMITMENTS AND CONTINGENCIES***

During the years ended December 31, 2014 and 2013, the Bank leased several office facilities and various equipment under operating leases. Lease expense for the years ended December 31, 2014 and 2013 was approximately $256,000 and $17,000, respectively. The amount expensed for related party rents was $177,429.

The Bank entered into a lease agreement for its Asheville office that commenced on August 1, 2010. The term of the lease shall expire ten years after the commencement date and includes a renewal option to extend the term of the lease for two separate and successive five year periods. The lease is in an agreement with a board member (related party) of the Bank.

The Bank also entered into a lease agreement for its Hendersonville office that commenced on October 1, 2011. The term of the lease shall expire five years after the commencement date and includes a renewal option to extend the term of the lease for one separate and successive five year period.

The Bank also entered into a lease agreement for its Charlotte office that commenced on January 1, 2015 for a four-year term.

In addition, the Bank is in its first two-year renewal option period for its Seneca branch, which will expire May 20, 2016. The Bank also leases its Anderson branch office, and the two-year original lease term will expire on September 8, 2015.

***NOTE 11 - COMMITMENTS AND CONTINGENCIES (Continued)***

Minimum future rentals under these leases are as follows:

| | |
|---|---|
| 2015 | $ **368,107** |
| 2016 | **356,000** |
| 2017 | **335,683** |
| 2018 | **345,639** |
| 2019 | **319,803** |
| 2020 and beyond | **182,638** |
| Total | $ **1,907,870** |

The Bank has a contract for data processing services with a remaining term of 30 months at December 31, 2014 with an average monthly minimum payment of approximately $44,000.

The Bank has entered into employment agreements with certain senior officers. These agreements include provisions regarding term, compensation, benefits, incentive programs, stock option plans, severance, and non-compete provisions. The agreements have terms ranging from two to three years and annually are extended automatically for successive one-year terms, provided that the Bank or officer may at any time give notice that the term is to be fixed at the term remaining at the last extension. The agreements also may be terminated if the officer's employment is terminated under various provisions of the agreements.

Management is not aware of any legal proceedings which would have a material adverse effect on the financial position or operating results of the Bank.

***NOTE 12 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK***

In the ordinary course of business, and to meet the financing needs of its customers, the Bank is a party to various financial instruments with off-balance sheet risk. These financial instruments, which include commitments to extend credit and standby letters of credit, involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheet. The contract amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments.

The Bank's exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amounts of those instruments. The same credit policies used for on-balance sheet instruments are used in making commitments and conditional obligations.

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

***NOTE 12 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (Continued)***

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any material condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. At December 31, 2014, the Bank's commitments to extend additional credit totaled approximately $74.1 million, the majority of which are at variable rates of interest with varying maturities. Included in the Bank's total commitments are standby letters of credit. Letters of credit are commitments issued by the Bank to guarantee the performance of a customer to a third party and totaled approximately $932,000 at December 31, 2014.

***NOTE 13 - PREFERRED STOCK***

On August 23, 2011, the Bank completed the sale of $5 million of Series A preferred stock to the Secretary of the Treasury under the Small Business Lending Fund ("SBLF"). The fund was established under the Small Business Jobs Act of 2010 that was created to encourage lending to small businesses by providing capital to qualified community banks with assets less than $10 billion.

Under the terms of the stock purchase agreement, the Treasury received 5,000 shares of $1.00 par value, non-cumulative perpetual preferred stock with a liquidation value of $1,000 per share in exchange for $5 million.

The Series A preferred stock qualifies as Tier 1 capital. Beginning with the initial dividend period, which ended September 30, 2011, and for each dividend period since, the Bank's dividend rate was one percent (1%). As of December 31, 2013, under the terms of the related purchase agreement, the dividend rate became fixed at one percent (1%). The Bank paid dividends of $50,000 for both years ended December 31, 2014 and 2013.

Subject to regulatory approval, the Bank is generally permitted to redeem the Series A preferred shares at par plus unpaid dividends.

***NOTE 14 - DIVIDENDS***

On September 5, 2014, the Bank's board of directors approved a ten percent stock dividend to the Bank's shareholders. The record date was September 22, 2014, and the distribution date was October 7, 2014. Earnings per share and average shares outstanding have been retroactively adjusted to reflect the stock dividend in our Consolidated Statements of Income and certain other share and per share disclosures.

Currently, the Bank has no plans to initiate payment of cash dividends on its common shares. It is anticipated that any future dividends paid by the Bank to common shareholders would be dependent on earnings, capital requirements, and financial condition. Additionally, as a condition of receiving a state banking charter, the Bank agreed to pay no cash dividends until its retained deficit was eliminated, which took place during the second quarter of 2013. This restriction was waived in connection with the Bank's participation in the SBLF program with regard to dividends on the Series A preferred stock.

## *NOTE 15 - STOCK COMPENSATION*

***Stock Option Plan -*** The Bank has three stock option plans (the "Plans") for the benefit of the Bank's officers, employees, and directors. Under terms of the Plans, the Board may grant options to purchase common stock ("options") of the Bank aggregating up to 21% of outstanding shares, which amounted to 957,739 and 580,263 at December 31, 2014 and 2013, respectively.

Options issued under the Plans have an exercise price equal to the stock's fair market value (based on the most recent stock trades) on the grant date. The life of options granted cannot exceed 10 years.

In connection with the Forest Commercial merger, the Bank assumed a total of 284,142 options outstanding under the Forest Commercial Bank 2008 Incentive Stock Option Plan and the Forest Commercial Bank 2008 Nonstatutory Stock Option Plan (the "FCB Plans"). Total options available for grant under the FCB Plans was frozen at the amount of options outstanding as of the merger date and the availability of options under the Carolina Alliance plan was reduced by the amount of option availability under these plans, such that options available for grant under the three plans combined totals 957,739 shares. All options outstanding under the FCB Plans were fully vested when assumed by the Bank and had a weighted average remaining life of 3.5 years. All had an exercise price of $11.04 and a negligible fair value.

The following is a summary of activity in the Plans for the years ended December 31, 2014 and 2013 (adjusted for the 10% stock dividend in 2014):

| | **2014** | | | **2013** | | |
|---|---|---|---|---|---|---|
| | **Shares** | **Weighted Average Exercise Price** | **Weighted Average Fair Value** | **Shares** | **Weighted Average Exercise Price** | **Weighted Average Fair Value** |
| Outstanding, beginning of year | **462,000** | **$ 9.22** | **$ 3.66** | 433,400 | $ 9.24 | $ 3.70 |
| FCB options assumed | **284,142** | **11.04** | **-** | - | - | - |
| Granted | **11,000** | **8.35** | **3.15** | 28,600 | 8.53 | 3.10 |
| Forfeited | **(8,250)** | **8.64** | **3.54** | - | - | - |
| Outstanding, end of period | **748,892** | **9.90** | **2.27** | 462,000 | 9.22 | 3.66 |
| Options exercisable | **677,392** | **10.04** | **2.15** | 366,960 | 9.36 | 3.73 |
| Non-vested options, end of period | **71,500** | **8.60** | **3.34** | 95,040 | 8.68 | 3.41 |
| Options vesting during period | **30,140** | **8.76** | **3.47** | 26,290 | 8.81 | 3.55 |
| Shares available for grant | **208,847** | | | 118,263 | | |

All options outstanding have a 10-year life and substantially all have a five-year vesting period. Stock options outstanding and vested at December 31, 2014 have an average remaining life of 3.7 years. Exercise prices per share of outstanding stock options range from $8.35 to $15.00. At December 31, 2014, 433,950 options had an intrinsic value of approximately $737,000. At December 31, 2013, 340,560 options had an intrinsic value of approximately $100,000.

The Bank utilizes the Black-Scholes valuation model to determine the compensation recognized under the fair value method described in Note 1. This fair value is then amortized on a straight-line basis over the vesting period of the option.

***NOTE 15 - STOCK COMPENSATION (Continued)***

The following assumptions were utilized in the application of the Black-Scholes model for the years ended December 31, 2014 and December 31, 2013):

***Weighted Average Risk-Free Interest Rate -*** The risk-free interest rate used to value option grants is based on the U.S. Treasury yield curve on the date of grant.

***Expected Volatility -*** As the Bank has a relatively short trading history, the volatility assumption was based on the review of volatility statistics of peer banks.

***Dividend Yield -*** Due to dividend restrictions early in the life of the Bank and the anticipated need for capital to fund growth, management assumes that no dividends will be paid over the expected life of options granted.

***Expected Life -*** The expected life is assumed to be 75% of the contractual life of the option. This is based on a review of average life assumptions used by seasoned community banks that base their average life assumptions on actual historical exercise statistics.

The following table summarizes the weighted average assumptions used by the Black-Scholes option-pricing model stock and other information concerning stock option awards granted by the Bank as of and for the years ended December 31, 2014 and 2013.

| | **2014** | **2013** |
|---|---|---|
| Weighted average risk-free interest rate | **2.31%** | 2.27% |
| Expected volatility | **30%** | 30% |
| Expected life (years) | **7.5 years** | 7.5 years |
| Dividend yield | **None** | None |
| Compensation charged against pretax income | **$108,243** | $ 95,736 |
| Approximate future compensation of options outstanding | **$108,658** | $182,000 |
| Weighted average years remaining to recognize future compensation | **2.1 years** | 2.6 years |

***Director Compensation Program -*** The Bank has a compensation plan for its 14 independent directors. Monthly fees earned by the directors are determined based on a combination of fixed amounts for board and committee membership, and variable amounts based on the number of meetings attended. The program was effective June 1, 2012, and total fee expense was approximately $143,000 and $152,000 in the years ended December 31, 2014 and 2013, respectively.

Directors may elect payment of fees in the form of cash or in Bank stock. Fees earned and payable in cash are paid quarterly, and fees payable in Bank stock are accrued monthly based on the market price of the stock on the last day of each respective month. The accrued compensation is settled from authorized but unissued shares semi-annually. Stock-settled fees earned and accrued in the year ended December 31, 2014 were $105,859, or 17,067 shares, of which 11,186 shares were issuable. These shares will be issued in the second quarter of 2015. The total of stock-settled fees earned and accrued in the year ended December 31, 2013 was $110,352, or 11,990 shares, of which 6,089 shares were issued in January 2014 (adjusted to reflect the stock dividend issued in October 2014).

## *NOTE 16 - REGULATORY MATTERS*

The Bank is subject to various regulatory capital requirements administered by the federal banking regulatory 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 Bank's financial statements.

Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification also are subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. As of December 31, 2014, the most recent notification from the Bank's primary regulator categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. There are no conditions or events that management believes have changed the Bank's category.

The following table summarizes the capital amounts and ratios of the Bank and the regulatory minimum requirements at December 31, 2014 and 2013:

| | Actual | | For Capital Adequacy Purposes Minimum | | To be Well Capitalized Under Prompt Corrective Action Provisions Minimum | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| | | | (Amounts in $000) | | | |
| **As of December 31, 2014:** | | | | | | |
| Total capital | | | | | | |
| (To risk weighted assets) | **$ 54,056** | **15.2%** | **$ 28,365** | **8.0%** | **$ 35,456** | **10.0%** |
| Tier 1 capital | | | | | | |
| (To risk weighted assets) | **50,085** | **14.1** | **14,182** | **4.0** | **21,274** | **6.0** |
| Tier 1 capital | | | | | | |
| (To average assets) | **50,085** | **12.0** | **16,709** | **4.0** | **20,887** | **5.0** |
| **As of December 31, 2013:** | | | | | | |
| Total capital | | | | | | |
| (To risk weighted assets) | $ 33,586 | 16.9% | $ 15,920 | 8.0% | $ 19,900 | 10.0% |
| Tier 1 capital | | | | | | |
| (To risk weighted assets) | 31,086 | 15.6 | 7,960 | 4.0 | 11,940 | 6.0 |
| Tier 1 capital | | | | | | |
| (To average assets) | 31,086 | 12.6 | 9,863 | 4.0 | 12,329 | 5.0 |

## ***NOTE 17 - RELATED PARTY TRANSACTIONS***

Certain directors, executive officers and companies with which they are affiliated (collectively referred to as "insiders") are customers of and have banking transactions with the Bank in the ordinary course of business. Loans to insiders are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable arms-length transactions. At December 31, 2014 and 2013, respectively, loans to insiders approximated $5.8 million and $10.3 million, and deposits from insiders approximated $9.0 million and $8.0 million. During the year ended December 31, 2014, rents totaling $177,429 were paid to a related party for the lease of our Asheville branch office.

## ***NOTE 18 - EMPLOYEE BENEFIT PLANS***

At December 31, 2014, the Bank had two 401(k) plans which covered all eligible employees. For the year ended December 31, 2014, participants could contribute up to $17,500 per year, and the Bank matched contributions equal to 100% of employee contributions up to three percent (3%) and four percent (4%) for the South Carolina plan and the North Carolina plan, respectively, of eligible compensation plus 50% of employee contributions up to the next two percent (2%) of eligible compensation. Contributions to the plan were approximately $190,000 and $111,000 in the years ended December 31, 2014 and 2013, respectively. On January 1, 2015, the two plans merged.

## ***NOTE 19 - FAIR VALUE OF FINANCIAL INSTRUMENTS***

Financial instruments include cash and due from banks, federal funds sold, investment securities, other investments, loans, deposit accounts, other borrowings, and accrued interest. The following methods and assumptions were used by the Bank in estimating fair values of financial instruments recorded or disclosed in the financial statements:

***Cash and Due from Banks -*** For these short-term instruments, the carrying amounts approximate their fair values.

***Federal Funds Sold and Interest Bearing Bank Balances -*** The carrying amounts of federal funds sold and interest bearing bank balances approximate their fair value due to their short maturities (daily).

***Bank Term Deposits -*** Fair values for fixed-rate certificates of deposit are estimated utilizing a discounted cash flow calculation that applies current market interest rates of certificates of deposits with similar remaining maturities to the portfolio of certificates of deposits.

***Investment Securities -*** Fair value for investment securities equals quoted market price if such information is available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities. The Bank utilizes a third party pricing service to provide valuations on its securities portfolio. Most of these securities are U.S. government agency debt obligations or agency mortgage-backed securities traded in active markets. The third party valuations are determined based on the characteristics of each security (such as maturity, duration, rating, etc.) and in reference to similar or comparable securities. Due to the nature and methodology of these valuations, the Bank considers these fair value measurements as Level 2.

***NOTE 19 - FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)***

***Other Investments -*** No ready market exists for the FHLB stock, and it has no quoted market value. However, redemption of the stock historically has been at par value; therefore, it is stated at the Bank's cost basis.

***Loans and Finance Leases-*** For variable rate loans that reprice based on each change in a reference rate (e.g. prime rate), fair values are based on carrying values. Fair values for all other loans and leases are estimated using discounted cash flow analyses, with interest rates currently being offered for loans and leases with similar terms to borrowers of similar credit quality. Fair values for impaired loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

***Accrued Interest Receivable and Payable -*** The carrying amounts for these items approximate their fair values due to the short period to settlement (three months or less).
***Deposits -*** The fair values disclosed for demand deposits are, by definition, equal to their carrying amounts. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated monthly maturities.

***Securities Sold Under Agreements to Repurchase -*** The carrying value of these retail repurchase agreements approximates fair value since these obligations mature daily.

***Advances from FHLB of Atlanta -*** The valuation methodology utilizes a discounted cash flow calculation that applies current offered interest rates for fixed rate advances with similar remaining maturities.

***Off-Balance Sheet Instruments -*** Fair values of off-balance sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The total fair value of such instruments is not material.

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

***NOTE 19 - FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)***

The estimated fair values of the Bank's financial instruments were as follows at December 31, 2014 and 2013:

| | 2014 | | 2013 | |
|---|---|---|---|---|
| | **Carrying Amount** | **Fair Value** | **Carrying Amount** | **Fair Value** |
| **Financial Assets**: | | | | |
| Cash and due from banks | **$ 6,698,634** | **$ 6,698,634** | $ 5,692,846 | $ 5,692,846 |
| Federal funds sold and interest bearing bank balances | **722,691** | **722,691** | 855,115 | 855,115 |
| Bank term deposits | **4,731,000** | **4,713,097** | 6,723,000 | 6,718,197 |
| Investment securities, available for sale | **60,776,574** | **60,776,574** | 44,547,635 | 44,547,635 |
| Other investments | **1,262,500** | **1,262,500** | 389,000 | 389,000 |
| Loans and finance leases, net | **326,872,734** | **328,177,000** | 179,330,714 | 180,724,844 |
| Accrued interest receivable | **1,111,812** | **1,111,812** | 705,547 | 705,547 |
| **Financial Liabilities:** | | | | |
| Deposits | **338,391,498** | **330,167,000** | 203,499,827 | 199,902,717 |
| Securities sold under agreements to repurchase | **5,992,085** | **5,992,085** | 10,142,253 | 10,142,253 |
| Advances from FHLB of Atlanta | **19,600,000** | **19,673,000** | 1,000,000 | 1,020,357 |
| Accrued interest payable | **59,050** | **59,050** | 44,428 | 44,428 |

The Bank reports fair value on a recurring basis for certain financial instruments, most notably available for sale investment securities. The table below presents the balances of assets and liabilities measured at fair value on a recurring basis:

| | **Total** | **Level 1** | **Level 2** | **Level 3** |
|---|---|---|---|---|
| **December 31, 2014:** | | | | |
| Investment securities, available for sale: | | | | |
| U.S. government agency and sponsored enterprises | **$14,718,210** | **$ -** | **$14,718,210** | **$ -** |
| Agency mortgage-backed securities | **20,942,456** | **-** | **20,942,456** | **-** |
| Agency collateralized mortgage obligations | **13,291,785** | **-** | **13,291,785** | **-** |
| Corporate securities | **1,000,410** | **-** | **1,000,410** | **-** |
| Municipal securities | **10,823,713** | **-** | **10,823,713** | **-** |
| Total | **$60,776,574** | **$ -** | **$60,776,574** | **$ -** |
| **December 31, 2013:** | | | | |
| Investment securities, available for sale: | | | | |
| U.S. government agency and sponsored enterprises | **$10,595,096** | **$ -** | **$10,595,096** | **$ -** |
| Agency mortgage-backed securities | **18,633,535** | **-** | **18,633,535** | **-** |
| Agency collateralized mortgage obligations | **6,285,622** | **-** | **6,285,622** | **-** |
| Municipal securities | **9,033,382** | **-** | **9,033,382** | **-** |
| Total | **$44,547,635** | **$ -** | **$44,547,635** | **$ -** |

***NOTE 19 - FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)***

The Bank may be required, from time to time, to measure certain assets at fair value on a non-recurring basis. These include assets that are measured at the lower of cost or market that were recognized at fair value which was below cost at the end of the period. Assets subject to non-recurring use of fair value measurements include impaired loans and foreclosed assets. Due to the use of both observable and unobservable inputs and the significant amount of judgment required in the determination of fair values, both of these categories of assets are considered to be valued under Level 3 inputs.

The fair value of impaired loans is determined based upon the present value of expected cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral-dependent. The fair value of collateral is determined by obtaining an observable market price or obtaining an appraised value from an independent licensed or certified appraiser, using observable market data. This data includes information such as selling price of similar properties and capitalization rates of similar properties sold within the market, adjusted for differences in the properties, expected future cash flows, or earnings of the subject property based on current market expectations and other relevant factors. In addition, management may apply selling and other discounts to the underlying collateral value to determine the fair value.

Other real estate owned is valued by use of appraisals and management's judgment as described for valuation of collateral underlying collateral-dependent impaired loans.

The following tables present the fair value measurement of assets measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fall at December 31, 2014 and 2013:

| | Total | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| **December 31, 2014:** | | | | |
| Impaired loans | **$ 7,359,197** | **$ -** | **$ -** | **$ 7,359,197** |
| Other real estate owned | **1,684,101** | **-** | **-** | **1,684,101** |
| Total | **$ 9,043,298** | **$ -** | **$ -** | **$ 9,043,298** |
| **December 31, 2013:** | | | | |
| Impaired loans | $ 5,391,288 | $ - | $ - | $ 5,391,288 |
| Other real estate owned | 1,108,731 | - | - | 1,108,731 |
| Total | $ 6,500,019 | $ - | $ - | $ 6,500,019 |

***NOTE 19 - FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)***

For Level 3 assets and liabilities measured at fair value on a recurring or non-recurring basis as of December 31, 2014, the significant unobservable inputs used in the fair value measurements were as follows:

| | Fair Value | Valuation Technique | Significant Unobservable Inputs |
|---|---|---|---|
| Impaired loans | **$ 7,359,197** | Appraised Value, Discounted Cash Flows and Market Value of the Underlying Collateral | Discount Factors Applied to Valuations for: Shorter Marketing Period (Liquidation Approach), Sales Commissions, and Selling Costs |
| Other real estate owned | **1,684,101** | Appraised Value and Estimates from Independent Sources | Discount Factors Applied to Valuations for: Shorter Marketing Period (Liquidation Approach), Sales Commissions, and Selling Costs |
| Total | **$ 9,043,298** | | |

***NOTE 20 – SUBSEQUENT EVENT***

On March 24, 2015, the Bank entered into an Agreement and Plan of Merger (the “PBSC Merger Agreement”) with PBSC Financial Corporation (“PBSC”), and PBSC’s wholly-owned subsidiary, Pinnacle Bank of South Carolina, a South Carolina state-chartered bank with its principal office in Greenville, South Carolina (“Pinnacle Bank”). Pursuant to the PBSC Merger Agreement, PBSC and Pinnacle Bank will merge with and into the Bank. Under terms of the PBSC Merger Agreement, for each PBSC common share held, shareholders of PBSC will have the option to receive either $12.00 or 1.0909 shares of the Bank’s common stock. The stock portion of the consideration is subject to adjustment depending upon the average price of CAB common stock prior to the closing of the merger. Cash will be paid in lieu of fractional shares. After the merger, Carolina Alliance’s existing shareholders will own approximately 74% of the total shares outstanding, on a fully diluted basis, and PBSC’s shareholders will own approximately 26% of Carolina Alliance’s outstanding shares on a fully diluted basis.

At December 31, 2014, Pinnacle Bank had total assets of $154.2 million, gross loans of $122.9 million, deposits of $123.0 million, and shareholders’ equity of $20.0 million. Also, as of December 31, 2014, Pinnacle Bank had a total risk-based capital ratio of 17.06%, a Tier 1 risk-based capital ratio of 15.81%, and a leverage ratio of 13.04%; Pinnacle Bank was considered “well-capitalized” for regulatory capital purposes.

***NOTE 20 – SUBSEQUENT EVENT (Continued)***

The merger is subject to the approval of the FDIC, the Federal Reserve, and the South Carolina Board of Financial Institutions. The merger also is subject to the approval of the holders of two-thirds of the outstanding shares of the Bank's common stock and the holders of a majority of the outstanding shares of common stock of each PBSC and Pinnacle Bank. Assuming all required regulatory and shareholder approvals are received, the transaction is expected to close in the fourth quarter of 2015.

If either party terminates the merger agreement by reason of the other party's material breach of its representations, warranties and/or covenants in the merger agreement, the parties agree that the party in breach shall pay $300,000 as liquidated damages to the non-breaching party. If the merger is not consummated under certain other specific circumstances, PBSC and Pinnacle Bank collectively have agreed to pay Carolina Alliance a termination fee of $1,000,000.

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## Officers

**John Poole**, *Chief Executive Officer*
**John Kimberly**, *President*
**Lamar Simpson**, *Chief Financial Officer & Chief Operating Officer*
**Jack Buice**, *Executive Vice President, Commercial Banking Officer*
**Tim Camp**, *Executive Vice President, Senior Commercial Banking Officer*
**Jeff Covington**, *Executive Vice President, Chief Credit Officer*
**Barry Mason**, *Executive Vice President, Commercial Team Leader*
**Kyle Thomas**, *Executive Vice President, Commercial Banking Officer*
**Larry Weiss**, *Executive Vice President, Treasurer*
**John York**, *Executive Vice President, Commercial Team Leader*
**Laura Austill**, *Senior Vice President, Controller*
**Steve Brown**, *Senior Vice President, Professional Banking Executive*
**Gail Crocker**, *Senior Vice President, Credit Policy Officer*
**Pat Crowley**, *Senior Vice President, Commercial Consultant*
**Kelly Davis**, *Senior Vice President, Professional Banking Officer*
**Coleman Edmunds**, *Senior Vice President, Retail Banking Executive*
**Kelly Leonard**, *Senior Vice President, Commercial Banking Officer*
**Pruitt Martin**, *Senior Vice President, Commercial Banking Officer*
**Wayne McKinney**, *Senior Vice President, Commercial Banking Officer*
**Pam Pless,** *Senior Vice President, Commercial Banking Officer*
**Steve Rush**, *Senior Vice President, Commercial Banking Officer*
**Bobby Scruggs**, *Senior Vice President, Commercial Banking Officer*
**Cyndi Waters**, *Senior Vice President, Professional Banking Officer*
**Dave McBride,** *Leasing Executive*
**Charles Shepherd,** *Leasing Executive*
**Janice Addington**, *Vice President, Human Resources & Marketing*
**Grant Brown**, *Vice President, Credit Analyst*
**Tina Gainey**, *Vice President, Senior Deposit Operations Officer*
**Pamela Gilliam**, *Vice President, Loan Compliance Officer*
**Steve Jennings**, *Vice President, Commercial Banking Officer*
**Carolyn MacIntosh**, *Vice President, Senior Mortgage Lender*
**Judy Price**, *Vice President, Senior Operations and Compliance Officer*
**Leslie Pruitt**, *Vice President, Retail Banking Officer*
**Chris Schwendimann**, *Vice President, Professional Banking Officer*
**Merrill Tibbals**, *Vice President, Professional Banking Officer*
**Ragan Ward**, *Vice President, Commercial Banking Officer*
**Jean Wauford**, *Vice President, Professional Banking Officer*
**Kathy Davis**, *Assistant Vice President, Loan Operations Servicing Manager*
**Lisa Parham**, *Assistant Vice President, Branch Manager*
**Rita Plemmons**, *Assistant Vice President, Loan Operations Director*
**Gina M. Smith**, *Assistant Vice President, Accounting Manager*
**Nichole Buchanan**, *Retail Lending Officer*
**Sarah Erwin**, *Credit Analyst*
**Donna Harakas**, *Cash Management Officer*
**Donna Hawkins,** *Assistant Controller*
**Scott Nesbitt,** *Special Assets Officer*
**Gina Rogers,** *Credit Analyst*
**Phyllis E. Shropshier**, *Deposit Operations Manager*

## Board of Directors

**Terry L. Cash**, *Chairman*
**W. Louis Bissette, Jr.,** *Vice Chairman*
**Carl R. Bartlett**
**T. Alexander Evins**
**Marsha H. Gibbs**
**George M. Groome**
**John D. Kimberly**
**Samuel H. Maw, Jr.**
**Susan H. McClinton**
**D. Byrd Miller III**
**John S. Poole**
**W. Allen Rogers II**
**R. Lamar Simpson**
**L. Terrell Sovey**
**W. Lewis White, Sr.**

## Advisory Boards

### South Carolina

**Charles E. Atchison, Sr.**
**Andrew M. Babb**
**Vic Bailey, III (Vollie C.)**
**James D. Bearden III, MD**
**Norman H. Chapman**
**Caleb C. Fort**

### North Carolina

**Robert F. Burgin**
**Thomas L. Cooper**
**Andrea J. Corn**
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**F. Jerry Grant**
**Oscar J. Honeycutt**
**Thomas D. Hunter IV**
**Adam L. Shealy**
**William W. White, Jr.**

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The common stock of Carolina Alliance Bank is traded over the counter through OTC Markets Group, Inc. (OTCQX: CRLN).