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INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders
of Siuslaw Financial Group, Inc.

We have audited the accompanying consolidated balance sheets of Siuslaw Financial Group, Inc. and its subsidiary, Siuslaw Bank, as of December 31, 2013 and 2012, and the related consolidated statements of comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these 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.

Auditors' 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 auditors' 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 auditors consider 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.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Siuslaw Financial Group, Inc. and its subsidiary, Siuslaw Bank, as of December 31, 2013 and 2012, 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.

DELAP LLP

March 12, 2014

CONSOLIDATED BALANCE SHEETS

Assets	December 31, 2013	December 31, 2012
Cash and cash equivalents:		
Cash and due from banks	$ 9,190,384	$ 7,343,624
Interest-bearing deposits in banks	50,673,863	36,187,560
Total cash and cash equivalents	59,864,247	43,531,184
Interest-bearing time deposits	16,132,000	13,130,000
Investment securities available-for-sale	13,364,548	17,717,310
Federal Home Loan Bank (FHLB) stock	620,000	643,200
Loans, net	236,581,467	219,297,862
Mortgage loans held for sale	524,233	1,416,880
Premises and equipment, net	5,883,807	5,871,053
Bank-owned life insurance	6,843,852	6,620,860
Other real estate owned (OREO)	3,889,621	2,489,757
Accrued interest receivable and other assets	8,697,889	9,076,171
Total assets	$ 352,401,664	$ 319,794,277

Liabilities and Stockholders' Equity

Liabilities:		
Deposits:		
Demand	$ 59,263,826	$ 49,811,753
NOW and money market	176,263,394	155,177,137
Savings	39,653,104	35,230,500
Time	27,458,887	31,682,584
Total deposits	302,639,211	271,901,974
Junior subordinated debentures	8,248,000	8,248,000
Accrued interest payable and other liabilities	4,860,504	4,762,469
Total liabilities	315,747,715	284,912,443
Stockholders' equity:		
Series A preferred stock, $1 par value; 200,000 shares authorized; 103,046 shares issued and outstanding (103,446 in 2012)	103,046	103,446
Common stock, $1 par value; 10,000,000 shares authorized; 3,992,937 shares issued and outstanding (3,993,937 in 2012)	3,992,937	3,993,937
Additional paid-in capital	7,691,966	7,694,766
Retained earnings	24,814,065	22,550,299
Accumulated other comprehensive income	51,935	539,386
Total stockholders' equity	36,653,949	34,881,834
Total liabilities and stockholders' equity	$ 352,401,664	$ 319,794,277

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

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Years ended December 31, 2013	Years ended December 31, 2012
Interest income:		
Interest and fees on loans	$ 12,015,067	$ 12,332,316
Taxable interest on investment securities available-for-sale	79,276	167,371
Nontaxable interest on investment securities available-for-sale	363,397	311,884
Interest on interest-bearing deposits	239,625	169,826
Total interest income	12,697,365	12,981,397
Interest expense:		
Deposits	506,052	651,953
Junior subordinated debentures	248,883	265,193
Total interest expense	754,935	917,146
Net interest income	11,942,430	12,064,251
Loan loss provision	550,000	930,000
Net interest income after loan loss provision	11,392,430	11,134,251
Noninterest income:		
Mortgage banking income, net	2,351,382	2,876,652
Service charges on deposit accounts	426,079	415,600
Interchange, ATM and associated fees	398,229	350,486
Credit card merchant fees, net	384,708	352,961
Earnings on bank-owned life insurance policies	279,207	287,810
Gains on sales of investment securities available-for-sale	–	273,976
Recoveries of income on certain loans	392,722	–
Other	302,440	525,160
Total noninterest income, net	4,534,767	5,082,645
Noninterest expense:		
Salaries and employee benefits	8,335,923	7,870,163
Occupancy, net	787,852	826,898
Professional fees	448,814	399,988
Communications	395,384	362,962
Regulatory insurance and assessments	332,314	322,847
Data processing	329,539	327,808
Amortization of low income housing tax investment	244,300	244,300
OREO	198,947	273,904
Other	1,298,129	1,347,205
Total noninterest expense, net	12,371,202	11,976,075
Income before income taxes	3,555,995	4,240,821
Provision for income taxes	466,000	851,000
Net income	3,089,995	3,389,821
Other comprehensive income (loss) – unrealized gains (losses) on investment securities available-for-sale (net of income taxes of approximately $300,000 in 2013 and $37,000 in 2012)	(487,451)	60,541
Comprehensive income	$ 2,602,544	$ 3,450,362
Basic earnings per common share	$ 0.75	$ 0.83

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

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

	Series A preferred stock		*Common stock*	
	Shares	*Amount*	*Shares*	*Amount*
Balances at December 31, 2011	104,582	$ 104,582	4,010,177	$ 4,010,177
Net income	–	–	–	–
Change in unrealized gains (losses) on investment securities available-for-sale (net of income taxes of approximately $37,000)	–	–	–	–
Repurchases of Series A preferred stock	(1,136)	(1,136)	–	–
Repurchases of common stock	–	–	(16,240)	(16,240)
Cash dividends paid:				
Common ($.40 per share)	–	–	–	–
Preferred ($.42 per share)	–	–	–	–
Balances at December 31, 2012	103,446	103,446	3,993,937	3,993,937
Net income	–	–	–	–
Change in unrealized gains (losses) on investment securities available-for-sale (net of income taxes of approximately $300,000)	–	–	–	–
Repurchases of Series A preferred stock	(400)	(400)	–	
Repurchases of common stock	–	–	(1,000)	(1,000)
Cash dividends paid:				
Common ($.20 per share)	–	–	–	–
Preferred ($.21 per share)	–	–	–	–
Balances at December 31, 2013	103,046	$ 103,046	3,992,937	$ 3,992,937

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

Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Total stockholders' equity
$ 7,729,518	$ 20,876,093	$ 478,845	$ 33,199,215
–	3,389,821	–	3,389,821
–	–	60,541	60,541
(2,272)	(4,731)	–	(8,139)
(32,480)	(68,770)	–	(117,490)
–	(1,598,537)	–	(1,598,537)
–	(43,577)	–	(43,577)
7,694,766	22,550,299	539,386	34,881,834
–	3,089,995	–	3,089,995
–	–	(487,451)	(487,451)
(800)	(1,800)	–	(3,000)
(2,000)	(4,200)	–	(7,200)
–	(798,588)	–	(798,588)
–	(21,641)	–	(21,641)
$ 7,691,966	$ 24,814,065	$ 51,935	$ 36,653,949

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years ended December 31, 2013	Years ended December 31, 2012
Cash flows from operating activities:		
Net income	$ 3,089,995	$ 3,389,821
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	845,240	799,092
Gains on sales of mortgage loans held for sale, net	(682,798)	(703,975)
Loan loss provision	550,000	930,000
Write-down of OREO	165,492	419,846
Losses (gains) on sales of OREO, net	111,825	(113,665)
Gain on insurance settlements	(52,624)	(154,768)
Amortization of low income housing tax investment	244,300	244,300
Provision (credit) for deferred income taxes	266,000	(701,000)
Amortization of net premiums on investment securities available-for-sale	212,675	306,259
Gains on sales of investment securities available-for-sale	–	(273,976)
Increase in cash surrender value of bank-owned life insurance	(222,992)	(231,594)
Increase in accrued interest receivable and other assets	(588,331)	(169,562)
Increase in accrued interest payable and other liabilities	398,217	401,944
Originations of mortgage loans held for sale	(35,126,000)	(54,993,000)
Proceeds from sales of mortgage loans held for sale	36,701,445	55,236,616
Net cash provided by operating activities	5,912,444	4,386,338
Cash flows from investing activities:		
(Increase) decrease in interest-bearing time deposits	(3,002,000)	2,169,000
Purchases of investment securities available-for-sale	–	(3,527,180)
Proceeds from maturities, calls, and prepayments of investment securities available-for-sale	3,352,454	3,178,490
Proceeds from sales of investment securities available-for-sale	–	2,168,365
Proceeds from sales of FHLB stock at par value	23,200	11,600
Net increase in other loans	(20,641,262)	(15,161,202)
Purchases of premises and equipment, net	(380,897)	(337,482)
Proceeds from insurance settlement	52,624	173,768
Purchases of mortgage servicing rights	(20,784)	(17,259)
Proceeds from sales of OREO	1,130,476	2,738,105
Net cash used by investing activities	(19,486,189)	(8,603,795)
Cash flows from financing activities:		
Net increase (decrease) in deposits	30,737,237	(31,117)
Repurchases of common and preferred stock	(10,200)	(125,629)
Cash dividends paid	(820,229)	(1,642,114)
Net cash provided (used) by financing activities	29,906,808	(1,798,860)
Net increase (decrease) in cash and cash equivalents	16,333,063	(6,016,317)
Cash and cash equivalents at beginning of year	43,531,184	49,547,501
Cash and cash equivalents at end of year	$ 59,864,247	$ 43,531,184

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation, Description of Business, and Summary of Significant Accounting Policies

Basis of Presentation

The accompanying consolidated financial statements include the accounts of Siuslaw Financial Group, Inc. (SFG), a bank holding company, and its wholly-owned subsidiary, Siuslaw Bank (the Bank) (collectively, "the Company"). All significant intercompany accounts and transactions have been eliminated in consolidation.

The Company has also established a subsidiary grantor trust in connection with the issuance of trust preferred securities (see Note 9). In accordance with accounting principles generally accepted in the United States of America (GAAP), the accounts and transactions of this trust are not included in the accompanying consolidated financial statements.

Certain amounts in 2012 have been reclassified to conform with the 2013 presentation.

Description of Business

The Bank conducts a general banking business in the Lane County, Oregon area and primarily operates in one business segment. Its activities include the usual lending and deposit functions of a commercial bank: commercial, real estate, installment, credit card, and mortgage loans; checking, money market, savings, and time deposit accounts; internet banking and bill payment; automated teller machines; collection and escrow services; and safe deposit facilities. The Bank also originates and sells mortgage loans into the secondary market.

Method of Accounting

The Company prepares its consolidated financial statements in conformity with GAAP and prevailing practices within the banking industry. The Company utilizes the accrual method of accounting which recognizes income and gains when earned and expenses and losses when incurred. The preparation of consolidated financial statements in conformity with GAAP requires management of the Company (Management) to make estimates and assumptions that affect the reported amounts of assets and liabilities, and the disclosure of contingent assets and liabilities as of the date of the consolidated balance sheet, and the reported amounts of income, gains, expenses, and losses during the reporting period. Actual results could differ from those estimates. A material estimate that is particularly susceptible to significant change in the near term relates to the determination of the reserve for loan losses (see Note 4).

Subsequent Events

Management has evaluated, for potential recognition or disclosure in the consolidated financial statements, subsequent events that have occurred through March 12, 2014, which is the date the consolidated financial statements were available to be issued.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks (including cash items in the process of collection), and interest-bearing deposits in banks with original maturities of three months or less.

The Bank maintains balances in correspondent bank accounts which, at times, may exceed federally insured limits. Management believes that its risk of loss associated with such balances is minimal due to the financial strength of the correspondent banks. The Bank has not experienced any losses in such accounts.

Supplemental Disclosures of Cash Flow Information

During 2013 and 2012, non-cash transactions included unrealized gains and losses on investment securities available-for-sale, as disclosed in the accompanying consolidated statements of changes in stockholders' equity. In addition, non-cash investing activities included the transfer of approximately $2,808,000 and $3,657,000 of loans to other real estate owned (OREO) in 2013 and 2012, respectively.

During 2013 and 2012, the Company paid approximately $757,000 and $962,000, respectively, in interest expense. During 2013 and 2012, the Company made income tax payments of approximately $688,000 and $1,033,000, respectively.

Interest-bearing Time Deposits

Interest-bearing time deposits with original maturities in excess of three months up to one year are carried at cost, which approximates fair value.

Investment Securities

Investment securities that Management has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and are reported at cost. The Company had no held-to-maturity securities during 2013 or 2012.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation, Description of Business, and Summary of Significant Accounting Policies (Continued)

Investment Securities (Continued)

Investment securities that are purchased and held principally for the purpose of selling them in the near term are classified as trading securities and are reported at fair value, with unrealized gains and losses included in noninterest income. The Company had no trading securities during 2013 or 2012.

Investment securities that are not classified as either held-to-maturity securities or trading securities are classified as available-for-sale securities and are reported at fair value, with unrealized gains and losses excluded from earnings and reported as other comprehensive income or loss, net of income taxes.

Management determines the appropriate classification of securities at the time of purchase.

Gains and losses on sales of available-for-sale securities – which are determined using the specific-identification method – are included in noninterest income. Amortization of premiums and accretion of discounts on available-for-sale securities are recognized in interest income using the interest method, generally over the expected period to maturity. Premiums and discounts on mortgage-backed securities are amortized/accreted using the interest method over a period that anticipates prepayment of principal.

Declines in the fair value of individual available-for-sale securities below their cost that are deemed to be other-than-temporary impairment (OTTI) would result in write-downs of the individual securities to their fair value. The fair value of the security would then become the new cost basis. In estimating OTTI losses, Management considers, among other things, (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, (3) the impact of changes in market interest rates, and (4) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery of fair value. The related write-downs would be included in earnings as realized losses. Management believes that all unrealized losses on individual investment securities as of December 31, 2013 are temporary (see Note 3).

FHLB Stock

As a member of the Federal Home Loan Bank system, the Bank is required to maintain a minimum level of investment in Federal Home Loan Bank of Seattle (FHLB) stock based on specific percentages of its outstanding mortgages, total assets, or FHLB advances. As of December 31, 2013 and 2012, the Bank met its minimum required investment. The Bank may request redemption at par value of any FHLB stock in excess of the minimum required investment; however, stock redemptions are at the discretion of the FHLB.

The Bank's investment in FHLB stock – which has limited marketability – is carried at cost, which approximates fair value. GAAP provides that, for impairment testing purposes, the value of long-term investments such as FHLB stock is based on the "ultimate recoverability" of the par value of the security without regard to temporary declines in value. The determination of whether a decline affects the ultimate recovery is influenced by criteria such as: (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount and length of time a decline has persisted; (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB; (3) the impact of legislative and regulatory changes on the FHLB; and (4) the liquidity position of the FHLB. During the quarter ended September 30, 2012, the Federal Housing Finance Agency ("Finance Agency") upgraded the FHLB's regulatory capital classification to "adequately capitalized" and granted the FHLB authority to repurchase up to $25 million of excess capital stock per quarter at par, provided the FHLB receives a non-objection for each quarter's repurchase from the Finance Agency. In addition, the FHLB announced in July 2013 that it had declared its first dividend in several years (cash dividend received by the Bank in 2013 was insignificant). Based on the Bank's evaluation of its investment in FHLB stock, including the long-term nature of the investment, the liquidity position of the FHLB, the actions being taken by the FHLB to address its regulatory situation and the Bank's intent and ability to hold the investment for a period of time sufficient to recover the par value, the Bank does not believe that its investment in FHLB stock is impaired as of December 31, 2013. However, future deterioration of the FHLB's financial condition may result in future impairment losses.

Loans

Loans that Management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are stated at the amount of unpaid principal, reduced by the reserve for loan losses and deferred loan fees.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation, Description of Business, and Summary of Significant Accounting Policies (Continued)

Loans (Continued)

Interest income on all loans is accrued as earned on the simple interest method. The accrual of interest on loans is discontinued when, in Management's opinion, the borrower may be unable to make payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all principal and interest payments contractually due are brought current and, in Management's opinion, future payments are reasonably assured. Past due status is based on the contractual terms of the loan. Interest income on nonaccrual loans that have not been fully charged off is subsequently recognized only to the extent that cash payments are received satisfying all delinquent principal and interest amounts and, in Management's judgment, the prospects for future payments in accordance with the loan agreement appear relatively certain. In accordance with regulatory guidance, cash payments received by the Bank on loans that had been fully charged off in previous years are credited to the allowance for loan losses to the extent of any previous charge-offs; any additional cash payments received on such loans are recorded in noninterest income as recoveries of income on certain loans.

Loan origination and commitment fees, net of certain direct loan origination costs, are deferred and generally recognized as an adjustment of the yield of the related loan. If the loan is repaid prior to maturity, the remaining unamortized deferred loan origination fee is recognized in interest income at the time of repayment.

Reserve for Loan Losses

The reserve for loan losses represents Management's recognition of the assumed risks of extending credit and the quality of the existing loan portfolio. The reserve is established to absorb Management's best estimate of known and inherent losses in the loan portfolio as of the consolidated balance sheet date. The reserve requires complex subjective judgments as a result of the need to make estimates about matters that are uncertain. The reserve is maintained at a level considered adequate to provide for potential loan losses based on Management's assessment of various factors affecting the portfolio. Such factors include historical loss experience; review of problem loans; underlying collateral values and guaranties; current economic conditions; and an overall evaluation of the quality, risk characteristics, and concentration of loans in the portfolio.

The reserve consists of general and specific components, as well as an unallocated portion. The general component covers non-impaired loans. The Bank's methodology for determining the appropriate level of the general component of the reserve generally consists of applying loss factors to outstanding loan balances segregated by loan type and risk rating. Loss factors are based on the Bank's historical loss experience adjusted for qualitative factors. Qualitative factors are determined by loan type and are based on Management's continuing evaluation of various factors underlying the quality of the loan portfolio, including lending policies and procedures, economic conditions, changes in the size and composition of the loan portfolio, experience of lending management, volume of troubled loans, quality of the Bank's loan review system, changes in collateral values, concentration of credit risk and other external factors including regulatory requirements. In calculating the general component of the reserve, the Bank aggregates its loans into various portfolio segments depending on various factors: owner occupied commercial real estate, non-owner occupied commercial real estate, multi-family real estate, commercial and industrial, construction and development, one-four family residential, municipal, and consumer and other. Risk factors impacting loans in each loan segment include reduced consumer and business spending as a result of continued high unemployment and reduced credit availability, and lack of consumer confidence in a sustainable economic recovery. Deterioration of property values is a risk factor that particularly impacts the construction and development, one-four family residential, and commercial real estate segments.

The specific component of the reserve relates to loans that are individually classified as impaired. The Bank considers loans to be impaired when Management believes that it is probable that all amounts due will not be collected according to the contractual terms. Amounts deemed impaired are either specifically allocated for in the reserve or reflected as a partial charge-off of the loan balance. Generally, the Bank evaluates a loan for impairment when it is placed on nonaccrual status. The Bank does not separately identify individual installment loans for impairment disclosure. Impaired loans are valued using the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price, the fair value of the loan's underlying collateral, net of selling costs, or the value of a related guaranty. The Bank primarily measures impairment on all large balance impaired loans (typically commercial and commercial real estate loans) based on the present value of expected future cash flows discounted at the loan's effective interest rate or the estimated fair value of the underlying collateral, net of selling costs.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation, Description of Business, and Summary of Significant Accounting Policies (Continued)

Reserve for Loan Losses (Continued)

The unallocated portion of the reserve is based upon Management's evaluation of various factors that are not directly measured in the determination of the general and specific components. Such factors include uncertainties in economic conditions, the imprecision of appraisals used in estimating collateral values, judgment as to whether specific impaired loans are collateral-dependent, uncertainties in identifying triggering events that directly correlate to subsequent loss rates, risk factors that have not yet manifested themselves in historical loss factors, and historical loss experience data that may not precisely correspond to the current portfolio. The unallocated portion may also be affected by review by the bank regulatory authorities who may require increases or decreases to the unallocated portion of the reserve based on their evaluation of the information available to them at the time of their examinations. Accordingly, the unallocated portion helps to minimize the risk related to the margin of imprecision inherent in the estimation of general and specific reserves. Due to the subjectivity involved in the determination of the unallocated portion of the reserve for loan losses, the relationship of the unallocated portion to the total reserve for loan losses may fluctuate from period to period.

The valuation of real estate collateral is subjective in nature and may be adjusted in future periods because of changes in economic conditions. Management considers third-party appraisals, as well as independent fair market value assessments from realtors or other persons involved in selling real estate in determining the estimated fair value of particular properties. In addition, as certain of these third-party appraisals and independent fair market value assessments are only updated periodically, changes in the values of specific properties may have occurred subsequent to the most recent appraisals. Accordingly, the amounts of any such potential changes and any related adjustments are generally recorded at the time such information is received. When the measurement of the impaired loan is less than the recorded investment in the loan, impairment is recognized by creating or adjusting an allocation of the reserve for loan losses, and uncollected interest income is reversed against interest income. If ultimate collection of the principal is in doubt, all cash receipts on impaired loans are applied to reduce the principal balance.

A provision for loan losses is charged against operations and is added to the reserve for loan losses based on a quarterly (or more frequently if needed) comprehensive analysis of the loan portfolio. The reserve for loan losses is allocated to certain loan categories based on the relative risk characteristics, asset classifications and actual loss experience of the loan portfolio. While Management has allocated the reserve for loan losses to various loan portfolio segments, the reserve is general in nature and is available for the loan portfolio in its entirety.

The reserve is based on estimates, and ultimate losses may vary from the current estimates. These estimates are reviewed periodically, and, as adjustments become necessary, they are reported in earnings in the periods in which they become known. The reserve is increased by provisions charged to operations and reduced by loans charged off, net of recoveries. Loan losses are charged against the reserve when Management deems a loan balance to be uncollectible.

The ultimate recovery of all loans is susceptible to future market factors beyond the Company's control. These factors may result in losses or recoveries differing significantly from those recorded in the accompanying consolidated financial statements. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's reserve. Such agencies may require the Bank to recognize increases to the reserve in the future based on their judgment of the information available to them at the time of their examinations of the Bank.

Troubled Debt Restructurings (TDRs)

A loan is classified as a TDR when a borrower is experiencing financial difficulties and the Bank grants a concession to the borrower in the restructuring that the Bank would not otherwise consider. These concessions may include – but are not limited to – certain interest rate reductions; certain extensions of maturity dates; a reduction in the face amount of the debt; a reduction in the accrued interest; or re-aging, extensions, deferrals, and renewals. TDR loans are considered to be impaired and are individually evaluated for impairment.

Reserve for Unfunded Loan Commitments

The Bank maintains a separate reserve for estimated losses related to unfunded loan commitments. Management estimates the amount of probable losses related to unfunded loan commitments by applying loss factors to an estimate of the expected amount of funding of these loan commitments. As of December 31, 2013 and 2012, the reserve for unfunded loan commitments totaled approximately $114,000. In accordance with industry practice and regulatory guidance, the reserve for estimated losses related to unfunded loan commitments is included in accrued interest payable and other liabilities in the accompanying consolidated balance sheets. Increases (decreases) in the reserve for estimated losses related to unfunded loan commitments are recorded in other noninterest expense in the accompanying consolidated statements of comprehensive income.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation, Description of Business, and Summary of Significant Accounting Policies (Continued)

Mortgage Loans and Mortgage Servicing Rights (MSRs)

Mortgage loans originated and intended for sale in the secondary market are reported as mortgage loans held for sale in the accompanying consolidated balance sheets and are carried at the lower of cost or estimated fair value. Fair value is determined on an aggregate loan basis. As of December 31, 2013 and 2012, mortgage loans held for sale were carried at cost, which approximated estimated fair value.
The carrying value of MSRs is the original estimated value of the originated MSRs or the cost of purchased MSRs, net of subsequent amortization, write-offs due to prepayments, or other write-downs or valuation allowances due to impairment. The originated value of MSRs approximates the value as measured by allocating the carrying value of loans between the assets sold and interest retained, based upon the relative estimated fair values at the date of sale. The MSRs are being amortized on a basis that approximates their proportion to, and period of, estimated net servicing income.

The Bank analyzes its MSRs by underlying investor, loan type and interest rate (primarily fixed and adjustable). The estimated fair value of MSRs is obtained through an independent third-party valuation, utilizing future cash flows which incorporate numerous assumptions including servicing income, servicing costs, market discount rates, prepayment speeds, default rates, and other market-driven data. Accordingly, changes in such assumptions could significantly affect the estimated fair values of the MSRs. GAAP requires that, in the event that the estimated fair value of MSRs falls below the Bank's carrying value, the Bank would record an impairment loss. To mitigate this risk, Management amortizes MSRs over their expected lives and fully amortizes MSRs that are specifically associated with any serviced mortgage loans that are paid-off.

The Bank does not employ specific hedges to mitigate fair value changes that may occur due to market fluctuations. There can be no assurance regarding the possible impairment of MSRs in future periods. The estimated fair value of MSRs was approximately $3,656,000 and $3,185,000 as of December 31, 2013 and 2 012, respectively. The net book value of MSRs as of December 31, 2013 and 2012 (approximately $1,209,000 and $1,221,000, respectively) is included in accrued interest receivable and other assets in the accompanying consolidated balance sheets.

Premises and Equipment

Premises and equipment are stated at cost, less accumulated depreciation and amortization. Expenditures for repairs and maintenance are charged to expense as incurred. Additions and betterments are capitalized. Depreciation and amortization are computed using straight-line and accelerated methods over the shorter of the estimated useful lives of the assets or terms of the related leases. Amortization of leasehold improvements is included in depreciation and amortization expense in the accompanying consolidated financial statements. Gains or losses on dispositions are reflected in earnings as incurred.

Management reviews premises and equipment for potential impairment whenever events or circumstances indicate that the carrying amount of such assets may not be recoverable. If there is an indication of impairment, Management would prepare an estimate of future cash flows (undiscounted and without interest charges) expected to result from the use of the asset and its eventual disposition. If these estimated cash flows were less than the carrying amount of the asset, an impairment loss would be recognized to write down the asset to its estimated fair value.

Bank-Owned Life Insurance (BOLI)

BOLI, purchased on certain executives and other employees, is recorded at the cash surrender value (net of surrender charges) of the underlying insurance contracts. Changes in the cash surrender value of BOLI are included in noninterest income in the accompanying consolidated statements of comprehensive income.

Investment in Low Income Housing Limited Partnership

In April 2010, the Bank entered into a limited partnership, formed to assist with the development and operation of housing for lower income households. The Bank contributed $515,000 to the partnership in 2010, and made its remaining mandatory contribution of $1,928,000 to the partnership in 2011. The Bank earns a return on its investment in the form of tax credits and deductions that flow through to it as a limited partner in these partnerships. The Bank has been recording amortization of its investment in the limited partnership in noninterest expense in the accompanying consolidated statements of comprehensive income. Amortization is computed on a straight line basis which approximates the Bank's share of the partnership's actual operating losses, excluding the related benefit of a low income housing tax credit (see Note 11). The period of amortization is 10 years which approximates the period during which the tax credits are expected to be used. As of December 31, 2013 there is approximately $2.7 million of remaining federal tax credits related to the low income housing limited partnership. The Bank's investment in the limited partnership is included in accrued interest receivable and other assets in the accompanying consolidated balance sheets.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation, Description of Business, and Summary of Significant Accounting Policies (Continued)

OREO

OREO, acquired through foreclosure or deeds in lieu of foreclosure, is carried at the lower of cost or estimated net realizable value. When the property is acquired, any excess of the loan balance over the estimated net realizable value is charged to the reserve for loan losses. Holding costs; subsequent write-downs to net realizable value, if any; and any disposition gains or losses are included in noninterest expense. The valuation of OREO is subjective in nature and may be adjusted in the future because of changes in economic conditions. The valuation of OREO is also subject to review by federal and state bank regulatory authorities who may require increases or decreases to carrying amounts based on their evaluation of the information available to them at the time of their examinations of the Bank. Management considers third-party appraisals, as well as independent fair market value assessments from realtors or other persons involved in selling OREO, in determining the fair value of particular properties. In addition, as certain of these third-party appraisals and independent fair market value assessments are only updated periodically, changes in the values of specific properties may have occurred subsequent to the most recent appraisals. Accordingly, the amounts of any such potential changes and any related adjustments are generally recorded at the time such information is received.

Stockholders' Equity

The Company's Series A preferred stock has a par value of $1, and holders of Series A preferred stock are entitled to a 5% preference in the distribution of dividends, when and if declared and paid by the Company. Holders of Series A preferred stock do not have any preemptive rights to purchase any additional shares of Series A preferred stock; the Series A preferred stock ranks senior to common stock with respect to dividend rights; and it does not have voting rights except under very limited circumstances.

The Company's basic earnings per common share is computed by dividing net income, less preferred stock dividends declared and undistributed earnings allocable to the participating preferred shares ($81,563 and $90,052 for the years ended December 31, 2013 and 2012, respectively), by the weighted average number of common shares outstanding (3,993,038 and 3,999,059 for the years ended December 31, 2013 and 2012, respectively).

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Advertising

Advertising costs are generally charged to expense during the year in which they are incurred. Advertising costs charged to expense were approximately $28,000 and $58,000 during the years ended December 31, 2013 and 2012, respectively.

Income Taxes

The Company utilizes the asset and liability method for accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future income tax consequences attributable to differences between the consolidated financial statement carrying values and their respective income tax bases (temporary differences). The resulting changes in the net deferred tax assets or liabilities are included in income. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the periods that the temporary differences are expected to be recovered or settled. The effect on deferred income tax assets and liabilities of a change in tax rates is included in income in the period that includes the substantial enactment date. Deferred income tax assets are evaluated periodically, and, if realization is not considered "more likely than not," a valuation allowance is provided.

Income tax positions that meet the "more likely than not" recognition threshold are measured as the largest amount of income tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with income tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized income tax benefits in the accompanying consolidated balance sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination. Interest and penalties associated with unrecognized income tax benefits would be classified as additional income taxes in the consolidated statements of comprehensive income. There were no unrecognized income tax benefits, nor any interest and penalties associated with unrecognized income tax benefits, accrued or expensed as of and for the years ended December 31, 2013 and 2012.

The Company files income tax returns for federal and State of Oregon tax jurisdictions. The Company's federal and state income tax returns for years before 2010 are no longer subject to examination by federal and state tax authorities.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation, Description of Business, and Summary of Significant Accounting Policies (Continued)

New Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-02, Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The new guidance requires an entity to provide information about the amount reclassified out of accumulated other comprehensive income by component and to present either on the face of the statement where net income is presented, or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income, but only if the amount reclassified is required to be reclassified to net income in its entirety in the same reporting period. This guidance was effective for the Company for the year ended December 31, 2013, and did not have a material impact on the Company's consolidated financial statements.

2. Cash and Due from Banks

By regulation, the Bank must meet reserve requirements as established by the Federal Reserve Bank (FRB). The Bank complies with such requirements by holding cash and maintaining average reserve balances with the FRB in accordance with such regulations. The Bank was not required to maintain a reserve balance with the FRB as of December 31, 2013 and 2012.

3. Investment Securities Available-For-Sale

Investment securities available-for-sale as of December 31, 2013 and 2012 consisted of the following:

	Amortized cost	*Gross unrealized gains*	*Gross unrealized losses*	*Estimated fair value*
2013				
Obligations of state and political subdivisions	$ 11,232,062	$ 215,564	$ 256,237	$ 11,191,389
Collateralized mortgage obligations	1,269,465	43,411	–	1,312,876
Mortgage-backed securities	777,861	82,422	–	860,283
	$ 13,279,388	$ 341,397	$ 256,237	$ 13,364,548
2012				
Obligations of state and political subdivisions	$ 12,232,201	$ 721,426	$ –	$ 12,953,627
Collateralized mortgage obligations	3,456,434	48,859	163	3,505,130
Mortgage-backed securities	1,155,882	102,671	–	1,258,553
	$ 16,844,517	$ 872,956	$ 163	$ 17,717,310

As of December 31, 2013, Management does not have the intent to sell any investment securities available-for-sale and believes that it is more likely than not that the Company will not have to sell any such securities before a recovery of cost. As of December 31, 2013, gross unrealized losses included in the above table related to six obligations of state and political subdivisions. As of December 31, 2012, gross unrealized losses included in the above table related to two collateralized mortgage obligations. None of these securities were in a significant continuous unrealized loss position for more than one year as of December 31, 2013 and 2012. The unrealized losses on the above investment securities are primarily due to increases in market interest rates over the yields available at the time the underlying investment securities were purchased by the Company. Management expects the fair values of these investment securities to recover as the investment securities approach their maturity dates or repricing dates or as market yields for such investment securities decline. Management does not believe that any of the investment securities are impaired due to reasons of credit quality. Accordingly, as of December 31, 2013 and 2012, Management believes that all unrealized losses on investment securities available-for-sale are temporary and, accordingly, no impairment losses have been realized in the accompanying consolidated statements of comprehensive income.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. Investment Securities Available-For-Sale (Continued)

The amortized cost and estimated fair value of investment securities available-for-sale as of December 31, 2013, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities, because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized cost	*Estimated fair value*
Due after one year through five years	$ 1,425,584	$ 1,486,574
Due after five years through ten years	916,981	978,003
Due after ten years	8,889,497	8,726,812
Collateralized mortgage obligations	1,269,465	1,312,876
Mortgage-backed securities	777,861	860,283
	$ 13,279,388	$ 13,364,548

Investment securities with a carrying value of approximately $12,223,000 and $7,003,000 as of December 31, 2013 and 2012, respectively, were pledged to secure public deposits (see Note 10) and for other purposes as required or permitted by law (see Note 8).

4. Loans and Reserve for Loan Losses

Loans as of December 31, 2013 and 2012 consisted of the following:

	2013	*2012*
Commercial real estate:		
Owner occupied	$ 67,140,308	$ 65,046,901
Non-owner occupied	66,882,845	54,699,715
Multi-family	27,297,017	22,924,921
Commercial and industrial	24,749,296	23,108,504
Construction and development	17,535,323	22,405,856
One-four family residential	27,306,411	23,031,424
Municipal	3,883,893	5,208,975
Consumer and other	6,959,849	8,026,738
	241,754,942	224,453,034
Less reserve for loan losses	4,122,274	4,120,775
Less deferred loan fees	1,051,201	1,034,397
Loans, net	$ 236,581,467	$ 219,297,862

The Bank's branches and customers are located in Lane County, Oregon, and a substantial portion of the Bank's loans are collateralized by real estate in this geographic area. Accordingly, the ultimate collectibility of a substantial portion of the Bank's loan portfolio is susceptible to changes in the economic conditions in this market.

In the normal course of business, the Bank finances qualified construction projects. The majority of residential construction loans are sold into the secondary market subsequent to completion of the projects.

The Bank has lending policies, practices, and procedures in place that are designed to generate loan income within an acceptable level of risk. The Bank's Board of Directors (the Board) reviews and approves the loan policies on an annual basis or when changes and/or additions are recommended to the Board by Management. A reporting and review process is provided by Management to the Board with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies, and non-performing and potential problem loans. Diversification within the loan portfolio is a means of managing risk associated with fluctuations in economic conditions.

Loans are underwritten after evaluating and understanding the borrower's loan request. Underwriting standards are designed to promote relationship banking by understanding a borrower's entire banking need. The Bank examines current and projected cash flows to determine the ability of the borrower to repay its obligation as agreed upon and also evaluates the underlying collateral provided by the borrower.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Reserve for Loan Losses (Continued)

The Bank periodically obtains an independent review of its loan portfolio for quality and accuracy in underwriting loans. Results of these reviews are presented to Management and the Board. The loan review process complements and reinforces the risk identification and assessment decisions made by the Bank's lenders and credit personnel, as well as the Bank's policies and procedures.

Risk characteristics of the Bank's loan portfolio segments are as follows (the Bank believes that its loan classes are the same as its loan portfolio segments):

Commercial real estate loans (owner occupied and non-owner occupied) are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Repayment of these loans is largely dependent on the successful operation of the related property, and collateral securing such loans may fluctuate in value due to economic or individual performance factors. Loan performance may be adversely affected by factors impacting the general economy and conditions specific to the real estate market such as geographic location and/or property type.

Multi-family loans are loans secured by multi-family dwellings units (more than four units). Due to the fact that payments on the loans secured by multi-family properties are often dependent on the successful operation and management of the properties, repayment of such loans may be affected by adverse conditions in the real estate market or economy. The Bank attempts to minimize these risks by scrutinizing the financial condition of the borrower, the quality of the collateral (which may fluctuate in value due to economic conditions or individual performance factors), and the management of the property securing the loan.

Commercial and industrial loans are made based primarily on the historical and projected cash flows of the borrowers and, secondarily, on the underlying collateral provided by the borrowers. The cash flows of borrowers, however, may not occur as forecasted, and collateral securing such loans may fluctuate in value due to economic or individual performance factors. Minimum standards and underwriting guidelines have been established for all commercial loan types.

Construction and development loans are loans where the loan proceeds are controlled by the Bank and used exclusively for the improvement of real estate in which the Bank holds a mortgage. Due to the inherent risk in this type of loan, they are monitored closely and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, government regulation of real property, general economic conditions, the availability of long-term financing, and fluctuations in collateral values.

One-four family residential loans are secured by collateral that may fluctuate in value due to economic conditions or individual performance factors.

Municipal loans are loans offered to local towns, school districts and other governments. Such loans are extended for the purposes of either tax anticipation, building improvements or other capital spending requirements. Municipal loans are typically secured by some type of collateral that represents an essential service.

Consumer and other loans are loans to purchase various items such as automobiles, boats, and recreational vehicles. The terms and rates are established periodically by Management. Consumer loans tend to involve relatively small loan amounts that are spread across many individual borrowers, minimizing significant risk to the Bank.

The following tables set forth information for the years ended December 31, 2013 and 2012 regarding activity in the reserve for loan losses by portfolio segment:

	Beginning reserve	*Provision (credit)*	*Charge-offs*	*Recoveries*	*Ending reserve*
2013					
Commercial real estate:					
Owner occupied	$ 775,086	$ 336,331	$ –	$ –	$ 1,111,417
Non-owner occupied	610,943	131,953	–	–	742,896
Multi-family	273,622	(12,248)	–	–	261,374
Commercial and industrial	531,099	(19,201)	–	3,630	515,528
Construction and development	871,324	300,743	(493,787)	–	678,280
One-four family residential	633,903	(3,787)	–	9,596	639,712
Municipal	6,991	3,143	–	–	10,134
Consumer and other	113,993	89,776	(74,584)	6,644	135,829
Unallocated	303,814	(276,710)	–	–	27,104
Total	$ 4,120,775	$ 550,000	$ (568,371)	$ 19,870	$ 4,122,274

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Reserve for Loan Losses (Continued)

	Beginning reserve	*Provision (credit)*	*Charge-offs*	*Recoveries*	*Ending reserve*
2012					
Commercial real estate:					
Owner occupied	$ 621,645	$ 153,441	$ –	$ –	$ 775,086
Non-owner occupied	557,112	193,831	(140,000)	–	610,943
Multi-family	99,060	174,562	–	–	273,622
Commercial and industrial	415,519	254,358	(142,623)	3,845	531,099
Construction and development	1,121,252	(249,928)	–	–	871,324
One-four family residential	615,292	209,682	(214,286)	23,215	633,903
Municipal	21,438	(14,447)	–	–	6,991
Consumer and other	84,643	46,381	(17,079)	48	113,993
Unallocated	141,694	162,120	–	–	303,814
Total	$ 3,677,655	$ 930,000	$ (513,988)	$ 27,108	$ 4,120,775

The following tables present the balance in the reserve for loan losses and recorded investment in loans by portfolio segment and impairment method as of December 31, 2013 and 2012:

	Reserve for loan losses			*Recorded investment in loans*		
	Individually evaluated for impairment	*Collectively evaluated for impairment*	*Total*	*Individually evaluated for impairment*	*Collectively evaluated for impairment*	*Total*
2013						
Commercial real estate:						
Owner occupied	$ 536,730	$ 574,687	$ 1,111,417	$ 2,670,010	$ 64,156,811	$ 66,826,821
Non-owner occupied	6,570	736,326	742,896	398,437	66,174,646	66,573,083
Multi-family	33,775	227,599	261,374	911,002	26,223,742	27,134,744
Commercial and industrial	206,076	309,452	515,528	510,960	24,146,537	24,657,497
Construction and development	342,638	335,642	678,280	7,246,701	10,210,378	17,457,079
One-four family residential	181,247	458,465	639,712	892,262	26,342,056	27,234,318
Municipal	–	10,134	10,134	–	3,881,127	3,881,127
Consumer and other	11,500	124,329	135,829	11,500	6,927,572	6,939,072
Unallocated	–	27,104	27,104	–	–	–
	$ 1,318,536	$ 2,803,738	$ 4,122,274	$ 12,640,872	$ 228,062,869	$ 240,703,741
2012						
Commercial real estate:						
Owner occupied	$ 238,325	$ 536,761	$ 775,086	$ 2,957,355	$ 61,784,862	$ 64,742,217
Non-owner occupied	–	610,943	610,943	1,616,321	52,761,547	54,377,868
Multi-family	58,608	215,014	273,622	313,144	22,497,251	22,810,395
Commercial and industrial	220,217	310,882	531,099	457,960	22,544,205	23,002,165
Construction and development	447,402	423,922	871,324	7,699,305	14,626,031	22,325,336
One-four family residential	218,349	415,554	633,903	2,211,661	20,773,007	22,984,668
Municipal	–	6,991	6,991	–	5,205,516	5,205,516
Consumer and other	–	113,993	113,993	16,047	7,954,425	7,970,472
Unallocated	–	303,814	303,814	–	–	–
	$ 1,182,901	$ 2,937,874	$ 4,120,775	$ 15,271,793	$ 208,146,844	$ 223,418,637

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Reserve for Loan Losses (Continued)

Information related to impaired loans by portfolio segment as of December 31, 2013 and 2012, and for the years then ended was as follows:

	December 31, 2013			*Year Ended December 31, 2013*	
	Recorded investment	***Unpaid principal balance***	***Related reserve***	***Average recorded investment***	***Interest income recognized***
With no related allowance recorded:					
Commercial real estate:					
Owner occupied	$ 405,592	$ 409,884	$ –	$ 413,798	$ 17,847
Multi-family	610,991	612,528	–	610,455	40,754
Construction and development	6,063,213	7,051,805	–	7,443,887	262,391
One-four family residential	444,673	444,673	–	445,342	38,612
Total with no related allowance recorded	7,524,469	8,518,890	–	8,913,482	359,604
With an allowance recorded:					
Commercial real estate:					
Owner occupied	2,264,418	2,312,560	536,730	2,282,585	60,765
Non-owner occupied	398,437	398,437	6,570	394,350	21,088
Multi-family	300,011	314,289	33,775	314,289	13,140
Commercial and industrial	510,960	512,612	206,076	518,826	33,998
Construction and development	1,183,488	1,344,335	342,638	1,339,768	52,025
One-four family residential	447,589	448,753	181,247	463,132	24,248
Consumer and other	11,500	12,503	11,500	14,236	1,003
Total with an allowance recorded	5,116,403	5,343,489	1,318,536	5,327,186	206,267
Total:					
Commercial real estate:					
Owner occupied	2,670,010	2,722,444	536,730	2,696,383	78,612
Non-owner occupied	398,437	398,437	6,570	394,350	21,088
Multi-family	911,002	926,817	33,775	924,744	53,894
Commercial and industrial	510,960	512,612	206,076	518,826	33,998
Construction and development	7,246,701	8,396,140	342,638	8,783,655	314,416
One-four family residential	892,262	893,426	181,247	908,474	62,860
Consumer and other	11,500	12,503	11,500	14,236	1,003
Total	$ 12,640,872	$ 13,862,379	$ 1,318,536	$ 14,240,668	$ 565,871

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Reserve for Loan Losses (Continued)

	December 31, 2012			Year Ended December 31, 2012	
	Recorded investment	*Unpaid principal balance*	*Related reserve*	*Average recorded investment*	*Interest income recognized*
With no related allowance recorded:					
Commercial real estate:					
Owner occupied	$ 298,749	$ 306,188	$ –	$ 307,340	$ 14,286
Non-owner occupied	1,616,321	1,616,726	–	1,627,349	78,245
Commercial and industrial	6,279,019	6,570,294	–	6,918,565	–
Construction and development	1,549,555	1,894,028	–	1,894,903	5,137
One-four family residential	16,047	16,047	–	16,303	222
Total with no related allowance recorded	9,759,691	10,403,283	–	10,764,460	97,890
With an allowance recorded:					
Commercial real estate:					
Owner occupied	2,658,606	2,660,918	238,325	2,636,070	133,793
Multi-family	313,144	314,289	58,608	315,620	17,739
Commercial and industrial	457,960	458,164	220,217	452,201	22,470
Construction and development	1,420,286	1,538,483	447,402	1,459,391	18,982
One-four family residential	662,106	663,500	218,349	745,543	35,633
Total with an allowance recorded	5,512,102	5,635,534	1,182,901	5,608,825	228,617
Total:					
Commercial real estate:					
Owner occupied	2,957,355	2,967,106	238,325	2,943,410	148,079
Non-owner occupied	1,616,321	1,616,726	–	1,627,349	78,245
Multi-family	313,144	314,289	58,608	315,620	17,739
Commercial and industrial	457,960	458,164	220,217	452,201	22,470
Construction and development	7,699,305	8,108,777	447,402	8,377,956	18,982
One-four family residential	2,211,661	2,555,528	218,349	2,640,446	40,770
Consumer and other	16,047	16,047	–	16,303	222
Total	$ 15,271,793	$ 16,038,637	$ 1,182,901	$ 16,373,285	$ 326,507

For the year ended December 31, 2013, $11,294 of interest income was recognized on a cash basis on impaired loans. For the year ended December 31, 2012, there was no interest income recognized on a cash basis on impaired loans.

The following table presents the recorded investment in loans on nonaccrual status as of December 31, 2013 and 2012:

	2013	*2012*
Commercial real estate:		
Owner occupied	$ 1,967,733	$ 133,035
Multi-family	300,011	–
Commercial and industrial	69,324	78,268
Construction and development	6,520,297	6,798,317
One-four family residential	–	1,476,255
Consumer and other	11,500	16,047
	$ 8,868,865	$ 8,501,922

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Reserve for Loan Losses (Continued)

The following tables present, by class of loans, the recorded investment in loans by aging category and in total as of December 31, 2013 and 2012:

	Days past due			*Total*		*Total*
	30 - 59	*60 - 89*	*90 or more*	*past due*	*Current*	*loans*
2013						
Commercial real estate:						
Owner occupied	$ –	$ –	$ –	$ –	$ 66,826,821	$ 66,826,821
Non-owner occupied	–	–	–	–	66,573,083	66,573,083
Multi-family	–	–	873,379	873,379	26,261,365	27,134,744
Commercial and industrial	30,049	48,312	69,324	147,685	24,509,812	24,657,497
Construction and development	–	786,115	2,046,839	2,832,954	14,624,125	17,457,079
One-four family residential	85,493	18,265	–	103,758	27,130,560	27,234,318
Municipal	–	–	–	–	3,881,127	3,881,127
Consumer and other	–	–	–	–	6,939,072	6,939,072
	$ 115,542	$ 852,692	$ 2,989,542	$ 3,957,776	$ 236,745,965	$ 240,703,741
2012						
Commercial real estate:						
Owner occupied	$ 142,859	$ –	$ 133,035	$ 275,894	$ 64,466,323	$ 64,742,217
Non-owner occupied	–	88,389	–	88,389	54,289,479	54,377,868
Multi-family	886,358	–	–	886,358	21,924,037	22,810,395
Commercial and industrial	74,217	–	78,268	152,485	22,849,680	23,002,165
Construction and development	–	–	2,885,308	2,885,308	19,440,028	22,325,336
One-four family residential	446,490	–	–	446,490	22,538,178	22,984,668
Municipal	–	–	–	–	5,205,516	5,205,516
Consumer and other	–	–	16,047	16,047	7,954,425	7,970,472
	$ 1,549,924	$ 88,389	$ 3,112,658	$ 4,750,971	$ 218,667,666	$ 223,418,637

Loans past due 90 days or more and still accruing interest totaled approximately $573,000 as of December 31, 2013. There were no such loans as of December 31, 2012.

The Bank categorizes all loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: quality of management, current financial information, historical payment experience, credit documentation, and geographic and industry risk, among other factors.

Risk ratings for all loans are reviewed at least quarterly or more often if warranted by events or circumstances. The Bank uses the following definitions for risk ratings:

Special mention: This classification is assigned to loans with emerging problems and those loans that contain potentially unsatisfactory characteristics. These loans are characterized by borrowers who have marginal cash flow, marginal profitability, or have experienced an unprofitable year and/or a declining financial condition. The borrower has in the past handled debts satisfactorily, but in recent months has either been late, delinquent in making payments, or made sporadic payments. While the Bank continues to be adequately secured, the borrower's operating margins have decreased or are decreasing. Other characteristics of such borrowers include inadequate credit information, or weakness of financial condition or repayment capacity, but with collateral that appears to limit exposure.

Substandard: Substandard loans are inadequately protected by current sound net worth, paying capacity of the borrower, or pledged collateral. Borrowers in this category have characteristics that provide unsatisfactory levels of risk and could jeopardize repayment. These characteristics include: inadequate cash flow, debt service coverage, or working capital; declining sales; rising costs; operating losses; few or no financing alternatives; or possible bankruptcy. Collateral may provide marginal protection.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Reserve for Loan Losses (Continued)

Doubtful Loans classified as doubtful have all the weaknesses inherent in a loan graded substandard. In addition, these weaknesses make collection in full – including repayment through full liquidation of collateral – on the basis of currently existing facts, conditions and value, highly questionable and improbable.

Loss: Loans classified as loss are considered uncollectible and of such minimal value that continuance as an asset is not warranted.

Loans not meeting the criteria above are considered to be pass-rated loans. The Bank has no loans classified as doubtful or loss as of December 31, 2013 and 2012.

The following tables present, by class of loans, the recorded investment in loans by risk rating as of December 31, 2013 and 2012, based on the most recent rating assigned to each loan as of those dates:

	Pass	*Special mention*	*Substandard*	*Total*
2013				
Commercial real estate:				
Owner occupied	$ 63,904,167	$ 252,644	$ 2,670,010	$ 66,826,821
Non-owner occupied	66,174,646	398,437	–	66,573,083
Multi-family	26,233,742	–	911,002	27,134,744
Commercial and industrial	24,024,598	121,939	510,960	24,657,497
Construction and development	10,117,933	92,444	7,246,702	17,457,079
One-four family residential	25,584,786	840,162	809,370	27,234,318
Municipal	3,881,127	–	–	3,881,127
Consumer and other	6,927,572	–	11,500	6,939,072
	$ 226,838,571	$ 1,705,626	$ 12,159,544	$ 240,703,741
2012				
Commercial real estate:				
Owner occupied	$ 61,784,862	$ –	$ 2,957,355	$ 64,742,217
Non-owner occupied	53,830,164	547,704	–	54,377,868
Multi-family	22,497,251	–	313,144	22,810,395
Commercial and industrial	22,368,803	175,402	457,960	23,002,165
Construction and development	13,087,610	1,714,768	7,522,958	22,325,336
One-four family residential	19,362,579	1,486,112	2,135,977	22,984,668
Municipal	5,205,516	–	–	5,205,516
Consumer and other	7,862,146	92,279	16,047	7,970,472
	$ 205,998,931	$ 4,016,265	$ 13,403,441	$ 223,418,637

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Reserve for Loan Losses (Continued)

The following table sets forth information with respect to the Bank's troubled debt restructurings by portfolio segment during the years ended December 31, 2013 and 2012:

	Number of loans	*Pre and post-modification outstanding recorded investment*
2013		
Commercial and industrial	1	$ 72,815
2012		
Commercial real estate:		
Owner occupied	1	$ 394,295
Commercial and industrial	1	83,649
Construction and development	1	208,074
One-four family residential	4	417,200
Total	7	$ 1,103,218

During the years ended December 31, 2013 and 2012, the Bank restructured loans to borrowers experiencing financial difficulties in various loan portfolio segments.

The loan modification in 2013 resulted in a reduction in the stated interest rate and the loan subsequently defaulted in 2013. All of the loan modifications in 2012 resulted in reductions in the stated interest rates. Modifications in 2012 to the owner occupied commercial real estate loan also included an extension of the maturity date. One loan modified during 2012 in the one-four family residential segment with a balance of $196,172 defaulted within twelve months of the restructuring.

The Bank's operations, like those of other financial institutions operating in the Bank's market, are significantly influenced by various economic conditions including local economies, the strength of the local real estate market, and the fiscal and regulatory policies of the federal and state governments and the regulatory authorities that govern financial institutions. There has been a significant slow-down in the local real estate markets due to negative economic trends and credit market disruption, the impacts of which are not yet completely known or quantified. Recently, there have been tighter credit underwriting and higher premiums on liquidity, both of which may continue to place downward pressure on real estate values. Any further downturn in the local real estate markets could materially and adversely affect the Bank's business because a significant portion of the Bank's loans are secured by real estate. The Bank's ability to recover on defaulted loans by selling the real estate collateral would then be diminished and the Bank would be more likely to suffer losses on defaulted loans. Consequently, the Bank's results of operations and financial condition are dependent upon the general trends in the economy, and, in particular, the local residential and commercial real estate markets. If there is a further decline in real estate values, the collateral for the Bank's loans would provide less security. Real estate values could be affected by, among other things, a worsening of economic conditions, an increase in foreclosures, a decline in home sale volumes, and an increase in interest rates. Furthermore, the Bank may experience an increase in the number of borrowers who become delinquent, file for protection under bankruptcy laws, or default on their loans or other obligations to the Bank given a sustained weakness or a weakening in business and economic conditions generally or specifically in the principal market in which the Bank does business. An increase in the number of delinquencies, bankruptcies, or defaults could result in a higher level of nonperforming assets, net charge-offs, and provision for loan losses.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. Mortgage Banking Activities

As of December 31, 2013 and 2012, the Bank held servicing rights to approximately $347,564,000 and $355,403,000, respectively, in mortgage loans which have been sold into the secondary market. The balances of these sold loans are not included in the accompanying consolidated balance sheets. The sales and servicing of these mortgage loans are subject to technical underwriting and servicing requirements, and related repurchase risks. As of December 31, 2013, Management is not aware of any mortgage loans that will have to be repurchased.

Transactions in the Bank's MSRs for the years ended December 31, 2013 and 2012 were as follows:

	2013	*2012*
Balance at beginning of year	$ 1,220,598	$ 1,018,390
Originations	336,786	574,138
Purchased	20,784	17,259
Amortization	(369,419)	(389,189)
Balance at end of year	$ 1,208,749	$ 1,220,598

Mortgage banking income, net, consisted of the following for the years ended December 31, 2013 and 2012:

	2013	*2012*
Origination and processing fees	$ 759,113	$ 1,318,629
Gains on sales of mortgage loans, net	682,798	703,975
Servicing fees, net	1,278,890	1,243,237
Amortization	(369,419)	(389,189)
Balance for the year	$ 2,351,382	$ 2,876,652

6. Premises and Equipment

Premises and equipment as of December 31, 2013 and 2012 consisted of the following:

	2013	*2012*
Land	$ 2,462,300	$ 2,444,425
Buildings and leasehold improvements	7,116,922	7,004,264
Furniture and equipment	2,382,965	2,401,989
	11,962,187	11,850,678
Less accumulated depreciation and amortization	6,078,380	5,979,625
Premises and equipment, net	$ 5,883,807	$ 5,871,053

During the year ended December 31, 2012, a fire destroyed one of the Bank's branch buildings. In 2012 the Bank received insurance proceeds of $173,768 and recorded a gain on the write-off of the property of $154,768, which is recorded in other noninterest income in the accompanying 2012 consolidated statement of comprehensive income. In 2013 the Bank received additional insurance proceeds of $43,473 related to the fire and recorded a gain in other noninterest income in the accompanying 2013 consolidated statement of comprehensive income.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

7. Time Deposits

Time deposits in excess of $100,000 aggregated approximately $11,510,000 and $15,884,000 as of December 31, 2013 and 2012, respectively.

As of December 31, 2013, the scheduled annual maturities of all time deposits were approximately as follows:

2014	$ 19,952,000
2015	3,559,000
2016	2,458,000
2017	576,000
2018	749,000
Thereafter	165,000
	$ 27,459,000

8. Short-Term Borrowings

The Bank has a committed line of credit from the FHLB for up to 25% of total assets, subject to the Bank pledging sufficient collateral and maintaining the required investment in FHLB stock. Borrowings outstanding under this credit line are collateralized by a blanket pledge agreement on the Bank's FHLB stock, any funds on deposit with the FHLB, investment securities, and loans. The Bank had assets pledged for collateral of approximately $40,964,000 as of December 31, 2013. As of December 31, 2013, the Bank's maximum available borrowings, given current collateral, were approximately $18,746,000. As of December 31, 2013 and 2012, the Bank had no outstanding borrowings from the FHLB.

As an additional source of liquidity, the Bank has federal fund borrowing agreements with correspondent banks aggregating approximately $30,000,000 as of December 31, 2013.

9. Junior Subordinated Debentures

The Company has a subsidiary grantor trust (Siuslaw Statutory Trust I) (the Trust) which issued $8,000,000 of trust preferred securities (the TPS) and $248,000 of common securities. The common securities were purchased by the Company and represent a 3% minority interest in the Trust. The Company's investment in the common securities is included in accrued interest receivable and other assets in the accompanying consolidated balance sheets. The TPS are subordinated to any other borrowings of the Company and are due and payable on June 17, 2034. The TPS pay quarterly interest at the 3-month London Inter-Bank Offered Rate (LIBOR) plus 2.7% (2.9% as of December 31, 2013). The Trust used the proceeds received from the issuance of the TPS and the common securities to purchase $8,248,000 of junior subordinated debentures (the Debentures) of the Company. The Debentures were issued with substantially the same terms as the TPS and are the sole assets of the Trust. The Company's obligations under the Debentures and related agreements, taken together, constitute a full and irrevocable guarantee by the Company of the obligations of the Trust. The TPS are mandatorily redeemable upon the maturity of the Debentures or upon earlier redemption as provided in the indenture related to the Debentures. The TPS are callable by the Company at par value. Management believes that as of December 31, 2013 and 2012, the TPS met applicable regulatory guidelines to qualify as Tier 1 capital.

10. Commitments, Guarantees, and Contingencies

In the ordinary course of business, the Bank is a party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. These financial instruments include commitments to extend credit, commitments under credit card lines of credit, and standby letters of credit. These financial instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of amounts recognized in the accompanying consolidated balance sheets. The contractual amounts of these financial instruments reflect the extent of the Bank's involvement in these particular classes of financial instruments. As of December 31, 2013 and 2012, the Bank had no commitments to extend credit at below-market interest rates and held no significant derivative financial instruments.

The Bank's exposure to credit loss for commitments to extend credit, commitments under credit card lines of credit, and standby letters of credit is represented by the contractual amount of these instruments. The Bank follows the same credit policies in underwriting and offering commitments and conditional obligations as it does for on-balance sheet financial instruments. The distribution of commitments to extend credit approximates the distribution of loans outstanding.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

10. Commitments, Guarantees, and Contingencies (Continued)

A summary of the Bank's off-balance sheet financial instruments as of December 31, 2013 and 2012 is approximately as follows:

	2013	*2012*
Commitments to extend credit	$ 27,592,000	$ 34,253,000
Commitments under credit card lines of credit	4,927,000	5,084,000
Standby letters of credit	738,000	639,000
Total off-balance sheet financial instruments	$ 33,257,000	$ 39,976,000

A commitment to extend credit is an agreement to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of fees. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank applies established credit related standards and underwriting practices in evaluating the creditworthiness of such obligors. The amount of collateral obtained, if it is deemed necessary by the Bank upon the extension of credit, is based on Management's credit evaluation of the counterparty. The Bank typically does not obtain collateral related to credit card commitments. Collateral held for other commitments varies but may include accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

Standby letters of credit are written conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. These guarantees are primarily issued to support public and private borrowing arrangements. In the event the customer does not perform in accordance with the terms of the agreement with the third party, the Bank would be required to fund the commitment. The maximum potential amount of future payments the Bank could be required to make is represented by the contractual amount of the commitment. If the commitment were funded, the Bank would be entitled to seek recovery from the customer. The Bank's policies generally require that standby letter of credit arrangements contain security and debt covenants similar to those involved in extending loans to customers. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loan facilities to customers.

The Bank considers the fees collected in connection with the issuance of standby letters of credit to be representative of the fair value of its obligations undertaken in issuing the guarantees. In accordance with GAAP related to guarantees, the Bank defers fees collected in connection with the issuance of standby letters of credit. The fees are then recognized in income proportionately over the life of the related standby letter of credit agreement. As of December 31, 2013 and 2012, the Bank's deferred standby letter of credit fees – which represent the estimated fair value of the Bank's potential obligations under the standby letter of credit guarantees – were insignificant to the accompanying consolidated financial statements.

The Bank also has certain lending commitments for conforming residential mortgage loans to be sold into the secondary market which are considered derivative instruments under GAAP. However, in the opinion of Management, such derivative amounts are not significant, and, therefore, no derivative assets or liabilities are recorded in the accompanying consolidated financial statements.

The Bank is a participant in the Oregon Public Funds Collateralization Program (the Program) and, accordingly, accepts deposit funds belonging to, or held for the benefit of, the State of Oregon, political subdivisions thereof, municipal corporations, and other public funds. In accordance with applicable state law, in the event of default of one bank, all participating banks in the state collectively assure that no loss of funds is suffered by any public depositor. Generally, in the event of default by a public depository, the assessment attributable to all public depositories is allocated on a pro rata basis in proportion to the maximum liability of each public depository as it existed on the date of loss. The Bank has pledged investment securities available-for-sale which fully collateralize public deposits held by the Bank which are not otherwise insured by the Federal Deposit Insurance Corporation (FDIC). At December 31, 2013, there was no liability associated with the Bank's participation in the Program, because all participating banks were required to fully collateralize uninsured Oregon public deposits or obtain supporting letters of credit, and there were no occurrences of an actual loss on Oregon public deposits at such participating banks. The maximum future contingent liability is dependent upon the occurrence of an actual loss, the amount of such loss, the failure of collateral to cover such a loss, and the resulting share of loss to be assessed to the Bank.

In the ordinary course of business, the Bank becomes involved in various litigation arising from normal banking activities. In the opinion of Management, the ultimate disposition of these actions will not have a material adverse effect on the Company's consolidated financial statements as of and for the year ended December 31, 2013.

The Bank leases space in certain of its buildings to third-parties and as of December 31, 2013, the lease agreements extend through June 2016. During the years ended December 31, 2013 and 2012 the Bank received rental income related to these leases of approximately $228,000 and $161,000, respectively, which is included in occupancy, net, in the accompanying consolidated statements of comprehensive income. As of December 31, 2013, future aggregate minimum rental income expected to be received in connection with these leases totaled approximately $245,000.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

11. Income Taxes

The provision (credit) for income taxes was comprised of the following for the years ended December 31, 2013 and 2012:

	2013	2012
Current		
Federal	$ 169,000	$ 1,311,000
State	31,000	241,000
	200,000	1,552,000
Deferred	266,000	(701,000)
Provision for income taxes	$ 466,000	$ 851,000

The provision for income taxes results in effective tax rates which are different than the federal income tax statutory rate. The nature of the differences for the years ended December 31, 2013 and 2012 were approximately as follows:

	2013	2012
Expected federal income tax provision at statutory rate	$ 1,209,000	$ 1,442,000
State income taxes, net of federal effect	178,000	211,000
Low income housing credit	(417,000)	(389,000)
Effect of nontaxable interest income, net	(216,000)	(176,000)
Effect of nontaxable earnings on BOLI	(95,000)	(98,000)
State tax credits	(154,000)	(113,000)
Other, net	(39,000)	(26,000)
	$ 466,000	$ 851,000

The components of the net deferred tax assets as of December 31, 2013 and 2012 were approximately as follows:

	2013	2012
Deferred tax assets:		
Deferred compensation plan expenses, net	$ 1,696,000	$ 1,583,000
Reserve for loan losses	1,347,000	1,374,000
Deferred loan fees and points	494,000	487,000
Nonaccrual interest	163,000	320,000
OREO	65,000	285,000
Other, net	226,000	227,000
Total deferred tax assets	3,991,000	4,276,000
Deferred tax liabilities:		
MSRs	458,000	463,000
Net unrealized gains on investment securities available-for-sale	33,000	333,000
FHLB stock dividends	148,000	162,000
Total deferred tax liabilities	639,000	958,000
Net deferred tax assets	$ 3,352,000	$ 3,318,000

Management believes that, based upon the Company's historical performance, the net deferred tax assets will be recognized in the normal course of operations, and, accordingly, Management has not reduced net deferred tax assets by a valuation allowance. Net deferred tax assets are included in accrued interest receivable and other assets in the accompanying consolidated balance sheets.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

12. Transactions with Related Parties

Certain directors, officers, and principal stockholders of the Company (and the companies with which they are associated) are customers of, and have had banking transactions with, the Bank in the ordinary course of the Bank's business. In addition, the Bank expects to continue to have such banking transactions in the future. All loans, and commitments to loan, to such parties are made in compliance with applicable laws and are generally made on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons. In the opinion of Management, these transactions do not involve more than the normal risk of collectibility or present any other unfavorable features.

Activity with respect to loans to officers and directors for the years ended December 31, 2013 and 2012 was approximately as follows:

	2013	*2012*
Balance at beginning of year	$ 685,000	$ 728,000
Repayments	(47,000)	(43,000)
Balance at end of year	$ 638,000	$ 685,000

13. Benefit Plans

401(k) Profit Sharing Plan

The Company maintains a 401(k) profit sharing plan (the Plan) which covers substantially all employees with at least 90 days of service. The Company matches 100% of each employee's voluntary contributions up to 4% of each employee's compensation. The Company may also contribute amounts to the Plan at the discretion of the Board. No discretionary contributions to the Plan were made during the years ended December 31, 2013 and 2012. Total expense related to the Plan was approximately $201,000 and $184,000 for the years ended December 31, 2013 and 2012, respectively.

Other Benefit Plans

The Bank has deferred compensation and salary continuation plans, and supplemental executive retirement plans (SERPs), for certain key executives and Board members. In accordance with the provisions of the deferred compensation plans, participants can elect to defer portions of their annual compensation or fees. The deferred amounts generally vest as deferred. The deferred compensation plus interest is generally payable upon termination or retirement in either a lump-sum or monthly installments for 10 years. The salary continuation plans and SERPs provide defined benefits to the participants upon termination of employment with the Bank and are paid in monthly installments over a range of 10 to 15 years. The benefits are subject to certain vesting requirements, and vested amounts are generally payable upon termination. For participants in the salary continuation plans, benefits would cease to accrue upon a change in control and would be paid out in monthly installments, plus interest if employment continues, over a period of 10 years. For participants in the SERPs, benefits would fully vest upon a change of control and termination of service within one year and would be paid out in a lump sum. The Bank annually expenses amounts sufficient to accrue for the present value of the benefits payable to the participants under these plans.

The salary continuation plans and SERPs also include death benefit provisions for certain participants. To assist in the funding of these plans, the Bank has purchased BOLI policies on all of the participants. Under these policies, the Bank receives benefits payable upon death of the insured. Under certain of these policies an endorsement split dollar agreement has been executed with the participant whereby a portion of the policy death benefit is payable to their designated beneficiaries. The endorsement split dollar agreement will provide post-retirement coverage for those participants meeting specified retirement qualifications. The Bank expenses the earned portion of the post-employment benefit through the vesting period. The cash surrender value of the BOLI policies as of December 31, 2013 and 2012 was approximately $6,844,000 and $6,621,000, respectively. As of December 31, 2013 and 2012, the liabilities related to the salary continuation plans and SERPs included in accrued interest payable and other liabilities in the accompanying consolidated balance sheets totaled approximately $3,047,000 and $2,833,000, respectively. The amount of expense charged to operations in 2013 and 2012 for the salary continuation plans and SERPs was approximately $371,000 and $265,000, respectively. For financial reporting purposes, such expense amounts have not been adjusted for income earned on the BOLI policies.

14. Fair Value

GAAP defines fair value, establishes a framework for measuring fair value, and requires certain disclosures about fair value measurements. GAAP permits an entity to choose to measure many financial instruments and certain other items at fair value and contains financial statement presentation and disclosure requirements for assets and liabilities for which the fair value option is elected. The Company has not elected to report any assets or liabilities at fair value in the consolidated financial statements under the "fair value option" provided by GAAP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

14. Fair Value (Continued)

The hierarchy of fair value valuation techniques under GAAP provides for three levels: Level 1 provides the most reliable measure of fair value, whereas Level 3, if applicable, generally would require significant Management judgment. The three levels for categorizing assets and liabilities under GAAP's fair value measurement requirements are as follows:

Level 1: Quoted unadjusted prices in active markets for identical assets or liabilities

Level 2: Significant observable inputs other than quoted prices in Level 1, such as quoted prices in active markets for similar assets or liabilities, or quoted prices for identical assets or liabilities in markets that are not active

Level 3: Significant unobservable inputs based on a company's own assumptions about the assumptions that market participants would use in pricing the asset or liability

An asset's or liability's fair value measurement level within the fair value hierarchy is based on the lowest level of any input that is significant to the fair value measurement. GAAP requires that valuation techniques used maximize the use of observable inputs and minimize the use of unobservable inputs.

Certain assets and liabilities are measured at fair value on a recurring or non-recurring basis. Assets and liabilities measured at fair value on a recurring basis are initially measured at fair value and then re-measured at fair value at each financial statement reporting date. Assets and liabilities measured at fair value on a non-recurring basis result from write-downs due to impairment or lower-of-cost-or-market accounting on assets or liabilities not initially measured at fair value.

The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes that the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates, and, therefore, estimates of fair value after the consolidated balance sheet date may differ significantly from the amounts presented herein.

As of December 31, 2013 and 2012, the Company had no financial or non-financial liabilities measured at fair value on a recurring basis.

The Company's financial assets measured at fair value on a recurring basis as of December 31, 2013 and 2012 were as follows:

	Level 1	*Level 2*	*Level 3*
2013			
Investment securities available-for-sale	$ –	$ 13,364,548	$ –
2012			
Investment securities available-for-sale	$ –	$ 17,717,310	$ –

The securities have been valued by reference to prices for similar securities or through model-based techniques in which all significant inputs are observable and, therefore, such valuations have been classified as Level 2. There were no losses related to such securities for the years ended December 31, 2013 and 2012.

As of December 31, 2013 and 2012, the Company had no financial or non-financial liabilities measured at fair value on a non-recurring basis.

The following table represents the assets measured at fair value on a non-recurring basis as of December 31, 2013 and 2012:

	Level 1	*Level 2*	*Level 3*
2013			
Impaired loans with specific valuation allowances	$ –	$ –	$ 3,797,867
OREO	–	–	3,889,621
	$ –	$ –	$ 7,687,488

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

14. Fair Value (Continued)

	Level 1	*Level 2*	*Level 3*
2012			
Impaired loans with specific valuation allowances	$ –	$ –	$ 4,329,201
OREO	–	–	2,489,757
	$ –	$ –	$ 6,818,958

Certain impaired loans are measured at fair value on a non-recurring basis. Periodically, the Company records non-recurring adjustments to the carrying value of impaired loans based on fair value measurements for partial charge-offs of the uncollectible portions of those loans. Non-recurring adjustments also include certain impairment amounts for collateral-dependent loans when establishing the reserve for loan losses. Such amounts are generally based on the estimated fair value of the underlying collateral supporting the loan less estimated costs to sell, which may be less than the carrying value of the loan less any previously calculated valuation adjustment. Real estate collateral is typically valued using appraisals or other indications of value based on recent comparable sales of similar properties or assumptions generally observable in the marketplace, and the related non-recurring fair value measurement adjustments have generally been classified as Level 3.

OREO is measured on a non-recurring basis at estimated fair value less estimated costs to sell. Fair value is generally determined based on third-party appraisals of fair value in an orderly sale. Historically, appraisals have considered comparable sales of similar assets in reaching a conclusion as to fair value. Many recent real estate sales could be termed "distressed sales" since a preponderance have been short-sale or foreclosure related and, accordingly, this has directly impacted appraisal valuation estimates. Estimated costs to sell OREO are based on standard market factors. The valuation of OREO is subject to significant external and internal judgment. Management periodically reviews OREO to determine whether the property continues to be carried at the lower of its recorded book value or estimated fair value, net of estimated costs to sell.

The following table presents quantitative and qualitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis as of December 31, 2013 and 2012:

	Estimated fair value	*Valuation techniques*	*Unobservable inputs*
2013			
Impaired loans with specific valuation allowances	$ 3,797,867	Market approach	Appraised value of collateral less selling costs and discounted cash flow analysis
OREO	3,889,621	Market approach	Lower of appraised value or listing price less selling costs
2012			
Impaired loans with specific valuation allowances	4,329,201	Market approach	Appraised value of collateral less selling costs and discounted cash flow analysis
OREO	2,489,757	Market approach	Lower of appraised value or listing price less selling costs

The Company did not change the methodology used to determine fair value for any financial instruments during the years ended December 31, 2013 and 2012. In addition, the Company did not have any transfers among Level 1, Level 2, or Level 3 during these periods.

The following disclosures are made in accordance with GAAP, which requires the disclosure of fair value information about financial instruments where it is practicable to estimate that value.

In cases where quoted market values are not available, the Company primarily uses present value techniques to estimate the fair values of its financial instruments. Valuation methods require considerable judgment, and the resulting estimates of fair value can be significantly affected by the assumptions made and methods used. Accordingly, the estimates provided herein do not necessarily indicate amounts which could be realized in a current market exchange.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

14. Fair Value (Continued)

In addition, as the Company normally intends to hold the majority of its financial instruments until maturity, it does not expect to realize many of the estimated amounts disclosed. The disclosures also do not include estimated fair value amounts for items which are not defined as financial instruments but which may have significant value. These include such off-balance sheet items as core deposit intangibles. The Company does not believe that it would be practicable to estimate a representational fair value for these types of items as of December 31, 2013 and 2012.

Because GAAP excludes certain financial and all nonfinancial instruments from its disclosure requirements, any aggregation of the fair value amounts presented would not represent the underlying value of the Company.

The Company used the following methods and assumptions to estimate the fair value of its financial instruments:

Cash and cash equivalents: The carrying amount approximates the estimated fair value of these instruments.

Interest-bearing time deposits: The carrying amount approximates the estimated fair value of these instruments.

Investment securities available-for-sale: The market value of investment securities has been estimated using quoted unadjusted prices in active markets for identical securities, by reference to prices for similar securities, or through model-based techniques.

FHLB stock: The carrying amount approximates the estimated fair value.

Loans, net: The estimated fair value of loans is calculated by discounting the contractual cash flows of the loans using December 31, 2013 and 2012 origination rates. The resulting amounts are adjusted to estimate the effect of changes in the credit quality of borrowers since the loans were originated.

Mortgage loans held for sale: The carrying amount approximates the estimated fair value of these instruments.

BOLI: The carrying amount approximates the estimated fair value of these instruments.

Deposits: The estimated fair value of demand deposits, consisting of checking, NOW and money market, and savings accounts, is represented by the amounts payable on demand. At the reporting date, the estimated fair value of time deposits is calculated by discounting the scheduled cash flows using the December 31, 2013 and 2012 rates offered on those instruments.

Junior subordinated debentures: The carrying amount of the junior subordinated debentures approximates fair value, as the interest rate is adjusted on a quarterly basis.

Loan commitments and standby letters of credit: The majority of the Bank's commitments to extend credit have variable interest rates and "escape" clauses if the customer's credit quality deteriorates. Therefore, the fair values of these items are not significant and are not included in the following tables.

The estimated fair values of the Company's significant on-balance sheet financial instruments as of December 31, 2013 were as follows:

			Fair value measurements using		
	Carrying amount	***Estimated fair value***	***Level 1***	***Level 2***	***Level 3***
Financial assets:					
Cash and cash equivalents	$ 59,864,247	$ 59,864,247	$ 59,864,247	$ –	$ –
Interest bearing time deposits	16,132,000	16,132,000	16,132,000	–	–
Investment securities available-for-sale	13,364,548	13,364,548	–	13,364,548	–
FHLB stock	620,000	620,000	620,000	–	–
Loans, net (including mortgage loans held for sale)	237,105,700	235,779,000	–	–	235,779,000
BOLI	6,843,852	6,843,852	6,843,852	–	–
Financial liabilities:					
Deposits	302,639,211	302,692,000	275,180,000	–	27,512,000
Junior subordinated debentures	8,248,000	8,248,000	8,248,000	–	–

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

14. Fair Value (Continued)

The estimated fair values of the Company's significant on-balance sheet financial instruments as of December 31, 2012 were as follows:

			Fair value measurements using		
	Carrying amount	***Estimated fair value***	***Level 1***	***Level 2***	***Level 3***
Financial assets:					
Cash and cash equivalents	$ 43,531,184	$ 43,531,184	$ 43,531,184	$ –	$ –
Interest bearing time deposits	13,130,000	13,130,000	13,130,000	–	–
Investment securities available-for-sale	17,717,310	17,717,310	–	17,717,310	–
FHLB stock	643,200	643,200	643,200	–	–
Loans, net (including mortgage loans held for sale)	220,714,742	222,196,000	–	–	222,196,000
BOLI	6,620,860	6,620,860	6,620,860	–	–
Financial liabilities:					
Deposits	271,901,974	272,116,000	240,219,000	–	31,897,000
Junior subordinated debentures	8,248,000	8,248,000	8,248,000	–	–

15. Regulatory Matters

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

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

As of December 31, 2013, the most recent notification from the FDIC categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized," the Bank must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since the notifications from the regulators that Management believes would change the Company's or the Bank's regulatory capital categorization.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

15. Regulatory Matters (Continued)

The Company's actual and required capital amounts and ratios as of December 31, 2013 and 2012 are presented in the following table (dollars in thousands):

	Actual		*Regulatory minimum to be "adequately capitalized"*		*Regulatory minimum to be "well capitalized" under prompt corrective action provisions*	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
2013						
Tier 1 capital (to average assets)	$ 44,902	12.5%	$ 14,376	4.0%	N/A	N/A
Tier 1 capital (to risk-weighted assets)	44,902	16.9	10,642	4.0	N/A	N/A
Total capital (to risk-weighted assets)	48,239	18.2	21,283	8.0	N/A	N/A
2012						
Tier 1 capital (to average assets)	42,759	13.0	13,155	4.0	N/A	N/A
Tier 1 capital (to risk-weighted assets)	42,759	16.9	10,116	4.0	N/A	N/A
Total capital (to risk-weighted assets)	45,535	18.0	20,232	8.0	N/A	N/A

The Bank's actual and required capital amounts and ratios as of December 31, 2013 and 2012 are presented in the following table (dollars in thousands):

	Actual		*Regulatory minimum to be "adequately capitalized"*		*Regulatory minimum to be "well capitalized" under prompt corrective action provisions*	
	Amount	*Ratio*	*Amount*	*Ratio*	*Amount*	*Ratio*
2013						
Tier 1 capital (to average assets)	$ 44,987	12.5%	$ 14,366	4.0%	$ 17,957	5.0%
Tier 1 capital (to risk-weighted assets)	44,987	16.9	10,642	4.0	15,962	6.0
Total capital (to risk-weighted assets)	48,324	18.2	21,283	8.0	26,604	10.0
2012						
Tier 1 capital (to average assets)	42,584	13.0	13,140	4.0	16,425	5.0
Tier 1 capital (to risk-weighted assets)	42,584	16.8	10,116	4.0	15,174	6.0
Total capital (to risk-weighted assets)	45,360	17.9	20,232	8.0	25,290	10.0