
2014

A N N U A L R E P O R T

THE SOUTHERN BANC COMPANY, INC.



THE SOUTHERN BANC COMPANY, INC.

P.O. BOX 1130, GADSDEN, ALABAMA 35902
(256) 543-3860

Dear Fellow Shareholders,

Once again it is my privilege to present the results of The Southern Banc Company Inc.'s most recent fiscal year. In 2014, we fell short of our overall loan growth goals, as well as our goals in accounts receivable factoring. The recent expansion of our leasing business is encouraging, however, we expect new challenges and higher personnel costs as we grow this line of business. While we were able to maintain credit quality and experienced some lease and loan growth, we are finding that the yield compression continues, even in higher risk areas of leasing and accounts receivable factoring. The specialty lending areas will continue to experience the same compression that conventional lending has seen until our economy expands at a normal rate. We anticipate that yields in these areas should then widen, giving an ample supplement to our traditional asset yields.

Our net income loss in 2014 is disappointing and we anticipate a return to profitability in 2015. Growth in the three areas of traditional banking, leasing and accounts receivable factoring should come from increased sales and marketing activity, with an emphasis on adding the best people and putting them in positions to succeed.

Community banking has a future, but it will look different from the past. For a window into how different, ask someone under 40 about how they do their banking, or if they know a banker. The answers, while not surprising to most, present a challenge to all banks as to how we create value for retail deposit customers and commercial clients alike. Rate cannot be the answer, lest we are only a commodity. We believe decisions and investments made now will provide us with long term sustainability and a unique and valuable company.

I appreciate your confidence in our company and look forward to discussing our results in twelve months. If we can be of service to you in any way, feel free to contact me directly. Our best advocates are our customers.

Sincerely,

Gates Little
President

THE SOUTHERN BANC COMPANY, INC.

The Southern Banc Company, Inc. (the “Company”) was incorporated at the direction of management of The Southern Bank Company (“Bank”), formerly First Federal Savings and Loan Association of Gadsden, Alabama (the “Original Bank”), for the purpose of serving as the holding company of the Bank upon the acquisition of all of the capital stock issued by the Original Bank in its conversion from mutual to stock form in 1995. At June 30, 2014, the Company had total consolidated assets of approximately \$94.3 million, deposits of \$72.1 million and stockholders’ equity of \$14.7 million, or 15.6% of total consolidated assets.

The Original Bank was organized in 1936 as a federal savings association, at which time it also became a member of the Federal Home Loan Bank (“FHLB”) System and obtained federal deposit insurance. On July 1, 2008, the Company announced that the Original Bank had converted its charter from a federal savings association to an Alabama state-chartered commercial bank. As a state-chartered bank, the Bank is regulated by the State of Alabama Banking Department (the “Banking Department”) and the Federal Deposit Insurance Corporation (“FDIC”). As a bank holding company, the Company is regulated by the Board of Governors of the Federal Reserve System (the “Federal Reserve”). In 1999, the Bank adopted its current corporate title.

The Bank currently operates through four full service banking offices located in Gadsden, Albertville, Guntersville and Centre, Alabama, and one commercial finance office located in Birmingham, Alabama. The Bank’s business strategy has been to operate as a profitable and independent community-oriented financial institution dedicated to providing quality customer service. Generally, the Bank has sought to implement this strategy by using retail deposits as its sources of funds and maintaining most of its assets in loans secured by owner-occupied one-to-four-family residential real estate properties located in the Bank’s market area, consumer loans, commercial loans and leases, mortgage-backed securities issued by Federal Home Loan Mortgage Corporation (“Freddie Mac”), the Government National Mortgage Association (“GNMA”) and Federal National Mortgage Association (“Fannie Mae”), U.S. government and agency securities, interest-earning deposits, and cash and equivalents.

The Bank’s business strategy incorporates the following key elements: (1) remaining a community-oriented financial institution while maintaining a strong core customer base by providing quality service and offering customers the access to senior management and services that a community-based institution can offer; (2) attracting a retail deposit base from the communities served by the Bank’s four banking offices; (3) maintaining asset quality by emphasizing investment in local residential mortgage loans, commercial loans, consumer loans, mortgage-backed securities and other securities issued or guaranteed by the U.S. government or agencies thereof; and (4) maintaining liquidity and capital substantially in excess of regulatory requirements.

The lending activities and other investments of the Bank must comply with various regulatory requirements, and the Banking Department and FDIC periodically examine the Bank for compliance with various regulatory requirements. The Bank must file reports with the regulators describing its activities and financial condition. The Company and the Bank are also subject to certain reserve and capital requirements promulgated by the Federal Reserve.

MARKET FOR COMMON STOCK AND RELATED STOCKHOLDER MATTERS

At June 30, 2014, there were 806,086 shares of the Common Stock outstanding and approximately 168 stockholders of record. This total does not reflect the number of persons or entities who hold Common Stock in nominee or “street name” through various brokerage firms.

The Company’s common stock trades in the over-the-counter market on the OTC Bulletin Board® (OTCBB) under the symbol “SRNN.”

The payment of dividends on the Common Stock is subject to determination and declaration by the Board of Directors of the Company. In addition, from time to time, the Board of Directors may pay special cash dividends in addition to, or in lieu of, regular cash dividends. The payment of future dividends will be subject to the requirements of applicable law and the determination by the Board of Directors of the Company that the net income, capital and financial condition of the Company and the Bank, industry trends and general economic conditions, justify the payment of dividends. There are no regulatory requirements that currently would restrict dividend payments. The Company’s principal source of funds for dividend payments is dividends from the Bank. See Note 12 of Notes to Consolidated Financial Statements.

On April 21, 2009, the Company announced that to preserve capital it would suspend the payment of future dividends. The determination was made in the best judgment of the Board of Directors and management in light of current economic conditions which have not substantially improved since that date.

The following table sets forth information as to high and low sales prices of the Company’s Common Stock for the calendar quarters indicated. The high and low sales prices of the Company’s common stock shown below are based on information posted on the OTC Bulletin Board by broker-dealers. These prices may include dealer mark-up, mark-down and/or commission and may not necessarily represent actual transactions.

| | <u>Price Per Share</u> | |
|--------------------|------------------------|------------|
| | <u>High</u> | <u>Low</u> |
| Fiscal 2013 | | |
| First Quarter | \$5.50 | \$4.55 |
| Second Quarter | \$6.00 | \$5.10 |
| Third Quarter | \$6.75 | \$6.00 |
| Fourth Quarter | \$10.20 | \$6.70 |
| Fiscal 2014 | | |
| First Quarter | \$10.20 | \$9.49 |
| Second Quarter | \$10.40 | \$9.00 |
| Third Quarter | \$10.40 | \$9.00 |
| Fourth Quarter | \$10.00 | \$8.75 |

SELECTED CONSOLIDATED FINANCIAL AND OTHER DATA

| | Year Ended June 30, | | | | |
|--|---------------------------------------|------------------|----------------|------------------|----------------|
| | <u>2014</u> | <u>2013</u> | <u>2012</u> | <u>2011</u> | <u>2010</u> |
| | (In thousands, except per share data) | | | | |
| INCOME STATEMENT DATA | | | | | |
| Interest income | \$ 3,334 | \$ 3,230 | \$ 3,296 | \$ 3,408 | \$ 3,984 |
| Interest expense | <u>752</u> | <u>930</u> | <u>981</u> | <u>1,103</u> | <u>1,608</u> |
| Net interest income | 2,582 | 2,300 | 2,315 | 2,305 | 2,376 |
| Provision for loan and lease losses | <u>---</u> | <u>101</u> | <u>13</u> | <u>---</u> | <u>48</u> |
| Net interest income after provision for loan and lease losses | 2,582 | 2,199 | 2,302 | 2,305 | 2,328 |
| Non-interest income | 306 | 303 | 399 | 291 | 250 |
| Non-interest expense | <u>3,329</u> | <u>3,020</u> | <u>2,880</u> | <u>2,737</u> | <u>2,478</u> |
| Income (loss) before provision for income taxes | (441) | (518) | (179) | (141) | 100 |
| Provision (benefit) for income taxes | <u>(176)</u> | <u>(216)</u> | <u>(183)</u> | <u>(49)</u> | <u>32</u> |
| Net income (loss) | <u>\$ (265)</u> | <u>\$ (302)</u> | <u>\$ 4</u> | <u>\$ (92)</u> | <u>\$ 68</u> |
| Earnings (loss) per share | | | | | |
| Basic | <u>\$ (0.34)</u> | <u>\$ (0.39)</u> | <u>\$ 0.01</u> | <u>\$ (0.12)</u> | <u>\$ 0.09</u> |
| Diluted | <u>\$ (0.34)</u> | <u>\$ (0.39)</u> | <u>\$ 0.01</u> | <u>\$ (0.12)</u> | <u>\$ 0.09</u> |

| | As of June 30, | | | | |
|--|----------------|-------------|-------------|-------------|-------------|
| | <u>2014</u> | <u>2013</u> | <u>2012</u> | <u>2011</u> | <u>2010</u> |
| | (In thousands) | | | | |
| BALANCE SHEET DATA | | | | | |
| Total assets | \$ 94,337 | \$ 95,972 | \$ 111,344 | \$ 95,437 | \$ 87,470 |
| Loans and leases receivable, net | 34,904 | 27,452 | 27,243 | 27,982 | 32,563 |
| Securities: | | | | | |
| Available for sale | 53,525 | 62,435 | 77,470 | 60,567 | 46,869 |
| Held to maturity | 5 | 13 | 28 | 37 | 60 |
| Federal Home Loan Bank stock | 407 | 454 | 985 | 665 | 338 |
| Deposits | 72,064 | 73,158 | 76,769 | 70,313 | 69,408 |
| Federal Home Loan Bank advances | 7,156 | 7,313 | 17,626 | 8,626 | 1,075 |
| Stockholders' equity | 14,704 | 14,922 | 16,257 | 15,863 | 16,165 |

| | Year Ended June 30, | | | | |
|--|---------------------|-------------|-------------|-------------|-------------|
| | <u>2014</u> | <u>2013</u> | <u>2012</u> | <u>2011</u> | <u>2010</u> |
| KEY OPERATING DATA | | | | | |
| Return on average assets | (0.28%) | (0.29%) | 0.00% | (0.10%) | 0.07% |
| Return on average equity | (1.81%) | (1.88%) | 0.02% | (0.58%) | 0.44% |
| Average equity to average assets | 15.30% | 15.36% | 15.56% | 17.13% | 6.46% |
| Dividend payout ratio | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% |
| Number of full service offices | 4 | 4 | 4 | 4 | 4 |

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

The following discussion and analysis is intended to assist you in understanding the consolidated financial condition and results of operations of The Southern Banc Company, Inc. and The Southern Bank Company (collectively, the "Company"), as of June 30, 2014 and June 30, 2013 and for the fiscal years ended June 30, 2014 and 2013. This discussion should be read in conjunction with the audited consolidated financial statements, accompanying footnotes and supplemental financial data included herein.

General

The principal business of the Bank consists of accepting deposits from the general public through the Bank's main and branch offices and investing those funds in loans secured by one-to-four family residential properties, commercial and consumer loans located in the Bank's primary market area. Due to the competition for loans in the Bank's market area, the Bank maintains a substantial portfolio of investment and mortgage-backed securities. Substantially all of the Bank's mortgage-backed securities are guaranteed as to principal and interest by GNMA, Freddie Mac or Fannie Mae. The Bank's securities portfolio consists primarily of mortgage backed securities, government agency securities, including agency notes. See Note 2 of Notes to Consolidated Financial Statements. The Bank maintains a substantial amount in interest-bearing deposits in other banks, primarily interest-bearing accounts with the FHLB of Atlanta and BBVA Compass Bank, the Bank's correspondents.

The Company's earnings is dependent primarily on the Bank's net interest income, which is the difference between interest income earned on its loans, income from factoring activities, mortgage-backed securities and securities portfolio and interest paid on customers' deposits and any other borrowings. The Company's earnings is also affected by the Bank's level of non-interest income, such as service charges on customers' deposit accounts, net gains or losses on the sale of securities, and other fees. In addition, earnings is affected by the level of non-interest expense, primarily consisting of compensation and employee benefit expense, data processing expense, professional service expense, office building and equipment expense, and other expenses.

The operations of the Company and the financial institution industry as a whole are significantly affected by prevailing economic conditions, competition and the monetary and fiscal policies of governmental agencies. Lending activities are influenced by the economy, the supply of housing, competition among lenders and the level of interest rates in the Bank's market area. The Bank's deposit flows and costs of funds are influenced by prevailing market rates of interest, primarily on competing investments, account maturities, and the levels of personal income and savings in the Bank's market area.

Comparison of Financial Condition at June 30, 2014 and June 30, 2013

Total consolidated assets decreased approximately \$1.6 million, or 1.70%, from \$95.9 million at June 30, 2013 to \$94.3 million at June 30, 2014. During the year ended June 30, 2014, net loans increased approximately \$7.5 million, or 27.14%, from \$27.5 million at June 30, 2013 to \$34.9 million at June 30, 2014. The increase in net loans was primarily attributable to an increase in the originations of new loans and lease receivables. For the fiscal year ended June 30, 2014, securities available for sale decreased approximately \$8.9 million, or 14.27%, from \$62.4 million at June 30, 2013 to \$53.5 million at June 30, 2014. During the fiscal year ended June 30, 2014, securities held to maturity decreased approximately \$8,000, or 60.71%, from approximately \$13,000 at June 30, 2013 to \$5,000 at June 30, 2014.

Cash and cash equivalents decreased approximately \$266,000 or 6.57%, from \$4.1 million at June 30, 2013 to \$3.8 million at June 30, 2014. This decrease in cash flow was primarily attributable to a decrease in securities available for sale of approximately \$8.9 million, a decrease in total deposits of approximately \$1.1 million, offset in part by an increase in loans and leases receivable of approximately \$7.5 million.

Accrued interest and dividends receivable decreased approximately \$44,000 or 13.24%, from approximately \$335,000 at June 30, 2013 to \$291,000 at June 30, 2014. This decrease was primarily attributable to a decrease in interest receivable on securities available for sale. Other assets increased approximately \$172,000, or 40.68%, from approximately \$422,000 at June 30, 2013 to \$594,000 at June 30, 2014. The increase in other assets was primarily attributable to an increase in deferred federal income taxes.

Total deposits decreased approximately \$1.1 million, or 1.49%, from approximately \$73.2 million at June 30, 2013 to \$72.1 million at June 30, 2014. During the fiscal year ended June 30, 2014 FHLB advances

decreased approximately \$156,000, or 2.14%, from approximately \$7.3 million at June 30, 2013 to \$7.2 million at June 30, 2014. Other liabilities decreased during the fiscal year ended June 30, 2013 by approximately \$167,000, or 28.78%, from approximately \$579,000 at June 30, 2013 to \$412,000 at June 30, 2014. The decrease in other liabilities was primarily attributable to a decrease in the factors client reserve.

Total consolidated equity decreased approximately \$218,000, or 1.46%, from approximately \$14.9 million at June 30, 2013 to \$14.7 million at June 30, 2014. This decrease was primarily attributable to a decrease in retained earnings of approximately \$265,000 and shares held in trust (shares at cost) of approximately \$70,000 offset in part by an increase in accumulated other comprehensive income of approximately \$117,000. The decrease in retained earnings was attributable to the net loss recorded for fiscal year 2014. No dividends were paid during the fiscal year ended June 30, 2014.

Comparison of Results of Operations for the Fiscal Years Ended June 30, 2014 and 2013

The Company reported net loss for the fiscal year ended June 30, 2014 of approximately \$265,000 as compared to a net loss of approximately \$302,000 for the fiscal year ended June 30, 2013. During the fiscal year ended June 30, 2014 net interest income after provision for loan and lease losses increased approximately \$383,000 or 17.42%. The increase in net interest income after provision for loan and lease losses was offset in part by an increase in total non-interest expenses of approximately \$308,000 or 10.19% from \$3.0 million at June 30, 2013 to approximately \$3.3 million at June 30, 2014.

Net Interest Income. For the year ended June 30, 2014 the net interest income before provision for loan and lease losses increased approximately \$283,000 or 12.29% when compared to fiscal year ended 2013. This increase was primarily attributable to an increase in the bank's net interest margin resulting from the current interest rate environment. Total interest income decreased approximately \$104,000 or 3.21% while total interest expense decreased approximately \$179,000, or 19.22% during the fiscal year ended June 30, 2014. For the fiscal year ended June 30, 2014, interest income on securities available for sale decreased approximately \$50,000, or 3.41%, interest and fees on loans increased approximately \$153,000, or 8.81%.

Provision for Loan and Lease Losses. During the fiscal year ended June 30, 2014 the Company recorded no provision for loan and lease losses as compared to \$101,000 for the fiscal year ended June 30, 2013. The allowance for loan and lease losses is based on management's evaluation of possible loan and lease losses inherent in the Bank's loan portfolio. Management considers, among other factors, past loss experience, current economic conditions, volume, growth and composition of the loan portfolio, and other relevant factors.

Non-Interest Income. Non-interest income increased approximately \$2,000 or 0.79%, for the fiscal year ended June 30, 2014 when compared to fiscal year ended 2013. The increase in non-interest income was primarily attributable to an increase in the gain on sale of securities available for sale of approximately \$67,000, or 71.19% offset in part by a decrease in service charges and fees of approximately \$31,000 or 18.61% and a decrease in other income of approximately \$34,000 or 77.71%.

Non-Interest Expense. Non-interest expense increased approximately \$308,000 or 10.19%, for the fiscal year ended June 30, 2014 when compared to fiscal year ended 2013. This increase was primarily attributable to increases in data processing expenses of approximately \$38,000 or 11.46%, in professional service expenses of approximately \$54,000 or 16.75% and an increase in salaries and benefits of approximately \$239,000, or 13.65%. For the year ended June 30, 2014 other operating expenses decreased approximately \$36,000, or 8.99%.

Provision (Benefit) for Income Taxes. During the fiscal year ended June 30, 2014, the income tax benefit increased approximately \$41,000 or 18.86%. This increase was primarily attributable to the increase in non-interest expenses of approximately \$308,000 or 10.19% and a decrease in net interest income after provision for loan and lease losses of approximately \$101,000. For the year ended June 30, 2014, the loss before income taxes was approximately \$441,000, as compared to a loss before income taxes of approximately \$519,000 for the year ended June 30, 2013. The income tax benefit was approximately \$176,000 for the year ended June 30, 2014, compared to a tax benefit of approximately \$216,000 for the year ended June 30, 2013, resulting in an effective tax rate benefit of approximately 39.83% for fiscal 2014 and 41.73% for fiscal 2013. The statutory federal tax rate in both years was 34%. See Note 7 of Notes to Consolidated Financial Statements for reconciliation between the statutory tax rate and the effective tax rate.

Asset/Liability Management

Net interest income, the primary component of the Company's net income, is determined by the difference or "spread" between the yields earned on the Bank's interest-earning assets and the rates paid on its interest-bearing liabilities and the relative amounts of such assets and liabilities. Key components of a successful asset/liability

strategy are the monitoring and managing of interest rate sensitivity on both the interest-earning assets and interest-bearing liabilities. The matching of the Bank's assets and liabilities may be analyzed by examining the extent to which its assets and liabilities are interest rate sensitive and by monitoring the expected effects of interest rate changes on an institution's net portfolio value.

An asset or liability is interest rate sensitive within a specific time period if it will mature or reprice within that time period. If the Bank's assets mature or reprice more quickly or to a greater extent than its liabilities, the Bank's net portfolio value and net interest income would tend to increase during periods of rising interest rates but decrease during periods of falling interest rates. If the Bank's assets mature or reprice more slowly or to a lesser extent than its liabilities, the Bank's net portfolio value and net interest income would tend to decrease during periods of rising interest rates but increase during periods of falling interest rates. The Bank's policy has been to seek to mitigate the interest rate risk inherent in the historical savings institution business of originating long term loans funded by short term deposits by pursuing the following strategies: (i) the Bank has historically maintained substantial liquidity and capital levels to sustain unfavorable movements in market interest rates; and (ii) in order to minimize the adverse effect of interest rate risk on future operations, the Bank purchases adjustable- and fixed-rate securities with maturities of primarily 5 to 15 years and originates limited amounts of shorter term consumer loans.

The Bank measures its interest rate risk by computing estimated changes in the net interest income ("NII") of its cash flows from assets, liabilities and off-balance sheet items in the event of a range of assumed changes in market interest rates. These computations estimate the effect on the Bank's NII of sudden and sustained 100 basis point to 400 basis point increases and 100 basis point to 200 basis point decreases in market interest rates. The Bank's Board of Directors has adopted an interest rate risk policy which establishes maximum decreases in the Bank's estimated NII of 20%, 30%, 35% and 40% and maximum decreases of 20% and 30% in the event of 100, 200, 300 and 400 basis point increases and 100 and 200 decreases in market interest rates, respectively. At June 30, 2014, based on the most recent available information, management estimated that the Bank's NII would decrease approximately -2.25%, -2.21%, -2.09%, and -1.88% in the event of an instantaneous and sustained 100, 200, 300 and 400 point increase and would increase approximately 3.03% and 0.04% in the event of an instantaneous and sustained 100 and 200 point decrease.

These calculations indicate that the Bank's net interest income would increase in the event of an instantaneous and sustained rate increase whereas the economic value (long term sensitivity) of the Bank's equity would decrease in the event of instantaneous and sustained rate increases. These calculations indicate that the Bank's interest-earning assets would be expected to reprice more quickly than the Bank's interest-bearing liabilities.

Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions, including relative levels of market interest rates, prepayments and deposit run-offs and should not be relied upon as indicative of actual results. Certain shortcomings are inherent in such computations. Although certain assets and liabilities may have similar maturity or periods of repricing, they may react at different times and in different degrees to changes in the market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while rates on other types of assets and liabilities may lag behind changes in market interest rates. Certain assets, such as adjustable rate mortgages, generally have features which restrict changes in interest rates on a short term basis and over the life of the asset. In the event of a change in interest rates, prepayments and early withdrawal levels could deviate significantly from those assumed in making calculations set forth above. Additionally, an increased credit risk may result, as the ability of many borrowers to service their debt may decrease in the event of an interest rate increase. Finally, virtually all of the adjustable rate loans in the Bank's portfolio contain conditions which restrict periodic changes in interest rates.

The Bank's Board of Directors is responsible for reviewing the Bank's asset and liability policies. On at least a quarterly basis, the Board reviews interest rate risk and trends, as well as liquidity and capital ratios and requirements. The Bank's management is responsible for administering the policies and determinations of the Board of Directors with respect to the Bank's asset and liability goals and strategies. Management expects that the Bank's asset and liability policies and strategies will continue as described above so long as competitive and regulatory conditions in the financial institution industry continue as they have in recent years.

Average Balance, Interest and Average Yields and Rates

The following table sets forth certain information relating to the Company's average interest-earning assets and interest-bearing liabilities, and reflects the average yield on assets and the average cost of liabilities for the periods and at the dates indicated. Such yields and costs are derived by dividing income or expense by the average monthly balance of assets or liabilities, respectively, for the periods indicated.

The table also presents information for the periods indicated with respect to the difference between the weighted average yield earned on interest-earning assets and the weighted average rate paid on interest-bearing liabilities, or “interest rate spread”, which banks have traditionally used as an indicator of profitability. Another indicator of an institution’s net interest income is its “net yield on interest-earning assets,” which is its net interest income divided by the average balance of interest-earning assets. Net interest income is affected by the interest rate spread and by the relative amounts of interest-earning assets and interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, any positive interest rate spread will generate net interest income.

| | Years Ended June 30, | | | | | |
|--|----------------------|-----------------|---|--------------------|-----------------|---------------------------|
| | 2014 | | | 2013 | | |
| | Average Balance | Interest | Average Yield/ Cost (Dollars in thousands) | Average Balance | Interest | Average Yield/ Cost |
| Interest-earning assets: | | | | | | |
| Loans receivable | \$ 28,927 | \$ 1,895 | 6.61% | \$ 26,982 | \$ 1,477 | 5.47% |
| Securities | 58,674 | 1,419 | 2.42 | 67,638 | 1,487 | 2.20 |
| Other interest-earning assets..... | <u>1,966</u> | <u>20</u> | <u>0.10</u> | <u>3,333</u> | <u>2</u> | <u>0.06</u> |
| Total interest-earning assets | 89,567 | <u>3,334</u> | 3.72 | 97,953 | <u>2,966</u> | 3.03 |
| Non-interest-earning assets..... | <u>6,199</u> | | | <u>6,912</u> | | |
| Total assets | <u>\$ 95,766</u> | | | <u>\$104,865</u> | | |
| Interest-bearing liabilities: | | | | | | |
| Deposits | \$ 72,702 | 677 | 0.93 | \$ 76,095 | 842 | 1.11 |
| FHLB advances | <u>8,419</u> | <u>74</u> | <u>0.88</u> | <u>11,466</u> | <u>89</u> | <u>0.78</u> |
| Total interest-bearing liabilities .. | 81,122 | <u>751</u> | 0.93 | 87,561 | <u>931</u> | 1.06 |
| Non-interest-bearing liabilities | <u>391</u> | | | <u>1,200</u> | | |
| Total liabilities | 81,115 | | | 88,761 | | |
| Stockholders’ equity | <u>14,651</u> | | | <u>16,104</u> | | |
| Total liabilities and equity | <u>\$ 95,766</u> | | | <u>\$104,865</u> | | |
| Net interest income | | <u>\$ 2,583</u> | | | <u>\$ 2,035</u> | |
| Interest rate spread..... | | | <u>2.79%</u> | | | <u>1.96%</u> |
| Net interest margin | | | <u>2.88%</u> | | | <u>2.08%</u> |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | | <u>110.41%</u> | | | <u>111.87%</u> |

Rate/Volume Analysis

The table below sets forth certain information regarding changes in interest income and interest expense of the Company for the periods indicated. For each category of interest-earning asset and interest-bearing liability, information is provided on changes attributable to: (i) changes in volume (changes in volume multiplied by old rate) and (ii) changes in rates (changes in rate multiplied by old volume).

| | Year Ended June 30, | | |
|---|---------------------|-----------------|---------------|
| | 2014 vs. 2013 | | |
| | Increase (Decrease) | | |
| | Due to | | |
| | <u>Rate</u> | <u>Volume</u> | <u>Total</u> |
| | (In thousands) | | |
| Interest income | | | |
| Loans | \$ 27 | \$ 127 | \$ 154 |
| Securities | 145 | (195) | (50) |
| Other interest-earning assets..... | <u>209</u> | <u>(209)</u> | <u>---</u> |
| Total interest-earning assets | <u>381</u> | <u>(277)</u> | <u>104</u> |
| Interest expense | | | |
| Deposits..... | (127) | (38) | (165) |
| Interest on FHLB advances | <u>9</u> | <u>(24)</u> | <u>(15)</u> |
| Total interest-bearing liabilities..... | <u>(118)</u> | <u>(62)</u> | <u>(180)</u> |
| Change in net interest income | <u>\$ 499</u> | <u>\$ (215)</u> | <u>\$ 284</u> |

Liquidity and Capital Resources

The Company conducts its business through its subsidiary, the Bank, which is required to maintain minimum levels of liquidity. The requirement, which varies from time to time depending upon economic conditions and deposit flows, is based upon a percentage of deposits and short-term borrowings. The Bank adjusts its liquidity levels in order to meet funding needs of deposit outflows, repayments of borrowings, and loan commitments. The Bank also adjusts liquidity as appropriate to meet its asset and liability management objectives.

The Bank's primary sources of funds are deposits, repayments of loans and mortgage-backed securities, maturities of investment securities and other investments. While scheduled principal repayments on loans and mortgage-backed securities are a relatively predictable source of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. The Bank invests, with the FHLB of Atlanta and other correspondent banks, in short-term interest-earning assets (e.g., Overnight Investments and Federal Funds Sold) that provide liquidity to meet lending requirements.

The Bank continues to maintain a high level of liquid assets in order to meet its funding requirements and compensating balance requirements of correspondent banks. At June 30, 2014, the Bank had approximately \$3.8 million in cash on hand and interest-bearing deposits in other banks, which represented 4.01% of total assets. The Bank's average liquidity ratio well exceeded the required minimum at and during the fiscal year ended June 30, 2014. At June 30, 2014, the Bank's level of liquid assets, as measured for regulatory compliance purposes, was approximately \$24.1 million, or 25.52% of total assets of the Bank.

At June 30, 2014, the Bank had approximately \$14.2 million of total equity, or 15.02% of total assets. The Bank continued to exceed its regulatory capital requirement ratios at June 30, 2014. Tangible capital and core capital was each approximately \$13.8 million, which represented 14.71% of adjusted total Bank average assets and 32.96% of total risk weighted assets (tier 1 capital) as of June 30, 2014, respectively. Risk-based capital was \$14.2 million, which represented 33.82% of total Bank risk-weighted assets at June 30, 2014. At that date, such amounts exceeded the respective minimum required ratios of 4.0%, 4.0% and 8.0% by 10.71%, 28.96% and 25.82%, respectively. At June 30, 2014, the Bank continued to meet the definition of a "well-capitalized" institution, the highest of the five categories under the prompt corrective action standards. See Note 12 of Notes to Consolidated Financial Statements.

Contractual Obligations

The following table sets forth the contractual obligations of the Bank as of June 30, 2014.

| | Less than One Year | One Year through Two Years | Two through Three Years | Over Three Years | Total |
|--|-----------------------|----------------------------------|----------------------------|---------------------|------------------|
| | | | (In thousands) | | |
| FHLB advances ⁽¹⁾ | \$ 2,000 | \$ 4,156 | \$ 1,000 | \$ 0 | \$ 7,156 |
| Certificates of deposit ⁽²⁾ | 25,931 | 10,606 | 5,071 | 5,718 | 47,326 |
| Total | <u>\$ 27,931</u> | <u>\$ 14,762</u> | <u>\$ 6,071</u> | <u>\$ 5,718</u> | <u>\$ 54,482</u> |

(1) See Note 6 of Notes to Consolidated Financial Statements.

(2) See Note 5 of Notes to Consolidated Financial Statements.

Commitments and Contingencies

In the normal course of business, the Bank is a party to activities that contain credit, market and operational risks that are not reflected in the Company's Consolidated Financial Statements. The Bank provides customers with off-balance sheet credit support through loan commitments and lines of credit. Many of the commitments expire unused or are only partially used. Therefore, the total amount of commitments does not necessarily represent future cash demand requirements. The Company anticipates that the Bank will continue to have sufficient funds together with available borrowings to satisfy its commitments. As of June 30, 2014 the Bank had approximately \$4.4 million of commitments to extend credit. See Note 10 of Notes to Consolidated Financial Statements.

Critical Accounting Policy

The accounting principles followed by the Company and the methods of applying principles conform with accounting principles generally accepted in the United States and with general practices followed by the banking industry. The most critical accounting policy relates to the allowance for loan and lease losses.

The allowance for loan and lease losses is maintained at a level which management considers to be adequate to absorb losses inherent in the loan portfolio. Management's estimation of the amount of the allowance is based on a continuing evaluation of the loan portfolio and includes such factors as economic conditions, analysis of individual loans, overall portfolio characteristics, delinquencies and balance of any impaired loans (generally considered to be nonperforming loans, excluding residential mortgages and other homogeneous loans).

Management reviews the adequacy of the allowance for loan and lease losses on a continuous basis by assessing the quality of the loan portfolio and adjusting the allowance when appropriate. Management's evaluation of certain specifically identified loans includes a review of the financial condition and capacity of the borrower, the value of the collateral, current economic trends, historical losses, workout and collective arrangements, and possible concentrations of credit. The loan review process also includes a collective evaluation of credit quality within the mortgage and installment loan portfolios. In establishing the allowance, loss percentages are applied to groups of loans with similar risk characteristics. These loss percentages are determined by historical experience, portfolio mix, regulatory influence, and other economic factors. Each month this review is quantified in a report to management, which uses it to determine whether an appropriate allowance is being maintained. This report is then submitted to the Board of Directors monthly.

Changes in the allowance can result from changes in economic events or changes in the creditworthiness of borrowers. The effect of these changes is reflected when known. Though management believes the allowance for loan and lease losses to be adequate, ultimate losses may vary from estimations. Specific allowances for impaired loans are generally based on comparisons of the carrying values of the loans to the estimated fair value of the collateral.

Impaired loans (generally considered to be nonperforming loans, excluding residential mortgages and other homogeneous loans) are measured based on the present value of expected future cash flows discounted at each loan's original effective interest rate. As a practical expedient, impairment is measured based on the loan's

observable market price or the fair value of the collateral if the loan is collateral dependent. When the measure of the impaired loan is less than the recorded investment of the loan, the impairment is recorded through a valuation allowance.

The Company ceases accrual of interest on a loan when payment on the loan is in excess of 90 days past due. Income is subsequently recognized only to the extent that cash payments are received until, in management's judgment, the borrower's ability to make periodic interest and principal payments has been reestablished, in which case the loan is returned to accrual status.

Recent Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers* (Topic 606). These amendments affect any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (e.g. insurance contracts or lease contracts). This ASU will supersede the revenue recognition requirements in Topic 605, Revenue Recognition, and most industry-specific guidance, and creates a Topic 606, Revenue from Contracts with Customers. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This ASU also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. This ASU will be effective for annual reporting periods beginning after December 15, 2016. Early adoption is not permitted. The ASU allows for either full retrospective or modified retrospective adoption. The Company is assessing the effects of this ASU, which exclude financial instruments from its scope, but does not anticipate that it will have a material impact on its financial position or results of operations.

In June 2014, the FASB issued ASU No. 2014-12, *Compensation—Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved After the Requisite Service Period*. The amendments clarify the proper method of accounting for share-based payments when the terms of an award provide that a performance target could be achieved after the requisite service period. This ASU requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. The performance target should not be reflected in estimating the grant-date fair value of the award. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. The amendments in this ASU are effective for annual periods beginning after December 15, 2015. Earlier adoption is permitted. None of the Company's share-based payment awards have service components, so the Company does not believe this ASU will have an impact of its financial position or results of operations.

Forward-Looking Statements

Management's discussion and analysis includes certain forward-looking statements addressing, among other things, the Company's prospects for earnings, asset growth and net interest margin. Forward-looking statements are accompanied by, and identified with, such terms as "anticipates," "believes," "expects," "intends," and similar phrases. Management's expectations for the Company's future involve a number of assumptions and estimates. Factors that could cause actual results to differ from the expectations expressed herein include: substantial changes in interest rates, and changes in the general economy; and changes in the Bank's strategies for credit-risk management, interest-rate risk management and investment activities. Accordingly, any forward-looking statements included herein do not purport to be predictions of future events or circumstances and may not be realized.



INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
The Southern Banc Company, Inc.
Gadsden, Alabama

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of **The Southern Banc Company, Inc. and Subsidiaries**, which comprise the consolidated balance sheets as of June 30, 2014 and 2013, and the related consolidated statements of operations, comprehensive loss, stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The Southern Banc Company, Inc. and Subsidiaries as of June 30, 2014 and 2013, and the results of their operations and their cash flows for the years then ended, in accordance with accounting principles generally accepted in the United States of America.

A handwritten signature in cursive script that reads "Mauldin & Jenkins, LLC".

Birmingham, Alabama
October 15, 2014

**THE SOUTHERN BANC COMPANY, INC.
AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS
JUNE 30, 2014 AND 2013**

| <u>Assets</u> | <u>2014</u> | <u>2013</u> |
|---|----------------------|----------------------|
| Cash and due from banks | \$ 2,560,366 | \$ 2,744,553 |
| Interest-bearing deposits in banks | 1,223,150 | 410,011 |
| Federal funds sold | - | 895,000 |
| Total cash and cash equivalents | 3,783,516 | 4,049,564 |
| Securities available for sale, at fair value | 53,525,041 | 62,435,162 |
| Securities held to maturity (fair value of \$5,371 and \$13,712, respectively) | 5,136 | 13,073 |
| Federal Home Loan Bank stock | 407,100 | 453,600 |
| Loans and leases receivable, net of allowance for loan losses of \$360,670 and \$365,418, respectively | 34,903,766 | 27,452,335 |
| Accrued interest receivable | 290,967 | 335,376 |
| Property and equipment, net | 827,801 | 810,706 |
| Other assets | 593,944 | 422,201 |
| Total assets | \$ 94,337,271 | \$ 95,972,017 |
| <u>Liabilities and Stockholders' Equity</u> | | |
| Deposits | | |
| Noninterest-bearing | \$ 3,146,805 | \$ 3,478,879 |
| Interest-bearing | 68,917,611 | 69,679,246 |
| Total deposits | 72,064,416 | 73,158,125 |
| Other borrowings | 7,156,452 | 7,312,904 |
| Other liabilities | 412,446 | 579,137 |
| Total liabilities | 79,633,314 | 81,050,166 |
| Commitments and contingencies | | |
| Stockholders' equity | | |
| Preferred stock, par value \$.01 per share, 500,000 shares authorized, no shares issued or outstanding | - | - |
| Common stock, par value \$.01 per share, 3,500,000 shares authorized, 1,454,750 shares issued, 806,086 shares outstanding | 14,548 | 14,548 |
| Additional paid-in capital | 13,886,524 | 13,886,524 |
| Retained earnings | 9,935,018 | 10,200,324 |
| Shares held in trust, 32,643 and 25,768 shares at cost | (640,135) | (570,629) |
| Treasury stock, 648,664 shares at cost | (8,825,282) | (8,825,282) |
| Accumulated other comprehensive income | 333,284 | 216,367 |
| Total stockholders' equity | 14,703,957 | 14,921,852 |
| Total liabilities and stockholders' equity | \$ 94,337,271 | \$ 95,972,018 |

See Notes to Consolidated Financial Statements.

**THE SOUTHERN BANC COMPANY, INC.
AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS
YEARS ENDED JUNE 30, 2014 AND 2013**

| | 2014 | 2013 |
|--|---------------------|---------------------|
| Interest income | | |
| Loans, including fees | \$ 1,894,990 | \$ 1,741,547 |
| Securities available for sale | 1,418,660 | 1,468,747 |
| Other interest and dividends | 20,241 | 19,945 |
| Total interest income | 3,333,891 | 3,230,239 |
| Interest expense | | |
| Deposits | 677,254 | 841,271 |
| Other borrowings | 74,363 | 89,229 |
| Total interest expense | 751,617 | 930,500 |
| Net interest income | 2,582,274 | 2,299,739 |
| Provision for loan losses | - | 100,613 |
| Net interest income after provision for loan losses | 2,582,274 | 2,199,126 |
| Other income | | |
| Service charges and fees | 134,424 | 165,167 |
| Gain on sale of securities available for sale, net | 161,418 | 94,294 |
| Other income | 9,743 | 43,714 |
| Total other income | 305,585 | 303,175 |
| Other expenses | | |
| Salaries and employee benefits | 1,990,555 | 1,751,525 |
| Data processing | 372,548 | 334,256 |
| Professional service | 377,677 | 323,482 |
| Equipment and occupancy expenses | 227,778 | 215,742 |
| Other operating expenses | 360,197 | 395,789 |
| Total other expenses | 3,328,755 | 3,020,794 |
| Loss before income tax benefit | (440,896) | (518,493) |
| Income tax benefit | (175,590) | (216,390) |
| Net loss | \$ (265,306) | \$ (302,103) |
| Earnings (loss) per share | | |
| Basic | \$ (0.34) | \$ (0.39) |
| Diluted | \$ (0.34) | \$ (0.39) |
| Average shares outstanding - basic | 774,931 | 780,318 |
| Average shares outstanding - diluted | 774,931 | 780,318 |

See Notes to Consolidated Financial Statements.

**THE SOUTHERN BANC COMPANY, INC.
AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE LOSS
YEARS ENDED JUNE 30, 2014 AND 2013**

| | 2014 | 2013 |
|---|---------------------|-----------------------|
| Net loss | \$ (265,306) | \$ (302,103) |
| Other comprehensive income (loss): | | |
| Unrealized holding gains (losses) on securities available for sale arising during period, net of tax (benefit) of \$131,605 and (\$589,349), respectively | 217,480 | (973,911) |
| Reclassification adjustment for gains on sales of securities realized in net loss, net of tax of \$60,855 and \$35,549, respectively | (100,563) | (58,746) |
| Other comprehensive income (loss) | 116,917 | (1,032,657) |
| Comprehensive loss | \$ (148,389) | \$ (1,334,760) |

See Notes to Consolidated Financial Statements.

**THE SOUTHERN BANC COMPANY, INC.
AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
YEARS ENDED JUNE 30, 2014 AND 2013**

| | Common Stock | Additional Paid-in Capital | Retained Earnings | Shares Held in Trust | Treasury Stock | Accumulated Other Comprehensive Income | Total Stockholders' Equity |
|--------------------------------|------------------|----------------------------------|----------------------|-------------------------|-----------------------|---|----------------------------------|
| Balance, June 30, 2012 | \$ 14,548 | \$ 13,886,524 | \$ 10,502,427 | \$ (570,629) | \$ (8,825,282) | \$ 1,249,024 | \$ 16,256,612 |
| Net loss | - | - | (302,103) | - | - | - | (302,103) |
| Other comprehensive loss | - | - | - | - | - | (1,032,657) | (1,032,657) |
| Balance, June 30, 2013 | 14,548 | 13,886,524 | 10,200,324 | (570,629) | (8,825,282) | 216,367 | 14,921,852 |
| Net loss | - | - | (265,306) | - | - | - | (265,306) |
| Other comprehensive income | - | - | - | - | - | 116,917 | 116,917 |
| Purchased shares held in trust | - | - | - | (69,506) | - | - | (69,506) |
| Balance, June 30, 2014 | <u>\$ 14,548</u> | <u>\$ 13,886,524</u> | <u>\$ 9,935,018</u> | <u>\$ (640,135)</u> | <u>\$ (8,825,282)</u> | <u>\$ 333,284</u> | <u>\$ 14,703,957</u> |

See Notes to Consolidated Financial Statements.

**THE SOUTHERN BANC COMPANY, INC.
AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED JUNE 30, 2014 AND 2013**

| | 2014 | 2013 |
|--|--------------|--------------|
| OPERATING ACTIVITIES | | |
| Net (loss) | \$ (265,306) | \$ (302,103) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| Depreciation | 80,985 | 58,902 |
| Net amortization and accretion of securities | 286,436 | 597,753 |
| Provision for loan losses | - | 100,613 |
| Deferred income taxes | (175,590) | (216,388) |
| Losses on other real estate owned | - | 39,404 |
| Gain on sale of available for sale securities, net | (161,418) | (94,294) |
| Impairment charge on available for sale security | - | 9,108 |
| Decrease in interest receivable | 44,409 | 80,611 |
| Decrease in interest payable | (1,491) | (1,526) |
| Decrease in prepaid expenses | 7,628 | 148,876 |
| Increase (decrease) in factor clients reserve | (293,377) | 282,795 |
| Net other operating activities | 53,646 | (240,234) |
| Net cash provided by (used in) operating activities | (424,078) | 463,517 |
| INVESTING ACTIVITIES | | |
| Proceeds from maturities and principal payments on securities available for sale | 10,990,711 | 18,666,453 |
| Proceeds from sales of securities available for sale | 7,636,388 | 5,707,199 |
| Purchase of securities available for sale | (9,654,335) | (11,509,206) |
| Proceeds from maturities and principal payments on securities held to maturity | 7,944 | 14,457 |
| Redemption of Federal Home Loan Bank stock | 46,500 | 531,400 |
| Proceeds from sale of other real estate owned | - | 79,596 |
| Net (increase) decrease in loans and lease receivables | (7,451,431) | 394,076 |
| Purchases of property and equipment | (98,080) | (63,112) |
| Net cash provided by investing activities | 1,477,697 | 13,820,863 |
| FINANCING ACTIVITIES | | |
| Net decrease in deposits | (1,093,709) | (3,610,870) |
| Purchase shares held in trust | (69,506) | - |
| Advances from other borrowings | 3,000,000 | 1,000,000 |
| Repayment of other borrowings | (3,156,452) | (11,313,452) |
| Net cash used in financing activities | (1,319,667) | (13,924,322) |
| Net increase (decrease) in cash and cash equivalents | (266,048) | 360,058 |
| Cash and cash equivalents at beginning of year | 4,049,564 | 3,689,506 |
| Cash and cash equivalents at end of year | \$ 3,783,516 | \$ 4,049,564 |
| SUPPLEMENTAL DISCLOSURE | | |
| Cash paid (received) during the year for: | | |
| Interest | \$ 753,108 | \$ 932,026 |
| Income taxes | \$ (25,299) | \$ (1,309) |

See Notes to Consolidated Financial Statements.

**THE SOUTHERN BANC COMPANY, INC.
AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

The Southern Banc Company, Inc. (the “Company”) was incorporated in the state of Delaware in May 1995, for the purpose of becoming a holding company to own all of the outstanding capital stock of The Southern Bank Company (the “Bank”), formerly First Federal Savings and Loan Association of Gadsden. Effective June 30, 2008, the Bank converted its charter from a federally chartered stock savings association to a commercial bank organized and existing under the laws of the state of Alabama.

The Bank is primarily engaged in the business of obtaining funds in the form of various deposit products and investing those funds in mortgage loans or single family real estate, commercial, and consumer loans. The Bank operates from its four offices in the northeast portion of Alabama and originates the majority of its loans in this market area. The Bank also operates a division that conducts accounts receivable management, or “factoring”, of commercial accounts.

Basis of Presentation and Accounting Estimates

The consolidated financial statements include the accounts of the Company and its two wholly-owned subsidiaries, the Bank and First Service Corporation. Significant intercompany transactions and balances have been eliminated in consolidation.

In preparing the financial statements in accordance with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the balance sheet date and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan losses, the valuation of debt securities and deferred tax assets, other-than-temporary impairments of securities, and the fair value of financial instruments.

The Company has evaluated all transactions, events, and circumstances for consideration or disclosure through October 15, 2014, the date these financial statements were available to be issued, and has reflected or disclosed those items within the consolidated financial statements and related footnotes as deemed appropriate.

Cash and Cash Equivalents

For purposes of reporting consolidated cash flows, cash and cash equivalents include cash and balances due from banks, interest-bearing deposits in banks and federal funds sold. Cash flows from restricted equity securities, loans, and deposits are reported net.

The Bank maintains amounts due from banks which, at times, may exceed federally insured limits. The Bank has not experienced any losses in such accounts.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Securities

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

The Company evaluates investment securities for other-than-temporary impairment (“OTTI”) using relevant accounting guidance on a regular basis. Consideration is given to (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 including an evaluation of credit ratings, (3) the impact of changes in market interest rates, (4) the intent of the Company to sell a security, and (5) whether it is more likely than not the Company will have to sell the security before recovery of its cost basis. If the Company intends to sell an impaired security, or if it is more likely than not the Company will have to sell the security before recovery of its cost basis, the Company records an other-than-temporary loss in an amount equal to the entire difference between fair value and amortized cost in earnings. Otherwise, only the credit portion of the estimated loss is recognized in earnings/(losses), with the other portion of the loss recognized in other comprehensive income (loss).

Restricted Equity Securities

The Company is required to maintain an investment in capital stock of the Federal Home Loan Bank of Atlanta (FHLB). Based on redemption provisions, the stock has no quoted market value and is carried at cost, which approximates fair value. At its discretion, the FHLB may declare dividends on the stock. Management monitors the Company’s investment in the capital stock of the FHLB.

Loans Held For Sale

Loans originated and intended for sale in the secondary market are carried at the lower of cost or fair value (LOCOM). For loans carried at LOCOM, gains and losses on loan sales (sales proceeds minus carrying value) are recorded in noninterest income upon sale of the loan. The estimated fair value of loans held for sale is based on independent third party quoted prices. The Company did not have any outstanding loans held for sale of as June 30, 2014 and 2013.

Loans and Leases Receivable

Loans and leases (collectively referred to as “loans”) that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding principal balances less deferred fees and costs on originated loans and the allowance for loan losses. Interest income is accrued on the outstanding principal balance. Loan origination fees, net of certain direct origination costs, are deferred depending on the fee amount and/or the maturity of the loan, and recognized as an adjustment of the related loan yield over the life of the loan, using the straight line method without anticipating prepayments. Additionally, the Company engages in direct lease financing. The net investment in direct financing leases is the sum of all minimum lease payments and estimated residual values less unearned income.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Loans and Leases Receivable (Continued)

The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due, or at the time the loan is 90 days past due, unless the loan is well-secured and in the process of collection. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal and interest is considered doubtful. All interest accrued but not collected for loans that are placed on non-accrual is reversed against interest income and interest accrued on loans that are charged off is reversed against interest income or charged to the allowance, unless management believes that the accrual of interest is recoverable through the liquidation of collateral. Interest income on nonaccrual loans is recognized on the cash basis, until the loans are returned to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and the loan has been performing according to the contractual terms generally for a period of not less than six months.

In an effort to diversify the Company's loan portfolio and to increase yield in the portfolio, the Company's management team and the Board of Directors developed and approved the Commercial Finance Division (CFD) of The Southern Bank Company, Inc. This division was officially started in January 2011. The business of the CFD is to purchase accounts receivable, also known as factoring. Factoring is a financial transaction whereby an outside company sells its accounts receivable to the Company, the factor, at a discount to obtain cash. The cash advance is a percentage of the invoice face value that the Company pays to the selling company upon submission. The Company records a reserve for the remainder of the total invoice amount held by the Company until the payment by the selling company's customer is made. Fees are the cost associated with the transaction that are deducted from the reserve prior to its being paid back to the seller. The interest charge fee is calculated based on the advanced amount outstanding, multiplied by an agreed-upon interest rate.

Allowance for Loan and Lease Losses

The allowance for loan losses is established through a provision charged to earnings when losses are estimated to have occurred. Loan losses are charged against the allowance when the loss is recognized. Subsequent recoveries, if any, are credited to the allowance.

The allowance is an amount that management believes will be adequate to absorb estimated losses relating to specifically identified loans, as well as probable credit losses inherent in the balance of the loan portfolio. The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the uncollectibility of loans in light of historical experience, the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, current economic conditions that may affect the borrower's ability to pay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. This evaluation does not include the effects of expected losses on specific loans or groups of loans that are related to future events or expected changes in economic conditions. While management uses the best information available to make its evaluation, future adjustments to the allowance may be necessary if there are significant changes in economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses, and may require the Company to make changes to the allowance based on their judgment about information available to them at the time of their examinations.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan and Lease Losses (continued)

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired. For those loans that are classified as impaired, an allowance is established when the discounted cash flows, collateral value, or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-impaired loans and is based on historical loss experience adjusted for qualitative factors. The qualitative factors considered by management include, among other factors, (1) changes in economic and business conditions; (2) changes in asset quality and foreclosure rates; (3) changes in loan portfolio volume; (4) the composition and concentrations of credit; (5) changes in collateral values in general; (6) the experience and ability of lending personnel and management; (7) effectiveness of the Company's loan policies, procedures and internal controls; and (8) the loan review system and oversight of the Board of Directors. An unallocated component may be maintained to cover uncertainties that could affect management's estimate of probable losses.

Troubled Debt Restructurings

A loan is considered a troubled debt restructuring ("TDR") based on individual facts and circumstances. The Company designates loan modifications as TDRs when for economic and legal reasons related to the borrower's financial difficulties, it grants a concession to the borrower that it would not otherwise consider. These concessions may include rate reductions, principal forgiveness, extension of maturity date and other actions intended to minimize potential losses.

In determining whether a borrower is experiencing financial difficulties, the Company considers if the borrower is in payment default or would be in payment default in the foreseeable future without the modification, the borrower declared or is in the process of declaring bankruptcy, the borrower's projected cash flows will not be sufficient to service any of its debt, or the borrower cannot obtain funds from sources other than the Company at a market rate for debt with similar risk characteristics.

In determining whether the Company has granted a concession, the Company assesses, if it does not expect to collect all amounts due, whether the current value of the collateral will satisfy the amounts owed, whether additional collateral or guarantees from the borrower will serve as adequate compensation for other terms of the restructuring, and whether the borrower otherwise has access to funds at a market rate for debt with similar risk characteristics.

Premises and Equipment

Land is carried at cost. Buildings and vault equipment are carried at cost less accumulated depreciation computed on the straight-line method over the estimated useful lives of the assets or the expected terms of the leases, if shorter. Expected terms include lease option periods to the extent that the exercise of such options is reasonably assured. Furniture, fixtures and other office equipment are carried at the cost less accumulated depreciation computed on the double-declining method over the estimated useful lives of the asset. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized. Gains and losses on dispositions are reflected in earnings/losses.

| <u>Asset Category</u> | <u>Years</u> |
|-------------------------|--------------|
| Buildings | 10-40 |
| Furniture and equipment | 5-20 |
| Automobiles | 3 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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 - put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (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 or the ability to unilaterally cause the holder to return specific assets.

Other Real Estate Owned

Assets acquired through or in lieu of loan foreclosure are held for sale and are initially recorded at fair value less costs to sell. Any write-down to fair value at the time of transfer to other real estate owned is charged to the allowance for loan losses. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Costs of improvements are capitalized, whereas costs relating to holding other real estate owned and any subsequent adjustments to the carrying value are expensed. The Company was not carrying any other real estate owned at June 30, 2014 and 2013, respectively.

Income Taxes

The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets may be reduced by deferred tax liabilities and a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Earnings (Loss) Per Share

Basic earnings (loss) per share were computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding. Common stock outstanding consists of issued shares, less treasury stock, and shares held in trust. Diluted earnings (loss) per share reflect additional potential common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares consist of stock options. There were no dilutive shares of common stock at June 30, 2014 and 2013.

Stock Compensation Plans

Stock compensation accounting guidance requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the grant date fair value of the equity or liability instruments issued. The stock compensation accounting guidance covers a wide range of share-based compensation arrangements including stock options and warrants, share appreciation rights, and employee share purchase plans.

The stock compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over the employees' service period, generally defined as the vesting period. A Black-Scholes model is used to estimate the fair value of stock options.

Comprehensive Income (Loss)

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income (loss). Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income (loss), are components of comprehensive income (loss).

Advertising Costs

Advertising costs consist of print and television media advertisements and promotional items and are expensed as incurred. Advertising costs totaled \$42,088 and \$57,068 during the years ended June 30, 2014 and 2013, respectively.

Fair Value of Financial Instruments

Fair values of financial instruments are estimates using relevant market information and other assumptions, as more fully disclosed in Note 13. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SECURITIES

The amortized cost and fair value of securities are summarized as follows:

| | <u>Amortized Cost</u> | <u>Gross Unrealized Gains</u> | <u>Gross Unrealized Losses</u> | <u>Fair Value</u> |
|--------------------------------------|---------------------------|---------------------------------------|--|-----------------------|
| Securities Available for Sale | | | | |
| June 30, 2014: | | | | |
| U.S. government agency securities | \$ 10,029,671 | \$ 90,120 | \$ (25,197) | \$ 10,094,594 |
| Mortgage-backed securities | 41,429,708 | 753,135 | (308,116) | 41,874,727 |
| Other | 1,530,695 | 33,765 | (8,740) | 1,555,720 |
| | <u>\$ 52,990,074</u> | <u>\$ 877,020</u> | <u>\$ (342,053)</u> | <u>\$ 53,525,041</u> |
| June 30, 2013: | | | | |
| U.S. government agency securities | \$ 8,114,381 | \$ 147,691 | \$ (25,007) | \$ 8,237,065 |
| Mortgage-backed securities | 50,483,637 | 884,787 | (767,018) | 50,601,406 |
| Other | 3,489,847 | 131,850 | (25,006) | 3,596,691 |
| | <u>\$ 62,087,865</u> | <u>\$ 1,164,328</u> | <u>\$ (817,031)</u> | <u>\$ 62,435,162</u> |
| Securities Held to Maturity | | | | |
| June 30, 2014: | | | | |
| Mortgage-backed securities | <u>\$ 5,136</u> | <u>\$ 235</u> | <u>\$ -</u> | <u>\$ 5,371</u> |
| June 30, 2013: | | | | |
| Mortgage-backed securities | <u>\$ 13,073</u> | <u>\$ 639</u> | <u>\$ -</u> | <u>\$ 13,712</u> |

The amortized cost and fair value of securities as of June 30, 2014 by contractual maturity are shown below. Actual maturities may differ from contractual maturities in mortgage-backed securities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Therefore, these securities are not presented by maturity category in the following summary:

| | <u>Securities Available for Sale</u> | | <u>Securities Held to Maturity</u> | |
|----------------------------|--------------------------------------|-----------------------|------------------------------------|-----------------------|
| | <u>Amortized Cost</u> | <u>Fair Value</u> | <u>Amortized Cost</u> | <u>Fair Value</u> |
| Due in one year or less | \$ 282,718 | \$ 283,312 | \$ - | \$ - |
| Due from one to five years | 2,461,683 | 2,445,551 | - | - |
| Due from five to ten years | 3,832,407 | 3,900,807 | - | - |
| Due after ten years | 4,983,558 | 5,020,644 | - | - |
| Mortgage-backed securities | 41,429,708 | 41,874,727 | 5,136 | 5,371 |
| | <u>\$ 52,990,074</u> | <u>\$ 53,525,041</u> | <u>\$ 5,136</u> | <u>\$ 5,371</u> |

Securities with a carrying value of \$4,061,215 and \$2,352,120 at June 30, 2014 and 2013, respectively, were pledged to secure public deposits and for other purposes as required or permitted by law.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SECURITIES (Continued)

Gains and losses on sales of securities and impairment losses consist of the following:

| | Years Ended June 30, | |
|--|----------------------|------------|
| | 2014 | 2013 |
| Gross gains | \$ 176,516 | \$ 94,294 |
| Gross losses | (15,098) | - |
| Net realized gains | 161,418 | 94,294 |
| Other-than-temporary impairment losses on securities | \$ - | \$ (9,108) |

Temporarily Impaired Securities

The following table shows the gross unrealized losses and fair value of the Company's securities with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2014 and 2013:

| | Less Than Twelve Months | | Over Twelve Months | | Total Unrealized Losses |
|---------------------------------------|-------------------------|-------------------------------|--------------------|-------------------------------|-------------------------------|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | |
| June 30, 2014: | | | | | |
| U.S. government agency securities | \$ 1,073,280 | \$ (1,720) | \$ 977,721 | \$ (23,477) | \$ (25,197) |
| Mortgage-backed securities | 4,871,542 | (13,026) | 11,710,099 | (295,090) | (308,116) |
| Other | - | - | 608,002 | (8,740) | (8,740) |
| Total temporarily impaired securities | \$ 5,944,822 | \$ (14,746) | \$ 13,295,822 | \$ (327,307) | \$ (342,053) |
| June 30, 2013: | | | | | |
| U.S. government agency securities | \$ 987,067 | \$ (21,438) | \$ 333,159 | \$ (3,569) | \$ (25,007) |
| Mortgage-backed securities | 23,560,723 | (754,578) | 544,924 | (12,440) | (767,018) |
| Other | 826,068 | (25,006) | - | - | (25,006) |
| Total temporarily impaired securities | \$ 25,373,858 | \$ (801,022) | \$ 878,083 | \$ (16,009) | \$ (817,031) |

The unrealized losses on 22 investments were caused by interest rate changes. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at June 30, 2014.

Other-Than-Temporary Impairment

Upon acquisition of a security, the Company evaluates for impairment under the accounting guidance for investments in debt and equity securities. The Company routinely conducts periodic reviews to identify and evaluate each investment security to determine whether an other-than-temporary impairment has occurred. Factors included in the evaluation process may include geographic concentrations, credit ratings, and other performance indicators of the underlying asset. As of June 30, 2014 and 2013, no securities within the Company's investment securities portfolio was considered other-than-temporarily impaired, except as noted below.

During 2013, the Company recorded an other-than-temporary impairment charge of \$9,108 related to its investment in a Countrywide Home Loan CMO bond. At the time of the impairment charge the value of the security had declined slightly but has continued shorting payments resulting from unfavorable market conditions. Based on the new cost basis the security was in an unrealized gain position as of June 30, 2014. Management believes an insignificant loss would be realized in the event this security was sold in the current open market.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. LOANS

The composition of loans is summarized as follows:

| | June 30, | |
|---|---------------|---------------|
| | 2014 | 2013 |
| Real estate mortgages: | | |
| Construction and development | \$ 1,729,667 | \$ 1,056,090 |
| 1-4 family first mortgages | 8,997,475 | 9,350,651 |
| Commercial | 7,766,332 | 5,911,320 |
| Other | 2,666,068 | 2,605,212 |
| Commercial, financial, and agricultural | 5,007,060 | 3,883,205 |
| Commercial lease financing | 8,054,827 | 3,792,384 |
| Consumer and other | 1,116,391 | 1,270,192 |
| | 35,337,820 | 27,869,054 |
| Net deferred loan fees | (73,384) | (51,301) |
| Allowance for loan losses | (360,670) | (365,418) |
| Loans, net | \$ 34,903,766 | \$ 27,452,335 |

Portfolio Segmentation

For purposes of the disclosures required pursuant to ASC 310, the loan portfolio was disaggregated into segments and then further disaggregated into classes for certain disclosures. A portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for loan losses. There are three loan portfolio segments that include real estate, commercial, and consumer. A class is generally determined based on the initial measurement attribute, risk characteristic of the loan, and the Company's method for monitoring and assessing credit risk. Classes within the real estate portfolio segment include construction and development loans, 1-4 family first mortgages, commercial real estate loans, and other real estate loans. The classes of the commercial portfolio segment include non-real estate commercial, financial, and agricultural loans, along with commercial lease financing. Consumer loans have not been further segregated by class.

The following describe risk characteristics relevant to each of the portfolio segments:

Real estate - As discussed below, the Company offers various types of real estate loan products. All loans within this portfolio segment are particularly sensitive to the valuation of real estate:

- Construction and development loans are repaid through cash flow related to the operations, sale or refinance of the underlying property. This portfolio segment includes extensions of credit to real estate developers or investors where repayment is dependent on the sale of the real estate or income generated from the real estate collateral.
- 1-4 family first mortgage loans are repaid by various means such as a borrower's income, sale of the property, or rental income derived from the property.
- Commercial real estate mortgage loans include both owner-occupied commercial real estate loans and other commercial real estate loans such as commercial loans secured by income producing properties. Owner-occupied commercial real estate loans made to operating businesses are long-term financing of land and buildings and are repaid by cash flows generated from business operations. Real estate loans for income-producing properties such as apartment buildings, office and industrial buildings, and retail shopping centers are repaid from rent income derived from the properties.
- Other real estate mortgage loans include home equity lines of credit, 1-4 family junior liens, loans secured by farmland and multi-family residential loans. These are repaid by various means such as a borrower's income, sale of the property, or rental income derived from the property.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. LOANS (Continued)

Portfolio Segmentation (Continued)

Commercial - The commercial loan portfolio segment includes commercial, financial, and agricultural loans. These loans include those loans to commercial customers for use in normal business operations to finance working capital needs, equipment purchases, or expansion projects. Loans are repaid by business cash flows. Collection risk in this portfolio is driven by the creditworthiness of the underlying borrower, particularly cash flows from the borrowers' business operations. Lease financing is also included in the commercial loan portfolio segment and is different in form from a loan; however, the basic considerations are similar: cash flow, capacity, credit history, management and projections of future operations.

Consumer and other - The consumer loan portfolio segment includes direct consumer installment loans, overdrafts and other revolving credit loans, and agricultural loans. Loans in this portfolio are sensitive to unemployment and other key consumer economic measures.

Credit Risk Management

Senior management and loan officers are involved in the credit risk management process and assess the accuracy of risk ratings, the quality of the portfolio and the estimation of inherent credit losses in the loan portfolio. This comprehensive process also assists in the prompt identification of problem credits. The Company has taken a number of measures to manage the portfolios and reduce risk, particularly in the more problematic portfolios.

The Company employs a credit risk management process with defined policies, accountability and routine reporting to manage credit risk in the loan portfolio segments. Credit risk management is guided by a comprehensive Loan Policy that provides for a consistent and prudent approach to underwriting and approvals of credits. Within the Board approved Loan Policy, procedures exist that elevate the approval requirements as credits become larger and more complex. All loans are individually underwritten, risk-rated, approved, and monitored.

Responsibility and accountability for adherence to underwriting policies and accurate risk ratings lies in each portfolio segment. For the consumer portfolio segment, the risk management process focuses on managing customers who become delinquent in their payments. For the commercial and real estate portfolio segments, the risk management process focuses on underwriting new business and, on an ongoing basis, monitoring the credit quality of the portfolios. To insure problem credits are identified on a timely basis, portfolio reviews are conducted to assess the larger adversely rated credits for proper risk rating and accrual status.

Credit quality and trends in the loan portfolio segments are measured and monitored regularly. Detailed reports, by product, collateral, accrual status, etc., are reviewed by the Chief Executive Officer, President, Officers Loan Committee, and Directors Loan Committee.

The following risk grade categories are utilized by management to analyze and manage the credit quality and risk of the loan portfolio:

- **Pass** - includes obligations where the probability of default is considered low.
- **Special Mention** - includes obligations that exhibit potential credit weaknesses or downward trends deserving management's close attention. If left uncorrected, these potential weaknesses may result in the deterioration of the repayment prospects or credit position at a future date. These loans are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. LOANS (Continued)

Credit Risk Management (Continued)

- **Substandard** - includes obligations with defined weaknesses that jeopardize the orderly liquidation of debt. A substandard loan is inadequately protected by the current sound worth and paying capacity of the borrower or by the collateral pledged, if any. Normal repayment from the borrower is in jeopardy although no loss of principal is envisioned. There is a distinct possibility that a partial loss of interest and/or principal will occur if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard loans, does not have to exist in individual loans classified substandard.
- **Doubtful** - includes obligations with all the weaknesses found in substandard loans with the added provision that the weaknesses make collection of debt in full, based on current existing facts, conditions, and values, highly questionable and improbable. Serious problems exist to the point where partial loss of principal is likely. The possibility of loss is extremely high, but because of certain important, reasonably specific pending factors that may work to strengthen the loan, the loans' classification as estimated losses is deferred until a more exact status may be determined.
- **Loss** - includes obligations incapable of repayment or unsecured debt. Such loans are considered uncollectible and of such little value, that continuance as an active asset is not warranted. Loans determined to be a loss are charged-off at the date of loss determination. There are no loans with a loss rating in the Company's portfolio as of June 30, 2014 and 2013.

The following tables summarize the risk categories, as defined above, of the Company's loan portfolio based upon on the most recent analysis performed as of June 30, 2014 and 2013:

| | <u>Pass</u> | <u>Special Mention</u> | <u>Substandard</u> | <u>Doubtful</u> | <u>Total</u> |
|---|----------------------|------------------------|---------------------|------------------|----------------------|
| June 30, 2014 | | | | | |
| Real estate mortgages: | | | | | |
| Construction and development | \$ 1,373,517 | \$ - | \$ 356,150 | \$ - | \$ 1,729,667 |
| 1-4 family first mortgages | 8,610,107 | - | 387,368 | - | 8,997,475 |
| Commercial | 6,950,458 | - | 815,874 | - | 7,766,332 |
| Other | 2,594,121 | - | 71,947 | - | 2,666,068 |
| Commercial, financial, and agricultural | 4,862,416 | - | 63,008 | 81,636 | 5,007,060 |
| Commercial lease financing | 8,054,827 | - | - | - | 8,054,827 |
| Consumer and other | 1,091,636 | - | 24,755 | - | 1,116,391 |
| Total: | <u>\$ 33,537,082</u> | <u>\$ -</u> | <u>\$ 1,719,102</u> | <u>\$ 81,636</u> | <u>\$ 35,337,820</u> |

| | | | | | |
|---|----------------------|-------------|---------------------|------------------|----------------------|
| June 30, 2013 | | | | | |
| Real estate mortgages: | | | | | |
| Construction and development | \$ 890,812 | \$ - | \$ 165,278 | \$ - | \$ 1,056,090 |
| 1-4 family first mortgages | 8,921,774 | - | 428,877 | - | 9,350,651 |
| Commercial | 5,131,289 | - | 780,031 | - | 5,911,320 |
| Other | 2,520,333 | - | 84,879 | - | 2,605,212 |
| Commercial, financial, and agricultural | 3,687,191 | - | 114,449 | 81,565 | 3,883,205 |
| Commercial lease financing | 3,792,384 | - | - | - | 3,792,384 |
| Consumer and other | 1,267,479 | - | 2,713 | - | 1,270,192 |
| Total: | <u>\$ 26,211,262</u> | <u>\$ -</u> | <u>\$ 1,576,227</u> | <u>\$ 81,565</u> | <u>\$ 27,869,054</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. LOANS (Continued)

Past Due Loans

A loan is considered past due if any required principal and interest payments have not been received as of the date such payments were required to be made under the terms of the loan agreement. Generally, the Company places loans on non-accrual when there is a clear indication that the borrower's cash flow may not be sufficient to meet payments as they become due, which is generally when a loan is 90 days past due. The following tables present the aging of the recorded investment in loans and leases as of June 30, 2014 and 2013:

| | Past Due Status (Accruing Loans and Leases) | | | | | Non-accrual | Total |
|---|---|-------------------|------------------|-------------|-------------------|-------------------|----------------------|
| | Current | 30-59 Days | 60-89 Days | 90+ Days | Total Past Due | | |
| June 30, 2014 | | | | | | | |
| Real estate mortgages: | | | | | | | |
| Construction and development | \$ 1,537,421 | \$ 36,156 | \$ - | \$ - | \$ 36,156 | \$ 156,090 | \$ 1,729,667 |
| 1-4 family first mortgages | 8,681,582 | 51,459 | 56,523 | - | 107,982 | 207,911 | 8,997,475 |
| Commercial | 7,516,460 | 249,872 | - | - | 249,872 | - | 7,766,332 |
| Other | 2,400,148 | 229,606 | - | - | 229,606 | 36,314 | 2,666,068 |
| Commercial, financial, and agricultural | 4,875,920 | - | - | - | - | 131,140 | 5,007,060 |
| Commercial lease financing | 8,054,827 | - | - | - | - | - | 8,054,827 |
| Consumer and other | 1,065,100 | 42,587 | 1,521 | - | 44,108 | 7,183 | 1,116,391 |
| Total: | \$ 34,131,458 | \$ 609,680 | \$ 58,044 | \$ - | \$ 667,724 | \$ 538,638 | \$ 35,337,820 |
| June 30, 2013 | | | | | | | |
| Real estate mortgages: | | | | | | | |
| Construction and development | \$ 1,005,306 | \$ - | \$ - | \$ - | \$ - | \$ 50,784 | \$ 1,056,090 |
| 1-4 family first mortgages | 8,789,078 | 166,497 | 43,598 | - | 210,095 | 351,478 | 9,350,651 |
| Commercial | 5,850,906 | 60,414 | - | - | 60,414 | - | 5,911,320 |
| Other | 2,423,847 | 140,643 | 20,275 | - | 160,918 | 20,447 | 2,605,212 |
| Commercial, financial, and agricultural | 3,678,688 | 9,600 | - | - | 9,600 | 194,917 | 3,883,205 |
| Commercial lease financing | 3,792,384 | - | - | - | - | - | 3,792,384 |
| Consumer and other | 1,255,320 | 4,225 | - | - | 4,225 | 10,647 | 1,270,192 |
| Total: | \$ 26,795,529 | \$ 381,379 | \$ 63,873 | \$ - | \$ 445,252 | \$ 628,273 | \$ 27,869,054 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. LOANS (Continued)

Allowance for Loan and Lease Losses

The following tables detail activity in the allowance for loan and lease losses by portfolio segment for the years ended June 30, 2014 and 2013. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

| | <u>Real Estate</u> | <u>Commercial</u> | <u>Consumer</u> | <u>Unallocated</u> | <u>Total</u> |
|--|----------------------|----------------------|---------------------|--------------------|----------------------|
| June 30, 2014 | | | | | |
| Allowance for loan losses: | | | | | |
| Beginning balance | \$ 158,938 | \$ 153,229 | \$ 50,687 | \$ 2,564 | \$ 365,418 |
| Loans charged-off | - | - | (4,748) | - | (4,748) |
| Recoveries of loans previously charged-off | - | - | - | - | - |
| Provision (credit) for loan losses | 1,718 | 3,713 | (2,867) | (2,564) | - |
| Ending balance | <u>\$ 160,656</u> | <u>\$ 156,942</u> | <u>\$ 43,072</u> | <u>\$ -</u> | <u>\$ 360,670</u> |
| Ending balance – individually evaluated for impairment | \$ 47,558 | \$ 7,809 | \$ - | \$ - | \$ 55,367 |
| Ending balance – collectively evaluated for impairment | 113,098 | 149,133 | 43,072 | - | 305,303 |
| Total ending balance | <u>\$ 160,656</u> | <u>\$ 156,942</u> | <u>\$ 43,072</u> | <u>\$ -</u> | <u>\$ 360,670</u> |
| Loans: | | | | | |
| Ending balance – individually evaluated for impairment | \$ 112,158 | \$ 28,973 | \$ - | \$ - | \$ 141,131 |
| Ending balance – collectively evaluated for impairment | 21,047,384 | 13,032,914 | 1,116,391 | - | 35,196,689 |
| Total ending balance | <u>\$ 21,159,542</u> | <u>\$ 13,061,887</u> | <u>\$ 1,116,391</u> | <u>\$ -</u> | <u>\$ 35,337,820</u> |
| June 30, 2013 | | | | | |
| Allowance for loan losses: | | | | | |
| Beginning balance | \$ 168,953 | \$ 90,681 | \$ 23,862 | \$ - | \$ 283,496 |
| Loans charged-off | (18,420) | - | (271) | - | (18,691) |
| Recoveries of loans previously charged-off | - | - | - | - | - |
| Provision for loan losses | 8,405 | 62,548 | 27,096 | 2,564 | 100,613 |
| Ending balance | <u>\$ 158,938</u> | <u>\$ 153,229</u> | <u>\$ 50,687</u> | <u>\$ 2,564</u> | <u>\$ 365,418</u> |
| Ending balance – individually evaluated for impairment | \$ 49,894 | \$ 19,416 | \$ - | \$ - | \$ 69,310 |
| Ending balance – collectively evaluated for impairment | 109,044 | 133,813 | 50,687 | 2,564 | 296,108 |
| Total ending balance | <u>\$ 158,938</u> | <u>\$ 153,229</u> | <u>\$ 50,687</u> | <u>\$ 2,564</u> | <u>\$ 365,418</u> |
| Loans: | | | | | |
| Ending balance – individually evaluated for impairment | \$ 114,494 | \$ 45,841 | \$ - | \$ - | \$ 160,335 |
| Ending balance – collectively evaluated for impairment | 18,808,779 | 7,629,748 | 1,270,192 | - | 27,708,719 |
| Total ending balance | <u>\$ 18,923,273</u> | <u>\$ 7,675,589</u> | <u>\$ 1,270,192</u> | <u>\$ -</u> | <u>\$ 27,869,054</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. LOANS (Continued)

Impaired Loans

A loan held for investment is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due (both principal and interest) according to the terms of the loan agreement. The following tables detail impaired loans, by portfolio class as of June 30, 2014 and 2013:

| | <u>Recorded Investment</u> | <u>Unpaid Principal Balance</u> | <u>Related Allowance</u> | <u>Average Recorded Investment</u> | <u>Interest Income Recognized</u> |
|---|--------------------------------|---|------------------------------|--|---|
| June 30, 2014 | | | | | |
| With no related allowance recorded: | | | | | |
| Real estate mortgages: | | | | | |
| Construction and development | \$ - | \$ - | \$ - | \$ - | \$ - |
| 1-4 family first mortgages | - | - | - | - | - |
| Commercial | - | - | - | - | - |
| Other | - | - | - | - | - |
| Commercial, financial, and agricultural | - | - | - | - | - |
| Commercial lease financing | - | - | - | - | - |
| Consumer and other | - | - | - | - | - |
| Total with no related allowance recorded | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> |
| With an allowance recorded: | | | | | |
| Real estate mortgages: | | | | | |
| Construction and development | 112,158 | 112,158 | 47,558 | 113,462 | 7,851 |
| 1-4 family first mortgages | - | - | - | - | - |
| Commercial | - | - | - | - | - |
| Other | - | - | - | - | - |
| Commercial, financial, and agricultural | 28,973 | 28,973 | 7,809 | 36,697 | 2,028 |
| Commercial lease financing | - | - | - | - | - |
| Consumer and other | - | - | - | - | - |
| Total with an allowance recorded | <u>141,131</u> | <u>141,131</u> | <u>55,367</u> | <u>150,159</u> | <u>9,879</u> |
| Total impaired loans: | <u>\$ 141,131</u> | <u>\$ 141,131</u> | <u>\$ 55,367</u> | <u>\$ 150,159</u> | <u>\$ 9,879</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. LOANS (Continued)

Impaired Loans (Continued)

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|--|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
| June 30, 2013 | | | | | |
| With no related allowance recorded: | | | | | |
| Real estate mortgages: | | | | | |
| Construction and development | \$ - | \$ - | \$ - | \$ - | \$ - |
| 1-4 family first mortgages | - | - | - | - | - |
| Commercial | - | - | - | - | - |
| Other | - | - | - | - | - |
| Commercial, financial, and agricultural | - | - | - | - | - |
| Commercial lease financing | - | - | - | - | - |
| Consumer and other | - | - | - | - | - |
| Total with no related allowance recorded | - | - | - | - | - |
| With an allowance recorded: | | | | | |
| Real estate mortgages: | | | | | |
| Construction and development | 114,494 | 114,494 | 49,894 | 116,270 | 8,139 |
| 1-4 family first mortgages | - | - | - | - | - |
| Commercial | - | - | - | - | - |
| Other | - | - | - | - | - |
| Commercial, financial, and agricultural | 45,841 | 45,841 | 19,416 | 53,261 | 3,728 |
| Commercial lease financing | - | - | - | - | - |
| Consumer and other | - | - | - | - | - |
| Total with an allowance recorded | 160,335 | 160,335 | 69,310 | 169,531 | 11,867 |
| Total impaired loans: | \$ 160,335 | \$ 160,335 | \$ 69,310 | \$ 169,531 | \$ 11,867 |

Troubled Debt Restructurings

The restructuring of a loan is considered a “troubled debt restructuring” if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession. Concessions may include interest rate reductions or below market interest rates, principal forgiveness, restructuring amortization schedules and other actions intended to minimize potential losses. At June 30, 2014 and 2013, there were no impaired loans that were classified as troubled debt restructurings, and there were no troubled debt restructurings during the prior twelve months ending June 30, 2014 or 2013.

Related Party Loans

In the ordinary course of business, the Company has granted loans to certain related parties, including directors, executive officers and their affiliates. The interest rates on these loans were substantially the same as rates prevailing at the time of the transaction and repayment terms are customary for the type of loan. Changes in related party loans are as follows:

| | Years Ended June 30, | |
|----------------------------|----------------------|------------|
| | 2014 | 2013 |
| Balance, beginning of year | \$ 120,948 | \$ 137,330 |
| Advances | 165,639 | 28,428 |
| Repayments | (98,168) | (44,810) |
| Changes in related parties | 106,454 | - |
| Balance, end of year | \$ 294,873 | \$ 120,948 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4. PREMISES AND EQUIPMENT

Premises and equipment are summarized as follows:

| | June 30, | |
|---------------------------|-------------|-------------|
| | 2014 | 2013 |
| Land | \$ 415,486 | \$ 415,486 |
| Building and improvements | 955,990 | 920,817 |
| Furniture and equipment | 614,022 | 600,720 |
| Automobiles | 25,600 | 25,600 |
| | 2,011,098 | 1,962,623 |
| Accumulated depreciation | (1,183,297) | (1,151,917) |
| | \$ 827,801 | \$ 810,706 |

Leases

The Bank leases its banking facility and copier in Birmingham, Alabama under operating lease agreements from unrelated entities. The Birmingham office lease term is 12 months with fixed monthly payments. The Birmingham copier lease term is 39 months with fixed monthly payments.

Future minimum lease payments on the leases described above are summarized as follows:

| | |
|------------|-----------|
| 2015 | \$ 7,250 |
| 2016 | 2,682 |
| 2017 | 224 |
| 2018 | - |
| 2019 | - |
| Thereafter | - |
| | \$ 10,156 |

Rental expense included in the statements of income for the years ended June 30, 2014 and 2013 is \$32,915 and \$20,154, respectively.

NOTE 5. DEPOSITS

The aggregate amount of time deposits in denominations of \$100,000 or more at June 30, 2014 and 2013 was \$19,571,290 and \$18,598,796, respectively. The scheduled maturities of time deposits at June 30, 2014 are as follows, (all maturities are presented on a fiscal year basis, i.e. 7/1/14 – 6/30/15 for 2015):

| | |
|------------|---------------|
| 2015 | \$ 25,931,099 |
| 2016 | 5,806,712 |
| 2017 | 4,799,160 |
| 2018 | 5,071,492 |
| 2019 | 5,717,456 |
| Thereafter | 235 |
| | \$ 47,326,154 |

At June 30, 2014 and 2013, overdraft deposits reclassified to loans totaled \$8,308 and \$20,974, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6. OTHER BORROWINGS

The Company was liable to the Federal Home Loan Bank of Atlanta on the following advances as of June 30, 2014 and 2013:

| <u>Maturity Date</u> | <u>Interest rate</u> | <u>2014</u> | <u>2013</u> |
|----------------------|----------------------|----------------------------|----------------------------|
| July 2013 | 0.180% | \$ - | \$ 1,000,000 |
| October 2013 | 0.930% | - | 2,156,452 |
| August 2014 | 0.790% | 2,000,000 | 2,000,000 |
| October 2015 | 1.730% | 2,156,452 | 2,156,452 |
| August 2015 | 0.610% | 2,000,000 | - |
| June 2017 | 1.120% | 1,000,000 | - |
| Total | | <u>\$ 7,156,452</u> | <u>\$ 7,312,904</u> |

The Federal Home Loan Bank advances are secured by pledged securities with a carrying value of \$29,577,585 and \$25,581,947 at June 30, 2014 and 2013, respectively. The interest rates on the notes are fixed and interest is payable monthly.

The scheduled maturities of FHLB advances at June 30, 2014 are as follows:

| | |
|--|----------------------------|
| Due in less than one year (7/1/14 – 6/30/15) | \$ 2,000,000 |
| Due in 1-2 years (7/1/15 – 6/30/16) | 4,156,452 |
| Due in 2-3 years (7/1/16 – 6/30/17) | 1,000,000 |
| | <u>\$ 7,156,452</u> |

At June 30, 2014, the Company has accommodations which allow the purchase of Federal funds from several correspondent banks on an overnight basis at prevailing overnight market rates. These accommodations are subject to various restrictions as to their term and availability, and in most cases, must be repaid in less than a month. At June 30, 2014 and 2013, the Company had no amounts outstanding under these arrangements. The Company may borrow up to \$5,000,000 under these arrangements as of June 30, 2014.

NOTE 7. INCOME TAXES

Income tax benefit consists of the following:

| | <u>Years Ended June 30,</u> | |
|--------------------|-----------------------------|----------------------------|
| | <u>2014</u> | <u>2013</u> |
| Current | \$ - | \$ - |
| Deferred | (175,590) | (216,390) |
| Income tax benefit | <u>\$ (175,590)</u> | <u>\$ (216,390)</u> |

The Company's income tax differs from the amounts computed by applying the federal income tax statutory rate to income before income taxes. A reconciliation of the differences is as follows:

| | <u>Years Ended June 30,</u> | |
|--|-----------------------------|----------------------------|
| | <u>2014</u> | <u>2013</u> |
| Pretax (loss) income tax at federal statutory rate | \$ (149,905) | \$ (176,284) |
| State income tax, net of federal tax benefits | (18,156) | (21,846) |
| Tax-exempt income | (9,810) | (10,898) |
| Other, net | 2,281 | (7,362) |
| Income tax benefit | <u>\$ (175,590)</u> | <u>\$ (216,390)</u> |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7. INCOME TAXES (Continued)

The components of deferred income taxes are as follows:

| | June 30, | |
|---|------------|------------|
| | 2014 | 2013 |
| Deferred income tax assets: | | |
| Allowance for loan losses, net | \$ 138,100 | \$ 139,918 |
| Net operating loss (NOL) carryforward | 447,804 | 305,354 |
| Property and equipment and leases | 48,743 | 52,841 |
| Deferred loan fees and costs, net | 25,268 | 19,643 |
| Other | 4,732 | - |
| | 664,647 | 517,756 |
| Deferred income tax liabilities: | | |
| Leases | - | (8,134) |
| Accretion of discount on securities | (139,257) | (158,579) |
| Unrealized gain on securities for sale, net | (201,682) | (130,932) |
| Other | - | (1,243) |
| | (340,939) | (298,888) |
| Net deferred income tax assets | \$ 323,708 | \$ 218,868 |

Realization of deferred tax assets associated with the NOL carryforwards and reversal of other temporary differences is dependent upon generating sufficient taxable income prior to the expiration of the NOL carryforwards. Management believes that no valuation allowance is necessary at June 30, 2014 and 2013 given the current estimates of future taxable income. The gross federal net operating loss carryforwards totaled approximately \$1,124,724 at June 30, 2014. The Federal net operating loss carryforward will expire in tax year 2034.

The Company and its subsidiaries are subject to U.S. federal income tax, as well as income tax within the State of Alabama. The Company is no longer subject to examination by taxing authorities for years before 2010.

NOTE 8. EMPLOYEE RETIREMENT AND SAVINGS PLANS

Employee Stock Ownership Plan

The Bank established an employee stock ownership plan (“ESOP”) for eligible employees in 1995. The ESOP purchased 116,380 shares of the Company’s common stock with the proceeds of a \$1,163,800 note payable to the Bank and secured by the common stock owned by the ESOP. Principal payments under the note were due in equal annual installments through December 2005; interest was payable annually at a variable rate which was adjusted each January 1. The difference between the fair value of shares committed to be released and the cost of those shares to the ESOP (i.e., unearned compensation) was charged/credited to additional paid-in capital. Unearned compensation was amortized into compensation expense based on employee services rendered in relation to shares which were committed to be released based on the fair value of shares. Shares in the plan totaled 58,094 and 70,384 at June 30, 2014 and 2013, respectively. All shares had been allocated as of June 30, 2014 and 2013.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. EMPLOYEE RETIREMENT AND SAVINGS PLANS (Continued)

401(k) Plan

The Company has a contributory, defined contribution plan which is qualified under Section 401(k) of the Internal Revenue Code. The plan is available to qualifying employees of the Company who have completed one year of service. The Company makes a contribution equal to three percent of the employee's salary under the Internal Revenue Code's Safe Harbor regulations. Additional matching contributions may be made at the discretion of the Company's Board of Directors and generally vest over five years. Contributions to the plan charged to expense totaled \$78,403 and \$77,760 for the years ended June 30, 2014 and 2013, respectively.

Employment Agreements

The Company has a 36-month employment agreement with its president. This agreement provides that if employment under the agreement is terminated by the Company in connection with or within 12 months after any change in control of the Company, the employee will be paid approximately three times his salary.

NOTE 9. STOCK-BASED COMPENSATION PLAN

The Company has a stock option plan which provides for the grant of incentive stock options to employees and non-incentive stock options to non-employee directors. The Company may grant up to 145,745 option shares. The options vest 20% per year and become exercisable upon the participant's completion of five years of service. There were no stock options outstanding at June 30, 2014 and 2013.

The Company purchased shares in the open market to be issued upon exercise of stock options (though there are currently no stock options outstanding). Such shares are reflected at cost as shares held in trust in the accompanying consolidated balance sheets.

NOTE 10. COMMITMENTS AND CONTINGENCIES

Loan Commitments

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit. Such commitments involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amount recognized in the balance sheets. The majority of all commitments to extend credit are variable rate instruments.

The Company's exposure to credit loss is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments as it does for on-balance sheet instruments. A summary of the Company's commitments is as follows:

| | June 30, | |
|------------------------------|---------------------|---------------------|
| | 2014 | 2013 |
| Commitments to extend credit | \$ 4,386,283 | \$ 2,338,210 |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. COMMITMENTS AND CONTINGENCIES (Continued)

Loan Commitments (Continued)

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

Contingencies

In the normal course of business, the Company is involved in various legal proceedings. In the opinion of management, any liability resulting from such proceedings would not have a material adverse effect on the Company's financial statements.

NOTE 11. CONCENTRATIONS OF CREDIT

The Company originates primarily commercial, commercial real estate, residential real estate, and consumer loans to customers in Etowah, Marshall, and Cherokee Counties and the adjoining counties in northeast Alabama. The ability of the majority of the Company's customers to honor their contractual loan obligations is dependent on the economy in these areas.

Sixty percent of the Company's loan portfolio is concentrated in loans secured by real estate, of which a substantial portion is secured by real estate in the Company's primary market area. Accordingly, the ultimate collectibility of the loan portfolio and recovery of the carrying amount of other real estate owned, if any, is susceptible to changes in real estate conditions in the Company's primary market area. The other concentrations of credit by type of loan are set forth in Note 3.

The Company does not extend credit to any single borrower or group of related borrowers on a secured basis in excess of 20% of capital, as defined, or approximately \$2,839,000, or on an unsecured basis in excess of 10% of capital, as defined, or approximately \$1,419,000. However, these limits are waived when the extension of credit is made to a state or political subdivision located within the State of Alabama.

NOTE 12. REGULATORY MATTERS

Dividends paid by the Bank are a principal source of funds available to the Company for payment of dividends to its stockholders and for other needs. Applicable federal and state statutes and regulations impose restrictions on the amounts of dividends that may be declared by the subsidiary bank. The Bank is able to pay dividends during 2014 in the amount of net earnings, as defined by applicable statutory limits, earned during 2014.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12. REGULATORY MATTERS (Continued)

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of its assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets, as defined, and of Tier 1 capital to average assets, as defined. Management believes, as of June 30, 2014, that the Bank met all capital adequacy requirements to which it is subject.

As of June 30, 2014, the most recent notification from the Federal Deposit Insurance Corporation 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 that notification that management believes have changed the Bank's category.

| | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|-----------|--------|-------------------------------|-------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| <i>(Dollars in Thousands)</i> | | | | | | |
| June 30, 2014: | | | | | | |
| Total Capital to Risk Weighted Assets | | | | | | |
| Consolidated | \$ 14,732 | 34.79% | \$ 3,388 | 8.00% | \$ N/A | N/A |
| Southern Bank Company | \$ 14,195 | 33.82% | \$ 3,358 | 8.00% | \$ 4,197 | 10.00% |
| Tier I Capital to Risk Weighted Assets | | | | | | |
| Consolidated | \$ 14,371 | 33.94% | \$ 1,694 | 4.00% | N/A | N/A |
| Southern Bank Company | \$ 13,834 | 32.96% | \$ 1,679 | 4.00% | \$ 2,518 | 6.00% |
| Tier I Capital to Average Assets | | | | | | |
| Consolidated | \$ 14,371 | 15.22% | \$ 3,778 | 4.00% | N/A | N/A |
| Southern Bank Company | \$ 13,834 | 14.71% | \$ 3,763 | 4.00% | \$ 4,703 | 5.00% |
| June 30, 2013: | | | | | | |
| Total Capital to Risk Weighted Assets | | | | | | |
| Consolidated | \$ 15,071 | 40.53% | \$ 2,975 | 8.00% | \$ N/A | N/A |
| Southern Bank Company | \$ 14,507 | 39.42% | \$ 2,944 | 8.00% | \$ 3,681 | 10.00% |
| Tier I Capital to Risk Weighted Assets | | | | | | |
| Consolidated | \$ 14,706 | 39.55% | \$ 1,487 | 4.00% | N/A | N/A |
| Southern Bank Company | \$ 14,142 | 38.42% | \$ 1,472 | 4.00% | \$ 2,208 | 6.00% |
| Tier I Capital to Average Assets | | | | | | |
| Consolidated | \$ 14,706 | 14.85% | \$ 3,961 | 4.00% | N/A | N/A |
| Southern Bank Company | \$ 14,142 | 14.34% | \$ 3,945 | 4.00% | \$ 4,932 | 5.00% |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13. FAIR VALUE OF ASSETS AND LIABILITIES

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the *Fair Value Measurements and Disclosures* topic (FASB ASC 820), the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices.

However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

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

Fair Value Hierarchy

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

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

Level 2 - Valuation is based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

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

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13. FAIR VALUE OF ASSETS AND LIABILITIES (Continued)

Fair Value Hierarchy (Continued)

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

Cash and Cash Equivalents: The carrying value of highly liquid instruments, such as cash on hand and cash equivalents are considered to approximate their fair value.

Securities: Where quoted prices are available in an active market, management classifies the securities within level 1 of the valuation hierarchy. Level 1 securities include highly liquid government bonds and exchange-traded equities.

If quoted market prices are not available, management estimates fair values using pricing models and discounted cash flows that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, and credit spreads. Examples of such instruments, which would generally be classified within level 2 of the valuation hierarchy, include U.S. Government sponsored agency securities and state and municipal securities. Mortgage-backed securities are included in level 2 if observable inputs are available. In certain cases where there is limited activity or less transparency around inputs to the valuation, we classify those securities in level 3.

Federal Home Loan Bank Stock: The carrying amount of restricted equity securities with no readily determinable fair value approximates fair value based on the redemption provisions of the issuers which is cost.

Loans: The carrying amount of variable-rate loans that reprice frequently and have no significant change in credit risk approximates fair value. The fair values of fixed rate loans is estimated based on discounted contractual cash flows using interest rates currently being offered for loans with similar terms to borrowers with similar credit quality. The fair value of impaired loans is based on discounted contractual cash flows or underlying collateral values, where applicable.

Deposits: The fair value of deposits with no stated maturity, such as interest and non-interest demand deposits, NOW accounts, savings accounts, and money market accounts, is, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for certificates of deposit are estimated using a discounted cash flow analysis that applies rates currently offered for certificates of similar remaining maturities.

Other Borrowings: Current market rates for debt with similar terms and remaining maturities are used to estimate fair value of existing debt. Fair value of long-term debt is based on quoted market prices or dealer quotes for the identical liability when traded as an asset in an active market. If a quoted market price is not available, an expected present value technique is used to estimate fair value.

Accrued Interest: The carrying amounts of accrued interest approximate fair value.

Off-Balance Sheet Credit-Related Instruments: Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13. FAIR VALUE OF ASSETS AND LIABILITIES (Continued)

The carrying amount and estimated fair value of the Company's financial instruments were as follows:

| | June 30, | | | |
|---|-------------------------------|---------------|--------------------|---------------|
| | 2014 | | 2013 | |
| | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Financial assets: | <i>(Dollars in Thousands)</i> | | | |
| Cash and cash equivalents | \$ 3,784 | \$ 3,784 | \$ 4,050 | \$ 4,050 |
| Securities available for sale | 53,525 | 53,525 | 62,435 | 62,435 |
| Securities held to maturity | 5 | 5 | 13 | 14 |
| Federal Home Loan Bank stock | 407 | 407 | 454 | 454 |
| Loans receivable, net | 34,904 | 35,188 | 27,452 | 27,630 |
| Accrued interest and dividends receivable | 291 | 291 | 335 | 335 |
| Financial liabilities: | | | | |
| Deposits | 72,064 | 72,867 | 73,158 | 73,319 |
| Other borrowings | 7,156 | 7,142 | 7,313 | 7,301 |
| Accrued interest payable | 9 | 9 | 11 | 11 |

Assets Measured at Fair Value on a Recurring Basis

Following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis and recognized in the accompanying balance sheet, as well as the general classification of such instruments pursuant to the valuation hierarchy.

The following tables present financial assets measured at fair value on a recurring basis:

| | Assets Measured at Fair Value | Fair Value Measurements Using | | |
|-----------------------------------|-------------------------------------|--|---|--|
| | | Quoted Prices In Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| At June 30, 2014: | | | | |
| U.S. Government agency securities | \$ 10,094,594 | \$ - | \$ 10,094,594 | \$ - |
| Mortgage-backed securities | 41,874,727 | - | 41,874,727 | - |
| Other | 1,555,720 | - | 1,555,720 | - |
| | \$ 53,525,041 | \$ - | \$ 53,525,041 | \$ - |
| At June 30, 2013: | | | | |
| U.S. Government agency securities | \$ 8,237,065 | \$ - | \$ 8,237,065 | \$ - |
| Mortgage-backed securities | 50,601,406 | - | 50,601,406 | - |
| Other | 3,596,691 | - | 3,596,691 | - |
| | \$ 62,435,162 | \$ - | \$ 62,435,162 | \$ - |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13. FAIR VALUE OF ASSETS AND LIABILITIES (Continued)

Assets Measured at Fair Value on a Nonrecurring Basis

Under certain circumstances management makes adjustments to fair value for assets and liabilities although they are not measured at fair value on an ongoing basis. The following tables present the financial instruments carried on the consolidated balance sheet by caption and by level in the fair value hierarchy at June 30, 2014 and 2013, for which a nonrecurring change in fair value has been recorded:

| Carrying Value at June 30, 2014 | | | | |
|---------------------------------|------------------|--|---|--|
| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Impaired loans | <u>\$ 85,764</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 85,764</u> |
| Carrying Value at June 30, 2013 | | | | |
| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Impaired loans | <u>\$ 91,025</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 91,025</u> |

Impaired Loans

Impaired loans, which are generally measured for impairment using the fair value of collateral, had a carrying amount of \$141,131 and \$160,335 with a specific valuation allowance of \$55,367 and \$69,310 at June 30, 2014 and 2013, respectively. Of the \$141,131 and \$160,335 impaired loan portfolio, \$141,131 and \$160,335 was carried at fair value as a result of charge-offs and/or specific valuation allowance at June 30, 2014 and 2013, respectively. Charge-offs and changes in specific valuation allowances during 2014 and 2013 on impaired loans carried at fair value resulted in no additional provision for loan losses.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14. PARENT COMPANY FINANCIAL INFORMATION

The following information presents the condensed balance sheets of The Southern Banc Company, Inc. as of June 30, 2014 and 2013, and the condensed statements of operations and cash flows for the years then ended:

CONDENSED BALANCE SHEETS

| | 2014 | 2013 |
|---|-------------------------------|------------------|
| | <i>(Dollars in Thousands)</i> | |
| Assets | | |
| Cash and cash equivalents | \$ 161 | \$ 168 |
| Investment in subsidiary | 14,168 | 14,380 |
| Other assets | 376 | 380 |
| Total assets | \$ 14,705 | \$ 14,928 |
| Liabilities and stockholders' equity | | |
| Other liabilities | \$ - | \$ 5 |
| Stockholders' equity | | |
| Common stock | 15 | 15 |
| Additional paid-in capital | 13,887 | 13,887 |
| Retained earnings | 9,935 | 10,200 |
| Shares held in trust | (640) | (571) |
| Treasury stock | (8,825) | (8,825) |
| Accumulated other comprehensive income | 333 | 217 |
| Total liabilities and stockholders' equity | \$ 14,705 | \$ 14,928 |

CONDENSED STATEMENTS OF OPERATIONS

| | 2014 | 2013 |
|---|-------------------------------|-----------------|
| | <i>(Dollars in Thousands)</i> | |
| Income | \$ 1 | \$ 9 |
| Expenses | (7) | (9) |
| Loss before income taxes and equity in undistributed loss of subsidiaries | (6) | - |
| Income tax benefit | - | - |
| Loss before equity in undistributed loss of subsidiaries | (6) | - |
| Equity in undistributed loss of subsidiaries | (259) | (302) |
| Net loss | \$ (265) | \$ (302) |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 15. PARENT COMPANY FINANCIAL INFORMATION (Continued)

CONDENSED STATEMENTS OF CASH FLOWS

| | 2014 | 2013 |
|---|-------------------------------|---------------|
| | <i>(Dollars in Thousands)</i> | |
| OPERATING ACTIVITIES | | |
| Net loss | \$ (265) | \$ (302) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Equity in undistributed loss of subsidiaries | 259 | 302 |
| Other operating activities, net | (1) | (7) |
| Net cash used in operating activities | (7) | (7) |
| Decrease in cash and cash equivalents | (7) | (7) |
| Cash and cash equivalents at beginning of year | 168 | 175 |
| Cash and cash equivalents at end of year | \$ 161 | \$ 168 |

CORPORATE INFORMATION

Directors and Executive Officers of the Company:

Gates Little
Chairman of the Board, President and Chief
Executive Officer of the Company

Thomas F. Dowling, III
Retired

F. Michael Haney
Inzer, Haney, McWhorter and Haney, LLC
Partner and Shareholder

James B. Little, III
New Capital Partners, LLC
Founder and Partner

Thomas Alan Ritchie, Jr.
RMI, Inc.
President

John E. Bell, III
FireRock Products, LLC
Chief Executive Officer

Executive Officers of the Bank:

Gates Little
Chairman of the Board, President and Chief
Executive Officer of the Bank

Peggy Smith
Secretary-Treasurer of the Company and of the
Bank

Teresa Elkins
Vice President of the Bank

Main Office:

221 S. 6th Street
Gadsden, Alabama

Branch Offices:

625 East Main Street
Albertville, Alabama

2204 Henry Street
Guntersville, Alabama

390 W. Main Street
Centre, Alabama

Independent Registered Public Accountants:

Mauldin & Jenkins, LLC
Birmingham, Alabama

General Counsel:

Inzer, Haney & McWhorter, P.A.
Gadsden, Alabama

Securities and Regulatory Counsel:

Jones Walker LLP
Washington, D.C.

Annual Stockholders Meeting:

November 19, 2014 - 5:00 p.m.
The Southern Bank Company
221 S. 6th Street
Gadsden, Alabama
Record Date – September 26, 2014

THE SOUTHERN BANC COMPANY, INC.

221 SOUTH 6TH STREET • GADSDEN, ALABAMA 35901 • (256) 543-3860

Stock Code#
002CSN3F5A