

TRI COUNTY FINANCIAL CORP /MD/  
Form 10-Q  
August 03, 2012

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

**(Mark One)**

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

For the Quarterly Period Ended June 30, 2012

OR

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

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

Commission File Number 0-18279

**Tri-County Financial Corporation**

(Exact name of registrant as specified in its charter)

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Maryland  
(State of other jurisdiction of  
incorporation or organization)

52-1652138  
(I.R.S.  
Employer  
Identification  
No.)

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

20601  
(Zip Code)

(301) 645-5601

(Registrant's telephone number, including area code)

Not applicable

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

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

Yes  No

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

Yes  No

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

Large Accelerated Filer  Accelerated Filer   
Non-accelerated Filer  Smaller Reporting Company   
(Do not check if a smaller reporting company)

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

Yes  No

As of July 31, 2012, the registrant had 3,035,999 shares of common stock outstanding.

**TRI-COUNTY FINANCIAL CORPORATION**

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**PART I FINANCIAL STATEMENTS****TRI-COUNTY FINANCIAL CORPORATION**

## ITEM I. FINANCIAL STATEMENTS

## TRI-COUNTY FINANCIAL CORPORATION

## CONSOLIDATED BALANCE SHEETS JUNE 30, 2012 AND DECEMBER 31, 2011

|  | June 30, 2012<br>(Unaudited) | December 31,<br>2011 |
|--|------------------------------|----------------------|
| <b>Assets</b>  |                              |                      |
| Cash and due from banks  | \$ 11,235,647                | \$ 13,074,091        |
| Federal funds sold   | 385,000                      | 5,040,000            |
| Interest-bearing deposits with banks   | 398,017                      | 1,004,098            |
| Securities available for sale (AFS), at fair value   | 40,665,026                   | 41,827,612           |
| Securities held to maturity (HTM), at amortized cost   | 126,915,558                  | 153,516,839          |
| Federal Home Loan Bank and Federal Reserve Bank stock - at cost  | 5,780,450                    | 5,587,000            |
| Loans receivable - net of allowance for loan losses of \$7,464,137 and \$7,655,041                               | 734,414,892                  | 710,088,775          |
| Premises and equipment, net  | 19,322,261                   | 16,440,902           |
| Foreclosed real estate (OREO)  | 5,562,158                    | 5,028,513            |
| Accrued interest receivable  | 3,079,092                    | 3,027,784            |
| Investment in bank owned life insurance  | 18,417,201                   | 18,098,085           |
| Other assets   | 9,699,419                    | 10,746,024           |
| <b>Total Assets</b>  | <b>\$975,874,721</b>         | <b>\$983,479,723</b> |
| <b>Liabilities and Stockholders' Equity</b>  |                              |                      |
| <b>Liabilities</b>   |                              |                      |
| <b>Deposits</b>  |                              |                      |
| Non-interest-bearing deposits  | \$84,661,470                 | \$81,097,622         |
| Interest-bearing deposits  | 731,112,854                  | 746,155,579          |
| <b>Total deposits</b>  | <b>815,774,324</b>           | <b>827,253,201</b>   |
| Short-term borrowings  | 3,000,000                    | -                    |
| Long-term debt   | 60,552,148                   | 60,576,595           |
| Guaranteed preferred beneficial interest in junior subordinated debentures                                       | 12,000,000                   | 12,000,000           |
| Accrued expenses and other liabilities   | 8,186,305                    | 8,195,829            |
| <b>Total Liabilities</b>   | <b>899,512,777</b>           | <b>908,025,625</b>   |
| <b>Stockholders' Equity</b>  |                              |                      |
| Preferred Stock, Senior Non-Cumulative Perpetual, Series C - par value \$1,000; authorized 20,000; issued 20,000 | 20,000,000                   | 20,000,000           |

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|  |               |               |
|--|---------------|---------------|
| Common stock - par value \$.01; authorized - 15,000,000 shares; issued<br>3,048,084 and 3,026,557 shares, respectively | 30,481        | 30,266        |
| Additional paid in capital   | 17,733,436    | 17,367,403    |
| Retained earnings  | 39,283,317    | 38,712,194    |
| Accumulated other comprehensive gain   | 297,350       | 289,599       |
| Unearned ESOP shares   | (982,640 )    | (945,364 )    |
| Total Stockholders' Equity   | 76,361,944    | 75,454,098    |
| Total Liabilities and Stockholders' Equity   | \$975,874,721 | \$983,479,723 |

See notes to consolidated financial statements

TRI-COUNTY FINANCIAL CORPORATION  
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (UNAUDITED)  
THREE AND SIX MONTHS ENDED JUNE 30, 2012 AND 2011

|   | Three Months Ended June 30, |             | Six Months Ended June 30, |              |
|---|-----------------------------|-------------|---------------------------|--------------|
|   | 2012                        | 2011        | 2012                      | 2011         |
| Interest and Dividend Income                            |                             |             |                           |              |
| Loans, including fees                                   | \$9,286,377                 | \$9,012,635 | \$18,511,260              | \$17,873,206 |
| Taxable interest and dividends on investment securities | 815,101                     | 889,515     | 1,696,918                 | 1,859,352    |
| Interest on deposits with banks                         | 1,064                       | 2,282       | 2,748                     | 3,664        |
| Total Interest and Dividend Income                      | 10,102,542                  | 9,904,432   | 20,210,926                | 19,736,222   |
| Interest Expenses                                       |                             |             |                           |              |
| Deposits  | 2,197,377                   | 2,595,961   | 4,609,719                 | 5,204,481    |
| Short-term borrowings                                   | 15,910                      | 10,022      | 31,751                    | 24,455       |
| Long-term debt  | 552,054                     | 562,446     | 1,147,556                 | 1,161,810    |
| Total Interest Expenses                                 | 2,765,341                   | 3,168,429   | 5,789,026                 | 6,390,746    |
| Net Interest Income                                     | 7,337,201                   | 6,736,003   | 14,421,900                | 13,345,476   |
| Provision for loan losses                               | 436,431                     | 890,861     | 777,505                   | 2,896,691    |
| Net Interest Income After Provision For Loan Losses     | 6,900,770                   | 5,845,142   | 13,644,395                | 10,448,785   |
| Noninterest Income                                      |                             |             |                           |              |
| Loan appraisal, credit, and miscellaneous charges       | 202,127                     | 193,633     | 383,441                   | 351,731      |
| Net losses on sale of OREO                              | -                           | -           | (96,917)                  | -            |
| Income from bank owned life insurance                   | 159,911                     | 164,509     | 319,117                   | 324,204      |
| Service charges   | 465,391                     | 539,874     | 1,001,903                 | 966,833      |
| Gain on sale of loans held for sale                     | 69,366                      | 54,583      | 135,341                   | 80,158       |
| Total Noninterest Income                                | 896,795                     | 952,599     | 1,742,885                 | 1,722,926    |
| Noninterest Expense                                     |                             |             |                           |              |
| Salary and employee benefits                            | 3,170,213                   | 2,675,393   | 6,490,079                 | 5,426,867    |
| Occupancy expense                                       | 464,319                     | 467,581     | 901,791                   | 884,972      |
| Advertising   | 179,083                     | 115,341     | 259,091                   | 234,037      |
| Data processing expense                                 | 421,153                     | 288,356     | 789,593                   | 571,109      |
| Professional fees                                       | 343,295                     | 233,153     | 568,504                   | 450,241      |
| Depreciation of furniture, fixtures, and equipment      | 162,364                     | 102,663     | 297,289                   | 202,192      |
| Telephone communications                                | 48,312                      | 44,207      | 92,086                    | 86,231       |
| Office supplies   | 71,928                      | 37,109      | 133,990                   | 75,900       |
| FDIC Insurance  | 447,587                     | 330,022     | 891,202                   | 656,341      |
| Valuation allowance on OREO                             | 326,176                     | -           | 626,176                   | 315,883      |
| Other   | 729,256                     | 629,473     | 1,211,304                 | 1,130,749    |
| Total Noninterest Expense                               | 6,363,686                   | 4,923,298   | 12,261,105                | 10,034,522   |



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|  |           |             |             |             |
|--|-----------|-------------|-------------|-------------|
| Income before income taxes                         | 1,433,879 | 1,874,443   | 3,126,175   | 2,137,189   |
| Income tax expense                                 | 492,727   | 654,648     | 1,079,770   | 675,896     |
| Net Income   | \$941,152 | \$1,219,795 | \$2,046,405 | \$1,461,293 |
| Preferred stock dividends                          | 50,000    | 211,732     | 100,000     | 423,465     |
| Net Income Available to Common Shareholders        | \$891,152 | \$1,008,063 | \$1,946,405 | \$1,037,828 |
| Net Income   | \$941,152 | \$1,219,795 | \$2,046,405 | \$1,461,293 |
| Other comprehensive income net of tax:             |           |             |             |             |
| Net unrealized holding gains arising during period | 49,657    | 130,007     | 7,751       | 32,557      |
| Comprehensive income                               | \$990,809 | \$1,349,802 | \$2,054,156 | \$1,493,850 |
| Per Common Share                                   |           |             |             |             |
| Basic earnings                                     | \$0.29    | \$0.33      | \$0.64      | \$0.34      |
| Diluted earnings                                   | \$0.29    | \$0.33      | \$0.64      | \$0.34      |
| Cash dividends paid                                | \$0.40    | \$0.40      | \$0.40      | \$0.40      |

See notes to consolidated financial statements

TRI-COUNTY FINANCIAL CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)  
SIX MONTHS ENDED JUNE 30, 2012 AND 2011

|   | Six Months Ended |               |
|---|------------------|---------------|
|   | June 30,<br>2012 | 2011          |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                  |               |
| Net income  | \$2,046,405      | \$1,461,293   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                  |               |
| Provision for loan losses   | 777,505          | 2,896,691     |
| Depreciation and amortization   | 521,935          | 434,471       |
| Loans originated for resale   | (3,292,600 )     | (2,992,200 )  |
| Proceeds from sale of loans originated for sale                                   | 3,402,426        | 3,051,520     |
| Gain on sale of loans held for sale   | (135,341 )       | (80,158 )     |
| Net loss on the sale of OREO  | 96,917           | -             |
| Net amortization of premium/discount on investment securities                     | 204,597          | 85,186        |
| Increase in OREO valuation allowance  | 626,176          | 315,883       |
| Increase in cash surrender of bank owned life insurance                           | (319,116 )       | (324,204 )    |
| Deferred income tax benefit   | (345,542 )       | 259,178       |
| Increase in accrued interest receivable   | (51,308 )        | (228,474 )    |
| Stock based compensation  | 263,612          | 245,294       |
| Decrease in deferred loan fees  | (11,099 )        | (456,619 )    |
| Decrease in accounts payable, accrued expenses, other liabilities                 | (9,524 )         | (370,871 )    |
| Decrease (Increase) in other assets   | 1,388,154        | (2,349,931 )  |
| Net cash provided by operating activities   | 5,163,197        | 1,947,059     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                  |               |
| Purchase of AFS investment securities   | (10,077,772 )    | (60,648 )     |
| Proceeds from sale, redemption or principal payments of AFS investment securities | 11,252,526       | 5,758,869     |
| Purchase of HTM investment securities   | (849,785 )       | (99,951 )     |
| Proceeds from maturities or principal payments of HTM investment securities       | 27,246,045       | 20,195,654    |
| Net (increase) decrease of FHLB and Federal Reserve stock                         | (193,450 )       | 357,800       |
| Loans originated or acquired  | (125,552,773)    | (142,803,152) |
| Principal collected on loans  | 98,929,725       | 102,193,367   |
| Purchase of premises and equipment  | (3,403,294 )     | (1,796,266 )  |
| Proceeds from sale of OREO  | 299,302          | -             |
| Net cash used in investing activities   | (2,349,476 )     | (16,254,327 ) |

TRI-COUNTY FINANCIAL CORPORATION  
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)  
SIX MONTHS ENDED JUNE 30, 2012 AND 2011 (continued)

|   | Six Months Ended<br>June 30, |                     |
|---|------------------------------|---------------------|
|   | 2012                         | 2011                |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>              |                              |                     |
| Net (decrease) increase in deposits                       | \$(11,478,877)               | \$29,349,504        |
| Payments of long-term borrowings                          | (24,447 )                    | (10,023,487)        |
| Net increase in short term borrowings                     | 3,000,000                    | 1,044,127           |
| Exercise of stock options                                 | 67,391                       | 58,284              |
| Dividends Paid  | (1,321,571 )                 | (1,633,321 )        |
| Net change in unearned ESOP shares                        | (1,942 )                     | (100,061 )          |
| Redemption of common stock                                | (153,800 )                   | (224,625 )          |
| Net cash (used in) provided by financing activities       | (9,913,246 )                 | 18,470,421          |
| <b>(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>   | <b>\$(7,099,525 )</b>        | <b>\$4,163,153</b>  |
| <b>CASH AND CASH EQUIVALENTS - JANUARY 1</b>              | <b>19,118,189</b>            | <b>9,823,436</b>    |
| <b>CASH AND CASH EQUIVALENTS - JUNE 30</b>                | <b>\$12,018,664</b>          | <b>\$13,986,589</b> |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b> |                              |                     |
| Cash paid during the six months for:                      |                              |                     |
| Interest  | \$5,797,788                  | \$6,516,129         |
| Income taxes  | \$1,020,000                  | \$929,500           |
| Transfer from loans to foreclosed real estate             | \$1,555,770                  | \$6,230,707         |
| Issuance of common stock for payment of compensation      | \$263,612                    | \$245,294           |

See notes to consolidated financial statements

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

**SIX MONTHS ENDED JUNE 30, 2012 AND 2011**

**1. BASIS OF PRESENTATION**

*General* - The consolidated financial statements of Tri-County Financial Corporation (the “Company”) and its wholly owned subsidiary, Community Bank of Tri-County (the “Bank”), and the Bank’s wholly owned subsidiary, Community Mortgage Corporation of Tri-County, included herein are unaudited. However, they reflect all adjustments consisting only of normal recurring accruals that, in the opinion of management, are necessary to present fairly the Company’s financial condition, results of operations, and cash flows for the periods presented. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. The Company believes that the disclosures are adequate to make the information presented not misleading. The balances as of December 31, 2011 have been derived from audited financial statements. There have been no significant changes to the Company’s accounting policies as disclosed in the 2011 Annual Report. The results of operations for the three and six months ended June 30, 2012 are not necessarily indicative of the results of operations to be expected for the remainder of the year or any other period. Certain previously reported amounts have been restated to conform to the 2012 presentation.

These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company’s 2011 Annual Report.

**2. NATURE OF BUSINESS**

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

**3. FAIR VALUE MEASUREMENTS**

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

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

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

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

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

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

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

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

There were no transfers between levels of the fair value hierarchy and the Company had no Level 3 fair value assets or liabilities for the six months ended June 30, 2012 and the year ended December 31, 2011, respectively. The following is a description of valuation methodologies used for assets and liabilities recorded at fair value:

### ***Securities Available for Sale***

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

### ***Loans Receivable***

The Company does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. Management estimates the fair value of impaired loans using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At December 31, 2011, substantially all of the impaired loans were evaluated based upon the fair value of the collateral. In accordance with FASB ASC 820, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the loan as nonrecurring Level 3.

### ***Loans Held for Sale***

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

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

***Foreclosed Real Estate (OREO)***

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

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

The tables below present the recorded amount of assets as of June 30, 2012 and December 31, 2011 measured at fair value on a recurring basis.

| Description of Asset                   | June 30, 2012 |   |   |  |
|--|---------------|---|---|--|
|  | Fair Value    | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Available for sale securities          |               |   |   |  |
| Asset-backed securities issued by GSEs |               |   |   |  |
| CMOs                                   | \$34,228,118  | \$ -  | \$34,228,118  | \$ -   |
| MBS                                    | 2,222,160     | -   | 2,222,160   | -  |
| Corporate equity securities            | 37,331        | -   | 37,331  | -  |
| Bond mutual funds                      | 4,177,417     | -   | 4,177,417   | -  |
| Total available for sale securities    | \$40,665,026  | \$ -  | \$40,665,026  | \$ -   |

| Description of Asset                   | December 31, 2011 |   |   |  |
|--|-------------------|---|---|--|
|  | Fair Value        | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Available for sale securities          |                   |   |   |  |
| Asset-backed securities issued by GSEs |                   |   |   |  |
| CMOs                                   | \$35,062,072      | \$ -  | \$35,062,072  | \$ -   |
| MBS                                    | 2,648,043         | -   | 2,648,043   | -  |
| Corporate equity securities            | 37,262            | -   | 37,262  | -  |
| Bond mutual funds                      | 4,080,235         | -   | 4,080,235   | -  |
| Total available for sale securities    | \$41,827,612      | \$ -  | \$41,827,612  | \$ -   |



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

The Company may be required from time to time to measure certain assets at fair value on a nonrecurring basis in accordance with U.S. GAAP. These include assets that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. Assets measured at fair value on a nonrecurring basis as of June 30, 2012 and December 31, 2011 are included in the table below.

| Description of Asset              | June 30, 2012     |   |   |  |
|-----------------------------------|-------------------|---|---|--|
|                                   | Fair Value        | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Loans with impairment             |                   |   |   |  |
| Commercial real estate            | \$ 1,700,643      | \$ -  | \$ 1,700,643  | \$ -   |
| Home equity and second mtg.       | 54,318            | -   | 54,318  | -  |
| Residential first mortgage        | 1,424,853         | -   | 1,424,853   | -  |
| Commercial loans                  | 291,323           | -   | 291,323   | -  |
| Total loans with impairment       | \$ 3,471,137      | \$ -  | \$ 3,471,137  | \$ -   |
| Foreclosed Real Estate            | \$ 5,562,158      | \$ -  | \$ 5,562,158  | \$ -   |
|                                   |                   |   |   |  |
| Description of Asset              | December 31, 2011 |   |   |  |
|                                   | Fair Value        | Quoted<br>Prices in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Loans with impairment             |                   |   |   |  |
| Commercial real estate            | \$ 1,170,467      | \$ -  | \$ 1,170,467  | \$ -   |
| Construction and land development | 1,313,550         | -   | 1,313,550   | -  |
| Residential first mortgage        | 505,206           | -   | 505,206   | -  |
| Commercial loans                  | 5,110,241         | -   | 5,110,241   | -  |
| Total loans with impairment       | \$ 8,099,464      | \$ -  | \$ 8,099,464  | \$ -   |
| Foreclosed Real Estate            | \$ 5,028,513      | \$ -  | \$ 5,028,513  | \$ -   |

Loans with impairment have unpaid principal balances of \$4,989,245 and \$10,096,399 at June 30, 2012 and December 31, 2011, respectively, and include impaired loans with a specific allowance.

**4. INCOME TAXES**

The Company files a consolidated federal income tax return with its subsidiaries. Deferred tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws. It is the Company's policy to recognize accrued interest and penalties related to unrecognized tax benefits as a component of tax expense.

**5. EARNINGS PER COMMON SHARE**

Basic earnings per common share are computed by dividing net income less dividends on preferred shares, by the weighted average number of common shares outstanding during the period. Diluted earnings per share are computed by dividing net income less dividends on preferred shares, by the weighted average number of common shares outstanding during the period, including any potential dilutive common shares outstanding, such as options and warrants. As of June 30, 2012 and 2011, there were 101,549 and 102,524 shares, respectively, excluded from the diluted net income per share computation because the exercise price of the stock options were greater than the market price, and thus were anti-dilutive. Basic and diluted earnings per share have been computed based on weighted-average common and common equivalent shares outstanding as follows:

|   | Three Months Ended |             | Six Months Ended |             |
|---|--------------------|-------------|------------------|-------------|
|   | June 30,<br>2012   | 2011        | June 30,<br>2012 | 2011        |
| Net Income  | \$941,152          | \$1,219,795 | \$2,046,405      | \$1,461,293 |
| Less: Dividends payable on preferred stock                            | (50,000 )          | (211,732 )  | (100,000 )       | (423,465 )  |
| Net income available to common shareholders                           | \$891,152          | \$1,008,063 | \$1,946,405      | \$1,037,828 |
| Average number of common shares outstanding                           | 3,045,979          | 3,024,625   | 3,041,679        | 3,017,112   |
| Effect of dilutive options  | 24,786             | 31,830      | 14,841           | 37,489      |
| Average number of shares used to calculate diluted earnings per share | 3,070,765          | 3,056,455   | 3,056,520        | 3,054,601   |

## 6. STOCK-BASED COMPENSATION

The Company has stock option and incentive arrangements to attract and retain key personnel. In May 2005, the 2005 Equity Compensation Plan (the "Plan") was approved by the shareholders, which authorizes the issuance of restricted stock, stock appreciation rights, stock units and stock options to the Board of Directors and key employees.

Compensation expense for service based awards is recognized over the vesting period. Performance based awards are recognized based on a vesting, if applicable, and the probability of achieving the goals.

Stock-based compensation expense totaled \$81,189 and \$93,810 for the six months ended June 30, 2012 and 2011, respectively, which consisted of grants of restricted stock and restricted stock units. Stock-based compensation included director compensation for stock granted in lieu of cash compensation. All outstanding options were fully vested at December 31, 2011. The Company has not granted any stock options since 2007.

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

The exercise price for options is set at the discretion of the committee administering the Plan, but is not less than the market value of the shares as of the date of grant. An option's maximum term is 10 years and the options vest at the discretion of the committee. The following tables below summarize outstanding and exercisable options at June 30, 2012 and December 31, 2011.

| Weighted<br>Average<br>Exercise | Aggregate<br>Intrinsic | Weighted-Average<br>Contractual Life<br>Remaining In |
|---------------------------------|------------------------|--|
|---------------------------------|------------------------|--|

|                                | Shares   | Price    | Value      | Years |
|--------------------------------|----------|----------|------------|-------|
| Outstanding at January 1, 2012 | 264,156  | \$ 17.90 | \$ 175,911 |       |
| Granted at fair value          | -        | -        |            |       |
| Exercised                      | (5,799 ) | 12.63    | 9,570      |       |
| Expired                        | -        |          |            |       |
| Forfeited                      | (2,044 ) | 19.73    |            |       |
| Outstanding at June 30, 2012   | 256,313  | \$ 18.00 | \$ 302,545 | 1.4   |
| Exercisable at June 30, 2012   | 256,313  | \$ 18.00 | \$ 302,545 | 1.4   |

|                                  | Shares    | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value | Weighted-Average<br>Contractual Life<br>Remaining In<br>Years |
|----------------------------------|-----------|--|---------------------------------|---|
| Outstanding at January 1, 2011   | 299,237   | \$ 16.86                                 | \$ 524,392                      |   |
| Granted at fair value            | -         | -  |                                 |   |
| Exercised                        | (33,163 ) | 8.75                                     | 286,061                         |   |
| Expired                          | (338 )    | 8.44                                     |                                 |   |
| Forfeited                        | (1,580 )  | 15.00                                    |                                 |   |
| Outstanding at December 31, 2011 | 264,156   | \$ 17.90                                 | \$ 175,911                      | 1.7   |
| Exercisable at December 31, 2011 | 264,156   | \$ 17.90                                 | \$ 175,911                      | 1.7   |

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

| Number Outstanding<br>June 30, 2012 | Weighted Average<br>Remaining Contractual Life | Weighted Average<br>Exercise Price |
|-------------------------------------|--|------------------------------------|
| 14,848                              | 1 years  | \$ 11.56                           |
| 54,098                              | 2 years  | 12.95                              |
| 85,817                              | 3 years  | 15.89                              |
| 80,138                              | 4 years  | 22.29                              |
| 21,411                              | 6 years  | 27.70                              |
| 256,313                             |  | 18.00                              |

The aggregate intrinsic value of outstanding stock options and exercisable stock options was \$302,545 and \$175,911 at June 30, 2012 and December 31, 2011, respectively. Aggregate intrinsic value represents the difference between the Company's closing stock price on the last trading day of the period, which was \$16.40 and \$15.00 at June 30, 2012 and December 31, 2011, respectively, and the exercise price multiplied by the number of options outstanding.

The Company has outstanding restricted stock and stock units granted in accordance with the Plan. The following tables below summarize the unvested restricted stock awards and units outstanding at June 30, 2012 and December 31, 2011.

|                  |                           |
|------------------|---------------------------|
| Restricted Stock | Restricted Stock<br>Units |
|------------------|---------------------------|

|                            | Number<br>of<br>Shares | Weighted<br>Average<br>Grant<br>Date Fair<br>Value | Number<br>of<br>Units | Fair<br>Value |
|----------------------------|------------------------|--|-----------------------|---------------|
| Nonvested at January, 2012 | 8,113                  | \$ 16.47   | 6,845                 | \$15.00       |
| Granted                    | 15,473                 | 15.09  | 2,105                 | 16.40         |
| Vested                     | (5,158 )               | 15.09  | (3,739)               | 14.80         |
| Nonvested at June 30, 2012 | 18,428                 | \$ 15.70   | 5,211                 | \$16.40       |

|                                | Restricted Stock |  | Restricted Stock Units |            |
|--------------------------------|------------------|--|------------------------|------------|
|                                | Number of Shares | Weighted Average Grant Date Fair Value | Number of Units        | Fair Value |
| Nonvested at January 1, 2011   | 2,720            | \$ 11.90                               | 3,739                  | \$15.00    |
| Granted                        | 12,934           | 16.49                                  | 3,106                  | 15.00      |
| Vested                         | (7,541 )         | 14.86                                  | -                      | -          |
| Nonvested at December 31, 2011 | 8,113            | \$ 16.47                               | 6,845                  | \$15.00    |

## 7. GUARANTEED PREFERRED BENEFICIAL INTEREST IN JUNIOR SUBORDINATED DEBENTURES

On June 15, 2005, Tri-County Capital Trust II (“Capital Trust II”), a Delaware business trust formed, funded and wholly owned by the Company, issued \$5,000,000 of variable-rate capital securities in a private pooled transaction. The variable rate is based on the 90-day LIBOR rate plus 1.70%. The Trust used the proceeds from this issuance, along with the \$155,000 for Capital Trust II’s common securities, to purchase \$5,155,000 of the Company’s junior subordinated debentures. The interest rate on the debentures and the trust preferred securities is variable and adjusts quarterly. These capital securities qualify as Tier I capital and are presented in the Consolidated Balance Sheets as “Guaranteed Preferred Beneficial Interests in Junior Subordinated Debentures.” Both the capital securities of Capital Trust II and the junior subordinated debentures are scheduled to mature on June 15, 2035, unless called by the Company.

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

## 8. PREFERRED STOCK

### *Small Business Lending Fund Preferred Stock*

On September 22, 2011, the Company entered into a Securities Purchase Agreement (the “Purchase Agreement”) with the Secretary of the Treasury (the “Secretary”), pursuant to which the Company issued 20,000 shares of the Company’s Senior Non-Cumulative Perpetual Preferred Stock, Series C (the “Series C Preferred Stock”), having a liquidation amount per share equal to \$1,000, for a total purchase price of \$20,000,000. The Purchase Agreement was entered

into, and the Series C Preferred Stock was issued, as authorized by the Small Business Lending Fund program.

The Series C Preferred Stock is entitled to receive non-cumulative dividends, payable quarterly. The dividend rate, as a percentage of the liquidation amount, can fluctuate on a quarterly basis during the first 10 quarters during which the Series C Preferred Stock is outstanding, based upon changes in the level of “Qualified Small Business Lending” or “QSBL” (as defined in the Purchase Agreement) by the Bank. Based upon the increase in the Bank’s level of QSBL over the baseline level calculated under the terms of the Purchase Agreement, the dividend rate for the initial dividend period has been set at one percent (1%). For the second through ninth calendar quarters, the dividend rate may be adjusted to between one percent (1%) and five percent (5%) per annum, to reflect the amount of change in the Bank’s level of QSBL. If the level of the Bank’s qualified small business loans declines so that the percentage increase in QSBL as compared to the baseline level is less than 10%, then the dividend rate payable on the Series C Preferred Stock would increase. For the tenth calendar quarter through four and one half years after issuance, the dividend rate will be fixed at between one percent (1%) and seven percent (7%) based upon the increase in QSBL as compared to the baseline. After four and one half years from issuance, the dividend rate will increase to nine percent (9%). In addition, beginning on January 1, 2014, and on all Series C Preferred Stock dividend payment dates thereafter ending on April 1, 2016, the Company will be required to pay to the Secretary, on each share of Series C Preferred Stock, but only out of assets legally available, a fee equal to 0.5% of the liquidation amount per share of Series C Preferred Stock.

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



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

*Redemption of Series A and B Preferred Stock - Troubled Asset Relief Program's (TARP) Capital Purchase Program*

On September 22, 2011, the Company entered into a letter agreement (the "Repurchase Letter") with the United States Department of the Treasury (the "Treasury"), in which the Company agreed to redeem, out of the proceeds of the issuance of the Series C Preferred Stock, all 15,540 outstanding shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A, liquidation amount \$1,000 per share (the "Series A Preferred Stock"), for a redemption price of \$15,619,858, including accrued but unpaid dividends to the date of redemption and all 777 outstanding shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series B, liquidation amount \$1,000 per share (the "Series B Preferred Stock"), for a redemption price of \$784,187, including accrued but unpaid dividends to the date of redemption.

The Company issued Series A Preferred Stock and Series B Preferred Stock on December 19, 2008. It was outstanding until redemption of 100% of all Series A Preferred Stock and Series B Preferred Stock on September 22, 2011. The annual dividend rates paid for Series A Preferred Stock and Series B Preferred Stock were 5% and 9%, respectively.

**9. SECURITIES**

|   | June 30, 2012     |             |             |               |
|---|-------------------|-------------|-------------|---------------|
|   | Amortized         | Gross       | Gross       | Estimated     |
|   | Cost              | Unrealized  | Unrealized  | Fair Value    |
|   |                   | Gains       | Losses      |               |
| Securities available for sale (AFS)       |                   |             |             |               |
| Asset-backed securities issued by GSEs    |                   |             |             |               |
| Residential MBS                           | \$2,004,078       | \$218,082   | \$-         | \$2,222,160   |
| Residentail CMOs                          | 34,035,060        | 204,893     | 11,835      | 34,228,118    |
| Corporate equity securities               | 37,310            | 306         | 285         | 37,331        |
| Bond mutual funds                         | 3,893,639         | 283,778     | -           | 4,177,417     |
| Total securities available for sale       | \$39,970,087      | \$707,059   | \$12,120    | \$40,665,026  |
| Securities held to maturity (HTM)         |                   |             |             |               |
| Asset-backed securities issued by GSEs    |                   |             |             |               |
| Residential MBS                           | \$32,870,312      | \$1,233,232 | \$-         | \$34,103,544  |
| Residential CMOs                          | 84,304,790        | 709,054     | 33,639      | 84,980,205    |
| Asset-backed securities issued by Others: |                   |             |             |               |
| Residential MBS                           | -                 | -           | -           | -             |
| Residential CMOs                          | 8,990,484         | 175,927     | 998,052     | 8,168,359     |
| Total debt securities held to maturity    | 126,165,586       | 2,118,213   | 1,031,691   | 127,252,108   |
| U.S. government obligations               | 749,972           | -           | -           | 749,972       |
| Other investments                         | -                 | -           | -           | -             |
| Total securities held to maturity         | \$126,915,558     | \$2,118,213 | \$1,031,691 | \$128,002,080 |
|   |                   |             |             |               |
|   | December 31, 2011 |             |             |               |
|   | Amortized         | Gross       | Gross       | Estimated     |
|   | Cost              | Unrealized  | Unrealized  | Fair Value    |
|   |                   | Gains       | Losses      |               |
| Securities available for sale (AFS)       |                   |             |             |               |
| Asset-backed securities issued by GSEs    |                   |             |             |               |
| Residential MBS                           | \$2,412,959       | \$235,084   | \$-         | \$2,648,043   |
| Residentail CMOs                          | 34,848,180        | 248,508     | 34,616      | 35,062,072    |
| Corporate equity securities               | 37,310            | 241         | 289         | 37,262        |
| Bond mutual funds                         | 3,840,473         | 239,762     | -           | 4,080,235     |
| Total securities available for sale       | \$41,138,922      | \$723,595   | \$34,905    | \$41,827,612  |
| Securities held to maturity (HTM)         |                   |             |             |               |
| Asset-backed securities issued by GSEs    |                   |             |             |               |
| Residential MBS                           | \$35,929,199      | \$854,497   | \$10,960    | \$36,772,736  |
| Residential CMOs                          | 106,998,467       | 1,104,141   | 27,411      | 108,075,197   |
| Asset-backed securities issued by Others  |                   |             |             |               |
|   |                   |             |             | -             |

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|  |                |              |              |                |
|--|----------------|--------------|--------------|----------------|
| Residential CMOs                       | 9,839,222      | 15,364       | 1,421,477    | 8,433,109      |
| Total debt securities held to maturity | 152,766,888    | 1,974,002    | 1,459,848    | 153,281,042    |
| U.S. government obligations            | 749,951        | -            | -            | 749,951        |
| Total securities held to maturity      | \$ 153,516,839 | \$ 1,974,002 | \$ 1,459,848 | \$ 154,030,993 |

At June 30, 2012, certain asset-backed securities with a carrying value of \$8.5 million were pledged to secure certain deposits. At June 30, 2012, asset-backed securities with a carrying value of \$10.5 million were pledged as collateral for advances from the Federal Home Loan Bank of Atlanta.

At June 30, 2012 and December 31, 2011, the AFS and HTM asset-backed securities investment portfolios were \$162,615,864, or 97%, and \$190,477,003, or 98%, respectively, of the Company's total AFS and HTM portfolios.

At June 30, 2012, 95% of the asset-backed securities portfolio was rated AAA by Standard & Poor's or equivalent credit rating from other major rating agency. AFS asset-backed securities issued by GSEs had an average life of 2.92 years and average duration of 2.78 years and are guaranteed by their issuer as to credit risk. HTM asset-backed securities issued by GSEs had an average life of 3.09 years and average duration of 2.92 years and are guaranteed by their issuer as to credit risk.

At December 31, 2011, 96% of the asset-backed securities portfolio was rated AAA by Standard & Poor's or equivalent credit rating from other major rating agency. AFS asset-backed securities issued by GSEs had an average life of 1.65 years and average duration of 1.61 years and are guaranteed by their issuer as to credit risk. HTM asset-backed securities issued by GSEs had an average life of 2.72 years and average duration of 2.57 years and are guaranteed by their issuer as to credit risk.

During the six months ended June 30, 2012 and for the year ended December 31, 2011, there were no sales of available for sale securities or held to maturity securities.

We believe that the securities with unrealized losses will either recover in market value or be paid off as agreed. The Company intends to, and has the ability to, hold these securities to maturity. We believe that the losses are the result of general perceptions of safety and creditworthiness of the entire sector and a general disruption of orderly markets in the asset class. No charges related to other-than-temporary impairment were made during the six months ended June 30, 2012 and the year ended December 31, 2011. During the year ended December 31, 2009, the Company recorded a charge of \$148,000 related to other-than-temporary impairment on a single CMO issue. At June 30, 2012, the CMO issue had a par value of \$999,000, a market fair value of \$768,000 and a carrying value of \$607,000.

Management has the ability and intent to hold the securities with unrealized losses classified as held to maturity until they mature, at which time the Company will receive full value for the securities. Because our intention is not to sell the investments and it is not more likely than not that we will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, management considers the unrealized losses in the held-to-maturity portfolio to be temporary, except for the single CMO issue noted above, for which an other-than-temporary charge was recorded in 2009 in the amount of \$148,000.

### ***AFS Securities***

At June 30, 2012, the AFS investment portfolio had a fair value of \$40,665,026 with unrealized losses from their amortized cost of \$12,120. Asset-backed securities and corporate securities with unrealized losses had a fair value of \$11,019,712 and all unrealized losses were for less than twelve months.

At December 31, 2011, the AFS investment portfolio had a fair value of \$41,827,612 with unrealized losses from their amortized cost of \$34,905. Asset-backed securities and corporate securities with unrealized losses had a fair value of \$18,170,977 and all unrealized losses were for less than twelve months.

### ***HTM Securities***

Gross unrealized losses and estimated fair value by length of time that the individual HTM securities have been in a continuous unrealized loss position at June 30, 2012 were as follows:

| June 30, 2012                           | Less Than 12 Months |                 | More Than 12 Months |                 | Total        |                   |
|---|---------------------|-----------------|---------------------|-----------------|--------------|-------------------|
|   | Fair Value          | Unrealized Loss | Fair Value          | Unrealized Loss | Fair Value   | Unrealized Losses |
| Asset-backed securities issued by GSEs  | \$18,789,945        | \$ 20,457       | \$2,568,623         | \$13,182        | \$21,358,568 | \$33,639          |
| Asset-backed securities issued by other | 134,765             | 2,167           | 6,405,636           | 995,885         | 6,540,401    | 998,052           |
|   | \$18,924,710        | \$ 22,624       | \$8,974,259         | \$1,009,067     | \$27,898,969 | \$1,031,691       |

At June 30, 2012, the HTM investment portfolio had an estimated fair value of \$128,002,080, of which \$27,898,969, or 22% of the securities, had some unrealized losses from their amortized cost. Of these securities, \$21,358,568, or 77%, were mortgage-backed securities issued by GSEs and the remaining \$6,540,401, or 23%, were asset-backed securities issued by others.

HTM securities issued by GSEs are guaranteed by the issuer. Total unrealized losses on the asset-backed securities issued by GSEs were \$33,639, or 0.03%, of the amortized cost of \$117,175,102. HTM asset-backed securities issued by GSEs with unrealized losses had an average life of 1.31 years and an average duration of 1.28 years. We believe that the securities will either recover in market value or be paid off as agreed. The Company intends to, and has the ability to, hold these securities to maturity.

HTM asset-backed securities issued by others are mortgage-backed securities. All of the securities have credit support tranches that absorb losses prior to the tranches which the Company owns. The Company reviews credit support positions on its securities regularly. Total unrealized losses on the asset-backed securities issued by others were \$998,052, or 11.10%, of the amortized cost of \$8,990,484. HTM asset-backed securities issued by others with unrealized losses had an average life of 2.44 years and an average duration of 1.79 years.

Gross unrealized losses and estimated fair value by length of time that the individual HTM securities have been in a continuous unrealized loss position at December 31, 2011 were as follows:

| December 31, 2011                       | Less Than 12 Months |                 | More Than 12 Months |                 | Total        |                   |
|---|---------------------|-----------------|---------------------|-----------------|--------------|-------------------|
|   | Fair Value          | Unrealized Loss | Fair Value          | Unrealized Loss | Fair Value   | Unrealized Losses |
| Asset-backed securities issued by GSEs  | \$30,220,777        | \$ 33,796       | \$2,847,703         | \$4,575         | \$33,068,480 | \$38,371          |
| Asset-backed securities issued by other | 131,301             | 11,507          | 6,632,200           | 1,409,970       | 6,763,501    | 1,421,477         |
|   | \$30,352,078        | \$ 45,303       | \$9,479,903         | \$1,414,545     | \$39,831,981 | \$1,459,848       |

At December 31, 2011, the HTM investment portfolio had an estimated fair value of \$154,030,993, of which \$39,831,981, or 26% of the securities, had some unrealized losses from their amortized cost. Of these securities, \$33,068,480, or 83%, were mortgage-backed securities issued by GSEs and the remaining \$6,763,501, or 17%, were asset-backed securities issued by others.

HTM securities issued by GSEs are guaranteed by the issuer. Total unrealized losses on the asset-backed securities issued by GSEs were \$38,371, or 0.03%, of the amortized cost of \$142,927,666. HTM asset-backed securities issued by GSEs with unrealized losses had an average life of 2.06 years and an average duration of 1.96 years. We believe that the securities will either recover in market value or be paid off as agreed. The Company intends to, and has the ability to, hold these securities to maturity.

HTM asset-backed securities issued by others are mortgage-backed securities. All of the securities have credit support tranches that absorb losses prior to the tranches which the Company owns. The Company reviews credit support positions on its securities regularly. Total unrealized losses on the asset-backed securities issued by others were \$1,421,477, or 14.45%, of the amortized cost of \$9,839,222. HTM asset-backed securities issued by others with unrealized losses had an average life of 2.35 years and an average duration of 1.61 years.

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

The tables below present the Standard & Poor's or equivalent credit rating from other major rating agencies for AFS and HTM asset-backed securities issued by GSEs and others at June 30, 2012 and December 31, 2011 by carrying value. GSE asset-backed securities that were downgraded by Standard and Poor's during 2011 were treated as AAA based on regulatory guidance.

| June 30, 2012 |               | December 31, 2011 |               |
|---------------|---------------|-------------------|---------------|
| Credit Rating | Amount        | Credit Rating     | Amount        |
| AAA           | \$153,953,157 | AAA               | \$181,958,323 |
| A+            | 136,928       | A+                | 142,808       |
| A             | 788,302       | A                 | -             |
| BBB           | 162,882       | BBB               | 1,258,268     |
| BBB-          | 1,234,498     | BBB-              | 1,061,017     |
| BB+           | 1,122,404     | BB+               | 1,240,901     |
| BB            | 517,236       | BB                | 337,998       |
| BB-           | 1,215,199     | BB-               | 615,716       |
| B+            | -             | B+                | 246,345       |
| CCC+          | 3,485,258     | CCC+              | 3,615,627     |
| Total         | \$162,615,864 | Total             | \$190,477,003 |

**10. FORECLOSED REAL ESTATE (OREO)**

Foreclosed assets are presented net of an allowance for losses. An analysis of the activity in foreclosed assets is as follows.

|                                  | Six Months Ended June |              |
|----------------------------------|-----------------------|--------------|
|                                  | 2012                  | 2011         |
| Balance at beginning of year     | \$5,028,513           | \$10,469,302 |
| Additions to underlying property | 1,555,770             | 6,781,857    |
| Disposals of underlying property | (395,949 )            | (6,388,395 ) |
| Valuation allowance              | (626,176 )            | (315,883 )   |
| Balance at end of period         | \$5,562,158           | \$10,546,881 |

During the six months ended June 30, 2012, the Bank disposed of two OREO properties for proceeds of \$299,032 and recognized net losses of \$96,917. Current year OREO additions include two construction and land development projects valued at \$1,038,000 that the Bank utilized the deposit method to account for the sale and transfer of legal title to the borrower. Payments of principal and interest will be recorded as a deposit (liability) until the transaction qualifies for full accrual or installment accounting treatment. As of June 30, 2012, the Bank has received \$109,000 in payments on these projects. OREO carrying amounts reflect management's estimate of the realizable value of these properties incorporating current appraised values, local real estate market conditions and related costs.

Expenses applicable to foreclosed assets include the following.

|                     | Three Months Ended |           | Six Months Ended |           |
|---------------------|--------------------|-----------|------------------|-----------|
|                     | June 30,           | June 30,  | June 30,         | June 30,  |
|                     | 2012               | 2011      | 2012             | 2011      |
| Valuation allowance | \$326,176          | \$-       | \$626,176        | \$315,883 |
| Operating expenses  | 32,546             | 150,582   | 30,845           | 294,450   |
|                     | \$358,722          | \$150,582 | \$657,021        | \$610,333 |

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



**11.****LOANS**

Loans consist of the following:

|                                   | June 30, 2012 | December 31,<br>2011 |
|-----------------------------------|---------------|----------------------|
| Commercial real estate            | \$398,017,392 | \$370,383,885        |
| Residential first mortgages       | 178,459,492   | 164,543,309          |
| Construction and land development | 32,405,839    | 36,744,865           |
| Home equity and second mortgage   | 22,525,909    | 24,138,324           |
| Commercial loans                  | 93,096,685    | 101,968,056          |
| Consumer loans                    | 1,007,453     | 1,000,983            |
| Commercial equipment              | 17,151,518    | 19,760,753           |
|                                   | 742,664,288   | 718,540,175          |
| Less:                             |               |                      |
| Deferred loan fees                | 785,259       | 796,359              |
| Allowance for loan loss           | 7,464,137     | 7,655,041            |
|                                   | 8,249,396     | 8,451,400            |
|                                   | \$734,414,892 | \$710,088,775        |

At June 30, 2012, the Bank's allowance for loan losses totaled \$7,464,137 or 1.01% of loan balances as compared to \$7,655,041 or 1.07% of loan balances at December 31, 2011. Management's determination of the adequacy of the allowance is based on a periodic evaluation of the portfolio with consideration given to the overall loss experience, current economic conditions, size, growth and composition of the loan portfolio, financial condition of the borrowers and other relevant factors that, in management's judgment, warrant recognition in providing an adequate allowance.

At December 31, 2011, gross loans included \$2,356,196 from the sale of two foreclosed real estate properties that the Bank financed during 2011 that did not qualify for full accrual sales treatment under ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition." The Bank utilized the cost recovery method and deferred gain of \$410,268. At June 30, 2012 and December 31, 2011, the deferred gain balance for these transactions was \$410,268.

### ***Risk Characteristics of Portfolio Segments***

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

*Commercial Real Estate*

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

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

*Residential First Mortgages*

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

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

### *Construction and Land Development*

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

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

### *Home Equity and Second Mortgage Loans*

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

### *Commercial Loans*

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

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

*Consumer Loans*

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

*Commercial Equipment Loans*

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

*Allowance for Loan Losses*

The following table details activity in the allowance for loan losses at and for the three and six months ended June 30, 2012 and June 30, 2011, respectively, and the year ended December 31, 2011 and loan receivable balances at June 30, 2012 and June 30, 2011, respectively, and at December 31, 2011. An allocation of the allowance to one category of loans does not prevent the Company's ability to utilize the allowance to absorb losses in a different category. The loan receivables are disaggregated on the basis of the Company's impairment methodology.

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|   | Commercial<br>Real Estate | Residential<br>First<br>Mortgage | Construction<br>and Land<br>Development | Home<br>Equity and<br>Second Mtg. | Commercial<br>Loans | Consumer<br>Loans | Commercial<br>Equipment | Total    |
|---|---------------------------|----------------------------------|---|-----------------------------------|---------------------|-------------------|-------------------------|----------|
| At and For<br>the Three<br>Months<br>Ended June<br>30, 2012 |                           |                                  |   |                                   |                     |                   |                         |          |
| Allowance<br>for loan<br>losses:                            |                           |                                  |   |                                   |                     |                   |                         |          |
| Balance at<br>April 1,                                      | \$3,385,036               | \$644,008                        | \$448,406                               | \$265,138                         | \$2,793,049         | \$18,350          | \$361,811               | \$7,915, |
| Charge-offs   | (85,381 )                 | -                                | -                                       | (41,942 )                         | (649,699 )          | (14 )             | (149,794 )              | (926,8   |
| Recoveries  | -                         | 37,247                           | -                                       | -                                 | 1,491               | -                 | -                       | 38,738   |
| Provisions  | 178,803                   | 220,250                          | 148,448                                 | (10,405 )                         | (176,350 )          | (20 )             | 75,705                  | 436,43   |
| Balance at<br>June 30,                                      | \$3,478,458               | \$901,505                        | \$596,854                               | \$212,791                         | \$1,968,491         | \$18,316          | \$287,722               | \$7,464, |
| At and For<br>the Six<br>Months<br>Ended June<br>30, 2012   |                           |                                  |   |                                   |                     |                   |                         |          |
| Allowance<br>for loan<br>losses:                            |                           |                                  |   |                                   |                     |                   |                         |          |
| Balance at<br>January 1,                                    | \$2,525,199               | \$539,205                        | \$354,385                               | \$143,543                         | \$3,850,294         | \$19,119          | \$223,296               | \$7,655, |
| Charge-offs   | (121,833 )                | -                                | -                                       | (41,942 )                         | (693,048 )          | (999 )            | (149,794 )              | (1,007,  |
| Recoveries  | -                         | 37,247                           | -                                       | -                                 | 1,960               | -                 | -                       | 39,207,  |
| Provisions  | 1,075,092                 | 325,053                          | 242,469                                 | 111,190                           | (1,190,715 )        | 196               | 214,220                 | 777,50   |
| Balance at<br>June 30,                                      | \$3,478,458               | \$901,505                        | \$596,854                               | \$212,791                         | \$1,968,491         | \$18,316          | \$287,722               | \$7,464, |
| Ending<br>balance:<br>individually<br>evaluated             | \$604,063                 | \$247,408                        | \$134,500                               | \$47,200                          | \$484,937           | \$-               | \$-                     | \$1,518, |
| for<br>impairment   |                           |                                  |   |                                   |                     |                   |                         |          |
| Ending<br>balance:<br>collectively<br>evaluated             | \$2,874,395               | \$654,097                        | \$462,354                               | \$165,591                         | \$1,483,554         | \$18,316          | \$287,722               | \$5,946, |
| for<br>impairment   |                           |                                  |   |                                   |                     |                   |                         |          |

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|   | Commercial<br>Real Estate | Residential<br>First<br>Mortgage | Construction<br>and Land<br>Development | Home<br>Equity and<br>Second Mtg. | Commercial<br>Loans | Consumer<br>Loans | Commercial<br>Equipment | Total     |
|---|---------------------------|----------------------------------|---|-----------------------------------|---------------------|-------------------|-------------------------|-----------|
| Loan<br>receivables:  |                           |                                  |   |                                   |                     |                   |                         |           |
| Ending<br>balance   | \$398,017,392             | \$178,459,492                    | \$32,405,839                            | \$22,525,909                      | \$93,096,685        | \$1,007,453       | \$17,151,518            | \$742,660 |
| Ending<br>balance:<br>individually<br>evaluated<br>for<br>impairment                                  | \$38,727,469              | \$6,328,588                      | \$7,812,520                             | \$409,348                         | \$18,536,881        | \$68,192          | \$803,700               | \$72,686  |
| Ending<br>balance:<br>collectively<br>evaluated<br>for<br>impairment                                  | \$359,289,923             | \$172,130,904                    | \$24,593,319                            | \$22,116,561                      | \$74,559,804        | \$939,261         | \$16,347,818            | \$669,974 |
| At and For<br>the Year<br>Ended<br>December<br>31, 2011   |                           |                                  |   |                                   |                     |                   |                         |           |
| Allowance<br>for loan<br>losses:  |                           |                                  |   |                                   |                     |                   |                         |           |
| Balance at<br>January 1,  | \$3,313,983               | \$204,073                        | \$1,266,625                             | \$97,519                          | \$2,552,039         | \$32,209          | \$202,699               | \$7,669   |
| Charge-offs   | (1,249,038 )              | (49,002 )                        | (213,007 )                              | -                                 | (2,441,076 )        | (3,000 )          | (150,005 )              | (4,108)   |
| Recoveries  | -                         | 967                              | -                                       | -                                 | 1,936               | 968               | -                       | 3,871     |
| Provisions  | 460,254                   | 383,167                          | (699,233 )                              | 46,024                            | 3,737,395           | (11,058 )         | 170,602                 | 4,087     |
| Balance at<br>December<br>31,<br>Ending<br>balance:<br>individually<br>evaluated<br>for<br>impairment | \$2,525,199               | \$539,205                        | \$354,385                               | \$143,543                         | \$3,850,294         | \$19,119          | \$223,296               | \$7,655   |
| Ending<br>balance:<br>collectively<br>evaluated   | \$2,102,106               | \$426,205                        | \$254,385                               | \$101,203                         | \$2,531,792         | \$19,119          | \$223,296               | \$5,658   |

|  |               |               |              |              |               |             |              |         |  |
|--|---------------|---------------|--------------|--------------|---------------|-------------|--------------|---------|--|
| for<br>impairment<br>Loan<br>receivables:                            |               |               |              |              |               |             |              |         |  |
| Ending<br>balance  | \$370,383,885 | \$164,543,309 | \$36,744,865 | \$24,138,324 | \$101,968,056 | \$1,000,983 | \$19,760,753 | \$718,5 |  |
| Ending<br>balance:<br>individually<br>evaluated                      | \$31,166,090  | \$5,849,538   | \$9,057,433  | \$492,319    | \$23,896,287  | \$82,036    | \$371,936    | \$70,91 |  |
| for<br>impairment<br>Ending<br>balance:<br>collectively<br>evaluated | \$339,217,795 | \$158,693,771 | \$27,687,432 | \$23,646,005 | \$78,071,769  | \$918,947   | \$19,388,817 | \$647,6 |  |
| for<br>impairment  |               |               |              |              |               |             |              |         |  |

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|  | Commercial<br>Real Estate | Residential<br>First<br>Mortgage | Construction<br>and Land<br>Development | Home<br>Equity and<br>Second Mtg. | Commercial<br>Loans | Consumer<br>Loans | Commercial<br>Equipment | Total       |
|--|---------------------------|----------------------------------|---|-----------------------------------|---------------------|-------------------|-------------------------|-------------|
| At and For<br>the Three<br>Months<br>Ended June<br>30, 2011          |                           |                                  |   |                                   |                     |                   |                         |             |
| Allowance<br>for loan<br>losses:                                     |                           |                                  |   |                                   |                     |                   |                         |             |
| Balance at<br>April 1,   | \$3,375,402               | \$345,935                        | \$970,283                               | \$95,455                          | \$2,312,814         | \$28,453          | \$153,435               | \$7,281,397 |
| Charge-offs  | (265,014 )                | 1                                | 3                                       | -                                 | (809,044 )          | -                 | 1                       | (1,074,107) |
| Recoveries   | -                         | -                                | -                                       | -                                 | -                   | 1,074             | -                       | 1,074       |
| Provisions   | 359,721                   | 13,603                           | (114,354 )                              | 1,077                             | 611,268             | (2,570 )          | 22,116                  | 890,863     |
| Balance at<br>June 30,   | \$3,470,109               | \$359,539                        | \$855,932                               | \$96,532                          | \$2,115,038         | \$26,957          | \$175,552               | \$7,099,153 |
| At and For<br>the Six<br>Months<br>Ended June<br>30, 2011            |                           |                                  |   |                                   |                     |                   |                         |             |
| Allowance<br>for loan<br>losses:                                     |                           |                                  |   |                                   |                     |                   |                         |             |
| Balance at<br>January 1,   | \$3,313,983               | \$204,073                        | \$1,266,625                             | \$97,519                          | \$2,552,039         | \$32,209          | \$202,699               | \$7,669,148 |
| Charge-offs  | (780,064 )                | (49,004 )                        | (213,017 )                              | -                                 | (2,377,194 )        | (1,000 )          | (48,004 )               | (3,468,292) |
| Recoveries   | -                         | -                                | -                                       | -                                 | -                   | 2,104             | -                       | 2,104       |
| Provisions   | 936,190                   | 204,470                          | (197,676 )                              | (987 )                            | 1,940,193           | (6,356 )          | 20,857                  | 2,896,488   |
| Balance at<br>June 30,   | \$3,470,109               | \$359,539                        | \$855,932                               | \$96,532                          | \$2,115,038         | \$26,957          | \$175,552               | \$7,099,153 |
| Ending<br>balance:<br>individually<br>evaluated                      | \$297,488                 | \$-                              | \$-                                     | \$-                               | \$1,068,912         | \$-               | \$27,780                | \$1,394,170 |
| for<br>impairment<br>Ending<br>balance:<br>collectively<br>evaluated | \$3,172,621               | \$359,539                        | \$855,932                               | \$96,532                          | \$1,046,126         | \$26,957          | \$147,772               | \$5,705,483 |
| for<br>impairment  |                           |                                  |   |                                   |                     |                   |                         |             |



|   |               |               |              |              |              |             |              |          |  |
|---|---------------|---------------|--------------|--------------|--------------|-------------|--------------|----------|--|
| Loan receivables:                                     |               |               |              |              |              |             |              |          |  |
| Ending balance  | \$375,502,810 | \$149,807,743 | \$31,937,744 | \$24,133,071 | \$99,908,997 | \$1,123,217 | \$17,412,667 | \$699,82 |  |
| Ending balance: individually evaluated for impairment | \$29,327,021  | \$4,027,547   | \$7,353,446  | \$580,470    | \$21,361,108 | \$147,665   | \$472,981    | \$63,270 |  |
| Ending balance: collectively evaluated for impairment | \$346,175,789 | \$145,780,196 | \$24,584,298 | \$23,552,601 | \$78,547,889 | \$975,552   | \$16,939,686 | \$636,55 |  |

### ***Non-accrual and Past Due Loans***

Loans are reviewed on a regular basis and are placed on non-accrual status when, in the opinion of management, the collection of additional interest is doubtful. The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well secured and in the process of collection. There were no accruing loans 90 days or greater past due at June 30, 2012 and December 31, 2011. Consumer loans are typically charged-off no later than 90 days past due. In all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. Non-accrual loans are evaluated for impairment on a loan by loan basis in accordance with the Company's impairment methodology.

All interest accrued but not collected from loans that are placed on non-accrual or charged-off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured. Non-accrual loans as of June 30, 2012 and December 31, 2011 were as follows:

|                                   | June 30, 2012 |                 | December 31, 2011 |                 |
|-----------------------------------|---------------|-----------------|-------------------|-----------------|
|                                   | Dollars       | Number of Loans | Dollars           | Number of Loans |
| Commercial real estate            | \$1,675,021   | 8               | \$2,866,539       | 11              |
| Residential first mortgages       | 3,430,204     | 9               | 2,438,771         | 7               |
| Construction and land development | 331,888       | 3               | 1,413,550         | 2               |
| Home equity and second mortgage   | 227,296       | 5               | 291,285           | 7               |
| Commercial loans                  | 5,204,771     | 9               | 2,263,916         | 4               |

|                      |              |    |             |    |
|----------------------|--------------|----|-------------|----|
| Consumer loans       | -            | -  | 500         | 1  |
| Commercial equipment | 102,814      | 4  | 236,056     | 3  |
|                      | \$10,971,994 | 38 | \$9,510,617 | 35 |

Non-accrual loans on which the recognition of interest has been discontinued, which did not have a specific allowance for impairment, amounted to \$9,371,381 and \$4,193,893 at June 30, 2012 and December 31, 2011, respectively.

Interest due at stated rates, but not recognized on these balances at June 30, 2012 and December 31, 2011 was \$355,654 and \$172,399, respectively. Non-accrual loans with a specific allowance for impairment on which the recognition of interest has been discontinued amounted to \$1,600,613 and \$5,316,724 at June 30, 2012 and December 31, 2011, respectively. Interest due not recognized on these balances at June 30, 2012 and December 31, 2011 was \$243,664 and \$242,705, respectively.

An analysis of past due loans as of June 30, 2012 and December 31, 2011 were as follows:

| June 30, 2012               | Current       | 31-60<br>Days | 61-89<br>Days | 90 or<br>Greater<br>Days | Total<br>Past Due | Total<br>Loan<br>Receivables |
|-----------------------------|---------------|---------------|---------------|--------------------------|-------------------|------------------------------|
| Commercial real estate      | \$393,504,269 | \$2,838,102   | \$-           | \$1,675,021              | \$4,513,123       | \$398,017,392                |
| Residential first mortgages | 173,820,097   | 1,109,678     | 99,513        | 3,430,204                | 4,639,395         | 178,459,492                  |
| Construction and land dev.  | 32,073,951    | -             | -             | 331,888                  | 331,888           | 32,405,839                   |
| Home equity and second mtg. | 22,110,912    | 87,929        | 99,772        | 227,296                  | 414,997           | 22,525,909                   |
| Commercial loans            | 85,783,837    | 1,467,140     | 640,937       | 5,204,771                | 7,312,848         | 93,096,685                   |
| Consumer loans              | 1,007,262     | 191           | -             | -                        | 191               | 1,007,453                    |
| Commercial equipment        | 16,760,851    | 32,213        | 255,640       | 102,814                  | 390,667           | 17,151,518                   |
| Total                       | \$725,061,179 | \$5,535,253   | \$1,095,862   | \$10,971,994             | \$17,603,109      | \$742,664,288                |

#### December 31, 2011

|                             |               |             |             |             |              |               |
|-----------------------------|---------------|-------------|-------------|-------------|--------------|---------------|
| Commercial real estate      | \$367,415,647 | \$101,699   | \$-         | \$2,866,539 | \$2,968,238  | \$370,383,885 |
| Residential first mortgages | 160,785,337   | 1,319,201   | -           | 2,438,771   | 3,757,972    | 164,543,309   |
| Construction and land dev.  | 35,331,315    | -           | -           | 1,413,550   | 1,413,550    | 36,744,865    |
| Home equity and second mtg. | 23,618,693    | 228,346     | -           | 291,285     | 519,631      | 24,138,324    |
| Commercial loans            | 95,961,076    | 49,781      | 3,693,283   | 2,263,916   | 6,006,980    | 101,968,056   |
| Consumer loans              | 991,838       | 8,645       | -           | 500         | 9,145        | 1,000,983     |
| Commercial equipment        | 19,450,929    | 24,869      | 48,899      | 236,056     | 309,824      | 19,760,753    |
| Total                       | \$703,554,835 | \$1,732,541 | \$3,742,182 | \$9,510,617 | \$14,985,340 | \$718,540,175 |

#### *Credit Quality Indicators*

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

Residential first mortgages, home equity and second mortgages and consumer loans are evaluated for creditworthiness in underwriting and are monitored on an ongoing basis based on borrower payment history. These loans are classified as unrated unless they are part of a larger commercial relationship that requires grading or are troubled debt restructures or nonperforming loans with an Other Assets Especially Mentioned (OAEM) or higher risk rating due to a delinquent payment history. At June 30, 2012 and December 31, 2011, \$4,615,179 and \$5,708,203 of these loans were rated OAEM or higher.

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

Loans subject to risk ratings are graded on a scale of 1 to 10.

*Ratings 1 thru 6 - Pass*

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

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

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

*Rating 8 - Substandard*

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

*Rating 9 - Doubtful*

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

*Rating 10 - Loss*

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

Credit quality indicators as of June 30, 2012 and December 31, 2011 were as follows:

Credit Risk Profile by Internally Assigned Grade

|                 | Commercial Real Estate |               | Construction and Land Dev. |              |
|-----------------|------------------------|---------------|----------------------------|--------------|
|                 | 6/30/2012              | 12/31/2011    | 6/30/2012                  | 12/31/2011   |
| Unrated         | \$13,327,650           | \$1,003,553   | \$150,378                  | \$-          |
| Pass            | 348,635,657            | 338,952,446   | 24,448,778                 | 27,687,432   |
| Special mention | 6,100,480              | -             | -                          | -            |
| Substandard     | 29,903,605             | 30,391,213    | 7,806,683                  | 9,057,433    |
| Doubtful        | 50,000                 | -             | -                          | -            |
| Loss            | -                      | 36,673        | -                          | -            |
| Total           | \$398,017,392          | \$370,383,885 | \$32,405,839               | \$36,744,865 |

|                 | Commercial Loans |               | Commercial Equipment |              |
|-----------------|------------------|---------------|----------------------|--------------|
|                 | 6/30/2012        | 12/31/2011    | 6/30/2012            | 12/31/2011   |
| Unrated         | \$2,635,510      | \$586,124     | \$1,069,660          | \$391,786    |
| Pass            | 71,931,585       | 78,183,487    | 15,380,972           | 19,209,380   |
| Special mention | 538,440          | -             | 695,735              | -            |
| Substandard     | 17,991,150       | 23,198,445    | 5,151                | 159,587      |
| Doubtful        | -                | -             | -                    | -            |
| Loss            | -                | -             | -                    | -            |
| Total           | \$93,096,685     | \$101,968,056 | \$17,151,518         | \$19,760,753 |

Credit Risk Profile Based on Payment Activity

|               | Residential First Mortgages |               | Home Equity and Second Mtg. |              | Consumer Loans |             |
|---------------|-----------------------------|---------------|-----------------------------|--------------|----------------|-------------|
|               | 6/30/2012                   | 12/31/2011    | 6/30/2012                   | 12/31/2011   | 6/30/2012      | 12/31/2011  |
| Performing    | \$175,029,288               | \$162,104,538 | \$22,298,613                | \$23,847,039 | \$1,007,453    | \$1,000,483 |
| Nonperforming | 3,430,204                   | 2,438,771     | 227,296                     | 291,285      | -              | 500         |
| Total         | \$178,459,492               | \$164,543,309 | \$22,525,909                | \$24,138,324 | \$1,007,453    | \$1,000,983 |

*Impaired Loans and Troubled Debt Restructures (TDRs)*

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's observable market price or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures unless such loans are the subject of a troubled debt restructuring agreement or are risk rated as OAEM or above or are part of a commercial relationship that requires grading.

Interest payments made on impaired loans are applied to principal unless collectability of the principal amount is reasonably assured. Interest recognized on impaired loans is on a cash basis. Impaired loans, including TDRs, at June 30, 2012 and June 30, 2011, respectively, and at December 31, 2011 were as follows:

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| June 30, 2012               | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance | Recorded Investment With Allowance | Total Recorded Investment | Related Allowance | Six Month Average Recorded Investment | Six Month Interest Income Recognized |
|-----------------------------|--------------------------------------|---------------------------------------|------------------------------------|---------------------------|-------------------|---------------------------------------|--------------------------------------|
| Commercial real estate      | \$7,809,718                          | \$5,097,362                           | \$2,304,706                        | \$7,402,068               | \$604,063         | \$7,836,028                           | \$225,935                            |
| Residential first mortgages | 2,579,409                            | 907,147                               | 1,672,261                          | 2,579,409                 | 247,408           | 2,585,146                             | 58,717                               |
| Construction and land dev.  | 1,851,415                            | 1,716,915                             | 134,500                            | 1,851,415                 | 134,500           | 2,189,748                             | 29,988                               |
| Home equity and second mtg. | 101,518                              | -                                     | 101,518                            | 101,518                   | 47,200            | 101,518                               | -                                    |
| Commercial loans            | 2,670,650                            | 1,894,390                             | 776,260                            | 2,670,650                 | 484,937           | 2,664,394                             | 51,967                               |
| Total                       | \$15,012,710                         | \$9,615,814                           | \$4,989,245                        | \$14,605,060              | \$1,518,108       | \$15,376,834                          | \$366,607                            |

| December 31, 2011           | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance | Recorded Investment With Allowance | Total Recorded Investment | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|-----------------------------|--------------------------------------|---------------------------------------|------------------------------------|---------------------------|-------------------|-----------------------------|----------------------------|
| Commercial real estate      | \$8,405,656                          | \$6,404,447                           | \$1,593,560                        | \$7,998,006               | \$423,093         | \$6,880,651                 | \$375,203                  |
| Residential first mortgages | 618,206                              | -                                     | 618,206                            | 618,206                   | 113,000           | 618,835                     | 10,294                     |
| Construction and land dev.  | 3,130,466                            | 1,716,915                             | 1,413,550                          | 3,130,466                 | 100,000           | 3,193,938                   | 84,107                     |
| Home equity and second mtg. | 42,340                               | -                                     | 42,340                             | 42,340                    | 42,340            | 42,340                      | -                          |
| Commercial loans            | 8,798,072                            | 2,369,329                             | 6,428,743                          | 8,798,072                 | 1,318,502         | 9,188,371                   | 314,216                    |
| Commercial equipment        | 129,876                              | 129,876                               | -                                  | 129,876                   | -                 | 147,035                     | 8,905                      |
| Total                       | \$21,124,616                         | \$10,620,567                          | \$10,096,399                       | \$20,716,966              | \$1,996,935       | \$20,071,170                | \$792,725                  |

| June 30, 2011              | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance | Recorded Investment With Allowance | Total Recorded Investment | Related Allowance | Six Month Average Recorded Investment | Six Month Interest Income Recognized |
|----------------------------|--------------------------------------|---------------------------------------|------------------------------------|---------------------------|-------------------|---------------------------------------|--------------------------------------|
| Commercial real estate     | \$11,107,498                         | \$8,446,709                           | \$2,253,139                        | \$10,699,848              | \$297,488         | \$9,131,959                           | \$271,124                            |
| Construction and land dev. | 1,716,915                            | 1,716,915                             | -                                  | 1,716,915                 | -                 | 1,716,915                             | 41,300                               |
| Commercial loans           | 9,157,106                            | 2,652,194                             | 6,504,912                          | 9,157,106                 | 1,068,912         | 10,568,967                            | 201,326                              |
| Commercial equipment       | 234,139                              | 206,358                               | 27,780                             | 234,139                   | 27,780            | 264,955                               | 11,880                               |
| Total                      | \$22,215,658                         | \$13,022,176                          | \$8,785,831                        | \$21,808,008              | \$1,394,180       | \$21,682,796                          | \$525,630                            |



At June 30, 2012 and December 31, 2011, impaired loans totaled \$14,605,060 and \$20,716,966, respectively. Impaired loans had specific allocations within the allowance for loan losses or have been reduced by charge-offs to recoverable values. Allocations of the allowance for loan losses relative to impaired loans at June 30, 2012 and December 31, 2011 were \$1,518,108 and \$1,996,935, respectively.

The Company considers all TDRs to be impaired and defines TDRs as loans whose terms have been modified to provide for a reduction of either interest or principal because of deterioration in the financial condition of the borrower. A loan extended or renewed at a stated interest rate equal to the current interest rate for new debt with similar risk is not considered a TDR. Once an obligation has been classified as a TDR it continues to be considered a TDR until paid in full or until the loan returns to performing status and yields a market interest rate equal to the current interest rate for new debt with similar risk. TDRs are evaluated by management on a regular basis utilizing the Company's risk grading scale and must have a passing loan grade to be removed as a TDR. TDRs are evaluated for impairment on a loan-by-loan basis in accordance with the Company's impairment methodology. The Company does not participate in any specific government or Company-sponsored loan modification programs. All restructured loan agreements are individual contracts negotiated with a borrower.

TDRs, included in the impaired loan schedule above, as of June 30, 2012 and December 31, 2011 were as follows:

|                                   | June 30, 2012 |                       | December 31, 2011 |                       |
|-----------------------------------|---------------|-----------------------|-------------------|-----------------------|
|                                   | Dollars       | Number<br>of<br>Loans | Dollars           | Number<br>of<br>Loans |
| Commercial real estate            | \$5,880,022   | 10                    | \$7,696,921       | 10                    |
| Residential first mortgages       | 907,147       | 2                     | -                 | -                     |
| Construction and land development | 1,716,915     | 1                     | 1,716,915         | 1                     |
| Commercial loans                  | 1,894,390     | 2                     | 2,369,329         | 3                     |
| Commercial equipment              | -             | -                     | 129,876           | 1                     |
|                                   | \$10,398,474  | 15                    | \$11,913,041      | 15                    |

At June 30, 2012, \$10,106,139 or 97.19%, of TDRs were performing according to the terms of their restructured agreements compared to \$11,113,326 or 93.3%, at December 31, 2011. Allocations of the allowance for loan losses relative to TDR impaired loans at June 30, 2012 and December 31, 2011 were \$267,658 and \$300,000, respectively. Interest income in the amount of \$277,360 and \$524,397 was recognized on these loans for the six months ended June 30, 2012 and year ended December 31, 2011, respectively.

During the six months ended June 30, 2012, the Bank modified five commercial real estate loans totaling \$1,327,421 and two residential first mortgages totaling \$907,368.

For the year ended December 31, 2011, TDR loans charged-off or transferred to OREO were \$187,891. TDRs charged-off were for two commercial equipment loans totaling \$76,592 and one TDR was transferred to foreclosed real estate for a commercial loan of \$111,299. For the six months ended June 30, 2012, one commercial real estate relationship consisting of two commercial mortgage TDR loans was charged-off in the amount of \$121,660 with the balance of \$382,500 transferred to OREO.

## 12. NEW ACCOUNTING STANDARDS

Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 820, “Fair Value Measurements and Disclosures” defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. Additional guidance issued Accounting Standards Update 2010-06 (“ASU”) under ASC Topic 820 requires expanded disclosures related to fair value measurements including (1) the amounts of significant transfers of assets or liabilities between Levels 1 and 2 of the fair value hierarchy and the reasons for the transfers, (2) the reasons for transfers of assets or liabilities in or out of Level 3 of the fair value hierarchy, with significant transfers disclosed separately, (3) the policy for determining when transfers between levels of the fair value hierarchy are recognized and (4) for recurring fair value measurements of assets and liabilities in

Level 3 of the fair value hierarchy, a gross presentation of information about purchases, sales, issuances and settlements. ASU 2010-06 further clarifies that (1) fair value measurement disclosures should be provided for each class of assets and liabilities (rather than major category), which would generally be a subset of assets or liabilities within a line item in the statement of financial position and (2) company's should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements for each class of assets and liabilities included in Levels 2 and 3 of the fair value hierarchy. The disclosures related to the gross presentation of purchases, sales, issuances and settlements of assets and liabilities included in Level 3 of the fair value hierarchy were required for the Company beginning January 1, 2011. The remaining disclosure requirements and clarifications made by ASU 2010-06 became effective for the Company on January 1, 2010. Adoption of this guidance did not have a material impact on the Company's consolidated financial statements.

ASU No. 2011-02; *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring ("TDR")*.

In April, 2011, FASB issued ASU No. 2011-02 intended to provide additional guidance to assist creditors in determining whether a restructuring of a receivable meets the criteria to be considered a troubled debt restructuring. This ASU was effective for the first interim or annual period beginning on or after June 15, 2011, and was applied retrospectively to the beginning of the annual period of adoption. As a result of applying the ASU, the Company may identify receivables that are newly considered impaired. The Company adopted the applicable guidance during the third quarter ended September 30, 2011 and it did not have a material impact on required disclosures in the Company's consolidated financial statements.

ASU No. 2011-03; *Transfers and Servicing (Topic 860) - Reconsideration of Effective Control for Repurchase Agreements*. ASU 2011-03 is intended to improve financial reporting of repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. ASU 2011-03 removes from the assessment of effective control (i) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (ii) the collateral maintenance guidance related to that criterion. ASU 2011-03 was effective for the Company on January 1, 2012 and did not have a material impact on the Company's consolidated financial statements.

ASU 2011-04; *Fair Value Measurement (Topic 820) - Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs*. ASU 2011-04 amends Topic 820, "Fair Value Measurements and Disclosures," to converge the fair value measurement guidance in U.S. generally accepted accounting principles and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 was effective for the Company January 1, 2012 and did not have a material impact on the Company's consolidated financial statements.

ASU No. 2011-05; *Presentation of Comprehensive Income*. In June, 2011, the FASB issued ASU No. 2011-05 requiring companies to present comprehensive income in a single statement below net income or in a separate statement of comprehensive income immediately following the income statement. The guidance eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. This guidance does not change which items are reported in other comprehensive income or the requirement to report reclassifications of items from other comprehensive income to net income. This guidance was effective for fiscal years and interim periods beginning after December 15, 2011 and required retrospective application for all periods presented.

**13. FAIR VALUE OF FINANCIAL INSTRUMENTS**

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

June 30, 2012

| Description of Asset   | Carrying Amount | Fair Value    | Fair Value Measurements  |   |   |
|--|-----------------|---------------|--|---|---|
|  |                 |               | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| <b>Assets:</b>   |                 |               |  |   |   |
| Investment Securities - Available for Sale                                 | \$40,665,026    | \$40,665,026  | \$-  | \$40,665,026                                  | \$ -                                      |
| Investment Securities - Held to Maturity                                   | 126,915,558     | 128,002,081   | 749,973  | 127,252,108                                   | -   |
| Federal Home Loan Bank and Federal Reserve Stock                           | 5,780,450       | 5,818,000     | -  | 5,818,000                                     | -   |
| Loans  | 734,414,892     | 755,143,310   | -  | 755,143,310                                   | -   |
| Foreclosed Real Estate   | 5,562,158       | 5,562,158     | -  | 5,562,158                                     | -   |
| <b>Liabilities:</b>  |                 |               |  |   |   |
| Savings, NOW and money market accounts                                     | \$378,524,653   | \$378,524,653 | \$-  | \$378,524,653                                 | \$ -                                      |
| Time Deposits  | 437,249,671     | 442,937,199   | -  | 442,937,199                                   | -   |
| Long-Term Debt   | 60,552,148      | -             | -  | -   | -   |
| Short Term Borrowings  | 3,000,000       | 3,000,000     | -  | 3,000,000                                     | -   |
| Guaranteed preferred beneficial interest in junior subordinated debentures | 12,000,000      | 2,400,000     | -  | 2,400,000                                     | -   |

December 31, 2011

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

(Level 1)

| Assets:  |               |               |         |               |    |   |
|--|---------------|---------------|---------|---------------|----|---|
| Investment Securities - Available for Sale                                 | \$41,827,612  | \$41,827,612  | \$-     | \$41,827,612  | \$ | - |
| Investment Securities - Held to Maturity                                   | 153,516,839   | 154,030,993   | 749,951 | 153,281,042   |    | - |
| Federal Home Loan Bank and Federal Reserve Stock                           | 5,587,000     | 5,624,000     | -       | 5,624,000     |    | - |
| Loans  | 710,088,775   | 726,238,000   | -       | 726,238,000   |    | - |
| Foreclosed Real Estate   | 5,028,513     | 5,028,513     | -       | 5,028,513     |    | - |
| Liabilities:   |               |               |         |               |    |   |
| Savings, NOW and money market accounts                                     | \$371,737,480 | \$371,737,480 | \$-     | \$371,737,480 | \$ | - |
| Time Deposits  | 455,515,721   | 462,192,000   | -       | 462,192,000   |    | - |
| Long-Term Debt   | 60,576,595    | 61,353,000    | -       | 61,353,000    |    | - |
| Guaranteed preferred beneficial interest in junior subordinated debentures | 12,000,000    | 2,400,000     | -       | 2,400,000     |    | - |

At June 30, 2012, the Company had outstanding loan commitments and standby letters of credit of \$21.4 million and \$22.7 million, respectively. Based on the short-term lives of these instruments, the Company does not believe that the fair value of these instruments differs significantly from their carrying values.

### Valuation Methodology

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

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

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

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

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

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

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

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

The fair value estimates presented herein are based on pertinent information available to management as of June 30, 2012 and December 31, 2011. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date and, therefore, current estimates of fair value may differ significantly from the amount presented herein.

## ITEM 2

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

This document contains forward-looking statements that are based on assumptions and may describe future plans, strategies and expectations of Tri-County Financial Corporation (the "Company") and Community Bank of Tri-County (the "Bank"). These forward-looking statements are generally identified by use of the words "believe," "expect," "intend," "anticipate," "estimate," "project" or similar expressions. The Company and the Bank's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors that could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in interest rates, national and regional economic conditions, legislative and regulatory changes, monetary and fiscal policies of the U.S. government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality and composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Company and the Bank's market area, changes in real estate market values in the Company and the Bank's market area and changes in relevant accounting principles and guidelines. Additional factors that may affect our results are discussed in Part I of the Company's Annual Report on Form 10-K for the year ended December 31, 2011 (the "Form 10-K"). These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Except as required by applicable law or regulation, the Company does not undertake, and specifically disclaims any obligation, to release publicly the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of the statements or to reflect the occurrence of anticipated or unanticipated events.

#### GENERAL

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

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



The Bank continues to evaluate its allowance for loan losses and the associated provision to compensate for the inherent risk in the loan portfolio. Any evaluation of the allowance for loan losses is inherently inexact and reflects management's expectations as to future interest rates and economic conditions in the region as well as individual borrowers' circumstances. Management believes that its allowance for loan losses is adequate. For further information on the Bank's allowance for loan losses see the discussion in the sections captioned "Financial Condition" and "Critical Accounting Policies" as well as the relevant discussions in the Form 10-K and Annual Report for the year ended December 31, 2011.

The Bank conducts business through its main office in Waldorf, Maryland and ten branch offices in Charles, Calvert and St. Mary's counties in Southern Maryland and in King George, Virginia. The Bank is the second largest overall deposit holder in the Tri-County area according to the most recent 2011 FDIC Summary of Deposit Survey. The Bank completed the building of its operations center during the second quarter of 2012 in Waldorf, Maryland.

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

On September 23, 2011, the U.S. Department of Treasury purchased \$20.0 million in the Company's preferred stock under the Small Business Lending Fund (the "SBLF"). The SBLF is a program intended to encourage small business lending by providing capital to qualified community banks at favorable rates. SBLF dividend rates can fluctuate between 1% and 7% during the first four and one half years, depending on the level of the Bank's small business lending. As of December 31, 2011, the Company's dividend rate on the SBLF funds was 1%. The Company used \$16.4 million of the proceeds from this investment to redeem all of the preferred stock that it sold to the Treasury under the TARP Capital Purchase Program ("TARP") on December 19, 2008 as well as to pay any accrued but unpaid dividends. The net proceeds, after repurchasing the TARP securities, were invested by the Company in the Bank. During 2012, if the Company maintains its current investment in qualified small business lending, annual preferred dividends will decrease to \$200,000 compared with previously paid annual TARP preferred dividends of \$846,930. For additional information regarding SBLF, refer to Note 18 of the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2011.

## SELECTED FINANCIAL DATA

|   | Three Months Ended |              | Six Months Ended |               |
|---|--------------------|--------------|------------------|---------------|
|   | June 30,<br>2012   | 2011         | June 30,<br>2012 | 2011          |
| <b>Condensed Income Statement</b>           |                    |              |                  |               |
| Interest and Dividend Income                | \$ 10,102,542      | \$ 9,904,432 | \$ 20,210,926    | \$ 19,736,222 |
| Interest Expense                            | 2,765,341          | 3,168,429    | 5,789,026        | 6,390,746     |
| Net Interest Income                         | 7,337,201          | 6,736,003    | 14,421,900       | 13,345,476    |
| Provision for Loan Loss                     | 436,431            | 890,861      | 777,505          | 2,896,691     |
| Noninterest Income                          | 896,795            | 952,599      | 1,742,885        | 1,722,926     |
| Noninterest Expense                         | 6,363,686          | 4,923,298    | 12,261,105       | 10,034,522    |
| Income Before Income Taxes                  | 1,433,879          | 1,874,443    | 3,126,175        | 2,137,189     |
| Income Tax Expense                          | 492,727            | 654,648      | 1,079,770        | 675,896       |
| Net Income                                  | 941,152            | 1,219,795    | 2,046,405        | 1,461,293     |
| Preferred Stock Dividends                   | 50,000             | 211,732      | 100,000          | 423,465       |
| Net Income Available to Common Shareholders | 891,152            | 1,008,063    | 1,946,405        | 1,037,828     |
| <b>Per Common Share</b>                     |                    |              |                  |               |
| Basic Earnings                              | \$0.29             | \$0.33       | \$0.64           | \$0.34        |
| Diluted Earnings                            | \$0.29             | \$0.33       | \$0.64           | \$0.34        |
| Cash Dividends Declared                     | \$0.40             | \$0.40       | \$0.40           | \$0.40        |
| Book Value                                  | \$18.49            | \$18.07      | \$18.49          | \$18.07       |

**RESULTS OF OPERATIONS – SIX MONTHS ENDED JUNE 30, 2012**

Net income available to common shareholders for the six-month period ended June 30, 2012 increased \$908,577 to \$1,946,405 (\$0.64 basic and diluted earnings per common share), compared to \$1,037,828 (\$0.34 basic and diluted earnings per common share) for the same period in the prior year. The increase in net income available to common shareholders for the six months ended June 30, 2012 compared to the same six months in 2011 was due to a decrease in the provision for loan losses of \$2,119,186, an increase in net interest income of \$1,076,424 and noninterest income of \$19,959 and a reduction in preferred stock dividends of \$323,465. These positive impacts to net income were offset by increases in noninterest expense of \$2,226,583 and income tax expense of \$403,874.

|  | Six Months Ended June 30, |                     |                    |                 |
|--|---------------------------|---------------------|--------------------|-----------------|
|  | 2012                      | 2011                | \$ Change          | % Change        |
| <b>Interest and Dividend Income</b>                        |                           |                     |                    |                 |
| Loans, including fees                                      | \$18,511,260              | \$17,873,206        | \$638,054          | 3.57 %          |
| Taxable interest and dividends on investment securities    | 1,696,918                 | 1,859,352           | (162,434)          | (8.74 %)        |
| Interest on deposits with banks                            | 2,748                     | 3,664               | (916)              | (25.00 %)       |
| <b>Total Interest and Dividend Income</b>                  | <b>20,210,926</b>         | <b>19,736,222</b>   | <b>474,704</b>     | <b>2.41 %</b>   |
| <b>Interest Expenses</b>                                   |                           |                     |                    |                 |
| Deposits   | 4,609,719                 | 5,204,481           | (594,762)          | (11.43 %)       |
| Short-term borrowings                                      | 31,751                    | 24,455              | 7,296              | 29.83 %         |
| Long-term debt   | 1,147,556                 | 1,161,810           | (14,254)           | (1.23 %)        |
| <b>Total Interest Expenses</b>                             | <b>5,789,026</b>          | <b>6,390,746</b>    | <b>(601,720)</b>   | <b>(9.42 %)</b> |
| <b>Net Interest Income</b>                                 | <b>14,421,900</b>         | <b>13,345,476</b>   | <b>1,076,424</b>   | <b>8.07 %</b>   |
| Provision for loan losses                                  | 777,505                   | 2,896,691           | (2,119,186)        | (73.16 %)       |
| <b>Net Interest Income After Provision For Loan Losses</b> | <b>\$13,644,395</b>       | <b>\$10,448,785</b> | <b>\$3,195,610</b> | <b>30.58 %</b>  |

Interest and dividend income increased by \$474,704 due to the growth of \$88.0 million to the average balance of interest-earning assets from \$809.1 million for the six months ended June 30, 2011 to \$897.1 million for the six months ended June 30, 2012. This growth was partially offset by a reduction in the average yield on interest-earning assets from 4.88% for the six months ended June 30, 2011 to 4.51% for the six months ended June 30, 2012.

Interest expense decreased \$601,720 due to a reduction in the average cost of funds on interest-bearing liabilities from 1.75% for the six months ended June 30, 2011 to 1.43% for the six months ended June 30, 2012. This was achieved by a decrease in the average rates paid on certificates of deposits and money market accounts, which declined from 1.96% and 1.02%, respectively, for the six months ended June 30, 2011 to 1.67% and 0.68%, respectively, for the six months ended June 30, 2012. The decline in the average cost of funds was partially offset by higher average deposit

balances. Average customer deposits increased \$75.4 million from \$652.6 million for the six months ended June 30, 2011 to \$728.0 million for the six months ended June 30, 2012.

The Company has been successful in increasing its core deposits and reducing the cost of funds in the low interest rate environment over the last several years and has limited the effect of the lower interest rate environment on loan rates through pricing and interest rate floors.

The following table presents information on the average balances of the Company's interest-earning assets and interest-bearing liabilities and interest earned or paid thereon for the six months ended June 30, 2012 and 2011, respectively. There are no tax equivalency adjustments.

| dollars in thousands   | For the Six Months Ended June 30, |          |                        |                 |          |                        |  |
|--|-----------------------------------|----------|------------------------|-----------------|----------|------------------------|--|
|  | 2012                              |          | 2011                   |                 |          |                        |  |
|  | Average Balance                   | Interest | Average Yield/<br>Cost | Average Balance | Interest | Average Yield/<br>Cost |  |
| <b>Assets</b>  |                                   |          |                        |                 |          |                        |  |
| <b>Interest-earning assets:</b>  |                                   |          |                        |                 |          |                        |  |
| Loan portfolio (1)   | \$712,597                         | \$18,511 | 5.20 %                 | \$653,757       | \$17,873 | 5.47 %                 |  |
| Investment securities, federal funds sold and interest-bearing deposits          | 184,477                           | 1,700    | 1.84 %                 | 155,359         | 1,863    | 2.40 %                 |  |
| Total interest-earning assets  | 897,074                           | 20,211   | 4.51 %                 | 809,116         | 19,736   | 4.88 %                 |  |
| Cash and cash equivalents  | 8,393                             |          |                        | 10,531          |          |                        |  |
| Other assets   | 53,564                            |          |                        | 54,154          |          |                        |  |
| Total Assets   | \$959,031                         |          |                        | \$873,801       |          |                        |  |
| <b>Liabilities and Stockholders' Equity</b>                                      |                                   |          |                        |                 |          |                        |  |
| <b>Interest-bearing liabilities:</b>   |                                   |          |                        |                 |          |                        |  |
| Savings  | \$31,716                          | \$38     | 0.24 %                 | \$32,528        | \$55     | 0.34 %                 |  |
| Interest-bearing demand and money market accounts                                | 252,889                           | 860      | 0.68 %                 | 195,638         | 994      | 1.02 %                 |  |
| Certificates of deposit  | 443,425                           | 3,711    | 1.67 %                 | 424,464         | 4,156    | 1.96 %                 |  |
| Long-term debt   | 59,870                            | 977      | 3.26 %                 | 62,268          | 1,007    | 3.23 %                 |  |
| Short-term debt  | 7,228                             | 32       | 0.89 %                 | 3,953           | 24       | 1.21 %                 |  |
| Guaranteed preferred beneficial interest in junior subordinated debentures       | 12,000                            | 171      | 2.85 %                 | 12,000          | 155      | 2.58 %                 |  |
| Total Interest-Bearing Liabilities   | 807,128                           | 5,789    | 1.43 %                 | 730,851         | 6,391    | 1.75 %                 |  |
| Noninterest-bearing demand deposits  | 67,434                            |          |                        | 64,466          |          |                        |  |
| Other liabilities  | 7,421                             |          |                        | 6,636           |          |                        |  |
| Stockholders' equity   | 77,048                            |          |                        | 71,848          |          |                        |  |
| Total Liabilities and Stockholders' Equity                                       | \$959,031                         |          |                        | \$873,801       |          |                        |  |
| Net interest income  |                                   | \$14,422 |                        |                 | \$13,345 |                        |  |
| Interest rate spread   |                                   |          | 3.07 %                 |                 |          | 3.13 %                 |  |
| Net yield on interest-earning assets   |                                   |          | 3.22 %                 |                 |          | 3.30 %                 |  |
| Ratio of average interest-earning assets to average interest bearing liabilities |                                   |          | 111.14 %               |                 |          | 110.71 %               |  |

(1) Average balance includes nonaccrual loans

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

|   | Six months ended June<br>30, 2012<br>compared to six months<br>ended |           |          |
|---|--|-----------|----------|
|   | June<br>30,<br>2011  |           |          |
|   | Volume   | Rate      | Total    |
| Interest income:  |  |           |          |
| Loan portfolio  | \$1,528  | \$(890 )  | \$638    |
| Investment securities, federal funds<br>sold and interest bearing deposits    | 268  | (431 )    | (163 )   |
| Total interest-earning assets   | \$1,796  | \$(1,321) | \$475    |
| Interest-bearing liabilities:   |  |           |          |
| Savings   | (1 )   | (16 )     | (17 )    |
| Interest-bearing demand and money<br>market accounts                          | 195  | (329 )    | (134 )   |
| Certificates of deposit   | 159  | (604 )    | (445 )   |
| Long-term debt  | (39 )  | 9         | (30 )    |
| Short-term debt   | 14   | (6 )      | 8        |
| Guaranteed preferred beneficial interest<br>in junior subordinated debentures | -  | 16        | 16       |
| Total interest-bearing liabilities  | \$328  | \$(930 )  | \$(602 ) |
| Net change in net interest income   | \$1,468  | \$(391 )  | \$1,077  |

The Company's provision for loan losses decreased \$2,119,186 and reflected improving asset quality and a decrease in the allowance for specific nonperforming loans based on management's estimate of realizable value. The provision for loan losses was impacted by increasing average loan balances, economic conditions that affected the loss factors used to compute the allowance, the level of delinquencies and charge-offs. Overall delinquency, which includes all loans greater than 30 days past due increased from 2.09% at December 31, 2011 to 2.37% at June 30, 2012. Nonperforming loans as a percentage of total loans were 1.48% at June 30, 2012 compared to 1.65% at March 31, 2012 and 1.32% at December 31, 2011. Net charge-offs decreased \$2,460,667 from \$3,468,283 for the six months ended June 30, 2011 to \$1,007,616 for the six months ended June 30, 2012.

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

|   | Six Months Ended June |             | \$       | %     |    |
|---|-----------------------|-------------|----------|-------|----|
|   | 2012                  | 2011        |          |       |    |
| Noninterest Income                                |                       |             |          |       |    |
| Loan appraisal, credit, and miscellaneous charges | \$383,441             | \$351,731   | \$31,710 | 9.02  | %  |
| Net losses on sale of OREO                        | (96,917 )             | -           | (96,917) | n/a   |    |
| Income from bank owned life insurance             | 319,117               | 324,204     | (5,087 ) | (1.57 | %) |
| Service charges                                   | 1,001,903             | 966,833     | 35,070   | 3.63  | %  |
| Gain on sale of loans held for sale               | 135,341               | 80,158      | 55,183   | 68.84 | %  |
| Total Noninterest Income                          | \$1,742,885           | \$1,722,926 | \$19,959 | 1.16  | %  |

Noninterest income increased primarily due to growth in service charge income and loan fees as a result of the increased asset size of the Bank. Gains on loan sales increased to \$135,341 on sales of \$3,286,050 for the six months ended June 30, 2012 compared to \$80,158 on sales of \$2,987,303 for the same period in 2011. During the six months ended June 30, 2012, the Bank disposed of two OREO properties for proceeds of \$299,032 and recognized net losses of \$96,917.



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

|  | Six Months Ended June 30, |              |             |          |
|--|---------------------------|--------------|-------------|----------|
|  | 2012                      | 2011         | \$ Change   | % Change |
| Noninterest Expense                                |                           |              |             |          |
| Salary and employee benefits                       | \$6,490,079               | \$5,426,867  | \$1,063,212 | 19.59 %  |
| Occupancy expense                                  | 901,791                   | 884,972      | 16,819      | 1.90 %   |
| Advertising  | 259,091                   | 234,037      | 25,054      | 10.71 %  |
| Data processing expense                            | 789,593                   | 571,109      | 218,484     | 38.26 %  |
| Professional fees                                  | 568,504                   | 450,241      | 118,263     | 26.27 %  |
| Depreciation of furniture, fixtures, and equipment | 297,289                   | 202,192      | 95,097      | 47.03 %  |
| Telephone communications                           | 92,086                    | 86,231       | 5,855       | 6.79 %   |
| Office supplies                                    | 133,990                   | 75,900       | 58,090      | 76.53 %  |
| FDIC Insurance                                     | 891,202                   | 656,341      | 234,861     | 35.78 %  |
| Valuation allowance on OREO                        | 626,176                   | 315,883      | 310,293     | 98.23 %  |
| Other  | 1,211,304                 | 1,130,749    | 80,555      | 7.12 %   |
| Total Noninterest Expense                          | \$12,261,105              | \$10,034,522 | \$2,226,583 | 22.19 %  |

For the six months ended June 30, 2012, noninterest expense increased primarily due to growth in employee compensation, increased valuation allowance on OREO properties, increased FDIC insurance and one-time conversion related costs for a change of the Bank's core service provider. Salary and employee benefits expense increased as the Bank added additional employees to support the Bank's balance sheet growth and increased compliance needs. In addition, approximately \$250,000 of employee compensation related to bonuses and overtime to implement the new core system. Data processing and professional fees increased from the comparable period in 2011 due mostly to conversion related costs. FDIC insurance grew as the Bank's average asset size increased. Employee compensation, data processing, professional fees and FDIC insurance increased to support the growth of the Bank and to accommodate greater than before regulatory compliance costs for both existing regulation and the initial impact of the Dodd-Frank Act.

The Company recorded income tax expense of \$1,079,770 or 34.5%, of pretax earnings of \$3,126,175, for the six months ended June 30, 2012 compared with 675,896 or 31.6%, of pretax earnings of \$2,137,189, for the six months ended June 30, 2011. The increase in the effective tax rate was the result of tax exempt income being relatively lower to total income in 2011.

The Company's preferred stock dividends decreased \$323,465 to \$100,000 for the six months ended June 30, 2012 from \$423,465 for the six months ended June 30, 2011. The decrease was due to the Company's participation in SBLF and payoff of TARP during the third quarter of 2011. If the Company maintains its 1% dividend for 2012, the annual preferred SBLF dividend will decrease to \$200,000 compared to a previous annualized cost of \$846,930 for TARP

participation.

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**RESULTS OF OPERATIONS – THREE MONTHS ENDED JUNE 30, 2012**

Net income available to common shareholders for the three-month period ended June 30, 2012 decreased \$116,911 to \$891,152 (\$0.29 basic and diluted earnings per common share), compared to \$1,008,063 (\$0.33 basic and diluted earnings per common share) for the same period in the prior year. The decrease in net income available to common shareholders for the three months ended June 30, 2012 compared to the same quarter in 2011 was attributable to increases in noninterest expense of \$1,440,388 and a decrease in noninterest income of \$55,804. These reductions of income were partially offset by increases in net interest income of \$601,198 due to larger average loan balances and a lower cost of funds, a lower provision for loan losses of \$454,430, a decrease in income tax expense of \$161,921 and a decrease in preferred stock dividends of \$161,732.

|  | Three Months Ended June 30, |                    |                    |                  |
|--|-----------------------------|--------------------|--------------------|------------------|
|  | 2012                        | 2011               | \$ Change          | % Change         |
| <b>Interest and Dividend Income</b>                        |                             |                    |                    |                  |
| Loans, including fees                                      | \$9,286,377                 | \$9,012,635        | \$273,742          | 3.04 %           |
| Taxable interest and dividends on investment securities    | 815,101                     | 889,515            | (74,414 )          | (8.37 %)         |
| Interest on deposits with banks                            | 1,064                       | 2,282              | (1,218 )           | (53.37 %)        |
| <b>Total Interest and Dividend Income</b>                  | <b>10,102,542</b>           | <b>9,904,432</b>   | <b>198,110</b>     | <b>2.00 %</b>    |
| <b>Interest Expenses</b>                                   |                             |                    |                    |                  |
| Deposits   | 2,197,377                   | 2,595,961          | (398,584 )         | (15.35 %)        |
| Short-term borrowings                                      | 15,910                      | 10,022             | 5,888              | 58.75 %          |
| Long-term debt   | 552,054                     | 562,446            | (10,392 )          | (1.85 %)         |
| <b>Total Interest Expenses</b>                             | <b>2,765,341</b>            | <b>3,168,429</b>   | <b>(403,088 )</b>  | <b>(12.72 %)</b> |
| <b>Net Interest Income</b>                                 | <b>7,337,201</b>            | <b>6,736,003</b>   | <b>601,198</b>     | <b>8.93 %</b>    |
| Provision for loan losses                                  | 436,431                     | 890,861            | (454,430 )         | (51.01 %)        |
| <b>Net Interest Income After Provision For Loan Losses</b> | <b>\$6,900,770</b>          | <b>\$5,845,142</b> | <b>\$1,055,628</b> | <b>18.06 %</b>   |

Interest rate spread and net interest margin for the second quarter of 2012 improved to 3.14% and 3.28%, respectively, from 3.00% and 3.15%, respectively, for the first quarter 2012. Net interest income increased \$252,502 from \$7,084,699 for the three months ended March 31, 2012 to \$7,337,201 for the three months ended June 30, 2012. The improvement was based on a decrease in the cost of interest-bearing liabilities. The average balances for both interest-bearing assets and interest-bearing liabilities were similar during both quarters and were not a material factor in the increase. Average deposit costs have fallen 11 basis points from 1.32% for the quarter ended March 31, 2012 to 1.21% for the quarter ended June 30, 2012. The positive trend of decreasing deposit funding costs is expected to continue during the third quarter based on the scheduled maturities of time deposits and current market rates. At June 30, 2012, the cost of deposits was 1.02%.

Interest and dividend income increased by \$198,110 due to growth of \$87.3 million to the average balance of interest-earning assets from \$807.8 million for the three months ended June 30, 2011 to \$895.1 million for the three months ended June 30, 2012. This growth was partially offset by a reduction in the average yield on interest-earning assets from 4.90% for the three months ended June 30, 2011 to 4.51% for the three months ended June 30, 2012.

Interest expense decreased \$403,088 due to a reduction in the average cost of funds on interest-bearing liabilities from 1.73% for the three months ended June 30, 2011 to 1.37% for the three months ended June 30, 2012. This was achieved by a decrease in the average rates paid on certificates of deposits and money market accounts, which declined from 1.94% and 1.03%, respectively, for the three months ended June 30, 2011 to 1.65% and 0.61%, respectively, for the three months ended June 30, 2012. The decline in the average cost of funds was partially offset by higher average deposit balances. Average customer deposits increased \$67.4 million from \$659.1 million for the three months ended June 30, 2011 to \$726.5 million for the three months ended June 30, 2012.

The following table presents information on the average balances of the Company's interest-earning assets and interest-bearing liabilities and interest earned or paid thereon for the three months ended June 30, 2012 and 2011, respectively. There are no tax equivalency adjustments.

| dollars in thousands   | For the Three Months Ended June 30, |          |                        |      |                 |          |                        |
|--|-------------------------------------|----------|------------------------|------|-----------------|----------|------------------------|
|  | 2012                                |          |                        | 2011 |                 |          |                        |
|  | Average Balance                     | Interest | Average Yield/<br>Cost |      | Average Balance | Interest | Average Yield/<br>Cost |
| <b>Assets</b>  |                                     |          |                        |      |                 |          |                        |
| <b>Interest-earning assets:</b>  |                                     |          |                        |      |                 |          |                        |
| Loan portfolio (1)   | \$721,400                           | \$9,286  | 5.15 %                 |      | \$658,599       | \$9,012  | 5.47 %                 |
| Investment securities, federal funds sold and interest-bearing deposits          | 173,721                             | 817      | 1.88 %                 |      | 149,228         | 893      | 2.39 %                 |
| Total interest-earning assets  | 895,121                             | 10,103   | 4.51 %                 |      | 807,827         | 9,905    | 4.90 %                 |
| Cash and cash equivalents  | 10,151                              |          |                        |      | 12,084          |          |                        |
| Other assets   | 54,370                              |          |                        |      | 55,030          |          |                        |
| Total Assets   | \$959,642                           |          |                        |      | \$874,941       |          |                        |
| <b>Liabilities and Stockholders' Equity</b>                                      |                                     |          |                        |      |                 |          |                        |
| <b>Interest-bearing liabilities:</b>   |                                     |          |                        |      |                 |          |                        |
| Savings  | \$32,561                            | \$5      | 0.06 %                 |      | \$31,777        | \$24     | 0.30 %                 |
| Interest-bearing demand and money market accounts                                | 255,670                             | 387      | 0.61 %                 |      | 206,330         | 533      | 1.03 %                 |
| Certificates of deposit  | 438,242                             | 1,805    | 1.65 %                 |      | 420,947         | 2,039    | 1.94 %                 |
| Long-term debt   | 59,172                              | 467      | 3.16 %                 |      | 60,605          | 486      | 3.21 %                 |
| Short-term debt  | 7,590                               | 16       | 0.84 %                 |      | 1,129           | 10       | 3.54 %                 |
| Guaranteed preferred beneficial interest in junior subordinated debentures       | 12,000                              | 85       | 2.83 %                 |      | 12,000          | 77       | 2.57 %                 |
| Total Interest-Bearing Liabilities   | 805,235                             | 2,765    | 1.37 %                 |      | 732,788         | 3,169    | 1.73 %                 |
| Noninterest-bearing demand deposits  | 69,240                              |          |                        |      | 64,159          |          |                        |
| Other liabilities  | 7,979                               |          |                        |      | 6,348           |          |                        |
| Stockholders' equity   | 77,188                              |          |                        |      | 71,646          |          |                        |
| Total Liabilities and Stockholders' Equity                                       | \$959,642                           |          |                        |      | \$874,941       |          |                        |
| Net interest income  |                                     | 7,338    |                        |      |                 | 6,736    |                        |
| Interest rate spread   |                                     |          | 3.14 %                 |      |                 |          | 3.17 %                 |
| Net yield on interest-earning assets   |                                     |          | 3.28 %                 |      |                 |          | 3.34 %                 |
| Ratio of average interest-earning assets to average interest bearing liabilities |                                     |          | 111.16 %               |      |                 |          | 110.24 %               |

(1) Average balance includes nonaccrual loans

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

|   | Three months ended<br>June 30, 2012<br>compared to three<br>months ended<br>June<br>30,<br>2011<br>Due<br>to |         |         |
|---|--|---------|---------|
|   | Volume   | Rate    | Total   |
| Interest income:  |  |         |         |
| Loan portfolio  | \$ 808   | \$(534) | \$ 274  |
| Investment securities, federal funds<br>sold and interest bearing deposits    | 115  | (191)   | (76 )   |
| Total interest-earning assets   | \$ 923   | \$(725) | \$ 198  |
| Interest-bearing liabilities:   |  |         |         |
| Savings   | -  | (19 )   | (19 )   |
| Interest-bearing demand and money<br>market accounts                          | 75   | (221)   | (146)   |
| Certificates of deposit   | 71   | (305)   | (234)   |
| Long-term debt  | (11 )  | (8 )    | (19 )   |
| Short-term debt   | 14   | (8 )    | 6       |
| Guaranteed preferred beneficial interest<br>in junior subordinated debentures | -  | 8       | 8       |
| Total interest-bearing liabilities  | \$ 149   | \$(553) | \$(404) |
| Net change in net interest income   | \$ 774   | \$(172) | \$ 602  |

The Company's provision for loan losses decreased \$454,430 from the comparable period in 2011. The decrease in the Company's provision for loan losses for the three months ended June 30, 2012 was primarily due to decreases in the allowance for specific nonperforming loans based on management's estimate of realizable value and a decrease in charge-offs. Net charge-offs decreased \$147,224 from \$1,074,054 for the three months ended June 30, 2011 to \$926,830 for the three months ended June 30, 2012.

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

|   | Three Months Ended |           | \$         | %      |    |
|---|--------------------|-----------|------------|--------|----|
|   | June 30,           |           |            |        |    |
|   | 2012               | 2011      | Change     | Change |    |
| Noninterest Income                                |                    |           |            |        |    |
| Loan appraisal, credit, and miscellaneous charges | \$202,127          | \$193,633 | \$8,494    | 4.39   | %  |
| Net losses on sale of OREO                        | -                  | -         | -          | n/a    |    |
| Income from bank owned life insurance             | 159,911            | 164,509   | (4,598 )   | (2.79  | %) |
| Service charges                                   | 465,391            | 539,874   | (74,483)   | (13.80 | %) |
| Gain on sale of loans held for sale               | 69,366             | 54,583    | 14,783     | 27.08  | %  |
| Total Noninterest Income                          | \$896,795          | \$952,599 | \$(55,804) | (5.86  | %) |

The \$55,804 decrease to noninterest income was principally due to a reduction in second quarter service charges compared to the prior year due to a one time one-month waiver of certain deposit account service charges during the Bank's transition to a new core system.



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

|  | Three Months Ended |             |             |          |
|--|--------------------|-------------|-------------|----------|
|  | June 30,           |             |             |          |
|  | 2012               | 2011        | \$ Change   | % Change |
| Noninterest Expense                                |                    |             |             |          |
| Salary and employee benefits                       | \$3,170,213        | \$2,675,393 | \$494,820   | 18.50 %  |
| Occupancy expense                                  | 464,319            | 467,581     | (3,262)     | (0.70 %) |
| Advertising  | 179,083            | 115,341     | 63,742      | 55.26 %  |
| Data processing expense                            | 421,153            | 288,356     | 132,797     | 46.05 %  |
| Professional fees                                  | 343,295            | 233,153     | 110,142     | 47.24 %  |
| Depreciation of furniture, fixtures, and equipment | 162,364            | 102,663     | 59,701      | 58.15 %  |
| Telephone communications                           | 48,312             | 44,207      | 4,105       | 9.29 %   |
| Office supplies                                    | 71,928             | 37,109      | 34,819      | 93.83 %  |
| FDIC Insurance                                     | 447,587            | 330,022     | 117,565     | 35.62 %  |
| Valuation allowance on OREO                        | 326,176            | -           | 326,176     | n/a      |
| Other  | 729,256            | 629,473     | 99,783      | 15.85 %  |
| Total Noninterest Expense                          | \$6,363,686        | \$4,923,298 | \$1,440,388 | 29.26 %  |

For the three months ended June 30, 2012, noninterest expense increased primarily due to growth in employee compensation, increased valuation allowance on OREO properties, increased FDIC insurance and one-time conversion related costs for a change of the Bank's core service provider. Salary and employee benefits expense increased as the Bank added additional employees to support the Bank's balance sheet growth and increased compliance needs. In addition, approximately \$250,000 of second quarter 2012 employee compensation related to bonuses and overtime to implement the new core system. Data processing and professional fees increased from the comparable period in 2011 due mostly to conversion related costs. FDIC insurance grew as the Bank's average asset size increased. Employee compensation, data processing, professional fees and FDIC insurance increased to support the growth of the Bank and to accommodate greater than before regulatory compliance costs for both existing regulation and the initial impact of the Dodd-Frank Act.

The Company recorded income tax expense of \$492,727 or 34.4%, of pretax earnings of \$1,433,879, for the three months ended June 30, 2012 compared with 654,648 or 34.9%, of pretax earnings of \$1,874,443, for the three months ended June 30, 2011. The lower effective tax rate was the result of a higher relative percentage of tax exempt income as a percentage of pretax income than the comparable period of the prior year.

The Company's preferred stock dividends decreased \$161,732 to \$50,000 for the three months ended June 30, 2012 from \$211,732 for the three months ended June 30, 2011. The decrease was due to the Company's participation in the SBLF and payoff of TARP during the third quarter of 2011.



**FINANCIAL CONDITION**

|   | June 30, 2012        | December 31,<br>2011 | \$ Change             | %<br>Change     |
|---|----------------------|----------------------|-----------------------|-----------------|
| <b>Assets</b>   |                      |                      |                       |                 |
| Cash and due from banks   | \$11,235,647         | \$13,074,091         | \$(1,838,444 )        | (14.06 %)       |
| Federal funds sold  | 385,000              | 5,040,000            | (4,655,000 )          | (92.36 %)       |
| Interest-bearing deposits with banks  | 398,017              | 1,004,098            | (606,081 )            | (60.36 %)       |
| Securities available for sale (AFS), at fair value  | 40,665,026           | 41,827,612           | (1,162,586 )          | (2.78 %)        |
| Securities held to maturity (HTM), at amortized cost  | 126,915,558          | 153,516,839          | (26,601,281)          | (17.33 %)       |
| Federal Home Loan Bank and Federal Reserve Bank stock - at cost                                 | 5,780,450            | 5,587,000            | 193,450               | 3.46 %          |
| Loans receivable - net of allowance for loan losses of \$7,464,137 and \$7,655,041 respectively | 734,414,892          | 710,088,775          | 24,326,117            | 3.43 %          |
| Premises and equipment, net   | 19,322,261           | 16,440,902           | 2,881,359             | 17.53 %         |
| Foreclosed real estate  | 5,562,158            | 5,028,513            | 533,645               | 10.61 %         |
| Accrued interest receivable   | 3,079,092            | 3,027,784            | 51,308                | 1.69 %          |
| Investment in bank owned life insurance   | 18,417,201           | 18,098,085           | 319,116               | 1.76 %          |
| Other assets  | 9,699,419            | 10,746,024           | (1,046,605 )          | (9.74 %)        |
| <b>Total Assets</b>   | <b>\$975,874,721</b> | <b>\$983,479,723</b> | <b>\$(7,605,002 )</b> | <b>(0.77 %)</b> |

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

|                                   | June 30, 2012 | %        | December 31,<br>2011 | %        |
|-----------------------------------|---------------|----------|----------------------|----------|
| Commercial real estate            | \$398,017,392 | 53.59 %  | \$370,383,885        | 51.55 %  |
| Residential first mortgages       | 178,459,492   | 24.03 %  | 164,543,309          | 22.90 %  |
| Construction and land development | 32,405,839    | 4.36 %   | 36,744,865           | 5.11 %   |
| Home equity and second mortgage   | 22,525,909    | 3.03 %   | 24,138,324           | 3.36 %   |
| Commercial loans                  | 93,096,685    | 12.54 %  | 101,968,056          | 14.19 %  |
| Consumer loans                    | 1,007,453     | 0.14 %   | 1,000,983            | 0.14 %   |
| Commercial equipment              | 17,151,518    | 2.31 %   | 19,760,753           | 2.75 %   |
|                                   | 742,664,288   | 100.00 % | 718,540,175          | 100.00 % |
| Less:                             |               |          |                      |          |
| Deferred loan fees                | 785,259       | 0.11 %   | 796,359              | 0.11 %   |
| Allowance for loan loss           | 7,464,137     | 1.01 %   | 7,655,041            | 1.07 %   |
|                                   | 8,249,396     |          | 8,451,400            |          |
|                                   | \$734,414,892 |          | \$710,088,775        |          |

Assets decreased primarily due to a decrease in securities and cash and cash equivalents, offsetting loan growth. Cash, maturing securities and Federal Home Loan Bank advances were utilized to fund loan growth and operating needs. The differences in allocations between the different cash and investment categories reflect operational needs.

Premises and equipment increased due primarily to construction completed during the second quarter of 2012 of the Bank's new operations center in Waldorf, Maryland and its newest branch in King George, Virginia, which opened in March 2012. Other assets decreased due to a reduction in prepaid expenses.

Gross loan growth of \$24,124,113 from \$718,540,175 at December 31, 2011 to \$742,664,288 at June 30, 2012, was due to net new loans of \$27,633,507 in commercial real estate and \$13,916,183 in residential mortgages offset by decreases of \$8,871,371 in commercial loans, \$4,339,026 in construction and land development loans, \$2,609,235 in commercial equipment loans and a net decrease in other loan categories of \$1,605,945. During 2010 and 2011, the Bank managed the relative size of the components of its loan portfolio to increase commercial real estate and residential first mortgage portfolios, growing from 46.88% and 18.59% of the loan portfolio, respectively, at December 31, 2009 to 53.59% and 24.03%, respectively, at June 30, 2012.

The table below highlights nonperforming asset ratio trends:

|   | As of<br>June<br>30,<br>2012 | As of<br>March<br>31,<br>2012 | As of<br>December<br>31, 2011 | As of<br>December<br>31, 2010 |
|---|------------------------------|-------------------------------|-------------------------------|-------------------------------|
| Past due loans (PDLs) to total loans (31 to 89 days)  | 0.89 %                       | 0.20 %                        | 0.76 %                        | 0.17 %                        |
| Nonperforming loans (NPLs) to total loans (>=90 days) | 1.48 %                       | 1.65 %                        | 1.32 %                        | 2.04 %                        |
| Total loan delinquency (PDLs + NPLs) to total loans   | 2.37 %                       | 1.85 %                        | 2.09 %                        | 2.21 %                        |
| Nonperforming assets (NPLs +OREO) to total assets     | 1.69 %                       | 1.71 %                        | 1.48 %                        | 2.71 %                        |
| Nonperforming assets to gross loans + OREO            | 2.21 %                       | 2.25 %                        | 2.01 %                        | 3.56 %                        |
| Nonperforming assets + TDRs to total assets (a)       | 2.73 %                       | 2.79 %                        | 2.61 %                        | 4.58 %                        |

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

The Company's nonperforming asset ratios improved from the first quarter of 2012. Although overall delinquency increased due to an increase in loans 31-89 days delinquent, nonperforming loans (loans 90 days or greater delinquent) decreased during the second quarter of 2012.

The Bank had 38 nonperforming loans at June 30, 2012 compared to 35 nonperforming loans at December 31, 2011. Nonperforming loans (loans 90 days or greater delinquent) decreased \$1,122,490 from March 31, 2012 and increased \$1,461,377 from December 31, 2011 to \$10,971,994 at June 30, 2012. The Company's allowance for loan losses decreased from \$7,915,798 or 1.07% of loans, at December 31, 2011 to \$7,464,137 or 1.01% of loans, at June 30, 2012 due to a reduction in specific reserves on loans evaluated for impairment and reflected a trend of improving asset quality over the last quarter. Management's determination of the adequacy of the allowance is based on a periodic evaluation of the portfolio with consideration given to: the overall loss experience; current economic conditions; size, growth and composition of the loan portfolio; financial condition of the borrowers; and other relevant factors that, in management's judgment, warrant recognition in providing an adequate allowance. Management believes that the allowance is adequate.

*Nonperforming Loans (Nonaccrual Loans) by Portfolio Segment*

| June 30, 2012 |              | December 31, 2011 |              |
|---------------|--------------|-------------------|--------------|
| Dollars       | Number<br>of | Dollars           | Number<br>of |

|                                   |              | Loans |             | Loans |
|-----------------------------------|--------------|-------|-------------|-------|
| Commercial real estate            | \$1,675,021  | 8     | \$2,866,539 | 11    |
| Residential first mortgages       | 3,430,204    | 9     | 2,438,771   | 7     |
| Construction and land development | 331,888      | 3     | 1,413,550   | 2     |
| Home equity and second mortgage   | 227,296      | 5     | 291,285     | 7     |
| Commercial loans                  | 5,204,771    | 9     | 2,263,916   | 4     |
| Consumer loans                    | -            | -     | 500         | 1     |
| Commercial equipment              | 102,814      | 4     | 236,056     | 3     |
|                                   | \$10,971,994 | 38    | \$9,510,617 | 35    |

Commercial real estate has been impacted by economic conditions in our local market mainly due to higher vacancies in commercial office space. Nonperforming residential first mortgages are the result of specific customer issues with unemployment and other circumstances requiring the liquidation of family assets. The 2012 increase in commercial nonperforming loans was primarily for one well secured customer relationship. The Company has decreased nonperforming construction and land development loans from \$9,504,414 at December 31, 2009 to \$331,888 at June 30, 2012 as loans were foreclosed or projects were completed. The Company has reduced its holdings in construction and land development loans from \$62,509,558, or 10.0% of total loans at December 31, 2009 to \$32,405,839, or 4.36% of total loans at June 30, 2012. At June 30, 2012, the Bank provided for a specific allowance of \$741,503 on nonperforming loans of \$1,600,613 and no allowance on \$9,371,381 of nonperforming loans. Specific allowances are based on management's evaluation of the underlying collateral and utilization of the Bank's credit evaluation criteria.

Management continues to monitor these loans and is working to resolve these loans in a manner that will preserve the most value for the Company. Additional loan information is presented in this Quarterly Report on Form 10-Q under Note 11 and for prior years is presented in the Company's Form 10-K for the year ended December 31, 2011.

The following table sets forth information with respect to the Bank's foreclosed real estate (OREO), nonaccrual loans and TDRs. The table includes a breakdown between nonperforming and impaired loans.

*OREO, Nonperforming (Nonaccrual Loans) and Impaired Loans*

|   | June 30,<br>2012 | December<br>31, 2011 |       |   |
|---|------------------|----------------------|-------|---|
| OREO  | \$5,562,158      | \$5,028,513          |       |   |
| Nonperforming loans                                   |                  |                      |       |   |
| Nonaccrual loans with impairment                      | \$1,308,278      | \$4,517,009          |       |   |
| Nonaccrual loans with no impairment                   | 9,371,381        | 4,193,893            |       |   |
| TDRs not performing according to terms                | 292,335          | 799,715              |       |   |
| Total Nonperforming Loans                             | \$10,971,994     | \$9,510,617          |       |   |
| Total Nonperforming Assets                            | \$16,534,152     | \$14,539,130         |       |   |
| Impaired loans  |                  |                      |       |   |
| Nonaccrual loans with impairment                      | \$1,308,278      | \$4,517,009          |       |   |
| Performing loans with impairment                      | 2,898,308        | 4,286,916            |       |   |
| TDRs not performing according to terms                | 292,335          | 799,715              |       |   |
| TDRs performing according to terms                    | 10,106,139       | 11,113,326           |       |   |
| Total Impaired Loans                                  | \$14,605,060     | \$20,716,966         |       |   |
| Asset Quality   |                  |                      |       |   |
| Nonperforming loans (NPLs)                            | \$10,971,994     | \$9,510,617          |       |   |
| Nonperforming assets (NPLs + OREO)                    | 16,534,152       | 14,539,130           |       |   |
| Troubled debt restructures (TDRs)                     | 10,398,474       | 11,913,041           |       |   |
| Allowance for loan losses to total loans              | 1.01             | %                    | 1.07  | % |
| Past due loans (PDLs) to total loans (31 to 89 days)  | 0.89             | %                    | 0.76  | % |
| Nonperforming loans (NPLs) to total loans (>=90 days) | 1.48             | %                    | 1.32  | % |
| Total loan delinquency (PDLs + NPLs) to total loans   | 2.37             | %                    | 2.09  | % |
| Allowance for loan losses to nonperforming loans      | 68.03            | %                    | 80.49 | % |
| Nonperforming assets (NPLs + OREO) to total assets    | 1.69             | %                    | 1.48  | % |
| Nonperforming assets to gross loans + OREO            | 2.21             | %                    | 2.01  | % |
| Nonperforming assets + TDRs to total assets (a)       | 2.73             | %                    | 2.61  | % |

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

The Company's June 30, 2012 OREO balance of \$5,562,158 increased \$533,645 compared to December 31, 2011, consisting of additions of \$1,555,770 offset by valuation allowances of \$626,176 to adjust for current appraised values and disposals of \$395,949. During the six months ended June 30, 2012, the Bank disposed of two OREO properties for proceeds of \$299,032 and recognized net losses of \$96,917. Current year OREO additions include two construction and land development projects valued at \$1,038,000 that the Bank utilized the deposit method to account for the sale and transfer of legal title to the borrower. Payments of principal and interest will be recorded as a deposit (liability) until the transaction qualifies for full accrual or installment accounting treatment. As of June 30, 2012, the Bank has received \$109,000 in payments on these projects. OREO carrying amounts reflect management's estimate of the realizable value of these properties incorporating current appraised values, local real estate market conditions and related costs.



|  | June 30, 2012        | December 31, 2011    | \$ Change             | % Change      |          |
|--|----------------------|----------------------|-----------------------|---------------|----------|
| <b>Liabilities</b>   |                      |                      |                       |               |          |
| <b>Deposits</b>  |                      |                      |                       |               |          |
| Non-interest-bearing deposits  | \$84,661,470         | \$81,097,622         | \$3,563,848           | 4.39          | %        |
| Interest-bearing deposits  | 731,112,854          | 746,155,579          | (15,042,725)          | (2.02)        | %        |
| Total deposits   | 815,774,324          | 827,253,201          | (11,478,877)          | (1.39)        | %        |
| Short-term borrowings  | 3,000,000            | -                    | 3,000,000             | n/a           |          |
| Long-term debt   | 60,552,148           | 60,576,595           | (24,447 )             | (0.04)        | %        |
| Guaranteed preferred beneficial interest in junior subordinated debentures | 12,000,000           | 12,000,000           | -                     | 0.00          | %        |
| Accrued expenses and other liabilities                                     | 8,186,305            | 8,195,829            | (9,524 )              | (0.12)        | %        |
| <b>Total Liabilities</b>   | <b>\$899,512,777</b> | <b>\$908,025,625</b> | <b>\$(8,512,848 )</b> | <b>(0.94)</b> | <b>%</b> |

The decrease in deposits is consistent with normal seasonal fluctuations of customer accounts. During 2012, lower-cost transaction accounts continued to increase as a percentage of total deposits and have increased from 44.94% at December 31, 2011 to 46.40% at June 30, 2012. Since December 31, 2010, transaction deposits have increased \$78,662,030 from \$286,368,452, or 39.52% of deposits, to \$378,524,653, or 46.40% at June 30, 2012. Total short-term borrowings increased to fund operating needs.

The most recent FDIC Annual Summary of Deposit Survey for deposits held on June 30, 2011 indicated that the Bank moved up one position this year to become the second largest overall deposit holder in the Tri-County area with a market share of 19.27%. Increasing deposit market share and core deposit relationships contributed significantly to the Bank's strategy of reducing funding costs. Since the FDIC survey date, deposits increased \$61,842,494 to \$815,774,324 at June 30, 2012 from \$753,931,830 at June 30, 2011.

|  | June 30, 2012       | December 31, 2011   | \$ Change        | % Change    |          |
|--|---------------------|---------------------|------------------|-------------|----------|
| <b>Stockholders' Equity</b>  |                     |                     |                  |             |          |
| Preferred Stock, Senior Non-Cumulative Perpetual, Series C - par value \$1,000; authorized 20,000; issued 20,000 | \$20,000,000        | \$20,000,000        | \$-              | 0.00        | %        |
| Common stock - par value \$.01; authorized - 15,000,000 shares; issued 3,048,084 and 3,026,557 shares            | 30,481              | 30,266              | 215              | 0.71        | %        |
| Additional paid in capital   | 17,733,436          | 17,367,403          | 366,033          | 2.11        | %        |
| Retained earnings  | 39,283,317          | 38,712,194          | 571,123          | 1.48        | %        |
| Accumulated other comprehensive gain   | 297,350             | 289,599             | 7,751            | 2.68        | %        |
| Unearned ESOP shares   | (982,640 )          | (945,364 )          | (37,276 )        | 3.94        | %        |
| <b>Total Stockholders' Equity</b>  | <b>\$76,361,944</b> | <b>\$75,454,098</b> | <b>\$907,846</b> | <b>1.20</b> | <b>%</b> |

The \$907,846 increase in stockholders' equity was due to net income of \$2,046,405, net stock related activities of \$175,261 and adjustments to other comprehensive income of \$7,751 partially offset by payments of common stock dividends of \$1,216,570 and preferred stock dividends of \$105,001. Common stockholders' equity of \$56,361,944 at June 30, 2012, resulted in a book value of \$18.49 per common share.

## LIQUIDITY AND CAPITAL RESOURCES

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

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

The Bank's principal sources of funds for investment and operations are net income, deposits, sales of loans, borrowings, principal and interest payments on loans, principal and interest received on investment securities and proceeds from the maturity and sale of investment securities. Its principal funding commitments are for the origination or purchase of loans, the purchase of securities and the payment of maturing deposits. Deposits are the primary source of funds supporting the Bank's lending and investment activities. The Bank also uses borrowings from the FHLB of Atlanta to supplement deposits. The amount of FHLB advances available to the Bank is limited to the lower of 40% of Bank assets or the amount supportable by eligible collateral including FHLB stock, loans and securities. In addition, the Bank has established lines of credit with the Federal Reserve Bank and commercial banks.

For additional information regarding these arrangements, including collateral, refer to Note 10 of the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2011.

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

Cash, federal funds sold, and interest-bearing deposits with banks as of June 30, 2012 totaled \$12,018,664, a decrease of \$7,099,525, or 37.13%, from the December 31, 2011 total of \$19,118,189. The decrease in cash was primarily due to a decrease in deposits and the excess of loan originations over principal payments collected partially offset by proceeds received from maturing investment securities.

During the six months ended June 30, 2012, all financing activities used \$9,913,246 in cash compared to \$18,470,421 in cash provided for the same period in 2011. The decrease of cash flows from financing activities of \$28,383,667 was primarily due to a net decrease in deposits of \$40,828,381 as customer deposits for the six months ended June 30, 2012 decreased \$11,478,877 compared to an increase in deposits of \$29,349,504 for the six months ended June 30,

2011. This was partially offset by increases in cash provided of \$11,954,913 for long-term debt and short term borrowing activity. The Bank increased short-term borrowings by \$3,000,000 for the six months ended June 30, 2012 compared to an increase in short term borrowings of \$1,044,127 for the same period in 2011. Additionally, scheduled pay downs on long-term debt decreased from \$10,023,487 for the six months ended June 30, 2011 to \$24,447 for the six months ended June 30, 2012. Other financing activities increased cash provided by \$489,801.

Operating activities provided cash of \$5,163,197 for the six months ended June 30, 2012 compared to \$1,947,059 of cash provided for the same period of 2011, an increase in cash of \$3,216,138 from the comparable period in 2011. Cash increased primarily due to an increase in net income and a decrease in other assets partially offset by a decrease in the provision for loan losses and an increase in deferred tax assets.

Investing activities used cash of \$2,349,476 during the six months ended June 30, 2012 compared to \$16,254,327 of cash used for the same period of 2011. The decrease in cash used of \$13,904,851 was primarily due to the decrease in the excess of loan originations over principal payments collected which resulted in a \$13,986,737 of the cash provided. For the six months ended June 30, 2012, loans originated exceeded principal collected by \$26,623,048 compared to the six months ended June 30, 2011 where loans originated exceeded principal collected by \$40,609,785. In addition, net investment transactions increased cash \$1,225,840 from a \$26,151,724 cash provided for the six months ended June 30, 2011 to \$27,377,564 cash provided for the six months ended June 30, 2012. Lastly, net cash was provided from proceeds for the sale of foreclosed real estate of \$299,302. These increased to cash were offset by an increase in net cash used of \$1,607,028 for premises and equipment related principally to acquisition and construction costs for the operations center in Waldorf, Maryland and the King George, Virginia branch.

**REGULATORY MATTERS**

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

| At June 30, 2012                         | Actual   |         | Required for<br>Capital<br>Adequacy<br>Purposes |        | To be<br>Considered Well<br>Capitalized<br>Under Prompt<br>Corrective<br>Action |         |
|--|----------|---------|---|--------|---|---------|
| (in thousands)                           |          |         |   |        |   |         |
| Total Capital (to risk weighted assets)  |          |         |   |        |   |         |
| The Company                              | \$95,529 | 12.55 % | \$60,878  | 8.00 % |   |         |
| The Bank                                 | \$92,449 | 12.20 % | \$60,599  | 8.00 % | \$75,749  | 10.00 % |
| Tier 1 Capital (to risk weighted assets) |          |         |   |        |   |         |
| The Company                              | \$88,065 | 11.57 % | \$30,439  | 4.00 % |   |         |
| The Bank                                 | \$84,985 | 11.22 % | \$30,299  | 4.00 % | \$45,449  | 6.00 %  |
| Tier 1 Capital (to average assets)       |          |         |   |        |   |         |
| The Company                              | \$88,065 | 9.16 %  | \$38,449  | 4.00 % |   |         |
| The Bank                                 | \$84,985 | 8.87 %  | \$38,310  | 4.00 % | \$47,887  | 5.00 %  |

**CRITICAL ACCOUNTING POLICIES**

Critical accounting policies are defined as those that involve significant judgments and uncertainties and could potentially result in materially different results under different assumptions and conditions. The Company considers its determination of other-than-temporary-impairment, the allowance for loan losses, the valuation of foreclosed real estate and the valuation of deferred tax assets to be critical accounting policies.

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

producing results that could be materially different than originally reported.

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

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

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

If management concludes an unrealized loss is temporary and our intention is to hold the investment until recovery of the amortized cost basis, which may be maturity, no charge to earnings is recorded. For additional information regarding the evaluation of OTTI, refer to Notes 4 of the Consolidated Financial Statements as presented in the Company’s Form 10-K for the year ended December 31, 2011.

### *Allowance for Loan Losses*

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

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

Management utilizes a risk scale to assign grades to commercial real estate, construction and land development, commercial loans and commercial equipment loans. Commercial loan relationships with an aggregate exposure to the Bank of \$750,000 or greater are risk rated. Residential first mortgages, home equity and second mortgages and consumer loans are evaluated for creditworthiness in underwriting and are monitored on an ongoing basis based on borrower payment history. Consumer loans and residential real estate loans are classified as unrated unless they are part of a larger commercial relationship that requires grading or are troubled debt restructures or nonperforming loans with an Other Assets Especially Mentioned or higher risk rating due to a delinquent payment history. Management engages a third-party firm to perform loan reviews of its commercial loan portfolio.

In establishing the general component of the allowance, management analyzes non-classified and non-impaired loans in the portfolio including changes in the amount and type of loans. Management also examines the Bank’s historical loss experience (including charge-offs and recoveries) within each loan category. The state of the local and national economy is also considered. Based upon these factors, the Bank’s loan portfolio is categorized and a loss factor is applied to each category. These loss factors may be higher or lower than the Bank’s actual recent average losses in any particular loan category, particularly in loan categories that are increasing or decreasing in size. Based upon these factors, the Bank will adjust the loan loss allowance by increasing or decreasing the provision for loan losses.

Management has significant discretion in making the judgments inherent in the determination of the allowance for loan losses, including in connection with the valuation of collateral, a borrower’s prospects of repayment and in establishing loss factors on the general component of the allowance. Changes in loss factors will have a direct impact on the amount of the provision and a corresponding effect on net income. Errors in management’s perception and

assessment of the global factors and their impact on the portfolio could result in the allowance not being adequate to cover losses in the portfolio, and may result in additional provisions or charge-offs. An increase or decrease in the allowance could result in a charge or credit to income before income taxes that materially impacts earnings.

For additional information regarding the allowance for loan losses, refer to Notes 1 and 5 of the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2011.

***Foreclosed Real Estate (Other Real Estate Owned "OREO")***

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

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



For additional information regarding foreclosed real estate, refer to Notes 1 and 7 of the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2011.

### ***Deferred Tax Assets***

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

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

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

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

Any change in the current federal or state income tax rates can affect the carrying amount of deferred taxes. Any change would be recorded through earnings in the period the new tax rates were enacted.

For additional information regarding the deferred tax assets, refer to Note 11 in the Consolidated Financial Statements as presented in the Company's Form 10-K for the year ended December 31, 2011.

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

Not applicable as the Company is a smaller reporting company.

**ITEM 4. CONTROLS AND PROCEDURES**

As of the end of the period covered by this report, management of the Company carried out an evaluation, under the supervision and with the participation of the Company's principal executive officer and principal financial officer, of the effectiveness of the Company's disclosure controls and procedures. Based on this evaluation, the Company's principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective in ensuring that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934, as amended, (1) is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and (2) is accumulated and communicated to the Company's management, including its principal executive and financial officers as appropriate to allow timely decisions regarding required disclosure. It should be noted that the design of the Company's disclosure controls and procedures is based in part upon certain reasonable assumptions about the likelihood of future events, and there can be no reasonable assurance that any design of disclosure controls and procedures will succeed in achieving its stated goals under all potential future conditions, regardless of how remote, but the Company's principal executive and financial officers have concluded that the Company's disclosure controls and procedures are, in fact, effective at a reasonable assurance level. There were no changes in the Company's internal control over financial reporting during the quarter ended June 30, 2012 that have materially affected, or are reasonable likely to materially affect, the Company's internal control over financial reporting.

**PART II - OTHER INFORMATION**

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

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

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

(a) Not applicable

(b) Not applicable

(c) On September 25, 2008, the Company announced a repurchase program under which it would repurchase up to 5% of its outstanding common stock or approximately 147,435 shares. As of June 30, 2012, 106,006 shares were available to be repurchased under the repurchase program. The following schedule provides repurchases for the three months ended June 30, 2012.

| Period           | (a)<br>Total<br>Number<br>of<br>Shares<br>Purchased | (b)<br>Average<br>Price<br>Paid<br>per<br>Share | Total<br>Number<br>of Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans<br>or<br>Programs | (d)<br>Maximum<br>Number<br>of Shares<br>that May<br>Yet Be<br>Purchased<br>Under<br>the Plans<br>or<br>Programs |
|------------------|---|---|---|--|
| April 1-30, 2012 | 9,000   | \$ 17.09  | 9,000   | 106,006  |
| May 1-31, 2012   | -   | -   | -   | 106,006  |

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|                 |       |          |       |         |
|-----------------|-------|----------|-------|---------|
| June 1-30, 2012 | -     | -        | -     | 106,006 |
| Total           | 9,000 | \$ 17.09 | 9,000 | 106,006 |

Item 3 - Default Upon Senior Securities - None

Item 4 – Mine Safety Disclosures – Not Applicable

Item 5 - Other Information - None

Item 6 - Exhibits

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

Exhibit 32 - Section 1350 Certifications Exhibit 31 - Rule 13a-14(a) Certifications

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**SIGNATURES**

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

**TRI-COUNTY  
FINANCIAL  
CORPORATION**

Date: August 3, 2012 By: /s/ Michael L. Middleton  
Michael L. Middleton  
Chief Executive Officer

Date: August 3, 2012 By: /s/ William J. Pasenelli  
William J. Pasenelli  
President and Chief Financial  
Officer