

PEOPLES FINANCIAL CORP /MS/  
Form 10-Q  
August 13, 2014

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

**x QUARTERLY REPORT PURSUANT TO SECTION 13 or 15 (D) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**For the quarterly period ended June 30, 2014**

**or**

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

**Commission File Number 001-12103**

**PEOPLES FINANCIAL CORPORATION**

**(Exact name of registrant as specified in its charter)**

**Mississippi  
(State or other jurisdiction of**

**64-0709834  
(I.R.S. Employer**

**incorporation or organization)**

**Identification No.)**

**Lameuse and Howard Avenues, Biloxi, Mississippi**  
**(Address of principal executive offices)**

**39533**  
**(Zip Code)**

**(228) 435-5511**

**(Registrant's telephone number, including area code)**

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  (Do not check if a smaller reporting company)

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date. Peoples Financial Corporation has only one class of common stock authorized. At July 31, 2014, there were 15,000,000 shares of \$1 par value common stock authorized, with 5,123,186 shares issued and outstanding.

**Part 1 Financial Information****Item 1: Financial Statements****Peoples Financial Corporation and Subsidiaries****Consolidated Statements of Condition****(in thousands except share data)**

|   | <b>June 30, 2014</b><br><b>(unaudited)</b> | <b>December 31, 2013</b><br><b>(audited)</b> |
|---|--|--|
| <b>Assets</b>   |  |  |
| Cash and due from banks   | \$ 31,990                                  | \$ 36,264                                    |
| Available for sale securities   | 272,718                                    | 275,440                                      |
| Held to maturity securities, fair value of<br>\$12,882 at June 30, 2014;<br>\$10,686 at December 31, 2013 | 13,011                                     | 11,142                                       |
| Other investments   | 3,056                                      | 3,262  |
| Federal Home Loan Bank Stock, at cost   | 3,566                                      | 3,834  |
| Loans   | 361,519                                    | 375,349                                      |
| Less: Allowance for loan losses   | 9,434                                      | 8,934  |
| Loans, net  | 352,085                                    | 366,415                                      |
| Bank premises and equipment, net of accumulated depreciation  | 24,538                                     | 25,308                                       |
| Other real estate   | 8,924                                      | 9,630  |
| Accrued interest receivable   | 2,784                                      | 2,607  |
| Cash surrender value of life insurance  | 17,765                                     | 17,456                                       |
| Other assets  | 8,723                                      | 10,906                                       |
| <b>Total assets</b>   | <b>\$ 739,160</b>                          | <b>\$ 762,264</b>                            |

**Peoples Financial Corporation and Subsidiaries**

**Consolidated Statements of Condition (continued)**

(in thousands except share data)

|   | June 30, 2014<br>(unaudited) | December 31, 2013<br>(audited) |
|---|------------------------------|--------------------------------|
| <b>Liabilities and Shareholders Equity</b>  |                              |                                |
| <b>Liabilities:</b>   |                              |                                |
| Deposits:   |                              |                                |
| Demand, non-interest bearing  | \$ 114,471                   | \$ 107,117                     |
| Savings and demand, interest bearing  | 222,924                      | 217,005                        |
| Time, \$100,000 or more   | 44,941                       | 60,519                         |
| Other time deposits   | 41,507                       | 43,917                         |
| Total deposits  | 423,843                      | 428,558                        |
| Federal funds purchased and securities sold under agreements to repurchase  | 117,370                      | 139,639                        |
| Borrowings from Federal Home Loan Bank  | 76,566                       | 77,684                         |
| Employee and director benefit plans liabilities   | 13,373                       | 12,725                         |
| Other liabilities   | 4,406                        | 4,511                          |
| <b>Total liabilities</b>  | <b>635,558</b>               | <b>663,117</b>                 |
| <b>Shareholders Equity:</b>   |                              |                                |
| Common stock, \$1 par value, 15,000,000 shares authorized, 5,123,186 shares issued and outstanding at June 30, 2014 and December 31, 2013 | 5,123                        | 5,123                          |
| Surplus   | 65,780                       | 65,780                         |
| Undivided profits   | 34,661                       | 34,259                         |
| Accumulated other comprehensive loss, net of tax  | (1,962)                      | (6,015)                        |
| <b>Total shareholders equity</b>  | <b>103,602</b>               | <b>99,147</b>                  |
| <b>Total liabilities and shareholders equity</b>  | <b>\$ 739,160</b>            | <b>\$ 762,264</b>              |

See notes to consolidated financial statements.

**Peoples Financial Corporation and Subsidiaries**

**Consolidated Statements of Operations**

(in thousands except per share data)(unaudited)

|  | Three Months Ended June 30, |                 | Six Months Ended June 30, |                 |
|--|-----------------------------|-----------------|---------------------------|-----------------|
|  | 2014                        | 2013            | 2014                      | 2013            |
| <b>Interest income:</b>  |                             |                 |                           |                 |
| Interest and fees on loans   | \$ 4,165                    | \$ 4,339        | \$ 8,417                  | \$ 8,778        |
| Interest and dividends on securities:                                      |                             |                 |                           |                 |
| U.S. Treasuries  | 158                         | 108             | 314                       | 291             |
| U.S. Government agencies   | 798                         | 748             | 1,605                     | 1,479           |
| Mortgage-backed securities   | 241                         | 139             | 486                       | 230             |
| States and political subdivisions  | 382                         | 382             | 764                       | 756             |
| Other investments  | 3                           | 3               | 4                         | 6               |
| Interest on federal funds sold   | 3                           | 31              | 7                         | 64              |
| <b>Total interest income</b>   | <b>5,750</b>                | <b>5,750</b>    | <b>11,597</b>             | <b>11,604</b>   |
| <b>Interest expense:</b>   |                             |                 |                           |                 |
| Deposits   | 274                         | 315             | 483                       | 635             |
| Borrowings from Federal Home Loan Bank                                     | 56                          | 40              | 106                       | 81              |
| Federal funds purchased and securities sold under agreements to repurchase | 22                          | 43              | 49                        | 89              |
| <b>Total interest expense</b>  | <b>352</b>                  | <b>398</b>      | <b>638</b>                | <b>805</b>      |
| <b>Net interest income</b>   | <b>5,398</b>                | <b>5,352</b>    | <b>10,959</b>             | <b>10,799</b>   |
| <b>Provision for allowance for loan losses</b>                             | <b>537</b>                  | <b>3,538</b>    | <b>1,074</b>              | <b>4,077</b>    |
| <b>Net interest income after provision for allowance for loan losses</b>   | <b>\$ 4,861</b>             | <b>\$ 1,814</b> | <b>\$ 9,885</b>           | <b>\$ 6,722</b> |

## Peoples Financial Corporation and Subsidiaries

## Consolidated Statements of Operations (continued)

(in thousands except per share data)(unaudited)

|  | Three Months Ended June 30, |                   | Six Months Ended June 30, |                 |
|--|-----------------------------|-------------------|---------------------------|-----------------|
|  | 2014                        | 2013              | 2014                      | 2013            |
| <b>Non-interest income:</b>                        |                             |                   |                           |                 |
| Trust department income and fees                   | \$ 357                      | \$ 336            | \$ 717                    | \$ 694          |
| Service charges on deposit accounts                | 1,633                       | 1,523             | 3,219                     | 3,031           |
| Gain on sales and calls of securities              |                             | 255               |                           | 255             |
| Income from other investments                      | 23                          | 31                | 30                        | 9               |
| Increase in cash surrender value of life insurance | 126                         | 122               | 245                       | 243             |
| Other income                                       | 141                         | 144               | 286                       | 300             |
| <b>Total non-interest income</b>                   | <b>2,280</b>                | <b>2,411</b>      | <b>4,497</b>              | <b>4,532</b>    |
| <b>Non-interest expense:</b>                       |                             |                   |                           |                 |
| Salaries and employee benefits                     | 3,202                       | 2,850             | 6,415                     | 5,991           |
| Net occupancy                                      | 675                         | 662               | 1,267                     | 1,236           |
| Equipment rentals, depreciation and maintenance    | 857                         | 762               | 1,573                     | 1,442           |
| FDIC assessments                                   | 265                         | 154               | 540                       | 445             |
| Data processing                                    | 355                         | 300               | 676                       | 620             |
| ATM expense  | 760                         | 613               | 1,415                     | 1,191           |
| Other expense                                      | 927                         | 873               | 1,906                     | 1,701           |
| <b>Total non-interest expense</b>                  | <b>7,041</b>                | <b>6,214</b>      | <b>13,792</b>             | <b>12,626</b>   |
| <b>Income (loss) before income tax benefit</b>     | <b>100</b>                  | <b>(1,989)</b>    | <b>590</b>                | <b>(1,372)</b>  |
| Income tax benefit                                 | (235)                       | (842)             | (324)                     | (831)           |
| <b>Net income (loss)</b>                           | <b>\$ 335</b>               | <b>\$ (1,147)</b> | <b>\$ 914</b>             | <b>\$ (541)</b> |
| <b>Basic and diluted earnings (loss) per share</b> | <b>\$ .07</b>               | <b>\$ (.23)</b>   | <b>\$ .18</b>             | <b>\$ (.11)</b> |
| <b>Dividends declared per share</b>                | <b>\$ .10</b>               | <b>\$</b>         | <b>\$ .10</b>             | <b>\$</b>       |

See notes to consolidated financial statements.

**Peoples Financial Corporation and Subsidiaries**

**Consolidated Statements of Comprehensive Income (Loss)**

(in thousands)(unaudited)

|   | <b>Three Months Ended June 30,</b> |             | <b>Six Months Ended June 30,</b> |             |
|---|------------------------------------|-------------|----------------------------------|-------------|
|   | <b>2014</b>                        | <b>2013</b> | <b>2014</b>                      | <b>2013</b> |
| <b>Net income (loss)</b>  | \$ 335                             | \$ (1,147)  | \$ 914                           | \$ (541)    |
| <b>Other comprehensive income (loss), net of tax:</b>   |                                    |             |                                  |             |
| Net unrealized gain (loss) on available for sale securities, net of tax of \$1,093 and \$3,185 for the three months ended June 30, 2014 and 2013, respectively, and \$2,088 and \$3,458 for the six months ended June 30, 2014 and 2013, respectively | 2,121                              | (6,182)     | 4,053                            | (6,713)     |
| Reclassification adjustment for realized gains on available for sale securities called or sold, net of tax of \$87 for the three months ended June 30, 2013 and \$87 for the six months ended June 30, 2013   |                                    | (168)       |                                  | (168)       |
| <b>Total other comprehensive income (loss)</b>  | 2,121                              | (6,350)     | 4,053                            | (6,881)     |
| <b>Total comprehensive income (loss)</b>  | \$ 2,456                           | \$ (7,497)  | \$ 4,967                         | \$ (7,422)  |

See notes to consolidated financial statements.

**Peoples Financial Corporation and Subsidiaries**

**Consolidated Statement of Changes in Shareholders' Equity**

(in thousands except share and per share data)

|  | Number of<br>Common<br>Shares | Common<br>Stock | Surplus   | Undivided<br>Profits | Accumulated<br>Other<br>Comprehensive<br>Loss | Total      |
|--|-------------------------------|-----------------|-----------|----------------------|---|------------|
| <b>Balance, January 1, 2014</b>        | 5,123,186                     | \$ 5,123        | \$ 65,780 | \$ 34,259            | \$ (6,015)                                    | \$ 99,147  |
| Net income                             |                               |                 |           | 914                  |   | 914        |
| Other comprehensive income, net of tax |                               |                 |           |                      | 4,053   | 4,053      |
| Cash dividends (\$.10 per share)       |                               |                 |           | (512)                |   | (512)      |
| <b>Balance, June 30, 2014</b>          | 5,123,186                     | \$ 5,123        | \$ 65,780 | \$ 34,661            | \$ (1,962)                                    | \$ 103,602 |

Note: Balances as of January 1, 2014 were audited.

See notes to consolidated financial statements.



**Peoples Financial Corporation and Subsidiaries**

**Consolidated Statements of Cash Flows**

(in thousands)(unaudited)

|  | <b>Six Months Ended June 30,</b> |                 |
|--|----------------------------------|-----------------|
|  | <b>2014</b>                      | <b>2013</b>     |
| <b>Cash flows from operating activities:</b>   |                                  |                 |
| <b>Net income (loss)</b>   | \$ 914                           | \$ (541)        |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                                  |                 |
| Depreciation   | 894                              | 884             |
| Provision for allowance for loan losses  | 1,074                            | 4,077           |
| Loss on sales of other real estate   | 76                               | 5               |
| Writedown of other real estate   | 174                              | 22              |
| Gain on sales of bank premises and equipment   |                                  | (15)            |
| Income from other investments  | (30)                             | (9)             |
| Gain on sales and calls of securities  |                                  | (255)           |
| Accretion of held to maturity securities   | (1)                              | (1)             |
| Change in accrued interest receivable  | (177)                            | 195             |
| Increase in cash surrender value of life insurance                                       | (245)                            | (243)           |
| Change in other assets   | 1,508                            | 1,032           |
| Change in other liabilities  | (868)                            | (980)           |
| <b>Net cash provided by operating activities</b>   | <b>\$ 3,319</b>                  | <b>\$ 4,171</b> |

**Peoples Financial Corporation and Subsidiaries**  
**Consolidated Statements of Cash Flows (continued)**  
**(in thousands) (unaudited)**

|  | <b>Six Months Ended June 30,</b> |                  |
|--|----------------------------------|------------------|
|  | <b>2014</b>                      | <b>2013</b>      |
| <b>Cash flows from investing activities:</b>   |                                  |                  |
| Proceeds from maturities, sales and calls of available for sale securities             | \$ 10,705                        | \$ 122,214       |
| Proceeds from maturities of held to maturity securities                                | 215                              |                  |
| Purchases of available for sale securities   | (1,844)                          | (155,825)        |
| Purchases of held to maturity securities   | (2,083)                          | (2,606)          |
| Redemption of Federal Home Loan Bank stock   | 268                              | 1,729            |
| Redemption of other investments  | 236                              | 230              |
| Proceeds from sales of bank premises and equipment                                     |                                  | 19               |
| Proceeds from sales of other real estate   | 650                              | 515              |
| Insurance proceeds from casualty loss on other real estate                             |                                  | 57               |
| Loans, net change  | 13,062                           | 26,785           |
| Acquisition of bank premises and equipment   | (124)                            | (723)            |
| Investment in cash surrender value of life insurance                                   | (64)                             | (59)             |
| <b>Net cash provided by (used in) investing activities</b>                             | <b>21,021</b>                    | <b>(7,664)</b>   |
| <b>Cash flows from financing activities:</b>   |                                  |                  |
| Demand and savings deposits, net change  | 13,273                           | 16,867           |
| Time deposits, net change  | (17,988)                         | (11,981)         |
| Cash dividends   | (512)                            |                  |
| Retirement of common stock   |                                  | (99)             |
| Borrowings from Federal Home Loan Bank   | 1,309,500                        |                  |
| Repayments to Federal Home Loan Bank   | (1,310,618)                      | (113)            |
| Federal funds purchased and securities sold under agreements to repurchase, net change | (22,269)                         | (2,863)          |
| <b>Net cash provided by (used in) financing activities</b>                             | <b>(28,614)</b>                  | <b>1,811</b>     |
| <b>Net decrease in cash and cash equivalents</b>                                       | <b>(4,274)</b>                   | <b>(1,682)</b>   |
| <b>Cash and cash equivalents, beginning of period</b>                                  | <b>36,264</b>                    | <b>54,020</b>    |
| <b>Cash and cash equivalents, end of period</b>  | <b>\$ 31,990</b>                 | <b>\$ 52,338</b> |

See notes to consolidated financial statements.

PEOPLES FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

For the Six Months Ended June 30, 2014 and 2013

1. Basis of Presentation:

Peoples Financial Corporation (the Company) is a one-bank holding company headquartered in Biloxi, Mississippi. It has two operating subsidiaries, PFC Service Corp., an inactive company, and The Peoples Bank, Biloxi, Mississippi (the Bank). The Bank provides a full range of banking, financial and trust services to state, county and local government entities and individuals and small and commercial businesses operating in those portions of Mississippi, Louisiana and Alabama which are within a fifty mile radius of the Waveland, Wiggins and Gautier branches, the Bank's three most outlying locations (the trade area).

The accompanying unaudited consolidated financial statements and notes thereto contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly, in accordance with accounting principles generally accepted in the United States of America (GAAP), the financial position of the Company and its subsidiaries as of June 30, 2014 and the results of their operations and their cash flows for the periods presented. The interim financial information should be read in conjunction with the annual consolidated financial statements and the notes thereto included in the Company's 2013 Annual Report and Form 10-K.

The results of operations for the quarter or six months ended June 30, 2014, are not necessarily indicative of the results to be expected for the full year.

**Use of Estimates** The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates. Material estimates common to the banking industry that are particularly susceptible to significant change in the near term include, but are not limited to, the determination of the allowance for loan losses, the valuation of other real estate acquired in connection with foreclosure or in satisfaction of loans and valuation allowances associated with the realization of deferred tax assets, which are based on future taxable income.

**Summary of Significant Accounting Policies** The accounting and reporting policies of the Company conform with GAAP and general practices within the banking industry. There have been no material changes or developments in the application of principles or in our evaluation of the accounting estimates and the underlying assumptions or methodologies that we believe to be Critical Accounting Policies as disclosed in our Form 10-K for the year ended December 31, 2013.

**New Accounting Pronouncements** In April 2014, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) No. 2014-06, *Technical Corrections and Improvements Related to Glossary Terms*. This ASU added, deleted, corrected and modified terms in the Master Glossary of the Codification and was effective upon issuance. The adoption of this ASU did not have a material effect on the Company's financial position, results of operations or cash flows.

## 2. Earnings Per Share:

Per share data is based on the weighted average shares of common stock outstanding of 5,123,186 and 5,132,494 for the quarters ended June 30, 2014 and 2013, respectively, and 5,123,186 and 5,134,620 for the six months ended June 30, 2014 and 2013, respectively.

## 3. Statements of Cash Flows:

The Company has defined cash and cash equivalents as cash and due from banks. The Company paid \$525,244 and \$814,566 for the six months ended June 30, 2014 and 2013, respectively, for interest on deposits and borrowings. Income tax payments of \$320,000 and \$310,000 were made during the six months ended June 30, 2014 and 2013, respectively. Loans transferred to other real estate amounted to \$194,328 and \$415,959 during the six months ended June 30, 2014 and 2013, respectively.

## 4. Investments:

The amortized cost and fair value of securities at June 30, 2014 and December 31, 2013, are as follows (in thousands):

| June 30, 2014                              | Amortized Cost    | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value     |
|--|-------------------|------------------------------|-------------------------------|-------------------|
| Available for sale securities:             |                   |                              |                               |                   |
| Debt securities:                           |                   |                              |                               |                   |
| U.S. Treasuries                            | \$ 44,658         | \$ 133                       | \$ (593)                      | \$ 44,198         |
| U.S. Government agencies                   | 148,797           | 750                          | (6,430)                       | 143,117           |
| Mortgage-backed securities                 | 48,214            | 512                          | (447)                         | 48,279            |
| States and political subdivisions          | 35,096            | 1,378                        |                               | 36,474            |
| <b>Total debt securities</b>               | <b>276,765</b>    | <b>2,773</b>                 | <b>(7,470)</b>                | <b>272,068</b>    |
| Equity securities                          | 650               |                              |                               | 650               |
| <b>Total available for sale securities</b> | <b>\$ 277,415</b> | <b>\$ 2,773</b>              | <b>\$ (7,470)</b>             | <b>\$ 272,718</b> |
| Held to maturity securities:               |                   |                              |                               |                   |
| States and political subdivisions          | \$ 13,011         | \$ 45                        | \$ (174)                      | \$ 12,882         |
| <b>Total held to maturity securities</b>   | <b>\$ 13,011</b>  | <b>\$ 45</b>                 | <b>\$ (174)</b>               | <b>\$ 12,882</b>  |

| December 31, 2013                          | Amortized Cost    | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value     |
|--|-------------------|------------------------------|-------------------------------|-------------------|
| <b>Available for sale securities:</b>      |                   |                              |                               |                   |
| <b>Debt securities:</b>                    |                   |                              |                               |                   |
| U.S. Treasuries                            | \$ 44,636         | \$ 54                        | \$ (1,042)                    | \$ 43,648         |
| U.S. Government agencies                   | 155,772           | 734                          | (10,701)                      | 145,805           |
| Mortgage-backed securities                 | 51,454            | 141                          | (1,269)                       | 50,326            |
| States and political subdivisions          | 33,764            | 1,248                        | (1)                           | 35,011            |
| <b>Total debt securities</b>               | <b>285,626</b>    | <b>2,177</b>                 | <b>(13,013)</b>               | <b>274,790</b>    |
| Equity securities                          | 650               |                              |                               | 650               |
| <b>Total available for sale securities</b> | <b>\$ 286,276</b> | <b>\$ 2,177</b>              | <b>\$ (13,013)</b>            | <b>\$ 275,440</b> |
| <b>Held to maturity securities:</b>        |                   |                              |                               |                   |
| States and political subdivisions          | \$ 11,142         | \$ 13                        | \$ (469)                      | \$ 10,686         |
| <b>Total held to maturity securities</b>   | <b>\$ 11,142</b>  | <b>\$ 13</b>                 | <b>\$ (469)</b>               | <b>\$ 10,686</b>  |

The amortized cost and fair value of debt securities at June 30, 2014 (in thousands), by contractual maturity, are shown on the next page. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|  | Amortized Cost    | Fair Value        |
|--|-------------------|-------------------|
| Available for sale securities:         |                   |                   |
| Due in one year or less                | \$ 16,420         | \$ 16,516         |
| Due after one year through five years  | 62,763            | 62,922            |
| Due after five years through ten years | 61,068            | 61,216            |
| Due after ten years                    | 88,300            | 83,135            |
| Mortgage-backed securities             | 48,214            | 48,279            |
| <b>Totals</b>                          | <b>\$ 276,765</b> | <b>\$ 272,068</b> |
| Held to maturity securities:           |                   |                   |
| Due in one year or less                | \$ 659            | \$ 662            |
| Due after one year through five years  | 3,031             | 3,035             |
| Due after five years through ten years | 5,877             | 5,852             |
| Due after ten years                    | 3,444             | 3,333             |
| <b>Totals</b>                          | <b>\$ 13,011</b>  | <b>\$ 12,882</b>  |

Available for sale and held to maturity securities with gross unrealized losses at June 30, 2014 and December 31, 2013, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows (in thousands):

|                                   | Less Than Twelve Months |                  | Over Twelve Months |                 | Total             |                  |
|-----------------------------------|-------------------------|------------------|--------------------|-----------------|-------------------|------------------|
|                                   | Gross Unrealized        |                  | Gross Unrealized   |                 | Gross Unrealized  |                  |
|                                   | Fair Value              | Losses           | Fair Value         | Losses          | Fair Value        | Losses           |
| <b>June 30, 2014:</b>             |                         |                  |                    |                 |                   |                  |
| U.S. Treasuries                   | \$ 10,949               | \$ 42            | \$ 33,249          | \$ 551          | \$ 44,198         | \$ 593           |
| U.S. Government agencies          | 9,769                   | 251              | 133,347            | 6,179           | 143,116           | 6,430            |
| Mortgage-backed securities        | 17,934                  | 45               | 30,345             | 402             | 48,279            | 447              |
| States and political subdivisions | 5,999                   | 17               | 36,326             | 157             | 42,325            | 174              |
| <b>TOTAL</b>                      | <b>\$ 44,651</b>        | <b>\$ 355</b>    | <b>\$ 233,267</b>  | <b>\$ 7,289</b> | <b>\$ 277,918</b> | <b>\$ 7,644</b>  |
| <b>December 31, 2013:</b>         |                         |                  |                    |                 |                   |                  |
| U.S. Treasuries                   | \$ 29,708               | \$ 1,042         | \$                 | \$              | \$ 29,708         | \$ 1,042         |
| U.S. Government agencies          | 113,446                 | 10,322           | 4,621              | 379             | 118,067           | 10,701           |
| Mortgage-backed securities        | 44,269                  | 1,269            |                    |                 | 44,269            | 1,269            |
| States and political subdivisions | 7,690                   | 470              |                    |                 | 7,690             | 470              |
| <b>TOTAL</b>                      | <b>\$ 195,113</b>       | <b>\$ 13,103</b> | <b>\$ 4,621</b>    | <b>\$ 379</b>   | <b>\$ 199,734</b> | <b>\$ 13,482</b> |

At June 30, 2014, 7 of the 11 securities issued by the U.S. Treasury, 24 of the 29 securities issued by U.S. Government agencies, 7 of the 13 mortgage-backed securities and 23 of the 160 securities issued by states and political subdivisions contained unrealized losses.

Management evaluates securities for other-than-temporary impairment on a monthly basis. In performing this evaluation, the length of time and the extent to which the fair value has been less than cost, the fact that the Company's securities are primarily issued by U.S. Treasury and U.S. Government Agencies and the cause of the decline in value are considered. In addition, the Company does not intend to sell and it is not more likely than not that it will be required to sell these securities before maturity. While some available for sale securities have been sold for liquidity purposes or for gains, the Company has traditionally held its securities, including those classified as available for sale, until maturity. As a result of the evaluation of these securities, the Company has determined that the unrealized losses summarized in the tables above are not deemed to be other-than-temporary.

Securities with a fair value of \$272,208,237 and \$262,830,011 at June 30, 2014 and December 31, 2013, respectively, were pledged to secure public deposits, federal funds purchased and other balances required by law.

Proceeds from the sale of available for sale debt securities were \$24,989,844 for the six months ended June 30, 2013. Available for sale debt securities were sold for a realized gain of \$254,841. There were no sales of available for sale securities in 2014.

#### 5. Loans:

The composition of the loan portfolio at June 30, 2014 and December 31, 2013, is as follows (in thousands):

|                                  | June 30, 2014 | December 31, 2013 |
|----------------------------------|---------------|-------------------|
| Gaming                           | \$ 27,993     | \$ 29,570         |
| Residential and land development | 19,060        | 19,403            |
| Real estate, construction        | 43,333        | 44,987            |
| Real estate, mortgage            | 233,364       | 237,158           |
| Commercial and industrial        | 28,896        | 35,007            |
| Other                            | 8,873         | 9,224             |
| Total                            | \$ 361,519    | \$ 375,349        |



The age analysis of the loan portfolio, segregated by class of loans, as of June 30, 2014 and December 31, 2013, is as follows (in thousands):

|                                  | Number of Days Past Due |                 |                  | Total Past Due   | Current           | Total Loans       | Loans Past Due Greater Than 90 Days & Still Accruing |
|----------------------------------|-------------------------|-----------------|------------------|------------------|-------------------|-------------------|--|
|                                  | 30 - 59                 | 60 - 89         | Greater Than 90  |                  |                   |                   |  |
| <b>June 30, 2014:</b>            |                         |                 |                  |                  |                   |                   |  |
| Gaming                           | \$                      | \$              | \$ 591           | \$ 591           | \$ 27,402         | \$ 27,993         | \$   |
| Residential and land development |                         |                 | 13,391           | 13,391           | 5,669             | 19,060            |  |
| Real estate, construction        | 1,082                   | 772             | 1,963            | 3,817            | 39,516            | 43,333            |  |
| Real estate, mortgage            | 9,790                   | 1,828           | 4,645            | 16,263           | 217,101           | 233,364           | 497  |
| Commercial and industrial        | 5,157                   | 10              | 15               | 5,182            | 23,714            | 28,896            | 15   |
| Other                            | 95                      | 61              |                  | 156              | 8,717             | 8,873             |  |
| <b>Total</b>                     | <b>\$ 16,124</b>        | <b>\$ 2,671</b> | <b>\$ 20,605</b> | <b>\$ 39,400</b> | <b>\$ 322,119</b> | <b>\$ 361,519</b> | <b>\$ 512</b>  |
| <b>December 31, 2013:</b>        |                         |                 |                  |                  |                   |                   |  |
| Gaming                           | \$                      | \$              | \$               | \$               | \$ 29,570         | \$ 29,570         | \$   |
| Residential and land development | 51                      |                 | 13,572           | 13,623           | 5,780             | 19,403            |  |
| Real estate, construction        | 3,846                   |                 | 9,452            | 13,298           | 31,689            | 44,987            | 146  |
| Real estate, mortgage            | 6,910                   | 2,684           | 5,134            | 14,728           | 222,430           | 237,158           | 505  |
| Commercial and industrial        | 1,192                   |                 |                  | 1,192            | 33,815            | 35,007            |  |
| Other                            | 227                     | 5               |                  | 232              | 8,992             | 9,224             |  |
| <b>Total</b>                     | <b>\$ 12,226</b>        | <b>\$ 2,689</b> | <b>\$ 28,158</b> | <b>\$ 43,073</b> | <b>\$ 332,276</b> | <b>\$ 375,349</b> | <b>\$ 651</b>  |

The Company monitors the credit quality of its loan portfolio through the use of a loan grading system. A score of 1 to 5 is assigned to the loan on factors including repayment ability, trends in net worth and/or financial condition of the borrower and guarantors, employment stability, management ability, loan to value fluctuations, the type and structure of the loan, conformity of the loan to bank policy and payment performance. Based on the total score, a loan grade of A - F is applied. A grade of A will generally be applied to loans for customers that are well known to the Company and that have excellent sources of repayment. A grade of B will generally be applied to loans for customers that have excellent sources of repayment which have no identifiable risk of collection. A grade of C will generally be applied to loans for customers that have adequate sources of repayment which have little identifiable risk of collection. Loans with a grade of C may be placed on the watch list if weaknesses are not resolved which could result in potential loss or for other circumstances that require monitoring. A grade of D will generally be applied to loans for customers that are inadequately protected by current sound net worth, paying capacity of the borrower, or pledged collateral. Loans with a grade of D have unsatisfactory characteristics such as cash flow deficiencies, bankruptcy filing by the borrower or dependence on the sale of collateral for the primary source of repayment, causing more than acceptable levels of risk. Loans 60 to 89 days past due receive a grade of D. A grade of E will generally be applied to loans for customers with weaknesses inherent in the D classification and in which collection or liquidation in full is questionable. In addition, on a monthly basis the Company determines which loans are 90 days or more past due and assigns a grade of E to

them. A grade of F is applied to loans which are considered uncollectible and of such little value that their continuance in an active bank is not warranted. Loans with this grade are charged off, even though partial or full recovery may be possible in the future.

An analysis of the loan portfolio by loan grade, segregated by class of loans, as of June 30, 2014 and December 31, 2013, is as follows (in thousands):

|                                  | Loans With A Grade Of: |                  |                  |                  |           | Total             |
|----------------------------------|------------------------|------------------|------------------|------------------|-----------|-------------------|
|                                  | A or B                 | C                | D                | E                | F         |                   |
| <b>June 30, 2014:</b>            |                        |                  |                  |                  |           |                   |
| Gaming                           | \$ 25,530              | \$               | \$               | \$ 2,463         | \$        | \$ 27,993         |
| Residential and land development | 4,142                  | 1,492            | 35               | 13,391           |           | 19,060            |
| Real estate, construction        | 37,059                 | 1,111            | 2,233            | 2,930            |           | 43,333            |
| Real estate, mortgage            | 200,890                | 4,803            | 17,433           | 10,238           |           | 233,364           |
| Commercial and industrial        | 26,309                 | 309              | 2,250            | 28               |           | 28,896            |
| Other                            | 8,820                  | 28               | 22               | 3                |           | 8,873             |
| <b>Total</b>                     | <b>\$ 302,750</b>      | <b>\$ 7,743</b>  | <b>\$ 21,973</b> | <b>\$ 29,053</b> | <b>\$</b> | <b>\$ 361,519</b> |
| <b>December 31, 2013:</b>        |                        |                  |                  |                  |           |                   |
| Gaming                           | \$ 23,975              | \$ 2,500         | \$               | \$ 3,095         | \$        | \$ 29,570         |
| Residential and land development | 4,236                  | 1,544            | 51               | 13,572           |           | 19,403            |
| Real estate, construction        | 38,808                 | 781              | 2,220            | 3,178            |           | 44,987            |
| Real estate, mortgage            | 204,569                | 4,495            | 17,852           | 10,242           |           | 237,158           |
| Commercial and industrial        | 31,902                 | 682              | 2,402            | 21               |           | 35,007            |
| Other                            | 9,131                  | 24               | 50               | 19               |           | 9,224             |
| <b>Total</b>                     | <b>\$ 312,621</b>      | <b>\$ 10,026</b> | <b>\$ 22,575</b> | <b>\$ 30,127</b> | <b>\$</b> | <b>\$ 375,349</b> |

A loan may be impaired but not on nonaccrual status when the loan is well secured and in the process of collection. Total loans on nonaccrual as of June 30, 2014 and December 31, 2013, are as follows (in thousands):

|                                  | June 30, 2014    | December 31, 2013 |
|----------------------------------|------------------|-------------------|
| Gaming                           | \$ 591           | \$ 1,223          |
| Residential and land development | 13,391           | 13,572            |
| Real Estate, construction        | 2,533            | 2,588             |
| Real Estate, mortgage            | 8,393            | 8,788             |
| <b>Total</b>                     | <b>\$ 24,908</b> | <b>\$ 26,171</b>  |

The Company has modified certain loans by granting interest rate concessions to these customers. These loans are in compliance with their modified terms, are currently accruing and the Company has classified them as troubled debt restructurings. Troubled debt restructurings as of June 30, 2014 and December 31, 2013 were as follows (in thousands except for number of contracts):

|                           | Number of<br>Contracts | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment | Related<br>Allowance |
|---------------------------|------------------------|---|--|----------------------|
| <b>June 30, 2014:</b>     |                        |   |  |                      |
| Real estate, construction | 2                      | \$ 881  | \$ 881   | \$ 265               |
| Real estate, mortgage     | 6                      | 9,915   | 9,915  | 2,136                |
| Commercial and industrial | 1                      | 667   | 667  |                      |
| <b>Total</b>              | <b>9</b>               | <b>\$ 11,463</b>  | <b>\$ 11,463</b>   | <b>\$ 2,401</b>      |
| <b>December 31, 2013:</b> |                        |   |  |                      |
| Real estate, construction | 2                      | \$ 891  | \$ 891   | \$ 270               |
| Real estate, mortgage     | 6                      | 10,012  | 10,012   | 994                  |
| Commercial and industrial | 1                      | 678   | 678  |                      |
| <b>Total</b>              | <b>9</b>               | <b>\$ 11,581</b>  | <b>\$ 11,581</b>   | <b>\$ 1,264</b>      |

Impaired loans, which include loans classified as nonaccrual and troubled debt restructurings, segregated by class of loans, as of June 30, 2014 and December 31, 2013, are as follows (in thousands):

|                                     | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-------------------------------------|--------------------------------|------------------------|----------------------|-----------------------------------|----------------------------------|
| <b>June 30, 2014:</b>               |                                |                        |                      |                                   |                                  |
| With no related allowance recorded: |                                |                        |                      |                                   |                                  |
| Gaming                              | \$ 1,691                       | \$ 591                 | \$                   | \$ 1,115                          | \$                               |
| Residential and land development    | 4,425                          | 4,425                  |                      | 4,425                             |                                  |
| Real estate, construction           | 2,271                          | 2,271                  |                      | 2,271                             | 13                               |
| Real estate, mortgage               | 9,995                          | 9,396                  |                      | 9,464                             | 19                               |
| Commercial and industrial           | 667                            | 667                    |                      | 673                               | 13                               |
| <b>Total</b>                        | <b>\$ 19,049</b>               | <b>\$ 17,350</b>       | <b>\$</b>            | <b>\$ 17,948</b>                  | <b>\$ 45</b>                     |
| With a related allowance recorded:  |                                |                        |                      |                                   |                                  |
| Residential and land development    | \$ 17,395                      | \$ 8,966               | \$ 436               | \$ 8,970                          | \$                               |
| Real estate, construction           | 1,143                          | 1,143                  | 294                  | 1,160                             | 6                                |
| Real estate, mortgage               | 8,912                          | 8,912                  | 2,233                | 9,033                             | 168                              |
| <b>Total</b>                        | <b>\$ 27,450</b>               | <b>\$ 19,021</b>       | <b>\$ 2,963</b>      | <b>\$ 19,163</b>                  | <b>\$ 174</b>                    |
| Total by class of loans:            |                                |                        |                      |                                   |                                  |
| Gaming                              | \$ 1,691                       | \$ 591                 | \$                   | \$ 1,115                          | \$                               |
| Residential and land development    | 21,820                         | 13,391                 | 436                  | 13,395                            |                                  |
| Real estate, construction           | 3,414                          | 3,414                  | 294                  | 3,431                             | 19                               |
| Real estate, mortgage               | 18,907                         | 18,308                 | 2,233                | 18,497                            | 187                              |
| Commercial and industrial           | 667                            | 667                    |                      | 673                               | 13                               |
| <b>Total</b>                        | <b>\$ 46,499</b>               | <b>\$ 36,371</b>       | <b>\$ 2,963</b>      | <b>\$ 37,111</b>                  | <b>\$ 219</b>                    |

|                                     | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
|-------------------------------------|--------------------------------|------------------------|----------------------|-----------------------------------|----------------------------------|
| December 31, 2013:                  |                                |                        |                      |                                   |                                  |
| With no related allowance recorded: |                                |                        |                      |                                   |                                  |
| Residential and land development    | \$ 4,425                       | \$ 4,425               | \$                   | \$ 4,465                          | \$                               |
| Real estate, construction           | 2,294                          | 2,294                  |                      | 2,054                             | 26                               |
| Real estate, mortgage               | 9,722                          | 9,123                  |                      | 9,097                             | 26                               |
| Commercial and industrial           | 678                            | 678                    |                      | 689                               | 24                               |
| <b>Total</b>                        | <b>\$ 17,119</b>               | <b>\$ 16,520</b>       | <b>\$</b>            | <b>\$ 16,305</b>                  | <b>\$ 76</b>                     |
| With a related allowance recorded:  |                                |                        |                      |                                   |                                  |
| Gaming                              | \$ 1,698                       | \$ 1,223               | \$ 626               | \$ 1,316                          | \$                               |
| Residential and land development    | 17,576                         | 9,147                  | 471                  | 15,909                            |                                  |
| Real estate, construction           | 1,185                          | 1,185                  | 337                  | 1,239                             | 23                               |
| Real estate, mortgage               | 9,677                          | 9,677                  | 1,110                | 8,801                             | 306                              |
| <b>Total</b>                        | <b>\$ 30,136</b>               | <b>\$ 21,232</b>       | <b>\$ 2,544</b>      | <b>\$ 27,265</b>                  | <b>\$ 329</b>                    |
| Total by class of loans:            |                                |                        |                      |                                   |                                  |
| Gaming                              | \$ 1,698                       | \$ 1,223               | \$ 626               | \$ 1,316                          | \$                               |
| Residential and land development    | 22,001                         | 13,572                 | 471                  | 20,374                            |                                  |
| Real estate, construction           | 3,479                          | 3,479                  | 337                  | 3,293                             | 49                               |
| Real estate, mortgage               | 19,399                         | 18,800                 | 1,110                | 17,898                            | 332                              |
| Commercial and industrial           | 678                            | 678                    |                      | 689                               | 24                               |
| <b>Total</b>                        | <b>\$ 47,255</b>               | <b>\$ 37,752</b>       | <b>\$ 2,544</b>      | <b>\$ 43,570</b>                  | <b>\$ 405</b>                    |

## 6. Allowance for Loan Losses:

Transactions in the allowance for loan losses for the quarters and six months ended June 30, 2014 and 2013, and the balances of loans, individually and collectively evaluated for impairment, as of June 30, 2014 and 2013, are as follows (in thousands):

|  | Gaming    | Residential and<br>Land Development | Real<br>Estate,<br>Construction | Real Estate,<br>Mortgage | Commercial<br>and Industrial | Other    | Total      |
|--|-----------|-------------------------------------|---------------------------------|--------------------------|------------------------------|----------|------------|
| <b>For the Six Months Ended</b>          |           |                                     |                                 |                          |                              |          |            |
| <b>June 30, 2014:</b>                    |           |                                     |                                 |                          |                              |          |            |
| <b>Allowance for Loan</b>                |           |                                     |                                 |                          |                              |          |            |
| <b>Losses:</b>                           |           |                                     |                                 |                          |                              |          |            |
| Beginning Balance                        | \$ 977    | \$ 776                              | \$ 695                          | \$ 5,553                 | \$ 632                       | \$ 301   | \$ 8,934   |
| Charge-offs                              | (626)     |                                     | (4)                             | (36)                     | (6)                          | (116)    | (788)      |
| Recoveries                               | 80        |                                     |                                 | 81                       | 24                           | 29       | 214        |
| Provision                                | (76)      | (71)                                | (5)                             | 1,151                    | 3                            | 72       | 1,074      |
| Ending Balance                           | \$ 355    | \$ 705                              | \$ 686                          | \$ 6,749                 | \$ 653                       | \$ 286   | \$ 9,434   |
| <b>For the Quarter Ended</b>             |           |                                     |                                 |                          |                              |          |            |
| <b>June 30, 2014:</b>                    |           |                                     |                                 |                          |                              |          |            |
| <b>Allowance for Loan</b>                |           |                                     |                                 |                          |                              |          |            |
| <b>Losses:</b>                           |           |                                     |                                 |                          |                              |          |            |
| Beginning Balance                        | \$ 1,004  | \$ 775                              | \$ 777                          | \$ 5,983                 | \$ 643                       | \$ 280   | \$ 9,462   |
| Charge-offs                              | (626)     |                                     |                                 | (36)                     | (6)                          | (39)     | (707)      |
| Recoveries                               | 35        |                                     |                                 | 81                       | 12                           | 14       | 142        |
| Provision                                | (58)      | (70)                                | (91)                            | 721                      | 4                            | 31       | 537        |
| Ending Balance                           | \$ 355    | \$ 705                              | \$ 686                          | \$ 6,749                 | \$ 653                       | \$ 286   | \$ 9,434   |
| <b>Allowance for loan losses,</b>        |           |                                     |                                 |                          |                              |          |            |
| <b>June 30, 2014:</b>                    |           |                                     |                                 |                          |                              |          |            |
| <b>Ending balance:</b>                   |           |                                     |                                 |                          |                              |          |            |
| individually evaluated for<br>impairment | \$        | \$ 436                              | \$ 578                          | \$ 2,967                 | \$ 321                       | \$       | \$ 4,302   |
| <b>Ending balance:</b>                   |           |                                     |                                 |                          |                              |          |            |
| collectively evaluated for<br>impairment | \$ 355    | \$ 269                              | \$ 108                          | \$ 3,782                 | \$ 332                       | \$ 286   | \$ 5,132   |
| <b>Total Loans, June 30,</b>             |           |                                     |                                 |                          |                              |          |            |
| <b>2014:</b>                             |           |                                     |                                 |                          |                              |          |            |
| <b>Ending balance:</b>                   |           |                                     |                                 |                          |                              |          |            |
| individually evaluated for<br>impairment | \$ 2,463  | \$ 13,426                           | \$ 5,162                        | \$ 27,671                | \$ 2,279                     | \$ 25    | \$ 51,026  |
|  | \$ 25,530 | \$ 5,634                            | \$ 38,171                       | \$ 205,693               | \$ 26,617                    | \$ 8,848 | \$ 310,493 |

Ending balance:  
collectively evaluated for  
impairment



|   | Gaming    | Residential and<br>Land<br>Development | Real<br>Estate,<br>Construction | Real Estate,<br>Mortgage | Commercial<br>and Industrial | Other    | Total      |
|---|-----------|--|---------------------------------|--------------------------|------------------------------|----------|------------|
| For the Six Months Ended<br>June 30, 2013:                  |           |  |                                 |                          |                              |          |            |
| Allowance for Loan<br>Losses:                               |           |  |                                 |                          |                              |          |            |
| Beginning Balance   | \$ 1,541  | \$ 200                                 | \$ 967                          | \$ 5,273                 | \$ 593                       | \$ 283   | \$ 8,857   |
| Charge-offs   | (474)     |  | (47)                            | (281)                    |                              | (130)    | (932)      |
| Recoveries  |           | 67                                     |                                 | 2                        | 22                           | 57       | 148        |
| Provision   | (81)      | 3,076                                  | 410                             | 594                      | 12                           | 66       | 4,077      |
| Ending Balance  | \$ 986    | \$ 3,343                               | \$ 1,330                        | \$ 5,588                 | \$ 627                       | \$ 276   | \$ 12,150  |
| For the Quarter Ended<br>June 30, 2013:                     |           |  |                                 |                          |                              |          |            |
| Allowance for Loan<br>Losses:                               |           |  |                                 |                          |                              |          |            |
| Beginning Balance   | \$ 1,146  | \$ 238                                 | \$ 935                          | \$ 5,551                 | \$ 667                       | \$ 298   | \$ 8,835   |
| Charge-offs   |           |  | (47)                            | (223)                    |                              | (65)     | (335)      |
| Recoveries  |           | 67                                     |                                 | 1                        | 11                           | 33       | 112        |
| Provision   | (160)     | 3,038                                  | 442                             | 259                      | (51)                         | 10       | 3,538      |
| Ending Balance  | \$ 986    | \$ 3,343                               | \$ 1,330                        | \$ 5,588                 | \$ 627                       | \$ 276   | \$ 12,150  |
| Allowance for loan losses,<br>June 30, 2013:                |           |  |                                 |                          |                              |          |            |
| Ending balance:<br>individually evaluated for<br>impairment |           |  |                                 |                          |                              |          |            |
|   | \$ 626    | \$ 3,143                               | \$ 1,302                        | \$ 2,220                 | \$ 331                       | \$ 33    | \$ 7,655   |
| Ending balance:<br>collectively evaluated for<br>impairment |           |  |                                 |                          |                              |          |            |
|   | \$ 360    | \$ 200                                 | \$ 28                           | \$ 3,368                 | \$ 296                       | \$ 243   | \$ 4,495   |
| Total Loans, June 30,<br>2013:                              |           |  |                                 |                          |                              |          |            |
| Ending balance:<br>individually evaluated for<br>impairment |           |  |                                 |                          |                              |          |            |
|   | \$ 21,579 | \$ 20,974                              | \$ 7,794                        | \$ 29,759                | \$ 2,320                     | \$ 73    | \$ 82,499  |
| Ending balance:<br>collectively evaluated for<br>impairment |           |  |                                 |                          |                              |          |            |
|   | \$ 28,758 | \$ 6,109                               | \$ 42,153                       | \$ 203,399               | \$ 32,019                    | \$ 8,161 | \$ 320,599 |

## 7. Deposits:

At June 30, 2014, time deposits of \$100,000 or more include brokered deposits of \$5,000,000, which mature in 2017.

## 8. Fair Value Measurements and Disclosures:

The Company utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Available for sale securities are recorded at fair value on a recurring basis. Additionally, from time to time, the Company may be required to record other assets at fair value on a non-recurring basis, such as impaired loans and ORE. These non-recurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets. Additionally, the Company is required to disclose, but not record, the fair value of other financial instruments.

#### Fair Value Hierarchy

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 fair value.

These levels are:

Level 1 Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2 Valuation is based upon quoted market prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include the use of option pricing models, discounted cash flow models and similar techniques.

Following is a description of valuation methodologies used to determine the fair value of financial assets and liabilities.

#### Cash and Due from Banks

The carrying amount shown as cash and due from banks approximates fair value.

#### Available for Sale Securities

The fair value of available for sale securities is based on quoted market prices. The Company's available for sale securities are reported at their estimated fair value, which is determined utilizing several sources. The primary source is Interactive Data Corporation, which utilizes pricing models that vary based on asset class and include available trade, bid and other market information and whose methodology includes broker quotes, proprietary models and vast descriptive databases. The other source for determining fair value is matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark securities. All of the Company's available for sale securities are Level 2 assets.

#### Held to Maturity Securities

The fair value of held to maturity securities is based on quoted market prices.

#### Other Investments

The carrying amount shown as other investments approximates fair value.

#### Federal Home Loan Bank Stock

The carrying amount shown as Federal Home Loan Bank Stock approximates fair value.

#### Loans

The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings for the remaining maturities. The cash flows considered in computing the fair value of such loans are segmented into categories relating to the nature of the contract and collateral based on contractual principal maturities. Appropriate adjustments are made to reflect probable credit losses. Cash flows have not been adjusted for such factors as prepayment risk or the effect of the maturity of

balloon notes. The

fair value of floating rate loans is estimated to be its carrying value. At each reporting period, the Company determines which loans are impaired. Accordingly, the Company's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan, which are generally collateral-dependent, is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by third-party valuation specialists. Factors including the assumptions and techniques utilized by the appraiser are considered by Management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. When the fair value of the collateral is based on an observable market price, the Company records the impaired loan as a non-recurring Level 2 asset. 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 impaired loan as a non-recurring Level 3 asset.

#### Other Real Estate

In the course of lending operations, Management may determine that it is necessary to foreclose on the related collateral. Other real estate acquired through foreclosure is carried at fair value, less estimated costs to sell. The fair value of the collateral is based on appraisals performed by third-party valuation specialists. Factors including the assumptions and techniques utilized by the appraiser are considered by Management. If the current appraisal is more than one year old and/or the loan balance is more than \$200,000, a new appraisal is obtained. Otherwise, the Bank's in-house property evaluator and Management will determine the fair value of the collateral, based on comparable sales, market conditions, Management's plans for disposition and other estimates of fair value obtained from principally independent sources, adjusted for estimated selling costs. When the fair value of the property is based on observable market price, the Company records the other real estate as a non-recurring Level 2 asset. When an appraised value is not available or Management determines the fair value of the other real estate is further impaired below the appraised value and there is no observable market price, the Company records the other real estate as a non-recurring Level 3 asset.

#### Cash Surrender Value of Life Insurance

The carrying amount of cash surrender value of bank-owned life insurance approximates fair value.

#### Deposits

The fair value of non-interest bearing demand and interest bearing savings and demand deposits is the amount reported in the financial statements. The fair value of time deposits is estimated by discounting the cash flows using current rates of time deposits with similar remaining maturities. The cash flows considered in computing the fair value of such deposits are based on contractual maturities, since approximately 98% of time deposits provide for automatic renewal at current interest rates.

#### Federal Funds Purchased and Securities Sold under Agreements to Repurchase

The carrying amount shown as federal funds purchased and securities sold under agreements to repurchase approximates fair value.

## Borrowings from Federal Home Loan Bank

The fair value of Federal Home Loan Bank ( FHLB ) fixed rate borrowings is estimated using discounted cash flows based on current incremental borrowing rates for similar types of borrowing arrangements. The fair value of FHLB variable rate borrowings is estimated to be its carrying value.

The balances of available for sale securities, which are the only assets measured at fair value on a recurring basis, by level within the fair value hierarchy and by investment type, as of June 30, 2014 and December 31, 2013 are as follows (in thousands):

|                                   | Fair Value Measurements |           |                   |           |
|-----------------------------------|-------------------------|-----------|-------------------|-----------|
|                                   | Total                   | Level 1   | Level 2           | Level 3   |
| June 30, 2014:                    |                         |           |                   |           |
| U.S. Treasuries                   | \$ 44,198               | \$        | \$ 44,198         | \$        |
| U.S. Government agencies          | 143,117                 |           | 143,117           |           |
| Mortgage-backed securities        | 48,279                  |           | 48,279            |           |
| States and political subdivisions | 36,474                  |           | 36,474            |           |
| Equity securities                 | 650                     |           | 650               |           |
| <b>Total</b>                      | <b>\$ 272,718</b>       | <b>\$</b> | <b>\$ 272,718</b> | <b>\$</b> |
| December 31, 2013:                |                         |           |                   |           |
| U.S. Treasuries                   | \$ 43,648               | \$        | \$ 43,648         | \$        |
| U.S. Government agencies          | 145,805                 |           | 145,805           |           |
| Mortgage-backed securities        | 50,326                  |           | 50,326            |           |
| States and political subdivisions | 35,011                  |           | 35,011            |           |
| Equity securities                 | 650                     |           | 650               |           |
| <b>Total</b>                      | <b>\$ 275,440</b>       | <b>\$</b> | <b>\$ 275,440</b> | <b>\$</b> |

Impaired loans, which are measured at fair value on a non-recurring basis, by level within the fair value hierarchy as of June 30, 2014 and December 31, 2013 are as follows (in thousands):

|                   | Fair Value Measurements Using |         |         |           |
|-------------------|-------------------------------|---------|---------|-----------|
|                   | Total                         | Level 1 | Level 2 | Level 3   |
| June 30, 2014     | \$ 16,200                     | \$      | \$      | \$ 16,200 |
| December 31, 2013 | 18,831                        |         |         | 18,831    |

The following table presents a summary of changes in the fair value of impaired loans which are measured using level 3 inputs (in thousands):

|   | For the six<br>Months Ended<br>June 30,<br>2014 | For the Year<br>Ended<br>December 31, 2013 |
|---|---|--|
| Balance, beginning of period  | \$ 18,831                                       | \$ 16,030                                  |
| Additions to impaired loans and troubled<br>debt restructurings       | 203   | 17,424                                     |
| Principal payments, charge-offs and<br>transfers to other real estate | (2,416)   | (15,153)                                   |
| Change in allowance for loan losses on<br>impaired loans              | (418)   | 530  |
| Balance, end of period  | \$ 16,200                                       | \$ 18,831                                  |

Other real estate, which is measured at fair value on a non-recurring basis, by level within the fair value hierarchy as of June 30, 2014 and December 31, 2013 are as follows (in thousands):

|                   | Fair Value Measurements<br>Using |         |         |          |
|-------------------|----------------------------------|---------|---------|----------|
|                   | Total                            | Level 1 | Level 2 | Level 3  |
| June 30, 2014     | \$ 8,924                         | \$      | \$      | \$ 8,924 |
| December 31, 2013 | 9,630                            |         |         | 9,630    |

The following table presents a summary of changes in the fair value of other real estate which is measured using level 3 inputs (in thousands):

|                                      | For the Six<br>Months Ended<br>June 30,<br>2014 | For the Year<br>Ended<br>December 31, 2013 |
|--------------------------------------|---|--|
| Balance, beginning of period         | \$ 9,630  | \$ 7,008                                   |
| Loans transferred to ORE             | 194   | 4,537                                      |
| Sales                                | (726)   | (1,188)                                    |
| Writedowns                           | (174)   | (670)                                      |
| Insurance proceeds for casualty loss |   | (57)                                       |
| Balance, end of period               | \$ 8,924  | \$ 9,630                                   |

The carrying value and estimated fair value of assets and liabilities, by level within the fair value hierarchy, at June 30, 2014 and December 31, 2013, are as follows (in thousands):

|  | Carrying<br>Amount | Fair Value Measurements Using |         |         | Total     |
|--|--------------------|-------------------------------|---------|---------|-----------|
|  |                    | Level 1                       | Level 2 | Level 3 |           |
| <b>June 30, 2014:</b>  |                    |                               |         |         |           |
| <b>Financial Assets:</b>   |                    |                               |         |         |           |
| Cash and due from banks  | \$ 31,990          | \$ 31,990                     | \$      | \$      | \$ 31,990 |
| Available for sale securities  | 272,718            |                               | 272,718 |         | 272,718   |
| Held to maturity securities  | 13,011             |                               | 12,882  |         | 12,882    |
| Other investments  | 3,056              | 3,056                         |         |         | 3,056     |
| Federal Home Loan Bank stock   | 3,566              |                               | 3,566   |         | 3,566     |
| Loans, net   | 352,085            |                               |         | 362,711 | 362,711   |
| Other real estate  | 8,924              |                               |         | 8,924   | 8,924     |
| Cash surrender value of life insurance                                     | 17,765             |                               |         | 17,765  | 17,765    |
| <b>Financial Liabilities:</b>  |                    |                               |         |         |           |
| <b>Deposits:</b>   |                    |                               |         |         |           |
| Non-interest bearing   | 114,471            | 114,471                       |         |         | 114,471   |
| Interest bearing   | 309,372            |                               |         | 311,066 | 311,066   |
| Federal funds purchased and securities sold under agreements to repurchase | 117,370            | 117,370                       |         |         | 117,370   |
| Borrowings from Federal Home Loan Bank                                     | 76,566             |                               | 77,527  |         | 77,527    |
| <b>December 31, 2013:</b>  |                    |                               |         |         |           |
| <b>Financial Assets:</b>   |                    |                               |         |         |           |
| Cash and due from banks  | \$ 36,264          | \$ 36,264                     | \$      | \$      | \$ 36,264 |
| Available for sale securities  | 257,440            |                               | 275,440 |         | 275,440   |
| Held to maturity securities  | 11,142             |                               | 10,686  |         | 10,686    |
| Other investments  | 3,262              | 3,262                         |         |         | 3,262     |
| Federal Home Loan Bank stock   | 3,834              |                               | 3,834   |         | 3,834     |
| Loans, net   | 366,415            |                               |         | 369,117 | 369,117   |
| Other real estate  | 9,630              |                               |         | 9,630   | 9,630     |
| Cash surrender value of life insurance                                     | 17,456             |                               |         | 17,456  | 17,456    |
| <b>Financial Liabilities:</b>  |                    |                               |         |         |           |
| <b>Deposits:</b>   |                    |                               |         |         |           |
| Non-interest bearing   | 107,117            | 107,117                       |         |         | 107,117   |
| Interest bearing   | 321,441            |                               |         | 322,535 | 322,535   |
| Federal funds purchased and securities sold under agreements to repurchase | 139,639            | 139,639                       |         |         | 139,639   |
| Borrowings from Federal Home Loan Bank                                     | 77,684             |                               | 79,051  |         | 79,051    |

#### 9. Reclassifications:

Certain reclassifications, which had no effect on prior year net income, have been made to prior period statements to conform to current year presentation.



## **Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **GENERAL**

The Company is a one-bank holding company headquartered in Biloxi, Mississippi. It has two operating subsidiaries, PFC Service Corp., an inactive company, and The Peoples Bank, Biloxi, Mississippi (the Bank). The Bank provides a full range of banking, financial and trust services to state, county and local government entities and individuals and small and commercial businesses operating in those portions of Mississippi, Louisiana and Alabama which are within a fifty mile radius of the Waveland, Wiggins and Gautier branches, the Bank's three most outlying locations (the trade area).

The following presents Management's discussion and analysis of the consolidated financial condition and results of operations of Peoples Financial Corporation and Subsidiaries. These comments should be considered in combination with the Consolidated Financial Statements and Notes to Consolidated Financial Statements included in this report on Form 10-Q and the Consolidated Financial Statements, Notes to Consolidated Financial Statements and Management's Discussion and Analysis included in the Company's Form 10-K for the year ended December 31, 2013.

### **Forward-Looking Information**

Congress passed the Private Securities Litigation Act of 1995 in an effort to encourage corporations to provide information about a company's anticipated future financial performance. This act provides a safe harbor for such disclosure which protects the companies from unwarranted litigation if actual results are different from management expectations. This report contains forward-looking statements and reflects industry conditions, company performance and financial results. These forward-looking statements are subject to a number of factors and uncertainties which could cause the Company's actual results and experience to differ from the anticipated results and expectations expressed in such forward-looking statements. Such factors and uncertainties include, but are not limited to: changes in interest rates and market prices, changes in local economic and business conditions, increased competition for deposits and loans, a deviation in actual experience from the underlying assumptions used to determine and establish the allowance for loan losses, changes in the availability of funds resulting from reduced liquidity, changes in government regulations and acts of terrorism, weather or other events beyond the Company's control.

### **New Accounting Pronouncements**

In April 2014, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) No. 2014-06, *Technical Corrections and Improvements Related to Glossary Terms*. This ASU added, deleted, corrected and modified terms in the Master Glossary of the Codification and was effective upon issuance. The adoption of this ASU did not have a material effect on the Company's financial position, results of operations or cash flows.

## Critical Accounting Policies

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ( GAAP ) requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company evaluates these estimates and assumptions on an on-going basis using historical experience and other factors, including the current economic environment. We adjust such estimates and assumptions when facts and circumstances dictate. Certain critical accounting policies affect the more significant estimates and assumptions used in the preparation of the consolidated financial statements.

### Allowance for loan losses:

The Company s most critical accounting policy relates to its allowance for loan losses ( ALL ), which reflects the estimated losses resulting from the inability of its borrowers to make loan payments. The ALL is established and maintained at an amount sufficient to cover the estimated loss associated with the loan portfolio of the Company as of the date of the financial statements. Credit losses arise not only from credit risk, but also from other risks inherent in the lending process including, but not limited to, collateral risk, operation risk, concentration risk and economic risk. As such, all related risks of lending are considered when assessing the adequacy of the ALL. On a quarterly basis, Management estimates the probable level of losses to determine whether the allowance is adequate to absorb reasonably foreseeable, anticipated losses in the existing portfolio based on our past loan loss experience, known and inherent risk in the portfolio, adverse situations that may affect the borrowers ability to repay and the estimated value of any underlying collateral and current economic conditions. Management believes that the ALL is adequate and appropriate for all periods presented in these financial statements. If there was a deterioration of any of the factors considered by Management in evaluating the ALL, the estimate of loss would be updated, and additional provisions for loan losses may be required. The analysis divides the portfolio into two segments: a pool analysis of loans based upon a five year average loss history which is updated on a quarterly basis and which may be adjusted by qualitative factors by loan type and a specific reserve analysis for those loans considered impaired under GAAP. All credit relationships with an outstanding balance of \$100,000 or greater that are included in Management s loan watch list are individually reviewed for impairment. All losses are charged to the ALL when the loss actually occurs or when a determination is made that a loss is likely to occur; recoveries are credited to the ALL at the time of receipt.

### Other Real Estate:

Other real estate ( ORE ) includes real estate acquired through foreclosure. Each other real estate property is carried at fair value, less estimated costs to sell. Fair value is principally based on appraisals performed by third-party valuation specialists. If Management determines that the fair value of a property has decreased subsequent to foreclosure, the Company records a write down which is included in noninterest expense.

#### Employee Benefit Plans:

Employee benefit plan liabilities and pension costs are determined utilizing actuarially determined present value calculations. The valuation of the benefit obligation and net periodic expense is considered critical, as it requires Management and its actuaries to make estimates regarding the amount and timing of expected cash outflows including assumptions about mortality, expected service periods and the rate of compensation increases.

#### Income Taxes:

GAAP requires the asset and liability approach for financial accounting and reporting for deferred income taxes. We use the asset and liability method of accounting for deferred income taxes and provide deferred income taxes for all significant income tax temporary differences. As part of the process of preparing our consolidated financial statements, the Company is required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as the provision for loan losses, for tax and financial reporting purposes. These differences result in deferred tax assets and liabilities that are included in our consolidated statement of condition. We must also assess the likelihood that our deferred tax assets will be recovered from future taxable income, and to the extent we believe that recovery is not likely, we must establish a valuation allowance. Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. To the extent the Company establishes a valuation allowance or adjusts this allowance in a period, we must include an expense within the tax provisions in the consolidated statement of income.

#### **OVERVIEW**

The Company is a community bank serving the financial and trust needs of its customers in its trade area of south Mississippi, southeast Louisiana and southwest Alabama. Maintaining a strong core deposit base and providing commercial and real estate lending in our trade area are the traditional focuses of the Company. Growth has largely been achieved through de novo branching activity, and it is expected that these strategies will continue to be emphasized in the future.

Net income for the second quarter of 2014 was \$335,000 compared with a net loss of \$1,147,000 for the second quarter of 2013 and net income for the first half of 2014 was \$914,000 as compared with a net loss of \$541,000 for the first half of 2013. The improved net earnings was directly related to lower provisions for the allowance for loan losses in 2014. The provision for the allowance for loan losses was \$537,000 and \$1,074,000 for the second quarter and first half of 2014, respectively, compared with \$3,538,000 and \$4,077,000, respectively, for the second quarter and first half of 2013.

Managing the net interest margin in the Company's highly competitive market and in context of larger economic conditions has been very challenging and will continue to be so for the foreseeable future. The yield on average loans has increased as nonaccrual loans have decreased significantly in 2014 as compared with 2013. The Company extended durations on its investments during 2013 in order to increase yield, which can be seen from the improved yield on average available for sale securities.

Monitoring asset quality, estimating potential losses in our loan portfolio and addressing non-performing loans continue to be emphasized during these difficult economic times, as the local and national economy continues to negatively impact collateral values and borrowers' ability to repay their loans. There has been improvement in nonaccrual loans in recent quarters, and the Company is working diligently to continue that trend. The Company's nonaccrual loans totaled \$24,908,000 and \$26,171,000 at June 30, 2014 and December 31, 2013, respectively. Most of these loans are collateral-dependent, and the Company has rigorously evaluated the value of its collateral to determine potential losses.

Non-interest income decreased \$131,000 and \$35,000 for the three and six months ended June 30, 2014 as compared with 2013 results. Service charges on deposit accounts increased \$110,000 for the three months ended June 30, 2014 as compared with 2013, and increased \$188,000 for the six months ended June 30, 2014 as compared with 2013. Results for the three and six months ended June 30, 2013 included gains on sales of securities of \$255,000, while there were no sales in 2014.

Non-interest expense increased \$827,000 and \$1,166,000 for the three and six months ended June 30, 2014 as compared with 2013 results. This increase for the three months ended June 30, 2014 was the result of increases in salaries and employee benefits of \$352,000, equipment rentals, depreciation and maintenance of \$95,000, FDIC assessments of \$111,000, and ATM expenses of \$147,000 as compared with 2013. These increases for the six months ended June 30, 2014 were the result of increases in salaries and employee benefits of \$424,000, equipment rentals, depreciation and maintenance of \$131,000, FDIC assessments of \$95,000, and ATM expenses of \$224,000 as compared with 2013.

Total assets at June 30, 2014 decreased \$23,104,000 as compared with December 31, 2013. Loans decreased \$13,830,000 at June 30, 2014 as compared with December 31, 2013, as principal payments, maturities, charge-offs and foreclosures on existing loans exceeded new loans.

## **RESULTS OF OPERATIONS**

### **Net Interest Income**

Net interest income, the amount by which interest income on loans, investments and other interest earning assets exceeds interest expense on deposits and other borrowed funds, is the single largest component of the Company's income. Management's objective is to provide the largest possible amount of income while balancing interest rate, credit, liquidity and capital risk. Changes in the volume and mix of interest earning assets and interest-bearing liabilities combined with changes in market rates of interest directly affect net interest income.

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Quarter Ended June 30, 2014 as Compared with Quarter Ended June 30, 2013

The Company's average interest earning assets decreased approximately \$88,688,000, or 12%, from approximately \$746,996,000 for the second quarter of 2013 to approximately \$658,308,000 for the second quarter of 2014. Average loans decreased as loan demand has been weak in the Company's trade area and the volume of maturities and pay-offs, particularly in the gaming portfolio, have been significant. Federal funds sold also decreased based on the liquidity position of the bank subsidiary.

The average yield on earning assets increased by 43 basis points, from 3.18% for the second quarter of 2013 to 3.61% for the second quarter of 2014. The yield on average loans increased from 4.24% in 2013 to 4.57% in 2014 as a result of the reduction in nonaccrual loans. Average nonaccrual loans decreased from approximately \$49,668,000 in 2013 to approximately \$25,447,000 in 2014. The yield on average taxable available for sale securities increased from 1.61% for the second quarter of 2013 to 2.01% for the second quarter of 2014 as a result of the Company's strategy of extending the duration of new investments. Future security purchases may be of shorter duration in anticipation of rising rates in the future.

Average interest bearing liabilities decreased approximately \$73,628,000, or 13%, from approximately \$588,106,000 for the second quarter of 2013 to approximately \$514,478,000 for the second quarter of 2014. Average time deposits decreased primarily as \$11,500,000 in brokered deposits matured in August of 2013. Average federal funds purchased and securities sold under agreements to repurchase, which only included non-deposit accounts, decreased \$76,021,000 as these customers reallocate their balances periodically. Average borrowings from the Federal Home Loan Bank increased \$52,418,000 due to the liquidity needs of the bank subsidiary.

The average rate paid on interest bearing liabilities for the second quarter of 2013 and the second quarter of 2014 was the same. The Company believes that it is unlikely that its cost of funds can be materially reduced further; however, any opportunity to do so will be considered.

The Company's net interest margin on a tax-equivalent basis, which is net interest income as a percentage of average earning assets, was 3.40% for the quarter ended June 30, 2014, up 43 basis points from 2.97% for the quarter ended June 30, 2013.

Six Months Ended June 30, 2014 as Compared with Six Months Ended June 30, 2013

The Company's average interest earning assets decreased approximately \$92,382,000, or 12%, from approximately \$756,359,000 for the first half of 2013 to approximately \$663,977,000 for the first half of 2014. Average loans decreased as loan demand has been weak in the Company's trade area and the volume of maturities and pay-offs, particularly in the gaming portfolio, have been significant. Federal funds sold also decreased based on the liquidity position of the bank subsidiary.

The average yield on earning assets increased by 44 basis points, from 3.17% for the first half of 2013 to 3.61% for the first half of 2014, with the biggest impact to the yield on taxable available for sale securities. The yield on average loans increased from 4.22% for the first half of 2013 to 4.57%

for the first half of 2014 as a result of the reduction in nonaccrual loans. Average nonaccrual loans decreased from approximately \$51,780,000 in 2013 to approximately \$25,540,000 in 2014. The yield on average taxable available for sale securities increased from 1.64% for the first half of 2013 to 2.01% for the first half of 2014 as a result of the Company's strategy of extending the duration of new investments. Future security purchases may be of shorter duration in anticipation of rising rates in the future.

Average interest bearing liabilities decreased approximately \$80,753,000, or 13%, from approximately \$603,625,000 for the first half of 2013 to approximately \$522,872,000 for the first half of 2014. Average time deposits decreased primarily as \$24,000,000 in brokered deposits matured during 2013. Average federal funds purchased and securities sold under agreements to repurchase, which only included non-deposit accounts, decreased \$61,375,000 as these customers reallocate their balances periodically. Average borrowings from the Federal Home Loan Bank increased \$42,477,000 due to the liquidity needs of the bank subsidiary.

The average rate paid on interest bearing liabilities decreased 3 basis points, from .27% for the first half of 2013 to .24% for the first half of 2014. The Company believes that it is unlikely that its cost of funds can be materially reduced further; however, any opportunity to do so will be considered.

The Company's net interest margin on a tax-equivalent basis, which is net interest income as a percentage of average earning assets, was 3.42% for the six months ended June 30, 2014, up 46 basis points from 2.96% for the six months ended June 30, 2013.

The tables on the following pages analyze the changes in tax-equivalent net interest income for the quarters ended June 30, 2014 and 2013 and the six months ended June 30, 2014 and 2013.

## Analysis of Average Balances, Interest Earned/Paid and Yield

(In Thousands)

|   | Three Months Ended June 30, 2014 |                      |              | Three Months Ended June 30, 2013 |                      |              |
|---|----------------------------------|----------------------|--------------|----------------------------------|----------------------|--------------|
|   | Average Balance                  | Interest Earned/Paid | Rate         | Average Balance                  | Interest Earned/Paid | Rate         |
| Loans (2)(3)                                | \$ 364,713                       | \$ 4,165             | 4.57%        | \$ 409,527                       | \$ 4,339             | 4.24%        |
| Federal funds sold                          | 4,135                            | 3                    | 0.29%        | 41,747                           | 31                   | 0.30%        |
| HTM:  |                                  |                      |              |                                  |                      |              |
| Non taxable (1)                             | 12,665                           | 111                  | 3.51%        | 9,368                            | 85                   | 3.63%        |
| AFS:  |                                  |                      |              |                                  |                      |              |
| Taxable                                     | 238,348                          | 1,197                | 2.01%        | 247,670                          | 996                  | 1.61%        |
| Non taxable (1)                             | 34,495                           | 468                  | 5.43%        | 37,383                           | 493                  | 5.28%        |
| Other                                       | 3,952                            | 3                    | 0.30%        | 1,301                            | 3                    | 0.92%        |
| <b>Total</b>                                | <b>\$ 658,308</b>                | <b>\$ 5,947</b>      | <b>3.61%</b> | <b>\$ 746,996</b>                | <b>\$ 5,947</b>      | <b>3.18%</b> |
| Savings & interest-bearing DDA              | \$ 239,772                       | \$ 46                | 0.08%        | \$ 252,948                       | \$ 50                | 0.08%        |
| Time deposits                               | 93,106                           | 228                  | 0.98%        | 129,955                          | 265                  | 0.82%        |
| Federal funds purchased                     | 121,352                          | 22                   | 0.07%        | 197,373                          | 43                   | 0.09%        |
| FHLB advances                               | 60,248                           | 56                   | 0.37%        | 7,830                            | 40                   | 2.04%        |
| <b>Total</b>                                | <b>\$ 514,478</b>                | <b>\$ 352</b>        | <b>0.27%</b> | <b>\$ 588,106</b>                | <b>\$ 398</b>        | <b>0.27%</b> |
| Net tax-equivalent spread                   |                                  |                      | 3.34%        |                                  |                      | 2.91%        |
| Net tax-equivalent margin on earning assets |                                  |                      | 3.40%        |                                  |                      | 2.97%        |

(1) All interest earned is reported on a taxable equivalent basis using a tax rate of 34% in 2014 and 2013.

(2) Loan fees of \$128 and \$97 for 2014 and 2013, respectively, are included in these figures.

(3) Includes nonaccrual loans.

## Analysis of Average Balances, Interest Earned/Paid and Yield

(In Thousands)

|  | Six Months Ended June 30, 2014 |                      |              | Six Months Ended June 30, 2013 |                      |              |
|--|--------------------------------|----------------------|--------------|--------------------------------|----------------------|--------------|
|  | Average Balance                | Interest Earned/Paid | Rate         | Average Balance                | Interest Earned/Paid | Rate         |
| Loans (2)(3)                                       | \$ 368,217                     | \$ 8,417             | 4.57%        | \$ 416,291                     | \$ 8,778             | 4.22%        |
| Federal funds sold                                 | 5,651                          | 7                    | 0.25%        | 48,675                         | 64                   | 0.26%        |
| <b>HTM:</b>  |                                |                      |              |                                |                      |              |
| Non taxable (1)                                    | 12,461                         | 218                  | 3.50%        | 8,713                          | 162                  | 3.72%        |
| <b>AFS:</b>  |                                |                      |              |                                |                      |              |
| Taxable  | 238,986                        | 2,405                | 2.01%        | 243,546                        | 2,000                | 1.64%        |
| Non taxable (1)                                    | 34,813                         | 940                  | 5.40%        | 37,489                         | 983                  | 5.24%        |
| Other  | 3,849                          | 4                    | 0.21%        | 1,645                          | 6                    | 0.73%        |
| <b>Total</b>                                       | <b>\$ 663,977</b>              | <b>\$ 11,991</b>     | <b>3.61%</b> | <b>\$ 756,359</b>              | <b>\$ 11,993</b>     | <b>3.17%</b> |
| Savings & interest-bearing DDA                     | \$ 235,906                     | \$ 88                | 0.07%        | \$ 261,564                     | \$ 97                | 0.07%        |
| Time deposits                                      | 96,412                         | 395                  | 0.82%        | 132,609                        | 538                  | 0.81%        |
| Federal funds purchased                            | 140,221                        | 49                   | 0.07%        | 201,596                        | 89                   | 0.09%        |
| FHLB advances                                      | 50,333                         | 106                  | 0.42%        | 7,856                          | 81                   | 2.06%        |
| <b>Total</b>                                       | <b>\$ 522,872</b>              | <b>\$ 638</b>        | <b>0.24%</b> | <b>\$ 603,625</b>              | <b>\$ 805</b>        | <b>0.27%</b> |
| <b>Net tax-equivalent spread</b>                   |                                |                      | <b>3.37%</b> |                                |                      | <b>2.90%</b> |
| <b>Net tax-equivalent margin on earning assets</b> |                                |                      | <b>3.42%</b> |                                |                      | <b>2.96%</b> |

(1) All interest earned is reported on a taxable equivalent basis using a tax rate of 34% in 2014 and 2013.

(2) Loan fees of \$256 and \$246 for 2014 and 2013, respectively, are included in these figures.

(3) Includes nonaccrual loans.



## Analysis of Changes in Interest Income and Interest Expense

(In Thousands)

|                                | For the Quarter Ended                     |               |                 |                |
|--------------------------------|---|---------------|-----------------|----------------|
|                                | June 30, 2014 compared with June 30, 2013 |               |                 |                |
|                                | Volume                                    | Rate          | Rate/Volume     | Total          |
| <b>Interest earned on:</b>     |   |               |                 |                |
| Loans                          | \$ (475)                                  | \$ 336        | \$ (35)         | \$ (174)       |
| Federal funds sold             | (28)                                      | (1)           | 1               | (28)           |
| Held to maturity securities:   |   |               |                 |                |
| Non taxable                    | 30  | (3)           | (1)             | 26             |
| Available for sale securities: |   |               |                 |                |
| Taxable                        | (37)                                      | 248           | (10)            | 201            |
| Non taxable                    | (38)                                      | 14            | (1)             | (25)           |
| Other                          | 6   | (2)           | (4)             |                |
| <b>Total</b>                   | <b>\$ (542)</b>                           | <b>\$ 592</b> | <b>\$ (50)</b>  | <b>\$</b>      |
| <b>Interest paid on:</b>       |   |               |                 |                |
| Savings & interest-bearing DDA | \$ (3)                                    | \$ (2)        | \$ 1            | \$ (4)         |
| Time deposits                  | (75)                                      | 53            | (15)            | (37)           |
| Federal funds purchased        | (17)                                      | (7)           | 3               | (21)           |
| FHLB advances                  | 268                                       | (33)          | (219)           | 16             |
| <b>Total</b>                   | <b>\$ 173</b>                             | <b>\$ 11</b>  | <b>\$ (230)</b> | <b>\$ (46)</b> |

## Analysis of Changes in Interest Income and Interest Expense

(In Thousands)

|                                       | For the Six Months Ended                  |                 |                 |                 |
|---------------------------------------|---|-----------------|-----------------|-----------------|
|                                       | June 30, 2014 compared with June 30, 2013 |                 |                 |                 |
|                                       | Volume                                    | Rate            | Rate/Volume     | Total           |
| <b>Interest earned on:</b>            |   |                 |                 |                 |
| Loans                                 | \$ (1,014)                                | \$ 737          | \$ (84)         | \$ (361)        |
| Federal funds sold                    | (57)                                      | (4)             | 4               | (57)            |
| <b>Held to maturity securities:</b>   |   |                 |                 |                 |
| Non taxable                           | 70  | (10)            | (4)             | 56              |
| <b>Available for sale securities:</b> |   |                 |                 |                 |
| Taxable                               | (37)                                      | 451             | (9)             | 405             |
| Non taxable                           | (70)                                      | 29              | (2)             | (43)            |
| Other                                 | 8   | (4)             | (6)             | (2)             |
| <b>Total</b>                          | <b>\$ (1,100)</b>                         | <b>\$ 1,199</b> | <b>\$ (101)</b> | <b>\$ (2)</b>   |
| <b>Interest paid on:</b>              |   |                 |                 |                 |
| Savings & interest-bearing DDA        | \$ (10)                                   | \$ 1            | \$              | \$ (9)          |
| Time deposits                         | (147)                                     | 5               | (1)             | (143)           |
| Federal funds purchased               | (27)                                      | (18)            | 5               | (40)            |
| FHLB advances                         | 438                                       | (64)            | (349)           | 25              |
| <b>Total</b>                          | <b>\$ 254</b>                             | <b>\$ (76)</b>  | <b>\$ (345)</b> | <b>\$ (167)</b> |

**Provision for Loan Losses**

In the normal course of business, the Company assumes risk in extending credit to its customers. This credit risk is managed through compliance with the loan policy, which is approved by the Board of Directors. The policy establishes guidelines relating to underwriting standards, including but not limited to financial analysis, collateral valuation, lending limits, pricing considerations and loan grading. The Company's Loan Review and Special Assets Departments play key roles in monitoring the loan portfolio and managing problem loans. New loans and, on a periodic basis, existing loans are reviewed to evaluate compliance with the loan policy. Loan customers in concentrated industries such as gaming and hotel/motel, as well as the exposure for out of area; residential and land development; construction and commercial real estate loans; and their direct and indirect impact on its operations are evaluated on a monthly basis. Loan delinquencies and deposit overdrafts are closely monitored in order to identify developing problems as early as possible. Lenders experienced in workout scenarios consult with loan officers and customers to address non-performing loans. A watch list of credits which pose a potential loss to the Company is prepared based on the loan grading system. This list forms the foundation of the Company's allowance for loan loss computation.

Management relies on its guidelines and existing methodology to monitor the performance of its loan portfolio and identify and estimate potential losses based on the best available information. The potential effect resulting from the economic downturn on a national and local level, the decline in real estate values and actual losses incurred by the Company were key factors in our analysis. Much of the Company's loan portfolio is collateral-dependent, requiring careful consideration of changes in the value of the collateral.

The Company's on-going, systematic evaluation resulted in the Company recording a provision for loan losses of \$537,000 and \$3,538,000 for the second quarters of 2014 and 2013, respectively, and \$1,074,000 and \$4,077,000 for the first half of 2014 and 2013, respectively. The allowance for loan losses as a percentage of loans was 2.61% and 2.38% at June 30, 2014 and December 31, 2013, respectively. The Company's analysis includes evaluating the current values of collateral securing all nonaccrual loans. Even though nonaccrual loans were \$24,908,000 and \$26,171,000 at June 30, 2014 and December 31, 2013, respectively, specific reserves of only \$562,000 and \$1,280,000, respectively, have been allocated to these loans as collateral values appear sufficient to cover loan losses or the loan balances have been charged down to their realizable value. The Company believes that its allowance for loan losses is appropriate as of June 30, 2014.

The allowance for loan losses is an estimate, and as such, events may occur in the future which may affect its accuracy. The Company anticipates that it is possible that additional information will be gathered in future quarters which may require an adjustment to the allowance for loan losses. Management will continue to closely monitor its portfolio and take such action as it deems appropriate to accurately report its financial condition and results of operations.

#### **Non-interest income**

##### Quarter Ended June 30, 2014 as Compared with Quarter Ended June 30, 2013

Non-interest income decreased \$131,000 for the second quarter of 2014 as compared with the second quarter of 2013. Trust department income and fees and service charges on deposit accounts increased in 2014 as compared with 2013. During the second quarter of 2013, the Company realized gains from sales and calls of securities while there were no sales or calls in 2014.

Trust department income and fees increased \$21,000 in 2014 as compared with 2013 as a result of the increase in market value, on which fees are based, of personal trust accounts.

Service charges on deposit accounts increased by \$110,000 during the second quarter of 2014 as compared with the second quarter of 2013. Fees from service charges increased \$36,000 as a result of the Company increasing per account and per transaction fees during the third quarter of 2013 and ATM fee income increased \$66,000 as the Company added three new off-site ATMs and per transaction fees increased.

Six Months Ended June 30, 2014 as Compared with Six Months Ended June 30, 2013

Non-interest income decreased \$35,000 for the first half of 2014 as compared with the first half of 2013. Trust department income and fees and service charges on deposit accounts increased in 2014 as compared with 2013. During the first half of 2013, the Company realized gains from sales and calls of securities while there were no sales or calls in 2014.

Trust department income and fees increased \$23,000 in 2014 as compared with 2013 as a result of the increase in market value, on which fees are based, of personal trust accounts.

Service charges on deposit accounts increased by \$188,000 during the first half of 2014 as compared with the first half of 2013. Fees from service charges increased \$63,000 as a result of the Company increasing per account and per transaction fees during the third quarter of 2013. NSF fee income decreased \$28,000. While NSF fee fluctuations are difficult to predict or analyze, it appears that customers may change their overdraft activity based on general economic conditions. ATM fee income increased \$142,000 as the Company added three new off-site ATMs and per transaction fees increased.

**Non-interest expense**

Quarter Ended June 30, 2014 as Compared with Quarter Ended June 30, 2013

Total non-interest expense increased \$827,000 for the second quarter of 2014 as compared with the second quarter of 2013. Salaries and employee benefits increased \$352,000; equipment rentals, depreciation and maintenance increased \$95,000; FDIC assessments increased \$111,000; data processing expenses increased \$55,000 and ATM expense increased \$147,000 for the second quarter of 2014 as compared with the second quarter of 2013.

The increase in salaries and employee benefits was primarily the result of an increase in salaries and increase in costs relating to the deferred compensation plans. Salaries increased \$77,000 in the second quarter of 2014 as compared with the second quarter of 2013 due to merit raises. Costs associated with the Company's deferred compensation plans increased \$260,000 as a result of a change in the discount rate utilized to compute the related liabilities.

The increase in equipment rentals, depreciation and maintenance expense was primarily the result of servicing costs associated with bank-wide hardware and software conversions during 2014.

FDIC assessment costs in 2013 included a refund of prepaid assessments which results in 2013 expense being lower than 2014 expense.

Data processing costs increased in 2014 as compared with 2013 as result of additional costs associated with bank-wide hardware and software conversions.

ATM expenses increased in 2014 as a result of increased ATM activity in the current year.

Six Months Ended June 30, 2014 as Compared with Six Months Ended June 30, 2013

Total non-interest expense increased \$1,166,000 for the first half of 2014 as compared with the first half of 2013. Salaries and employee benefits increased \$424,000; equipment rentals, depreciation and maintenance increased \$131,000; FDIC assessments increased \$95,000; data processing expenses increased \$56,000 and ATM expense increased \$224,000 for the first half of 2014 as compared with the first half of 2013.

The increase in salaries and employee benefits was primarily the result of an increase in salaries and increase in costs relating to the deferred compensation plans. Salaries increased \$134,000 in the first half of 2014 as compared with the first half of 2013 due to merit raises. Costs associated with the Company's deferred compensation plans increased \$250,000 as a result of a change in the discount rate utilized to compute the related liabilities.

The increase in equipment rentals, depreciation and maintenance expense was primarily the result of servicing costs associated with bank-wide hardware and software conversions during 2014.

FDIC assessment costs in 2013 included a refund of prepaid assessments which results in 2013 expense being lower than 2014 expense.

Data processing costs increased in 2014 as compared with 2013 as result of additional costs associated with bank-wide hardware and software conversions.

ATM expenses increased in 2014 as a result of increased ATM activity in the current year.

**Income Taxes (Benefit)**

Income taxes have been impacted by non-taxable income and federal tax credits during the quarters and six months ended June 30, 2014 and 2013, as follows (in thousands except rate):

|                                     | Quarters Ended June 30, |              |                |             |
|-------------------------------------|-------------------------|--------------|----------------|-------------|
|                                     | 2014                    |              | 2013           |             |
|                                     | Tax                     | Rate         | Tax            | Rate        |
| Taxes at statutory rate             | \$ 34                   | 34           | \$(676)        | (34)        |
| Increase (decrease) resulting from: |                         |              |                |             |
| Tax-exempt interest income          | (130)                   | (130)        | (61)           | (3)         |
| Income from BOLI                    | (43)                    | (43)         | (41)           | (2)         |
| Federal tax credits                 | (74)                    | (74)         | (74)           | (4)         |
| Other                               | (22)                    | (22)         | 10             | 1           |
| <b>Total income taxes (benefit)</b> | <b>\$(235)</b>          | <b>(235)</b> | <b>\$(842)</b> | <b>(42)</b> |

|                                     | Six Months Ended June 30, |             |                 |             |
|-------------------------------------|---------------------------|-------------|-----------------|-------------|
|                                     | 2014                      |             | 2013            |             |
|                                     | Tax                       | Rate        | Tax             | Rate        |
| Taxes at statutory rate             | \$ 201                    | 34          | \$ (466)        | (34)        |
| Increase (decrease) resulting from: |                           |             |                 |             |
| Tax-exempt interest income          | (260)                     | (44)        | (146)           | (11)        |
| Income from BOLI                    | (83)                      | (14)        | (82)            | (6)         |
| Federal tax credits                 | (148)                     | (25)        | (148)           | (11)        |
| Other                               | (34)                      | (6)         | 11              | 1           |
| <b>Total income taxes (benefit)</b> | <b>\$ (324)</b>           | <b>(55)</b> | <b>\$ (831)</b> | <b>(61)</b> |

## FINANCIAL CONDITION

Cash and due from banks decreased \$4,274,000 at June 30, 2014, compared with December 31, 2013 in the management of the bank subsidiary's liquidity position.

Loans decreased \$13,830,000 at June 30, 2014 compared with December 31, 2013, as principal payments, maturities, charge-offs and foreclosures on existing loans exceeded new loans.

Other real estate ( ORE ) decreased \$706,000 at June 30, 2014 as compared with December 31, 2013. Loans totaling \$194,000 were transferred into ORE while \$650,000 was sold for a loss of \$76,000 and writedowns of ORE to fair value were \$174,000 during the first six months of 2014.

Other assets decreased \$2,183,000 at June 30, 2014 as compared with December 31, 2013 as deferred tax assets decreased \$2,350,000 primarily as the increase in fair value of available for sale securities reduced an unrealized loss and other prepaid assets and receivables increased \$371,000.

Total deposits decreased \$4,715,000 at June 30, 2014, as compared with December 31, 2013. Typically, significant increases or decreases in total deposits and/or significant fluctuations among the different types of deposits from quarter to quarter are anticipated by Management as customers in the casino industry and county and municipal entities reallocate their resources periodically.

Federal funds purchased and securities sold under agreements to repurchase decreased \$22,269,000 at June 30, 2014 as compared with December 31, 2013 as several county and municipal entities reallocated their balances from a non-deposit account during the first half of 2014.

Employee and director benefit plans liabilities increased \$648,000 at June 30, 2014 as compared with December 31, 2013 due to deferred compensation benefits earned by officers and directors during 2014.

**SHAREHOLDERS EQUITY AND CAPITAL ADEQUACY**

Strength, security and stability have been the hallmark of the Company since its founding in 1985 and of its bank subsidiary since its founding in 1896. A strong capital foundation is fundamental to the continuing prosperity of the Company and the security of its customers and shareholders.

The Company and the Bank are subject to regulatory capital adequacy requirements imposed by the federal banking agencies. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, specific capital guidelines that involve quantitative measures of the bank subsidiary's assets and certain off-balance sheet items, adjusted for credit risk, as calculated under regulatory accounting practices must be met. The risk-based capital standards currently in effect are designed to make regulatory capital requirements more sensitive to differences in risk profiles among bank holding companies and banks and to account for off-balance sheet exposure. Quantitative measures established by regulation to ensure capital adequacy require the Company and Bank to maintain minimum amounts and ratios of Total and Tier 1 capital to risk-weighted assets, and Tier 1 capital to average assets.

As of June 30, 2014, the most recent notification from the Federal Deposit Insurance Corporation categorized the bank subsidiary as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the bank subsidiary must have a Total risk-based capital ratio of 10.00% or greater, a Tier 1 risk-based capital ratio of 6.00% or greater and a Leverage capital ratio of 5.00% or greater. There are no conditions or events since that notification that Management believes have changed the bank subsidiary's category.

The actual capital amounts and ratios and required minimum capital amounts and ratios for the Company as of June 30, 2014 and December 31, 2013, are as follows (in thousands):

|  | Actual<br>Amount | Ratio  | For Capital Adequacy Purposes<br>Amount | Ratio |
|--|------------------|--------|---|-------|
| <b>June 30, 2014:</b>                    |                  |        |   |       |
| Total Capital (to Risk Weighted Assets)  | \$ 111,330       | 23.69% | \$ 37,600                               | 8.00% |
| Tier 1 Capital (to Risk Weighted Assets) | 105,411          | 22.43% | 18,800                                  | 4.00% |
| Tier 1 Capital (to Average Assets)       | 105,411          | 14.19% | 29,711                                  | 4.00% |
| <b>December 31, 2013:</b>                |                  |        |   |       |
| Total Capital (to Risk Weighted Assets)  | \$ 111,141       | 22.79% | \$ 39,022                               | 8.00% |
| Tier 1 Capital (to Risk Weighted Assets) | 105,009          | 21.54% | 19,511                                  | 4.00% |
| Tier 1 Capital (to Average Assets)       | 105,009          | 13.48% | 31,170                                  | 4.00% |

The actual capital amounts and ratios and required minimum capital amounts and ratios for the Bank as of June 30, 2014 and December 31, 2013, are as follows (in thousands):

|  | Actual     |        | For Capital Adequacy Purposes |       | To Be Well Capitalized |        |
|--|------------|--------|-------------------------------|-------|------------------------|--------|
|  | Amount     | Ratio  | Amount                        | Ratio | Amount                 | Ratio  |
| <b>June 30, 2014:</b>                    |            |        |                               |       |                        |        |
| Total Capital (to Risk Weighted Assets)  | \$ 107,602 | 22.93% | \$ 37,548                     | 8.00% | \$ 46,935              | 10.00% |
| Tier 1 Capital (to Risk Weighted Assets) | 101,691    | 21.67% | 18,774                        | 4.00% | 28,161                 | 6.00%  |
| Tier 1 Capital (to Average Assets)       | 101,691    | 13.71% | 29,677                        | 4.00% | 37,097                 | 5.00%  |
| <b>December 31, 2013:</b>                |            |        |                               |       |                        |        |
| Total Capital (to Risk Weighted Assets)  | \$ 106,870 | 21.94% | \$ 38,968                     | 8.00% | \$ 48,711              | 10.00% |
| Tier 1 Capital (to Risk Weighted Assets) | 100,746    | 20.69% | 19,484                        | 4.00% | 29,227                 | 6.00%  |
| Tier 1 Capital (to Average Assets)       | 100,746    | 13.02% | 30,958                        | 4.00% | 38,697                 | 5.00%  |

In addition to monitoring its risk-based capital ratios, the Company also determines the primary capital ratio on a quarterly basis. This ratio was 14.88% at June 30, 2014, which is well above the regulatory minimum of 6.00%. Management continues to emphasize the importance of maintaining the appropriate capital levels of the Company and has established the goal of maintaining its primary capital ratio at 8.00%, which is the minimum requirement for classification as being well-capitalized by the banking regulatory authorities.

## LIQUIDITY

Liquidity represents the Company's ability to adequately provide funds to satisfy demands from depositors, borrowers and other commitments by either converting assets to cash or accessing new or existing sources of funds. Management monitors these funds requirements in such a manner as to satisfy these demands and provide the maximum earnings on its earning assets. The Company manages and monitors its liquidity position through a number of methods, including through the computation of liquidity risk targets and the preparation of various analyses of its funding sources and utilization of those sources on a monthly basis. The Company also uses proforma liquidity projections which are updated on a monthly basis in the management of its liquidity needs and also conducts periodic contingency testing on its liquidity plan.

Deposits, payments of principal and interest on loans, proceeds from maturities of investment securities and earnings on investment securities are the principal sources of funds for the Company. Borrowings from the FHLB, federal funds sold and federal funds purchased are utilized by the Company to manage its daily liquidity position. The Company has also been approved to participate in the Federal Reserve Bank's Discount Window Primary Credit Program, which it intends to use only as a contingency.



## **REGULATORY MATTERS**

During 2009, Management identified opportunities for improving risk management, addressing asset quality concerns, managing concentrations of credit risk and ensuring sufficient liquidity at the Bank as a result of its own investigation as well as examinations performed by certain bank regulatory agencies. In concert with the regulators, the Company and the Bank identified specific corrective steps and actions to enhance its risk management, asset quality and liquidity policies, controls and procedures. The Company and the Bank may not declare or pay any cash dividends without the prior written approval of their regulators.

### **Item 4: Controls and Procedures**

As of June 30, 2014, an evaluation was performed under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer of the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e)). Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms.

There were no changes in the Company's internal control over financial reporting that occurred during the period ended June 30, 2014 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **Item 1: Legal Proceedings**

The Bank is involved in various legal matters and claims which are being defended and handled in the ordinary course of business. None of these matters is expected, in the opinion of Management, to have a material adverse effect upon the financial position or results of operations of the Company.

### **Item 5: Other Information**

None.

**Item 6 - Exhibits and Reports on Form 8-K**

(a) Exhibits

- Exhibit 31.1: Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes Oxley Act of 2002
- Exhibit 31.2: Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act of 2002
- Exhibit 32.1: Certification of Chief Executive Officer Pursuant to 18 U.S.C. ss. 1350
- Exhibit 32.2: Certification of Chief Financial Officer Pursuant to 18 U.S.C. ss. 1350
- Exhibit 101 The following materials from the Company's quarterly report on Form 10-Q for the quarter ended June 30, 2014, formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Statements of Condition at June 30, 2014 and December 31, 2013, (ii) Consolidated Statements of Operations for the quarters and six months ended June 30, 2014 and 2013, (iii) Consolidated Statements of Comprehensive Income for the quarters and six months ended June 30, 2014 and 2013, (iv) Statement of Changes in Shareholders' Equity for the six months ended June 30, 2014, (v) Consolidated Statements of Cash Flows for the six months ended June 30, 2014 and 2013 and (vi) Notes to the Unaudited Consolidated Financial Statements for the six months ended June 30, 2014 and 2013.

(b) Reports on Form 8-K

A Form 8-K was filed on April 23, 2014, April 24, 2014, May 28, 2014 and July 23, 2014.

SIGNATURES

Pursuant to the requirement of Section 13 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.

PEOPLES FINANCIAL CORPORATION

(Registrant)

Date: August 13, 2014

By: /s/ Chevis C. Swetman

Chevis C. Swetman  
Chairman, President and Chief Executive  
Officer  
(principal executive officer)

Date: August 13, 2014

By: /s/ Lauri A. Wood

Lauri A. Wood  
Chief Financial Officer and Controller  
(principal financial and accounting officer)