

**FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C. 20429**

FORM 8-K/A

**CURRENT REPORT
PURSUANT TO SECTION 13 OF
THE SECURITIES EXCHANGE ACT OF 1934**

June 22, 2016

Date of Report (Date of earliest event reported)

TOWNE BANK

(Exact name of registrant as specified in its charter)

Virginia

(State or other jurisdiction of
incorporation)

35095

(FDIC Insurance Cert. No.)

54-1910608

(IRS Employer Identification No.)

5716 High Street, Portsmouth, Virginia

(Address of principal executive offices)

23703

(Zip Code)

(757) 638-7500

(Registrant's telephone number, including area code)

No Change

(Former name or former address, if changed since last report)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions:

- ☐ [] Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)
- ☐ [] Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)
- ☐ [] Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))
- ☐ [] Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))

Explanatory Note

On June 28, 2016, TowneBank filed a Form 8-K reporting the completion of its acquisition of Monarch Financial Holdings, Inc. (“Monarch”) and Monarch Bank, the wholly-owned bank subsidiary of Monarch, on June 24, 2016. In that filing, TowneBank indicated that it would amend the Form 8-K at a later date to include the financial information required by Item 9.01 of Form 8-K. This amendment to TowneBank’s June 28, 2016 Form 8-K is being filed to provide such financial information, which is attached to this report as Exhibits 99.1, 99.2 and 99.3.

Item 9.01 Financial Statements and Exhibits.

(a) *Financial statements of businesses acquired.*

(i) The audited consolidated statements of condition of Monarch as of December 31, 2015 and 2014, and the related consolidated statements of income, comprehensive income, stockholders’ equity, and cash flows for each of the three years in the period ended December 31, 2015, and the related notes and report of independent auditors thereto, are attached hereto as Exhibit 99.1 and incorporated by reference herein (collectively, the “Monarch Audited Information”).

(ii) The unaudited consolidated statements of condition of Monarch as of March 31, 2016, the unaudited consolidated statements of income for the three months ended March 31, 2016 and 2015, the unaudited consolidated statements of comprehensive income for the three months ended March 31, 2016 and 2015, the unaudited consolidated statements of changes in stockholders’ equity for the three months ended March 31, 2016 and 2015, and the unaudited consolidated statements of cash flows for the three months ended March 31, 2016 and 2015, and the related notes thereto, are attached hereto as Exhibit 99.2 and incorporated by reference herein (collectively, the “Monarch Unaudited Information”).

(b) *Pro forma financial information.*

The TowneBank and Monarch unaudited pro forma condensed combined balance sheet as of March 31, 2016, and the unaudited pro forma condensed combined statements of income for the three months ended March 31, 2016 and for the year ended December 31, 2015, and the related notes to the unaudited pro forma condensed combined financial information, are attached hereto as Exhibit 99.3 and incorporated by reference herein (collectively, the “TowneBank-Monarch Pro Forma Financial Information”).

(d) *Exhibits.*

The following exhibits are filed herewith:

<u>Exhibit No.</u>	<u>Description of Exhibit</u>
99.1	Monarch Audited Information.
99.2	Monarch Unaudited Information.
99.3	TowneBank-Monarch Pro Forma Financial Information.

SIGNATURES

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

TowneBank
(Registrant)

Date: September 7, 2016

By: /s/ Clyde E. McFarland, Jr.
Clyde E. McFarland, Jr.
Senior Executive Vice President
and Chief Financial Officer

EXHIBIT INDEX

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Certified Public Accountants and Consultants

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders
Monarch Financial Holdings, Inc.
Chesapeake, Virginia

We have audited the accompanying consolidated statements of condition of Monarch Financial Holdings, Inc. and subsidiaries as of December 31, 2015 and 2014, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2015. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Monarch Financial Holdings, Inc. and subsidiaries as of December 31, 2015 and 2014, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2015, in conformity with U.S. generally accepted accounting principles.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Monarch Financial Holdings, Inc. and subsidiaries' internal control over financial reporting as of December 31, 2015, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated March 11, 2016 expressed an unqualified opinion on the effectiveness of Monarch Financial Holdings, Inc. and subsidiaries' internal control over financial reporting.

/s/ Yount, Hyde & Barbour, P.C.

Winchester, Virginia
March 11, 2016

MONARCH FINANCIAL HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF CONDITION

	December 31,	
	2015	2014
ASSETS:		
Cash and due from banks	\$ 13,945,507	\$ 14,503,072
Interest bearing bank balances	58,637,565	49,790,751
Federal funds sold	1,296,438	1,135,151
Total cash and cash equivalents	73,879,510	65,428,974
Investment securities available-for-sale, at fair value	30,213,130	23,725,362
Loans held for sale, at fair value	169,345,205	147,690,276
Loans held for investment, net of unearned income	829,269,305	772,589,535
Less: allowance for loan losses	(8,887,199)	(8,948,837)
Loans, net	820,382,106	763,640,698
Property and equipment, net	28,971,862	30,247,464
Restricted equity securities, at cost	3,881,200	3,632,500
Bank owned life insurance	10,634,814	9,656,803
Goodwill	775,000	775,000
Other real estate owned	—	144,000
Other assets	23,365,328	21,795,897
Total assets	\$ 1,161,448,155	\$ 1,066,736,974
LIABILITIES:		
Deposits:		
Demand deposits - non-interest bearing	\$ 280,079,558	\$ 235,301,171
Demand deposits - interest bearing	68,963,364	66,681,905
Savings deposits	19,516,673	20,003,086
Money market deposits	364,893,441	369,221,343
Time deposits	265,640,562	228,206,408
Total deposits	999,093,598	919,413,913
Borrowings:		
Trust preferred subordinated debt	10,000,000	10,000,000
Federal Home Loan Bank advances	16,000,000	11,075,497
Total borrowings	26,000,000	21,075,497
Other liabilities	18,632,147	18,710,247
Total liabilities	1,043,725,745	959,199,657
STOCKHOLDERS' EQUITY:		
Preferred stock, \$5 par value, 1,185,300 shares authorized; none issued	—	—
Noncumulative perpetual preferred stock, series B, liquidation value of \$20.0 million, \$5 par value; 800,000 shares authorized, 0 issued and outstanding at December 31, 2015 and December 31, 2014	—	—
Common stock, \$5 par value: 20,000,000 shares authorized; issued and outstanding - 11,880,909 shares (includes non-vested shares of 441,040) at December 31, 2015 and 10,652,475 shares (includes non-vested shares of 279,750) at December 31, 2014	57,199,345	51,863,625
Additional paid-in capital	17,241,281	8,335,538
Retained earnings	43,349,447	47,354,407
Accumulated other comprehensive loss	(156,594)	(102,237)
Total Monarch Financial Holdings, Inc. stockholders' equity	117,633,479	107,451,333
Non-controlling interests	88,931	85,984
Total equity	117,722,410	107,537,317
Total liabilities and stockholders' equity	\$ 1,161,448,155	\$ 1,066,736,974

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

MONARCH FINANCIAL HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF INCOME

	For the Year Ended December 31,		
	2015	2014	2013
Interest income:			
Interest and fees on loans held for investment	\$ 40,393,696	\$ 37,327,978	\$ 36,645,065
Interest on mortgage loans held for sale	5,963,440	4,866,818	7,021,186
Interest on investment securities	324,921	359,604	230,496
Interest on federal funds sold	33,661	84,850	115,963
Dividends on equity securities	194,313	106,955	277,700
Interest on other bank accounts	485,152	244,702	58,027
Total interest income	47,395,183	42,990,907	44,348,437
Interest expense:			
Interest on deposits	2,868,240	3,185,965	3,936,203
Interest on trust preferred subordinated debt	191,071	416,233	491,910
Interest on borrowings	87,825	58,966	358,345
Total interest expense	3,147,136	3,661,164	4,786,458
Net interest income	44,248,047	39,329,743	39,561,979
Provision for loan losses	—	—	—
Net interest income after provision for loan losses	44,248,047	39,329,743	39,561,979
Non-interest income:			
Mortgage banking income	79,578,461	62,440,013	65,672,402
Service charges and fees	2,227,224	2,058,262	1,941,926
Title income	967,223	669,785	789,253
Investment and insurance income	1,607,823	1,592,398	1,053,429
Gain (loss) on sale of assets	140,578	(266)	58,460
Gain on sale/call of securities	22,801	155	—
Other	569,982	318,894	366,801
Total non-interest income	85,114,092	67,079,241	69,882,271
Non-interest expenses:			
Salaries and employee benefits	39,349,089	34,134,998	34,112,834
Commissions	36,995,519	24,754,633	28,344,347
Loan origination expenses	7,382,476	6,652,007	7,891,835
Occupancy expenses	5,938,736	6,118,265	5,408,567
Furniture and equipment expenses	3,503,532	3,430,278	3,041,345
Marketing expense	3,625,625	3,151,374	2,912,864
Data processing services	2,329,983	2,272,785	1,696,535
Professional fees	2,120,004	1,322,268	1,053,499
Telephone	1,373,579	1,226,389	1,184,894
Foreclosed property expense	93,949	77,936	10,118
Valuation adjustments on other assets held	100,000	—	—
FDIC insurance	558,079	530,486	567,819
Other	5,001,140	4,808,437	4,686,161
Total non-interest expenses	108,371,711	88,479,856	90,910,818
Income before income taxes	20,990,428	17,929,128	18,533,432
Income tax provision	(7,583,820)	(6,490,273)	(6,386,040)
Net income	13,406,608	11,438,855	12,147,392
Less: Net income attributable to non-controlling interests	(191,787)	(227,005)	(1,056,385)
Net income available to common stockholders	\$ 13,214,821	\$ 11,211,850	\$ 11,091,007
Basic net income per share (1)	\$ 1.12	\$ 0.96	\$ 0.99
Diluted net income per share (1)	\$ 1.11	\$ 0.96	\$ 0.98

(1) All per share amounts have been adjusted to reflect the 11 for 10 stock split granted December 4, 2015.

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

MONARCH FINANCIAL HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	Year Ended December 31,		
	2015	2014	2013
Net Income	\$ 13,406,608	\$ 11,438,855	\$ 12,147,392
Other comprehensive income (loss):			
Change in unrealized gain on interest rate swap, net of income taxes	—	146,537	191,332
Change in unrealized (loss) gain on securities available for sale, net of income taxes and reclassification adjustments	(66,310)	165,365	(271,491)
Change in unrealized gain (loss) on supplemental executive retirement plan, net of income taxes	12,197	5,148	(139,315)
Change in unrealized (loss) gain on deferred compensation asset	(244)	209	—
Other comprehensive (loss) income	(54,357)	317,259	(219,474)
Total comprehensive income	13,352,251	11,756,114	11,927,918
Less: Comprehensive income attributable to non-controlling interests	(191,787)	(227,005)	(1,056,385)
Comprehensive income attributable to Monarch Financial Holdings, Inc.	\$ 13,160,464	\$ 11,529,109	\$ 10,871,533
Unrealized gain on interest rate swap		\$ 225,442	\$ 286,481
Income tax expense	—	(78,905)	(95,149)
Net unrealized gain on interest rate swap	\$ —	\$ 146,537	\$ 191,332
Unrealized holding (loss) gain on securities available for sale	\$ (79,214)	\$ 254,563	\$ (414,465)
Reclassification adjustment for realized securities gains	(22,801)	(155)	—
Income tax benefit (expense)	35,705	(89,043)	142,974
Net unrealized (loss) gain on securities available for sale	\$ (66,310)	\$ 165,365	\$ (271,491)
Unrealized gain (loss) on supplemental executive retirement plan	\$ 18,765	\$ 7,920	\$ (214,331)
Income tax (expense) benefit	(6,568)	(2,772)	75,016
Net unrealized gain (loss) on supplemental executive retirement plan	\$ 12,197	\$ 5,148	\$ (139,315)
Unrealized (loss) gain on deferred compensation asset	\$ (244)	\$ 209	\$ —
Net unrealized (loss) gain on deferred compensation asset	\$ (244)	\$ 209	\$ —

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

MONARCH FINANCIAL HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Common Stock		Additional Paid-In	Preferred	Retained	Accumulated Other Comprehensive	Non- controlling	Total
	Shares	Amount	Capital	Stock	Earnings	Income (Loss)	Interests	
Balance - December 31, 2012	8,326,479	\$ 41,632,395	\$ 12,717,727	\$ 2,405,615	\$ 30,786,208	\$ (200,022)	\$ 1,604,918	\$ 88,946,841
Net income for year ended December 31, 2013					11,091,007		1,056,385	12,147,392
Other comprehensive loss						(219,474)		(219,474)
Stock-based compensation expense, net of forfeitures and income tax benefit	17,400	87,000	506,721					593,721
Stock options exercised, including tax benefit for exercise of options	115,359	576,795	318,365					895,160
Series B noncumulative perpetual preferred shares converted to common stock, less fractional shares	1,804,184	9,020,920	(6,615,558)	(2,405,615)				(253)
Cash dividend declared on common stock (\$0.22 per share)					(2,440,096)			(2,440,096)
Common stock issued through dividend reinvestment	22,941	114,705	141,460					256,165
Distributions to non-controlling interests							(2,433,858)	(2,433,858)
Balance - December 31, 2013	10,286,363	\$ 51,431,815	\$ 7,068,715	\$ —	\$ 39,437,119	\$ (419,496)	\$ 227,445	\$ 97,745,598
Net income for year ended December 31, 2014					11,211,850		227,005	11,438,855
Other comprehensive income						317,259		317,259
Stock-based compensation expense, net of forfeitures and income tax benefit	17,760	88,800	735,697					824,497
Stock options exercised, including tax benefit for exercise of options	42,414	212,070	344,055					556,125
Cash dividend declared on common stock (\$0.28 per share)					(3,294,562)			(3,294,562)
Common stock issued through dividend reinvestment	26,188	130,940	187,071					318,011
Contributions from non-controlling interests							99	99
Distributions to non-controlling interests							(368,565)	(368,565)
Balance - December 31, 2014	10,372,725	\$ 51,863,625	\$ 8,335,538	\$ —	\$ 47,354,407	\$ (102,237)	\$ 85,984	\$ 107,537,317
Net income for the year ended December 31, 2015					13,214,821		191,787	13,406,608
Other comprehensive loss						(54,357)		(54,357)
Stock-based compensation expense, net of forfeitures and income tax benefit	1,385	6,925	826,326					833,251
Stock options exercised, including tax benefit for exercise of options	85,916	429,580	326,658					756,238
Stock dividend 11 for 10 shares, net of cash in lieu of fractional shares	1,045,433	5,227,165	8,222,728		(13,453,884)			(3,991)
Cash dividend declared on common stock (\$0.32 per share)					(3,765,897)			(3,765,897)
Common stock repurchase	(65,590)	(327,950)	(469,969)					(797,919)
Distributions to non-controlling interests							(188,840)	(188,840)
Balance— December 31, 2015	11,439,869	\$ 57,199,345	\$ 17,241,281	\$ —	\$ 43,349,447	\$ (156,594)	\$ 88,931	\$ 117,722,410

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

MONARCH FINANCIAL HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended December 31,		
	2015	2014	2013
Operating activities:			
Net income	\$ 13,406,608	\$ 11,438,855	\$ 12,147,392
Adjustments to reconcile to net cash (used in) provided by operating activities:			
Provision for loan losses	—	—	—
Depreciation	2,977,243	2,886,838	2,424,478
Accretion of discounts and amortization of premiums, net	4,664	4,951	23,091
Deferral of loan fees, net of deferred (costs)	124,912	251,788	(92,506)
Amortization of intangible assets	—	104,167	178,572
Stock-based compensation	833,251	824,497	621,511
Appreciation of bank-owned life insurance	(273,943)	(247,367)	(236,377)
Net (gain) loss on sale of assets	(140,578)	266	(58,460)
Net loss on sale of other real estate	51,035	6,976	3,020
Valuation adjustment of repossessed assets	100,000	—	—
Net gain on sale/call of securities	(22,801)	(155)	—
Deferred income tax (benefit) expense	(48,909)	(304,779)	849,060
Changes in:			
Loans held for sale	(21,654,929)	(47,972,491)	319,357,304
Interest receivable	(22,228)	64,252	(193,122)
Other assets	(1,392,757)	(2,836,791)	8,800,567
Other liabilities	(192,723)	4,160,968	(819,660)
Net cash (used in) provided by operating activities	(6,251,155)	(31,618,025)	343,004,870
Investing activities:			
Purchases of available-for-sale securities	(21,894,721)	(15,346,950)	(38,567,095)
Proceeds from sales and maturities of available-for-sale securities	15,317,094	40,692,960	3,941,512
Proceeds from sale of other real estate	342,965	1,093,272	92,054
Proceeds from sale of assets	185,148	—	381,556
Purchase of bank owned life insurance	(704,068)	(2,000,000)	—
Purchases of premises and equipment	(1,783,486)	(4,284,773)	(5,894,911)
Purchase of restricted equity securities, net of redemptions	(248,700)	50,750	8,679,950
Loan originations, net of principal repayments	(57,116,320)	(61,224,673)	(53,730,467)
Net cash used in investing activities	(65,902,088)	(41,019,414)	(85,097,401)
Financing activities:			
Net increase in non-interest-bearing deposits	44,778,387	28,409,672	16,771,004
Net (decrease) increase in interest-bearing deposits	34,901,298	(2,114,249)	(25,434,386)
Cash dividends paid on common stock	(3,765,897)	(3,294,562)	(2,440,096)
Net increase (decrease) in FHLB advances	4,924,503	9,900,012	(193,123,038)
Net decrease in short term borrowings	—	—	(5,000,000)
Contributions from non-controlling interests	—	99	—
Distributions to non-controlling interests	(188,840)	(368,565)	(2,433,858)
Proceeds from issuance of common stock, net of issuance costs	—	318,011	256,165
Proceeds from exercise of stock options	756,238	304,673	633,737
Cash paid for fractional shares	(3,991)	—	(253)
Repurchase of common stock, net of repurchase costs	(797,919)	—	—
Net cash provided by (used in) financing activities	80,603,779	33,155,091	(210,770,725)
CHANGE IN CASH AND CASH EQUIVALENTS	8,450,536	(39,482,348)	47,136,744
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	65,428,974	104,911,322	57,774,578
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 73,879,510	\$ 65,428,974	\$ 104,911,322

MONARCH FINANCIAL HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS - CONTINUED

SUPPLEMENTAL SCHEDULES AND CASH FLOW INFORMATION	2015	2014	2013
Cash paid for:			
Interest on deposits and other borrowings	\$ 3,085,899	\$ 3,676,288	\$ 4,958,111
Income taxes	\$ 7,601,000	\$ 5,351,700	\$ 7,207,630
Loans transferred to foreclosed real estate during the year	\$ 250,000	\$ 942,285	\$ 397,037
Unrealized (loss) gain on securities available for sale	\$ (107,996)	\$ 254,563	\$ (414,465)
Unrealized gain on interest rate swap	\$ —	\$ 225,442	\$ 286,481
Unrealized gain (loss) on supplemental executive retirement plan	\$ 18,765	\$ 7,920	\$ (214,331)
Unrealized (loss) gain on mutual fund	\$ (244)	\$ 209	\$ —

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

NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and Nature of Operations: Monarch Financial Holdings, Inc. (the “Company”, “we” or “Monarch”) is a Virginia chartered Bank Holding Company that offers a full range of banking services, primarily to individuals and businesses in the Hampton Roads area of southeastern Virginia and northeastern North Carolina. On June 1, 2006, the Company was created through a reorganization plan, under the laws of the Commonwealth of Virginia, in which Monarch Bank (the “Bank”) became a wholly-owned subsidiary of Monarch Financial Holdings, Inc. Monarch Bank was incorporated on May 1, 1998, and commenced operations on April 14, 1999.

In addition to banking services, we offer financial planning, trust and investment services, under the name Monarch Bank Private Wealth, to high net worth individuals. We originate mortgage loans in both the residential and commercial markets which are then sold with servicing released. Residential services are offered under the name Monarch Mortgage and through joint ventures between Monarch Investment, LLC and a minority partner under the name Coastal Home Mortgage, LLC. Commercial mortgages are offered by the Bank’s 100% owned subsidiary, Monarch Capital, LLC. Investment services are provided under the name Monarch Investments. Residential and commercial title insurance is offered to our clients through Real Estate Security Agency, LLC, a 75% owned subsidiary.

TowneBank Merger: On December 17, 2015, the Company and Bank entered into a definitive agreement with TowneBank (“Towne”), pursuant to which Towne will acquire all of the common stock of Monarch in a stock transaction valued at approximately \$221 million, based on Towne’s closing price December 16, 2015. Upon completion of the transaction, Towne expected to have approximately \$7.3 billion in assets, \$5.4 billion in loans and \$5.8 billion in deposits.

Under the terms of the agreement, which has been approved by the Board of Directors of both companies, the share price and total deal value will be determined utilizing the conversion ratio of 0.8830 shares of Towne common stock for each share of Monarch common stock at the closing date. The transaction, which is subject to regulatory approval, the approval of the shareholders of Monarch and Towne, and other customary conditions, is expected to close in the second quarter of 2016.

Principles of Consolidation: Our consolidated financial statements include the accounts of the Company, the Bank and its subsidiaries, collectively referred to as the “Company” or “Monarch”. All significant inter-company transactions have been eliminated.

Use of Estimates: Our consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States of America and general practices within the banking industry which requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the period. Our actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, the fair value of derivative financial instruments and the fair values of available for sale securities.

Cash and Cash Equivalents: We define cash and cash equivalents to include currency, balances due from banks (including non-interest bearing and interest bearing deposits) and federal funds sold. We are required to maintain certain reserve balances with the Federal Reserve Bank. These required reserves were \$21.2 million at December 31, 2015 and \$16.8 million at December 31, 2014.

Investment Securities: Investments classified as available-for-sale are stated at fair value with unrealized holding gains and losses excluded from earnings and reported, net of deferred tax, as a component of other comprehensive income until realized. Investments in debt securities classified as held-to-maturity are stated at cost, adjusted for amortization of premiums and accretion of discounts using the interest method. Management has the positive intent and ability to hold these securities to maturity and, accordingly, adjustments are not made for temporary declines in their fair value below amortized cost.

Gains and losses on the sale of securities are determined using the specific identification method. Other-than-temporary declines in the fair value of individual available-for-sale and held-to-maturity securities below their cost, if any, are included in earnings as realized losses.

Loans Held for Sale: Loans originated and intended for sale in the secondary market are carried at fair value. The Company made this election in fiscal year 2014. Net unrealized losses, if any, are recognized through charges to income.

Loans Held for Investment: Loans are reported at their recorded investment, which is the principal outstanding balance net of charge-offs, deferred loan fees and costs on originated loans, unearned income, and unamortized premiums or discounts, if any, on purchased loans. Interest income is recognized over the term of the loan and is calculated using the simple-interest method on principal amounts outstanding. Further information on loans is contained in Note 4 to our Consolidated Financial Statements.

Deferred Loan Fees and Costs: Certain fees and costs associated with loans held for investment originations are recognized as an adjustment to interest income over the contractual life of the loans.

Allowance for Loan Losses: The allowance for loan losses reflects management's judgment of probable losses inherent in the portfolio at the balance sheet date. A loan is considered impaired, based on current information and events, if it is probable we will be unable to collect the scheduled payments of principal and/or interest when due, according to the contractual terms of the loan agreement. The measurement of impaired loans is generally based on the present value of expected future cash flows discounted at the historical effective interest rate, except in the case of collateral-dependent loans which may be measured for impairment based on the fair value of the collateral. Further information on loans is contained in Note 4 to our Consolidated Financial Statements.

The establishment of the allowance for loan losses relies on a consistent process that requires multiple layers of management review and judgment and responds to changes in economic conditions, client behavior, and collateral value, among other influences. Management uses a disciplined process and methodology to establish the allowance for loan losses on a monthly basis. To determine the total allowance for loan losses, the Company estimates the reserves needed for each class of the portfolio, including loans analyzed on a pooled basis and individually.

The allowance for loan losses consists of amounts applicable to three loan types: (i) commercial loans; (ii) real estate loans; (iii) consumer loans. Loans within these types are further separated into classes. Loans are pooled by loan class and modeled utilizing historical loss experience, probable and inherent risks, and quantitative techniques which management determined fit the characteristics of that class. Additionally, loans that have been specifically identified as a credit risk due to circumstances that may affect the ability of the borrower to repay interest and/or principal are analyzed on an individual basis. Adverse circumstances may include loss of repayment source, deterioration in the estimated value of collateral, elevated trends of delinquencies, and charge-offs.

We evaluate the adequacy of the allowance for loan losses monthly in order to maintain the allowance at a level that is sufficient to absorb probable credit losses. Such factors as the level and trend of interest rates and the condition of the national and local economies are also considered. From time to time, events or economic factors may affect the loan portfolio, causing management to provide additional amounts to or release balances from the allowance for loan losses. The Company's allowance for loan losses is sensitive to risk ratings assigned to individually evaluated loans, economic assumptions, and delinquency trends driving statistically modeled reserves. In addition, various regulatory agencies, as an integral part of their examination process, periodically review our allowance for losses on loans. Such agencies may require that we recognize additions to the allowance based on their judgments of information available to them at the time of their examination.

The allowance for loan losses is established through charges to earnings in the form of a provision for loan losses. Increases and decreases in the allowance due to changes in the measurement of impaired loans, if applicable, are included in the provision for loan losses. Impairment is measured on a loan by loan basis, by either the present value of expected future cash flows discounted to the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral less costs to sell, if the loan is collateral dependent. Loans continue to be classified as impaired unless they are brought fully current and the collection of scheduled interest and principal is considered probable.

When we determine a loan or portion of a loan is not collectible, that portion is charged against the allowance. Subsequent recoveries, if any, are credited to the allowance until fully recaptured, prior to the resumption of recording additional principal curtailments and/or interest.

Loan Charge-off Policies: Our loan charge-off policy delineates between secured and unsecured loans in addition to consumer, residential real estate, and commercial and construction loans.

- Unsecured loans are to be charged-off when they become 120 days delinquent or when it is determined that the debt is uncollectible, whichever comes first. Overdrafts are to be charged-off when it is determined a recovery is not likely or the overdraft becomes 90 days old, whichever comes first.
- Secured consumer loans, except those secured by the borrower's primary or secondary residence, are to be charged-off or charged-down to net recoverable value of collateral on or before becoming 120 days past due, or whenever collection is doubtful, whichever comes first.
- Residential real estate loans are to be charged-off when they become 365 days delinquent. Home equity and improvement loans are to be reviewed before they become 180 days past due and are to be charged off unless they are well-secured and in process of collection.
- Charge-offs on commercial, commercial real estate and construction loans are to be taken promptly upon determination that all or a portion of any loan balance is uncollectible. A loan is considered uncollectible when the borrower is delinquent in principal or interest repayment and: a) the loan becomes 90 days past due, b) the borrower is unlikely to have the ability to pay the debt in a timely manner, c) the collateral value of the securing asset is insufficient to cover the outstanding indebtedness, and/or d) the guarantors do not provide adequate support for the debt.

- Charge-offs are taken immediately on any loan graded a “9” or considered statutory bad debt. Statutory bad debt exists when interest on a loan is past due and unpaid for six months and the loan is not well secured and in process of collection.

Income Recognition on Impaired and Nonaccrual Loans: Loans, including impaired loans, are generally classified as nonaccrual if they are past due as to maturity or payment of principal and/or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. If a loan or a portion of a loan is classified as doubtful, or is partially charged off, the loan is generally classified as nonaccrual. Loans that are on a current payment status or past due less than 90 days may also be classified as nonaccrual, if repayment in full of principal and/or interest is in doubt.

Loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance by the borrower, in accordance with the contractual terms of interest and principal.

While a loan is classified as nonaccrual and the future collectability of the recorded loan balance is doubtful, collections of interest and principal are generally applied as a reduction to principal outstanding. When the future collectability of the recorded loan balance is expected, interest income may be recognized on a cash basis. In the case where a nonaccrual loan had been partially charged off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded loan balance at the contractual interest rate. Cash receipts of interest in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

Restructured Loans: A restructured loan is an impaired loan in which it has been determined the borrower’s financial difficulties will prevent performance under the original contractual terms of the loan agreement and a concession is made with regard to those terms which would not be considered under normal circumstances.

If the value of a restructured loan is determined to be less than the recorded investment in the loan, a specific reserve in our allowance for loan loss is established for the difference between the value of the restructured loan and the recorded investment. Measurement of the value of a restructured loan is generally based on the present value of expected future cash flows discounted at the loan’s effective interest rate. Restructured loans are periodically reevaluated to determine if additional adjustments to the carrying value are necessary.

Collections of interest and principal are recorded as recoveries to the allowance for loan losses until all charged-off balances have been fully recovered.

Other Real Estate Owned: Real estate properties acquired through or in lieu of loan foreclosure are initially recorded at the fair value less estimated selling costs at the date of foreclosure. Any write-downs based on the asset’s fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, valuations are periodically performed by management and property held for sale is carried at the lower of the new cost basis or fair value less cost to sell. Property held and used is considered impaired when the carrying amount of a property exceeds its fair value. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. The portion of interest costs relating to development of real estate is capitalized. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its cost or fair value less cost to sell.

Bank Owned Life Insurance: The Company has purchased life insurance policies on certain key executives. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Goodwill and Other Intangible Assets: Goodwill resulting from business combinations prior to January 1, 2009 represents the excess of the purchase price over the fair value of the net assets of businesses acquired. Goodwill resulting from business combinations after January 1, 2009, is generally determined as the excess of the fair value of the consideration transferred, plus the fair value of any non-controlling interests in the acquiree, over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually or more frequently if events and circumstances exist that indicate a goodwill impairment test should be performed. The Company has selected December 31, as the date to perform the annual impairment test. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on our balance sheet.

Property and Equipment: Land is carried at cost. Property and equipment are stated at cost less accumulated depreciation. Leasehold improvements are amortized over the terms of the respective leases or the estimated useful lives of the improvement, whichever is shorter. Repairs and maintenance costs are charged to operations as incurred and additions and improvements to premises and equipment are capitalized. For financial reporting purposes, assets are depreciated using the straight-line method over their estimated useful lives, which range from 3 years to 30 years, depending on the asset type and

any related contracts. For income tax purposes, the accelerated cost recovery system and the modified accelerated cost recovery system are used.

Restricted Equity Securities: As a requirement for membership, we invest in the stock of the Federal Home Loan Bank of Atlanta ("FHLB"), Community Bankers Bank ("CBB"), and the Federal Reserve Bank ("FRB"). These investments are carried at cost based on the redemption provisions of these entities.

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

Credit Related Financial Instruments: In the ordinary course of business, we have entered into commitments to extend credit, including commercial letters of credit, and standby letters of credit. Such financial instruments are recorded when they are funded.

Mortgage Banking Income: We derive our mortgage banking income from discounted fees, or points, collected on loans originated, premiums received on the sale of mortgage loans and their related servicing rights to investors, and other fees. We recognize this income, including discount fees and points, when loan rates are locked. All of these components determine the gain on sale of the underlying mortgage loans to investors.

Rate Lock Commitments: Commitments to fund mortgage loans (interest rate locks) to be sold into the secondary market and forward commitments for the future delivery of these mortgage loans are accounted for as free standing derivatives. The fair value of the interest rate lock is recorded at the time the commitment to fund the mortgage loans is executed and is adjusted for the expected exercise of the commitment before the loan is funded. In order to hedge the change in interest rates resulting from its commitments to fund the loans, the Company enters into forward commitments for the future delivery of mortgage loans when interest rate locks are entered into. Fair value of these mortgage derivatives are estimated based on changes in mortgage interest rates from the date the interest on the loan is locked. Changes in the fair value of these derivatives are included in net gains on sale of loans. The period of time between the issuance of a loan commitment and closing and sale of the loan generally ranges between 15 to 90 days.

The majority of our loans are delivered to an investor in through "best efforts". Under "best efforts" the Company protects itself from changes in interest rates by entering into loan purchase agreements with third party investors that provide for the investor to purchase loans at the same terms, including interest rate, as committed to the borrower. Under the contractual relationship with these third party investors, the Company is obligated to sell the loan to the investor, and the investor is obligated to buy the loan, only if the loan closes. No other obligation exists.

When the market is favorable, we participate in a "mandatory" delivery program for a portion of our mortgage loans. Under the mandatory delivery program, we commit to deliver loans to an investor at a preset cost prior to the close of such loans. This differs from a "best efforts" delivery, which sets the cost to the investor on a loan by loan basis when the loan is locked. Mandatory delivery creates a higher level of risk for the Company because it relies on rate lock commitments rather than closed loans, thereby exposing the Company to fluctuations in interest rate and pricing. A rate lock commitment is a binding commitment for the Company but is not binding to the client. Our client could decide, at any time, between the time of the rate lock and actual closing on their mortgage loan, not to proceed with the commitment. There is a higher occurrence of this during periods of interest rate volatility. To mitigate this risk, we pair the rate lock commitment with the sale of a notional security bearing similar attributes. At the time the loan is delivered to the investor, matched securities are repurchased. Any gains or losses associated with this pairing are recorded in mortgage banking income on our income statement as incurred. We had \$72.8 million in a mandatory delivery program at December 31, 2015 and \$48.6 million at December 31, 2014.

Advertising: Advertising costs, which totaled \$3,625,625 in 2015, \$3,151,374 in 2014, and \$2,912,864 in 2013, are expensed as incurred.

Income Taxes: Deferred income tax assets and liabilities are determined using the balance sheet method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax basis of the various balance sheet assets and liabilities and includes recognition to changes in current tax rates and laws.

A tax position is recognized as a benefit only if it is "more likely than not" that the tax position will be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded.

Segment Reporting: Public business enterprises are required to report information about operating segments in financial statements and selected information about operating segments in financial reports issued to shareholders. Operating segments are components of an enterprise about which separate financial information is available that is evaluated regularly by management in determining how to allocate resources and to assess effectiveness of the segments' performance. Generally, financial information is required to be reported on the basis that is used internally for evaluating segment performance and deciding how to allocate resources to segments. We have two reporting segments, one for general banking services and one for mortgage banking operations.

Earnings Per Share: Basic earnings per share (EPS) excludes dilution, and is computed by dividing income available to common stockholders by the weighted-average number of shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised, converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity.

Reclassifications: Certain immaterial reclassifications have been made to prior year's information to conform to the current year's presentation. Reclassifications had no impact on prior year net income or stockholders equity.

Derivative Financial Instruments and Hedging Activities: At the inception of a derivative contract, the Company designates the derivative as one of three types based on the Company's intentions and belief as to the likely effectiveness as a hedge. These three types are (1) a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment ("fair value hedge"), (2) a hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability ("cash flow hedge"), or (3) an instrument with no hedging designation ("stand-alone derivative"). For a fair value hedge, the gain or loss on the derivative, as well as the offsetting loss or gain on the hedged item, are recognized in current earnings as fair values change. For a cash flow hedge, the gain or loss on the derivative is reported in other comprehensive income and is reclassified into earnings in the same periods during which the hedged transaction affects earnings. For both types of hedges, changes in the fair value of the derivatives that are not highly effective in hedging the changes in fair value or expected cash flows of the hedged item are recognized immediately in current earnings. Changes in the fair value of derivatives that do not qualify for hedge accounting are reported currently in earnings, as non-interest income.

Net cash settlements on derivatives that qualify for hedge accounting are recorded in interest income or interest expense, based on the item being hedged. Net cash settlements on derivatives that do not qualify for hedge accounting are reported in non-interest income. Cash flows on hedges are classified in the cash flow statement the same as the cash flows of the items being hedged.

The Company formally documents the relationship between derivatives and hedged items, as well as the risk-management objective and the strategy for undertaking hedge transactions at the inception of the hedging relationship. This documentation includes linking fair value or cash flow hedges to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions. The Company also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivative instruments that are used are highly effective in offsetting changes in fair values or cash flows of the hedged items. The Company discontinues hedge accounting when it determines the derivative is no longer effective in offsetting changes in the fair value or cash flows of the hedged item, the derivative is settled or terminates, a hedged forecasted transaction is no longer probable, a hedged firm commitment is no longer firm, or treatment of the derivative as a hedge is not longer appropriate or intended.

When hedge accounting is discontinued, subsequent changes in fair value of the derivatives are recorded as non-interest income. When a fair value hedge is discontinued, the hedged asset or liability is no longer adjusted for changes in fair value and the existing basis adjustment is amortized or accreted over the remaining life of the asset or liability. When a cash flow hedge is discontinued but the hedged cash flows or forecasted transactions are still expected to occur, gains or losses that were accumulated in other comprehensive income are amortized into earnings over the same periods which the hedged transactions will affect earnings.

Comprehensive Income: Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income. Components of other comprehensive income in 2015, which are reported in our consolidated statements of comprehensive income, consist of unrealized gains and losses on available-for-sale securities, unrealized gains and losses on SERP and unrealized gains and losses on mutual funds. Components of other comprehensive income in 2014, which are reported in our consolidated statements of comprehensive income, consist of unrealized gains and losses on available-for-sale securities, unrealized gains and losses on SERP and a derivative financial liability related to an interest rate swap.

Stock Compensation Plans: In May 2014, our shareholders ratified the adoption of a new stock-based compensation plan to succeed the Monarch Bank 2006 Equity Incentive Plan. The 2014 Equity Incentive Plan authorizes the compensation committee to grant options, stock appreciation rights, stock awards, performance stock awards, and stock units to designated

directors, officers, key employees, consultants and advisers to the Company and its subsidiaries. We are authorized through the Plan to issue up to 1,000,000 shares of our common stock plus the number of shares of our common stock outstanding under the 2006 and 1999 Plans. The Plan also provides that no award may be granted more than 10 years after the May 2014 ratification date.

On January 1, 2006, we adopted Accounting Standards Codification (“ASC”) 718-10, that addresses the accounting for share-based payment transactions in which a company receives employee services in exchange for either equity instruments of the company or liabilities that are based on the fair value of the company’s equity instruments or that may be settled by the issuance of such equity instruments. ASC 718-10 requires that such transactions be accounted for using a fair-value-based method and recognized as expense in the consolidated statement of income.

Fair Value Measurements: Fair Value is the exchange price in an orderly transaction, which is not a forced liquidation or distressed sale, between market participants to sell an asset or transfer a liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset/liability. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset/liability. Fair value focuses on exit price and prioritizes, within a measurement of fair value, the use of market-based inputs over entity-specific inputs. The framework for measuring fair value is comprised of a three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date. A financial instrument’s categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

For additional information on Fair Value Measurements see Note 18.

We review the appropriateness of our classification of assets/liabilities within the fair value hierarchy on a quarterly basis, which could cause such assets/liabilities to be reclassified among the three hierarchy levels. We use inputs that are current as of the measurement date, which may include periods of market dislocation, during which price transparency may be reduced. While we believe our valuation methods are appropriate and consistent with other market participants, the use of different methodologies, or assumptions, to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. The methods used to produce a fair value calculation may not be indicative of net realizable value or reflective of future fair values.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2014, the FASB issued ASU No. 2014-12, “Compensation - Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period.” The new guidance applies to reporting entities that grant employees share-based payments in which the terms of the award allow a performance target to be achieved after the requisite service period. The amendments in the ASU require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Existing guidance in “Compensation - Stock Compensation (Topic 718),” should be applied to account for these types of awards. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Early adoption is permitted and reporting entities may choose to apply the amendments in the ASU either on a prospective or retrospective basis. The Company is currently assessing the impact that ASU 2014-12 will have on its consolidated financial statements.

In August 2014, the FASB issued ASU No. 2014-15, “Presentation of Financial Statements - Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity’s Ability to Continue as a Going Concern.” This update is intended to provide guidance about management’s responsibility to evaluate whether there is substantial doubt about an entity’s ability to continue as a going concern and to provide related footnote disclosures. Management is required under the new guidance to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity’s ability to continue as a going concern within one year after the date the financial statements are issued when preparing financial statements for each interim and annual reporting period. If conditions or events are identified, the ASU specifies the process that must be followed by management and also clarifies the timing and content of going concern footnote disclosures in order to reduce diversity in practice. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-15 to have a material impact on its consolidated financial statements.

In November 2014, the FASB issued ASU No. 2014-16, “Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity.” The amendments in ASU do not change the current criteria in U.S. GAAP for determining when separation of certain embedded derivative features in a hybrid financial instrument is required. The amendments clarify how current U.S. GAAP should be interpreted in evaluating the economic characteristics and risks of a host contract in a hybrid financial instrument that is issued in the form of a share. Specifically, the amendments clarify that an entity should consider all relevant terms and features, including the embedded derivative feature being evaluated for bifurcation, in evaluating the nature of the host contract. Furthermore, the amendments clarify that no

single term or feature would necessarily determine the economic characteristics and risks of the host contract. Rather, the nature of the host contract depends upon the economic characteristics and risks of the entire hybrid financial instrument. The amendments in this ASU also clarify that, in evaluating the nature of a host contract, an entity should assess the substance of the relevant terms and features (i.e., the relative strength of the debt-like or equity-like terms and features given the facts and circumstances) when considering how to weight those terms and features. The amendments in this ASU are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption, including adoption in an interim period, is permitted. The Company does not expect the adoption of ASU 2014-16 to have a material impact on its consolidated financial statements.

In January 2015, the FASB issued ASU No. 2015-01, “Income Statement-Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items.” The amendments in this ASU eliminate from U.S. GAAP the concept of extraordinary items. Subtopic 225-20, Income Statement - Extraordinary and Unusual Items, required that an entity separately classify, present, and disclose extraordinary events and transactions. Presently, an event or transaction is presumed to be an ordinary and usual activity of the reporting entity unless evidence clearly supports its classification as an extraordinary item. If an event or transaction meets the criteria for extraordinary classification, an entity is required to segregate the extraordinary item from the results of ordinary operations and show the item separately in the income statement, net of tax, after income from continuing operations. The entity also is required to disclose applicable income taxes and either present or disclose earnings-per-share data applicable to the extraordinary item. The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The Company does not expect the adoption of ASU 2015-01 to have a material impact on its consolidated financial statements.

In February 2015, the FASB issued ASU No. 2015-02, “Consolidation (Topic 810): Amendments to the Consolidation Analysis.” The amendments in this ASU are intended to improve targeted areas of consolidation guidance for legal entities such as limited partnerships, limited liability corporations, and securitization structures (collateralized debt obligations, collateralized loan obligations, and mortgage-backed security transactions). In addition to reducing the number of consolidation models from four to two, the new standard simplifies the FASB Accounting Standards Codification™ and improves current GAAP by placing more emphasis on risk of loss when determining a controlling financial interest, reducing the frequency of the application of related-party guidance when determining a controlling financial interest in a variable interest entity (VIE), and changing consolidation conclusions for public and private companies in several industries that typically make use of limited partnerships or VIEs. The amendments in this ASU are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted, including adoption in an interim period. ASU 2015-02 may be applied retrospectively in previously issued financial statements for one or more years with a cumulative-effect adjustment to retained earnings as of the beginning of the first year restated. The Company does not expect the adoption of ASU 2015-02 to have a material impact on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-03, “Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs.” The amendments in this ASU are intended to simplify the presentation of debt issuance costs. These amendments require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this ASU. The amendments in this ASU are effective for public business entities for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Early adoption is permitted for financial statements that have not been previously issued. The Company does not expect the adoption of ASU 2015-03 to have a material impact on its consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-05, “Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Fees Paid in a Cloud Computing Arrangement.” The amendments in this ASU provide guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The amendments do not change the accounting for a customer’s accounting for service contracts. As a result of the amendments, all software licenses within the scope of Subtopic 350-40 will be accounted for consistent with other licenses of intangible assets. The amendments in this ASU are effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted. An entity can elect to adopt the amendments either: (1) prospectively to all arrangements entered into or materially modified after the effective date; or (2) retrospectively. The Company is currently assessing the impact that ASU 2015-05 will have on its consolidated financial statements.

In May 2015, the FASB issued ASU No. 2015-08, “Business Combinations (Topic 805): Pushdown Accounting - Amendments to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115.” The amendments in ASU 2015-08 amend various SEC

paragraphs pursuant to the issuance of Staff Accounting Bulletin No. 115, Topic 5: Miscellaneous Accounting, regarding various pushdown accounting issues, and did not have a material impact on our (consolidated) financial statements.

In July 2015, the FASB issued ASU No. 2015-12, "Plan Accounting: Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962), and Health and Welfare Benefit Plans (Topic 965) - 1. Fully Benefit-Responsive Investment Contracts, 2. Plan Investment Disclosures, and 3. Measurement Date Practical Expedient." The amendments within this ASU are in 3 parts. Among other things, Part I amendments designate contract value as the only required measure for fully benefit-responsive investment contracts; Part II amendments eliminate the requirement that plans disclose: (a) individual investments that represent 5 percent or more of net assets available for benefits; and (b) the net appreciation or depreciation for investments by general type requirements for both participant-directed investments and nonparticipant-directed investments. Part III amendments provide a practical expedient to permit plans to measure investments and investment-related accounts (e.g., a liability for a pending trade with a broker) as of a month-end date that is closest to the plan's fiscal year-end, when the fiscal period does not coincide with month-end. The amendments in Parts I and II of this ASU are effective on a retrospective basis and Part III is effective on a prospective basis, for fiscal years beginning after December 15, 2015. Early adoption is permitted. The Company is currently assessing the impact that ASU 2015-12 will have on its consolidated financial statements.

In August 2015, the FASB issued ASU No. 2015-14, "Revenue from Contracts with Customers (Topic 606): Deferral of Effective Date." The amendments in ASU 2015-14 defer the effective date of ASU 2014-09 for all entities by one year. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. All other entities should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. All other entities may apply the guidance in ASU 2014-09 earlier as of an annual reporting period beginning after December 15, 2016, including interim reporting periods within that reporting period. All other entities also may apply the guidance in ASU 2014-09 earlier as of an annual reporting period beginning after December 15, 2016, and interim reporting periods within annual reporting periods beginning one year after the annual reporting period in which the entity first applies the guidance in ASU 2014-09. The Company does not expect the adoption of ASU 2015-14 (or ASU 2014-09) to have a material impact on its consolidated financial statements.

In August 2015, the FASB issued ASU 2015-15, "Interest - Imputation of Interest (Subtopic 835-30) - Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements (Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting)." On April 7, 2015, the FASB issued ASU 2015-03, Interest-Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs, which requires entities to present debt issuance costs related to a recognized debt liability as a direct deduction from the carrying amount of that debt liability. The guidance in ASU 2015-03 (see paragraph 835-30-45-1A) does not address presentation or subsequent measurement of debt issuance costs related to line-of-credit arrangements.

Given the absence of authoritative guidance within ASU 2015-03 for debt issuance costs related to line-of-credit arrangements, the SEC staff stated that they would not object to an entity deferring and presenting debt issuance costs as an asset and subsequently amortizing the deferred debt issuance costs ratably over the term of the line-of-credit arrangement, regardless of whether there are any outstanding borrowings on the line-of-credit arrangement. ASU 2015-15 adds these SEC comments to the "S" section of the Codification. The Company does not expect the adoption of ASU 2015-15 to have a material impact on its consolidated financial statements.

In September 2015, the FASB issued ASU 2015-16, "Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments." The amendments in ASU 2015-16 require that an acquirer recognize adjustments to estimated amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The amendments require that the acquirer record, in the same period's financial statements, the effect on earnings of changes in depreciation, amortization, or other income effects, if any, as a result of the change to the estimated amounts, calculated as if the accounting had been completed at the acquisition date. The amendments also require an entity to present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the estimated amounts had been recognized as of the acquisition date. The amendments in this ASU are effective for public business entities for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The amendments should be applied prospectively to adjustments to provisional amounts that occur after the effective date with earlier application permitted for financial statements that have not been issued. The Company does not expect the adoption of ASU 2015-16 to have a material impact on its consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." The amendments in ASU 2016-01, among other things: 1) Requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the

investee) to be measured at fair value with changes in fair value recognized in net income. 2) Requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. 3) Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables). 4) Eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The amendments in this ASU are effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently assessing the impact that ASU 2016-01 will have on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Company is currently assessing the impact that ASU 2016-02 will have on its consolidated financial statements.

NOTE 2 – INVESTMENT SECURITIES

Securities available-for-sale consisted of the following:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2015				
U.S. government agency obligations	\$ 26,376,230	\$ 17,635	\$ (157,620)	\$ 26,236,245
Mortgage-backed securities	995,360	6,216	(3,187)	998,389
Municipal securities	2,900,734	90,294	(12,532)	2,978,496
	<u>\$ 30,272,324</u>	<u>\$ 114,145</u>	<u>\$ (173,339)</u>	<u>\$ 30,213,130</u>

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2014				
U.S. government agency obligations	\$ 20,498,822	\$ 41,548	\$ (86,495)	\$ 20,453,875
Mortgage-backed securities	1,271,166	13,449	(982)	1,283,633
Municipal securities	1,906,572	97,807	(16,525)	1,987,854
	<u>\$ 23,676,560</u>	<u>\$ 152,804</u>	<u>\$ (104,002)</u>	<u>\$ 23,725,362</u>

The Company did not have any held-to-maturity or trading securities at December 31, 2015 or December 31, 2014.

The amortized cost and estimated fair value of securities, all of which are classified as available for sale at December 31, 2015, by contractual maturity are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to prepay obligations with or without call or prepayment penalties.

Securities available-for-sale:

	Amortized Cost	Fair Value
Due in one year or less	\$ 500,000	\$ 498,759
Due from one to five years	27,491,647	27,343,236
Due from five to ten years	793,860	833,474
Due after ten years	1,486,817	1,537,661
Total	\$ 30,272,324	\$ 30,213,130

The gross unrealized losses in our securities portfolio at December 31, 2015 and December 31, 2014 are as follows:

As of December 31, 2015	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Securities Description						
U.S. government agency obligations	\$ 15,761,617	\$ (134,401)	\$ 2,976,782	\$ (23,219)	\$ 18,738,399	\$ (157,620)
Mortgage-backed securities	684,506	(3,187)	—	—	684,506	(3,187)
Municipal securities	498,715	(1,285)	504,170	(11,247)	1,002,885	(12,532)
Total temporarily impaired securities	\$ 16,944,838	\$ (138,873)	\$ 3,480,952	\$ (34,466)	\$ 20,425,790	\$ (173,339)

As of December 31, 2014	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Securities Description						
U.S. government agency obligations	\$ 7,482,955	\$ (18,941)	\$ 6,433,135	\$ (67,554)	\$ 13,916,090	\$ (86,495)
Mortgage-backed securities	338,707	(982)	—	—	338,707	(982)
Municipal securities	—	—	502,135	(16,525)	502,135	(16,525)
Total temporarily impaired securities	\$ 7,821,662	\$ (19,923)	\$ 6,935,270	\$ (84,079)	\$ 14,756,932	\$ (104,002)

There are twenty-eight investments in our securities portfolio that had unrealized losses as of December 31, 2015. Of these, seven investments have been in a continuous unrealized loss position for more than 12 months. Those seven securities are as follows:

	Count	Amortized Cost	Fair Value
U.S. government agency obligations	6	\$ 3,000,000	\$ 2,976,782
Municipal securities	1	515,417	504,170
Total	7	\$ 3,515,417	\$ 3,480,952

We have the ability to carry these investments to the final maturity of the instruments. Other-than-temporarily impaired (“OTTI”) guidance for investments states that an impairment is OTTI if any of the following conditions exist: the entity intends to sell the security; it is more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis; or, the entity does not expect to recover the security’s entire amortized cost basis (even if the entity does not intend to sell). An impaired security identified as OTTI should be separated and losses should be recognized in earnings.

We believe the unrealized losses in our portfolio are temporary impairments, caused by liquidity discounts and increases in the risk premiums required by market participants, rather than adverse changes in cash flows or fundamental weaknesses in the credit quality of the issuer or underlying assets as of December 31, 2015. There were no losses related to OTTI recognized in accumulated other comprehensive loss at either December 31, 2015 or 2014.

U.S. government agency obligations. The unrealized losses on our U.S. government agency obligations were caused by interest rate increases. The contractual cash flows of these investments are guaranteed by the U.S. government. Accordingly, it is expected the securities would not be settled at a price less than the amortized cost bases of our investment. Because we do not intend to sell the investments and it is not more likely than not we would be required to sell the investments before the recovery of their amortized bases, which may be maturity, we do not consider those investments to be OTTI at December 31, 2015.

Mortgage-backed securities. The unrealized losses on our mortgage-backed securities were caused by interest rate increases. The cash flows of these investments are based on the repayment schedule of the underlying mortgage loans. These securities are government agency issued. Accordingly, it is expected the securities would not be settled at a price less than the

amortized cost bases of our investment. Because we do not intend to sell the investments and it is not more likely than not we would be required to sell the investments before the recovery of their amortized bases, which may be maturity, we do not consider those investments to be OTTI at December 31, 2015.

Municipal securities. The unrealized loss on our investment in municipal securities which is related to one security was caused by interest rate increases. This security is guaranteed by the Virginia General Assembly and the General Fund of the Commonwealth of Virginia. Accordingly, it is expected the security will not be settled at a price less than the amortized cost basis of our investment. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because we do not intend to sell the investment and it is not more likely than not we will be required to sell the investment before recovery of the amortized basis, which may be maturity, we do not consider this investment to be OTTI at December 31, 2015.

All of our mortgage-backed securities are government agency issued. The carrying value of our government agency issued mortgage backed securities was \$998,389 or 100% of the total mortgage-backed securities at December 31, 2015 and \$1,283,633 or 100% at December 31, 2014.

Securities with carrying values of \$1,571,592 were pledged to secure public deposits and borrowings from the Federal Home Loan Bank of Atlanta at December 31, 2015 and securities with carrying values of \$4,570,469 were pledged to secure public deposits and borrowings from the Federal Home Loan Bank of Atlanta at December 31, 2014.

We recorded gross realized gains on the call of an available-for-sale investment of \$22,801, \$155 and \$0 in 2015, 2014 and 2013, respectively. Proceeds from maturities, sales, pay downs and calls of investment securities were \$15,317,094, \$40,692,960 and \$3,941,512 for 2015, 2014 and 2013, respectively.

NOTE 3 – ACCUMULATED OTHER COMPREHENSIVE LOSS

The following table presents the changes in accumulated other comprehensive income (loss), by category, net of tax:

	Accumulated Other Comprehensive Income (Loss)				
	Unrealized Loss on Supplemental Executive's Retirement Plan	Unrealized (Loss) Gain on Securities	Unrealized Loss on Interest Rate Swap	Unrealized Gain on Mutual Funds	Accumulated Other Comprehensive Loss
Balance at December 31, 2014	\$ (134,167)	\$ 31,721	\$ —	\$ 209	\$ (102,237)
Net change for the year ended December 31, 2015	12,197	(66,310)	—	(244)	(54,357)
Balance at December 31, 2015	<u>\$ (121,970)</u>	<u>\$ (34,589)</u>	<u>\$ —</u>	<u>\$ (35)</u>	<u>\$ (156,594)</u>
Balance at December 31, 2013	\$ (139,315)	\$ (133,644)	\$ (146,537)	\$ —	\$ (419,496)
Net change for the year ended December 31, 2014	5,148	165,365	146,537	209	317,259
Balance at December 31, 2014	<u>\$ (134,167)</u>	<u>\$ 31,721</u>	<u>\$ —</u>	<u>\$ 209</u>	<u>\$ (102,237)</u>
Balance at December 31, 2012	\$ —	\$ 137,847	\$ (337,869)	\$ —	\$ (200,022)
Net change for the year ended December 31, 2013	(139,315)	(271,491)	191,332	—	(219,474)
Balance at December 31, 2013	<u>\$ (139,315)</u>	<u>\$ (133,644)</u>	<u>\$ (146,537)</u>	<u>\$ —</u>	<u>\$ (419,496)</u>

An unrealized (loss) gain of (\$35) and \$209 on Mutual Funds associated with the Company's Executive Savings Plan was recorded in other comprehensive loss in 2015 and 2014. The offset for this gain is carried in the investment in mutual funds on the balance sheet. An unrealized loss of \$143,176, net of tax, associated with a change in the discount rate on the Company's Supplemental Executive's Retirement Plan ("SERP") from 5.85% to 4.50%, was moved into other comprehensive loss in the second quarter of 2013. Expenses of \$12,197, \$5,148 and \$3,861 related to SERP were re-classed out of other comprehensive loss into other expense in earnings during the years ended December 31, 2015, 2014 and 2013, respectively. Security gains of \$22,801, \$155 and \$0 were re-classed out of accumulated other comprehensive loss into gain on sale/call of securities during the years ended December 31, 2015, 2014 and 2013.

NOTE 4 – LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

Loans held for investment consisted of the following at December 31:

	2015	2014
Commercial	\$ 158,072,698	\$ 138,430,999
Real estate		
Construction	190,422,992	172,502,330
Residential (1-4 family)	113,278,318	109,404,283
Home equity lines	59,097,607	67,487,000
Multifamily	11,590,641	21,809,189
Commercial	290,531,083	256,966,820
Real estate subtotal	664,920,641	628,169,622
Consumer		
Consumer and installment loans	6,356,473	5,968,990
Overdraft protection loans	121,217	96,736
Loans to individuals subtotal	6,477,690	6,065,726
Total gross loans	829,471,029	772,666,347
Unamortized loan (fees) costs, net	(201,724)	(76,812)
Loans held for investment, net of unearned	829,269,305	772,589,535
Allowance for loan losses	(8,887,199)	(8,948,837)
Total net loans	\$ 820,382,106	\$ 763,640,698

We have certain lending policies and procedures in place that are designed to balance loan growth and income with an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, credit concentrations, policy exceptions, loan delinquencies and non-performing and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions.

Our loans held for investment portfolio is divided into three loan types; commercial, real estate and consumer. Some of these loan types are further broken down into classes. The commercial loan portfolio, which is not broken down further, includes commercial and industrial loans which are usually secured by the assets being financed or other business assets. The real estate loan portfolio is broken down into construction, residential 1-4 family, home equity lines, multifamily, and commercial real estate loan segments. The consumer loan portfolio is segmented into consumer and installment loans and overdraft protection loans.

Commercial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and prudently expand its business. Underwriting standards are designed to promote relationship banking rather than transactional banking. Once it is determined the borrower's management possesses sound ethics and solid business acumen, we examine current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and normally incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation or sale of the income producing property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing our commercial real estate portfolio are diverse in terms of type. This diversity helps reduce our exposure to adverse economic events that affect any single market or industry. Management monitors and evaluates commercial real estate loans based on purpose, collateral, geography, cash flow, loan to value and risk grade criteria. As a general rule, we avoid financing special purpose projects unless other underwriting factors are present to help mitigate risk. In addition, management tracks the level of owner-occupied commercial real estate

loans versus non-owner occupied loans. At December 31, 2015, 40% and at December 31, 2014, 44% of the outstanding principal balance of our commercial real estate loan portfolio was secured by owner-occupied properties.

With respect to loans to developers and builders that are secured by non-owner occupied properties that we may originate from time to time, we generally require the borrower to have an existing relationship with the Company and a proven record of success. Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews, sensitivity analysis of absorption and lease rates and financial analysis of the developers and property owners. Construction loans are generally based on estimates of costs and value associated with the complete project. These estimates may be inaccurate. Construction loans often involve the disbursement of considerable funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate source of repayment being sensitive to interest rate changes, supply and demand, and governmental regulation of real property, general economic conditions and the availability of long-term financing.

We generally require multifamily real estate loan borrowers to have an existing relationship with the Company, a proven record of success and guarantor financial strength, commensurate with the project size. The underlying feasibility of a multifamily project is stress tested for sensitivity to both capitalization and interest rate changes. Each project is underwritten separately and additional underwriting standards are required for the guarantors, which include, but are not limited to, a maximum loan-to-value percentage, global cash flow analysis and contingent liability analysis. Sources of repayment for these types of loans may be rent rolls or sales of the developed property, either by unit or as a whole.

Consumer and residential loan originations, including home equity lines of credit, utilize analytics to supplement the underwriting process. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed. This monitoring, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk. Additionally, trend, sensitivity analysis, shock analysis and outlook reports are reviewed by management on a regular basis. Underwriting standards for home equity loans are heavily influenced by statutory requirements, which include, but are not limited to, a maximum loan-to-value percentage of 80%, collection remedies, the number of such loans a borrower can have at one time and documentation requirements.

We perform periodic reviews on various segments of our loan portfolio in addition to presenting the majority of our loan relationships for loan committee review. We utilize an independent company to perform a periodic review to evaluate and validate our credit risk program. Results of these reviews are presented to management and our board. Additionally, we are subject to annual examination by our regulators. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as our policies and procedures.

We have an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. This methodology begins with a look at the three loan types; commercial, real estate, and consumer. Loans within the commercial and real estate types are evaluated on an individual or relationship basis and assigned a risk grade based on the characteristics of the loan or relationship. Loans within the consumer type are assigned risk grades and evaluated as a pool, unless specifically identified through delinquency or other signs of credit deterioration, at which time the identified loan would be individually evaluated.

We designate loans within our loans held for investment portfolio as either "pass" or "watch list" based on nine numerical risk grades which are assigned to loans. These numeric designations represent, from best to worst: (1) minimal, (2) modest, (3) average, (4) acceptable, (5) acceptable with care, (6) special mention, (7) substandard, (8) doubtful and (9) loss. Special mention, substandard, doubtful and loss risk grades are watch list. A loan risk graded as loss is generally charged-off when identified. A loan risk graded as doubtful is considered watch list and classified as nonaccrual. There were no loans in our portfolio classified as doubtful or loss on December 31, 2015 or December 31, 2014. Special mention and substandard loans are considered watch list and may or may not be classified as nonaccrual, based on current performance. Watch list graded loans or relationships are evaluated individually to determine if all, or a portion, of our investment in the borrower is at risk. If a risk is quantified, a specific loss allowance will be assigned to the identified loan or relationship. We evaluate our investment in the borrower using either the present value of expected future cash flows, discounted at the historical effective interest rate of the loan, or for a collateral-dependent loan, the fair value of the underlying collateral.

Beginning with the quarter ended March 31, 2013, we changed the methodology for evaluating additional risk inherent in our satisfactory risk grade groups which should be included in our allowance for loan losses. The prior methodology had focused on our satisfactory risk grade groups as a whole and assigned a single loss factor to this group based on a three year "look-back" at actual net charge offs in the entire portfolio. This meant all loan segments were allocated the same loss factor and the distribution of the allowance for that segment was dependent on size rather than actual losses that had occurred within the segment. Under the new methodology, loans within this group are evaluated on a pool basis by loan segment which is further delineated by purpose. Each segment is assigned an expected loss factor which is based on a moving average "look-

back” at our historical losses for that particular segment. In 2013, management determined it was prudent to extend the "look-back" period to a four-year average of net charge offs or sixteen quarters. In 2014, with the continued decline in net charge offs, we reexamined our loss history and determined a five year "look-back" or twenty quarter history would be a more prudent approach to modeling historical losses. Therefore, at September 30, 2014 we began extending our "look-back" period by one quarter with a goal of twenty quarters or five years by June 30, 2015. We believe this current year adjustment is a change within our methodology and not a change of the methodology itself. We completed the extension of our "look-back" period during 2015, and at December 31, 2015 the adjustment created a \$291,800 decrease in the unallocated component of the allowance for loan losses. We believe this methodology provides a more accurate evaluation of the potential risk in our portfolio because the additional delineation by purpose establishes a direct correlation to areas of weakness and strength within the portfolio. For example, under our old methodology, real estate commercial loans and home equity lines were evaluated the same despite the lower historical losses in our commercial real estate portfolio, resulting in too large of an allocation to the commercial real estate portfolio and too little to the home equity segment when considering actual losses.

The portfolio mix has also changed over the past five years, with growth occurring in segments that have historically experienced lower levels of charge offs. At December 31, 2010 home equity lines totaled \$81 million, or 14% of the loan portfolio while commercial real estate loans totaled \$163 million, or 29% of the loan portfolio. At December 31, 2015 home equity lines had decreased to \$59 million, to 9% of the portfolio and commercial real estate loans had grown to \$291 million, or 33% of the loan portfolio. Simultaneously, the five year average net charge offs for home equity lines total \$746.0 thousand and for commercial real estate total \$78 thousand, or 33% and 3% of the five year portfolio average for net charge offs, respectively.

With the change from a single loss factor based on actual net losses for all segments, under the old model, to a more granular approach based on actual net losses by loan segment, under the current model, these trends are captured. The change has impacted the distribution of the provision expense by appropriately shifting expense away from areas with lower historical net charge offs relative to portfolio size to those with higher risk and higher incurred losses. This resulted in minimal impact of the overall provision expense. This change in methodology for evaluating additional risk inherent in our satisfactory risk groups is applied to December 31, 2015, 2014 and 2013.

Additional metrics, in the form of environmental risk factors, may be applied to a specific class or risk grade of loans within the portfolio based on local or national trends, identifiable events or other economic factors. For the years ended December 31, 2015, 2014 and 2013, nine environmental factors; five internal and four external, were applied to the general risk grade groups. The five internal environmental factors took into consideration the potential risk due to changes within the Company. These factors addressed any changes in 1.) the strength and depth of management, 2.) lending policies and procedures, 3.) the nature, volume and terms of various portfolios, 4.) the quality of loan review and 5.) the effects of concentrations of credit and changes in those levels. The four external factors considered risks associated with events and circumstances outside of Company control. The first factor addressed the potential impact of legal change, regulatory change and new competition in the market. The second factor took into consideration changes in international, national and local economic conditions. The third looked at changes in risk taken due to competitive pressure. The final external environmental factor addressed the risk associated with the government's management of fiscal policy and its potential impact on our local economy.

The assumptions used to determine the allowance are reviewed to ensure that their theoretical foundation, data integrity, computational processes, and reporting practices are appropriate and properly documented.

We utilize various sources in assessing the economic conditions in our target markets and areas of concentration. We track unemployment trends in both Hampton Roads and Virginia compared to the national average. We monitor trends in our industry and among our peers through reports such as the Uniform Bank Performance Report which are made available to us through the Federal Financial Institutions Examination Council. Additionally, we utilize various industry sources that include information published by CB Richard Ellis, an international firm specializing in commercial real estate reporting and REIS, a provider of commercial real estate information and analytics to monitor local, state and national trends.

We evaluate the adequacy of our allowance for loan losses monthly. A degree of imprecision or uncertainty is inherent in our allowance estimates because it requires that we incorporate a range of probable outcomes which may change from period to period. It requires that we exercise judgment as to the risks inherent in our portfolios, economic uncertainties, historical loss and other subjective factors, including industry trends. No single statistic or measurement determines the adequacy of the allowance for loan loss. Changes in the allowance for loan loss and the related provision expense can materially affect net income.

A summary of our loan portfolio by class and delineated between pass and watch list as of December 31, 2015 and December 31, 2014 is as follows:

December 31, 2015					
	Pass	Watch List		Total	Weighted Average Risk Grade
		Special Mention	Substandard		
Commercial	\$ 157,818,177	\$ 233,073	\$ 21,448	\$ 158,072,698	3.24
Real estate					
Construction	189,254,940	710,758	457,294	190,422,992	3.18
Residential (1-4 family)	108,692,612	1,075,477	3,510,229	113,278,318	3.71
Home equity lines	57,657,772	—	1,439,835	59,097,607	4.15
Multifamily	11,590,641	—	—	11,590,641	3.56
Commercial	288,533,180	1,007,152	990,751	290,531,083	3.39
Real estate subtotal	655,729,145	2,793,387	6,398,109	664,920,641	3.46
Consumer					
Consumer and installment loans	6,291,430	—	65,043	6,356,473	4.03
Overdraft protection loans	118,690	—	2,527	121,217	4.76
Loans to individuals subtotal	6,410,120	—	67,570	6,477,690	4.04
Total gross loans	\$ 819,957,442	\$ 3,026,460	\$ 6,487,127	\$ 829,471,029	3.42

December 31, 2014					
	Pass	Watch List		Total	Weighted Average Risk Grade
		Special Mention	Substandard		
Commercial	\$ 135,292,747	\$ 1,588,289	\$ 1,549,963	\$ 138,430,999	3.31
Real estate					
Construction	171,136,553	93,397	1,272,380	172,502,330	3.26
Residential (1-4 family)	101,860,683	177,735	7,365,865	109,404,283	3.93
Home equity lines	66,282,828	102,575	1,101,597	67,487,000	4.12
Multifamily	19,616,130	2,193,059	—	21,809,189	3.53
Commercial	253,525,106	2,029,203	1,412,511	256,966,820	3.54
Real estate subtotal	612,421,300	4,595,969	11,152,353	628,169,622	3.59
Consumer					
Consumer and installment loans	5,893,286	—	75,704	5,968,990	4.04
Overdraft protection loans	96,736	—	—	96,736	4.64
Loans to individuals subtotal	5,990,022	—	75,704	6,065,726	4.05
Total gross loans	\$ 753,704,069	\$ 6,184,258	\$ 12,778,020	\$ 772,666,347	3.55

There were no loans classified as doubtful or loss included in our loan portfolio at December 31, 2015 or December 31, 2014.

An aging of our loan portfolio by class as of December 31, 2015 and December 31, 2014 is as follows:

Age Analysis of Past Due Loans

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Recorded Investment > 90 days and Accruing	Recorded Investment Nonaccrual Loans
December 31, 2015							
Commercial	\$ 99,291	\$ —	\$ 21,448	\$ 120,739	\$ 157,951,959	\$ —	\$ 21,448
Real estate							
Construction	—	101,677	—	101,677	190,321,315	—	101,677
Residential (1-4 family)	1,195,961	31,885	622,770	1,850,616	111,427,702	248,326	1,008,650
Home equity lines	316,425	—	249,987	566,412	58,531,195	—	483,859
Multifamily	—	—	—	—	11,590,641	—	—
Commercial	—	153,349	220,775	374,124	290,156,959	—	374,125
Real estate subtotal	1,512,386	286,911	1,093,532	2,892,829	662,027,812	248,326	1,968,311
Consumer							
Consumer and installment loans	97,135	56,287	—	153,422	6,203,051	—	—
Overdraft protection loans	64	—	—	64	121,153	—	—
Loans to individuals subtotal	97,199	56,287	—	153,486	6,324,204	—	—
Total gross loans	\$ 1,708,876	\$ 343,198	\$ 1,114,980	\$ 3,167,054	\$ 826,303,975	\$ 248,326	\$ 1,989,759
December 31, 2014							
Commercial:	\$ —	\$ —	\$ 582,059	\$ 582,059	\$ 137,848,940	\$ —	\$ 582,059
Real estate							
Construction	248,420	—	100,000	348,420	172,153,910	—	212,552
Residential (1-4 family)	761,696	2,412,128	1,252,644	4,426,468	104,977,815	174,976	1,427,931
Home equity lines	109,456	—	249,915	359,371	67,127,629	—	249,915
Multifamily	—	—	—	—	21,809,189	—	—
Commercial	—	166,618	230,994	397,612	256,569,208	—	230,994
Real estate subtotal	1,119,572	2,578,746	1,833,553	5,531,871	622,637,751	174,976	2,121,392
Consumer							
Consumer and installment loans	139,446	—	—	139,446	5,829,544	—	1,121
Overdraft protection loans	—	—	—	—	96,736	—	—
Loans to individuals subtotal	139,446	—	—	139,446	5,926,280	—	1,121
Total gross loans	\$ 1,259,018	\$ 2,578,746	\$ 2,415,612	\$ 6,253,376	\$ 766,412,971	\$ 174,976	\$ 2,704,572

A summary of the activity in the allowance for loan losses account is as follows:

Allocation of the Allowance for Loan Losses
For the Years Ended December 31, 2015, 2014 and 2013

	Real Estate					
	Commercial	Construction	Residential	Home Equity	Multifamily	Commercial
2015						
Allowance for credit losses:						
Beginning balance	\$ 1,157,867	\$ 1,678,022	\$ 2,456,418	\$ 1,911,634	\$ 85,056	\$ 1,458,664
Charge-offs	(207,059)	(17,500)	(658,953)	(70,042)	—	—
Recoveries	599,359	69,624	27,941	194,861	—	—
Provision	(694,354)	67,155	51,122	(381,908)	(32,898)	719,226
Ending balance	\$ 855,813	\$ 1,797,301	\$ 1,876,528	\$ 1,654,545	\$ 52,158	\$ 2,177,890
Ending balance						
Individually evaluated for impairment	\$ 21,448	\$ 112,963	\$ 568,424	\$ 688,596	\$ —	\$ 644,162
Collectively evaluated for impairment	\$ 834,365	\$ 1,684,338	\$ 1,308,104	\$ 965,949	\$ 52,158	\$ 1,533,728
Financing receivables:						
Ending balance	\$ 158,072,698	\$ 190,422,992	\$ 113,278,318	\$ 59,097,607	\$ 11,590,641	\$ 290,531,083
Ending balance: individually evaluated for impairment	\$ 21,448	\$ 1,148,363	\$ 3,743,313	\$ 1,439,835	\$ —	\$ 2,901,513
Ending balance: collectively evaluated for impairment	\$ 158,051,250	\$ 189,274,629	\$ 109,535,005	\$ 57,657,772	\$ 11,590,641	\$ 287,629,570
	Consumer					
	Consumer and installment loans	Overdraft protection	Unallocated	Total		
Allowance for credit losses:						
Beginning balance	\$ 104,661	\$ 260	\$ 96,255	\$ 8,948,837		
Charge-offs	(1,869)	—	—	(955,423)		
Recoveries	—	2,000	—	893,785		
Provision	(6,767)	777	277,647	—		
Ending balance	\$ 96,025	\$ 3,037	\$ 373,902	\$ 8,887,199		
Ending balance						
Individually evaluated for impairment	\$ 65,043	\$ 2,527	\$ —	\$ 2,103,163		
Collectively evaluated for impairment	\$ 30,982	\$ 510	\$ 373,902	\$ 6,784,036		
Financing receivables:						
Ending balance	\$ 6,356,473	\$ 121,217	\$ —	\$ 829,471,029		
Ending balance: individually evaluated for impairment	\$ 65,043	\$ 2,527	\$ —	\$ 9,322,042		
Ending balance: collectively evaluated for impairment	\$ 6,291,430	\$ 118,690	\$ —	\$ 820,148,987		

2014	Real Estate					
	Commercial	Construction	Residential	Home Equity	Multifamily	Commercial
Allowance for credit losses:						
Beginning balance	\$ 1,219,255	\$ 1,978,320	\$ 1,685,502	\$ 2,132,916	\$ 59,586	\$ 1,305,131
Charge-offs	(21,789)	(190,812)	(163,048)	(174,319)	—	—
Recoveries	205,200	79,922	31,505	122,809	—	—
Provision	(244,799)	(189,408)	902,459	(169,772)	25,470	153,533
Ending balance	\$ 1,157,867	\$ 1,678,022	\$ 2,456,418	\$ 1,911,634	\$ 85,056	\$ 1,458,664
Ending balance						
Individually evaluated for impairment	\$ 441,265	\$ 100,159	\$ 1,261,490	\$ 547,172	\$ —	\$ 335,033
Collectively evaluated for impairment	\$ 716,602	\$ 1,577,863	\$ 1,194,928	\$ 1,364,462	\$ 85,056	\$ 1,123,631
Financing receivables:						
Ending balance	\$ 138,430,999	\$ 172,502,330	\$ 109,404,283	\$ 67,487,000	\$ 21,809,189	\$ 256,966,820
Ending balance: individually evaluated for impairment	\$ 1,549,963	\$ 1,272,380	\$ 7,198,325	\$ 1,101,597	\$ —	\$ 3,130,893
Ending balance: collectively evaluated for impairment	\$ 136,881,036	\$ 171,229,950	\$ 102,205,958	\$ 66,385,403	\$ 21,809,189	\$ 253,835,927

	Consumer			
	Consumer and installment loans	Overdraft protection	Unallocated	Total
Allowance for credit losses:				
Beginning balance	\$ 99,271	\$ 688	\$ 580,700	\$ 9,061,369
Charge-offs	—	(2,000)	—	(551,968)
Recoveries	—	—	—	439,436
Provision	5,390	1,572	(484,445)	—
Ending balance	\$ 104,661	\$ 260	\$ 96,255	\$ 8,948,837
Ending balance				
Individually evaluated for impairment	\$ 74,582	\$ —	\$ —	\$ 2,759,701
Collectively evaluated for impairment	\$ 30,079	\$ 260	\$ 96,255	\$ 6,189,136
Financing receivables:				
Ending balance	\$ 5,968,990	\$ 96,736	\$ —	\$ 772,666,347
Ending balance: individually evaluated for impairment	\$ 75,704	\$ —	\$ —	\$ 14,328,862
Ending balance: collectively evaluated for impairment	\$ 5,893,286	\$ 96,736	\$ —	\$ 758,337,485

Real Estate						
2013	Commercial	Construction	Residential	Home Equity	Multifamily	Commercial
Allowance for credit losses:						
Beginning balance	\$ 1,749,641	\$ 2,360,707	\$ 1,545,315	\$ 1,402,448	\$ 290,532	\$ 2,882,398
Charge-offs	(2,468,074)	—	(148,766)	(582,480)	—	—
Recoveries	175,991	1,039,591	39,607	98,067	—	20,000
Provision	1,761,697	(1,421,978)	249,346	1,214,881	(230,946)	(1,597,267)
Ending balance	\$ 1,219,255	\$ 1,978,320	\$ 1,685,502	\$ 2,132,916	\$ 59,586	\$ 1,305,131
Ending balance						
Individually evaluated for impairment	\$ 712,699	\$ 736,248	\$ 274,259	\$ 510,118	\$ —	\$ 616,393
Collectively evaluated for impairment	\$ 506,556	\$ 1,242,072	\$ 1,411,243	\$ 1,622,798	\$ 59,586	\$ 688,738
Financing receivables:						
Ending balance	\$ 119,367,962	\$ 155,551,690	\$ 89,846,277	\$ 67,177,011	\$ 27,392,561	\$ 250,178,584
Ending balance: individually evaluated for impairment	\$ 6,842,132	\$ 7,095,195	\$ 5,956,407	\$ 1,386,245	\$ 308,053	\$ 5,715,403
Ending balance: collectively evaluated for impairment	\$ 112,525,830	\$ 148,456,495	\$ 83,889,870	\$ 65,790,766	\$ 27,084,508	\$ 244,463,181

Consumer				
	Consumer and installment loans	Overdraft protection	Unallocated	Total
Allowance for credit losses:				
Beginning balance	\$ 55,192	\$ 501	\$ 623,266	\$ 10,910,000
Charge-offs	(22,759)	(416)	—	(3,222,495)
Recoveries	587	21	—	1,373,864
Provision	66,251	582	(42,566)	—
Ending balance	\$ 99,271	\$ 688	\$ 580,700	\$ 9,061,369
Ending balance				
Individually evaluated for impairment	\$ 83,792	\$ —	\$ —	\$ 2,933,509
Collectively evaluated for impairment	\$ 15,479	\$ 688	\$ 580,700	\$ 6,127,860
Financing receivables:				
Ending balance	\$ 2,911,397	\$ 71,009	\$ —	\$ 712,496,491
Ending balance: individually evaluated for impairment	\$ 88,143	\$ —	\$ —	\$ 27,391,578
Ending balance: collectively evaluated for impairment	\$ 2,823,254	\$ 71,009	\$ —	\$ 685,104,913

A loan is considered impaired when, based on current information and events; it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. In addition to loans 90 days past due and still accruing and nonaccrual loans, all restructured loans, all loans risk graded doubtful or substandard and a portion of the loans risk graded special mention qualify, by definition, as impaired. Loans 90 days past due and still accruing totaling \$248,326 and nonaccrual loans totaling \$1,989,759 are included in impaired loans at December 31, 2015. Loans 90 days past due and still accruing totaling \$174,976 and nonaccrual loans totaling \$2,704,572 are included in impaired loans at December 31, 2014.

The following table summarizes our impaired loans at December 31, 2015 and 2014.

Impaired Loans				
	With No Related Allowance			
	Recorded Investment	Unpaid Principal Balance	Average Recorded Investment	Interest Income Recognized
December 31, 2015				
Commercial	\$ —	\$ —	\$ —	\$ —
Real estate				
Construction	930,955	930,955	947,162	64,402
Residential (1-4 family)	1,850,482	1,912,515	1,942,407	63,532
Home equity lines	445,092	461,134	456,349	6,862
Multifamily	—	—	—	—
Commercial	894,603	899,189	921,147	50,773
Consumer				
Consumer and installment loans	—	—	—	—
Overdraft protection loans	—	—	—	—
Total	\$ 4,121,132	\$ 4,203,793	\$ 4,267,065	\$ 185,569
December 31, 2014				
Commercial	\$ —	\$ —	\$ —	\$ —
Real estate				
Construction	935,467	935,467	954,181	56,004
Residential (1-4 family)	2,704,883	2,880,739	3,067,193	119,011
Home equity lines	115,925	115,925	115,324	3,962
Multifamily	—	—	—	—
Commercial	1,430,533	1,430,533	1,317,972	79,891
Consumer				
Consumer and installment loans	1,122	2,729	3,088	—
Overdraft protection loans	—	—	—	—
Total	\$ 5,187,930	\$ 5,365,393	\$ 5,457,758	\$ 258,868

	With Related Allowance				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2015					
Commercial	\$ 21,448	\$ 21,448	\$ 21,448	\$ 26,406	\$ 568
Real estate					
Construction	217,408	244,963	112,963	228,737	10,325
Residential (1-4 family)	1,892,831	2,032,255	568,424	1,909,161	66,605
Home equity lines	994,743	994,743	688,596	997,110	42,663
Multifamily	—	—	—	—	—
Commercial	2,006,910	2,016,187	644,162	1,699,033	60,710
Consumer					
Consumer and installment loans	65,043	65,043	65,043	70,199	2,461
Overdraft protection loans	2,527	2,527	2,527	2,787	629
Total	\$ 5,200,910	\$ 5,377,166	\$ 2,103,163	\$ 4,933,433	\$ 183,961
December 31, 2014					
Commercial	\$ 1,549,963	\$ 1,549,963	\$ 441,265	\$ 1,618,461	\$ 93,073
Real estate					
Construction	336,913	441,459	100,159	408,460	12,358
Residential (1-4 family)	4,493,442	4,535,549	1,261,490	4,564,008	232,522
Home equity lines	985,672	985,672	547,172	988,494	46,161
Multifamily	—	—	—	—	—
Commercial	1,700,360	1,700,360	335,033	1,721,563	79,323
Consumer					
Consumer and installment loans	74,582	74,582	74,582	79,632	2,792
Overdraft protection loans	—	—	—	—	—
Total	\$ 9,140,932	\$ 9,287,585	\$ 2,759,701	\$ 9,380,618	\$ 466,229

Interest received in cash and recognized on impaired loans was \$369,530, \$725,097 and \$1,924,008 for 2015, 2014 and 2013, respectively.

Restructured loans are loans for which it has been determined the borrower will not be able to perform under the original terms of the loan agreement and a concession has been made to those terms that would not otherwise have been considered. If the value of a restructured loan is determined to be less than the recorded investment in the loan, a valuation allowance is created with a corresponding charge-off to the allowance for loan losses and any collection of interest and principal are recorded as recoveries to the allowance for loan losses until all charged-off balances are fully recovered. Measurement of the value of a restructured loan is generally based on the present value of expected future cash flows discounted at the loan's effective interest rate, unless in the case of collateral-dependent loans, the observable market price, or the fair value of the collateral can be readily determined. Restructured loans are reevaluated periodically and additional adjustments to the carrying value may be made. In addition, if it is determined the borrower is unable to perform under the modified terms, further steps, such as a full charge-off or foreclosure may be taken. We did not have any commitments to lend additional funds on restructured loans at December 31, 2015 or 2014.

We currently have ten loans classified as restructured loans; seven residential 1-4 family loan for \$1,481,143, two commercial real estate loans for \$1,550,360 and one consumer loan for \$65,043. At December 31, 2015, three residential 1-4 family restructured loans totaling \$695,886 are not current, and one commercial real estate restructured loan for \$220,775 is not current. All remaining restructured loans, which total \$2,179,885 are current. There were three restructured loans added during the year ended December 31, 2015. We did not have any defaults on restructured loans within twelve months of restructuring during the years ended December 31, 2015 and 2014.

Additional information on restructured loans during the period is as follows:

Troubled Debt Restructurings

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
Year Ended December 31, 2015	3	\$ 806,460	\$ 806,460
Year Ended December 31, 2014	4	\$ 1,367,499	\$ 1,304,499

Troubled Debt Restructurings That Subsequently Defaulted

	Number of Contracts	Recorded Investment
Year Ended December 31, 2015	None	\$ —
Year Ended December 31, 2014	None	\$ —

NOTE 5 – OTHER REAL ESTATE OWNED

Other real estate is real estate properties acquired through or in lieu of loan foreclosure. At foreclosure, these properties are recorded at their fair value less estimated selling costs as a nonperforming asset, with any write-downs to the carrying value of our investment charged to the allowance for loan loss. After foreclosure, periodic evaluations are performed to determine if any decrease in the fair value less estimated selling costs has occurred. Further adjustments to this fair value are charged to operations, in non-interest expense, when identified. Expenses associated with the maintenance of other real estate are charged to operations, as incurred. When a property is sold, any gain or loss on the sale is recorded as non-interest expense.

Information on other real estate:

	2015		2014		2013	
	Balance	Number	Balance	Number	Balance	Number
January 1,	\$ 144,000	1	\$ 301,963	1	\$ —	—
Balance moved into other real estate	250,000	2	942,285	3	397,037	2
	394,000	3	1,244,248	4	397,037	2
Properties sold	(394,000)	(3)	(1,100,248)	(3)	(95,074)	(1)
Balance December 31,	\$ —	—	\$ 144,000	1	\$ 301,963	1
Gross gains of sale of other real estate	\$ —		\$ —		\$ —	
Gross losses on sale of other real estate	(51,035)		(6,976)		(3,020)	
Rental income, other real estate	1,955		9,620		—	
Other real estate expense	(44,869)		(80,580)		(7,098)	
Foreclosed property expense	\$ (93,949)		\$ (77,936)		\$ (10,118)	

There was one residential real estate property totaling \$45,844 in the process of foreclosure at December 31, 2015 and one residential real estate property totaling \$182,256 in process of foreclosure at December 31, 2014.

NOTE 6 – PROPERTY AND EQUIPMENT

Property and equipment consist of the following at December 31:

	2015	2014
Buildings	\$ 18,556,418	\$ 18,221,806
Land	7,747,480	7,747,480
Leasehold improvements	4,054,056	3,883,408
Equipment, furniture and fixtures	14,245,439	13,557,589
	<u>44,603,393</u>	<u>43,410,283</u>
Less accumulated depreciation	(15,631,531)	(13,162,819)
Property and equipment, net	<u>\$ 28,971,862</u>	<u>\$ 30,247,464</u>

Depreciation expense of \$2,977,243, \$2,886,838 and \$2,424,478 was included in occupancy and equipment expense for 2015, 2014 and 2013, respectively.

We have thirty-three non-cancellable leases for premises. The lease terms are from one to thirty years and have various renewal dates. Rental expense was \$3,846,737, \$4,239,011 and \$3,964,392 in 2015, 2014 and 2013, respectively. Minimum lease payments for succeeding years pertaining to these non-cancellable operating leases are as follows:

2016	\$ 3,045,531
2017	2,799,339
2018	1,571,320
2019	652,508
2020	382,387
Thereafter	7,285,350
	<u>\$ 15,736,435</u>

NOTE 7 – GOODWILL AND INTANGIBLE ASSETS

On August 10, 2007, we acquired a Maryland mortgage office plus certain other mortgage related assets from Resource Bank (now Fulton Bank), a Virginia Beach based bank owned by Fulton Financial of Lancaster, Pennsylvania. The assets and results of operations have been included in the consolidated financial statements since that date. The aggregate purchase price was \$2.1 million including legal expenses of \$53,000. The intangible assets had a weighted-average useful life of seven years.

Information concerning intangible assets and goodwill attributable to the Maryland mortgage office acquired on August 10, 2007 is presented in the following table:

	December 31,		Acquisition
	2015	2014	Cost
Amortizable intangible assets, net	\$ —	\$ —	\$ 1,250,000
Goodwill	775,000	775,000	775,000
Amortization expense	—	104,167	

Annual impairment review indicated that goodwill was not impaired in 2015 or 2014.

NOTE 8 – RESTRICTED EQUITY SECURITIES

Restricted equity securities are securities that do not have a readily determinable fair value and lack a market. Therefore, they are carried at cost. The following table represents balances as of December 31, 2015 and 2014, respectively:

	2015	2014
Federal Reserve Bank Stock	\$ 2,107,700	\$ 2,086,000
Federal Home Loan Bank Stock	1,639,800	1,412,800
Community Bankers Bank Stock	133,700	133,700
Total restricted equity securities	<u>\$ 3,881,200</u>	<u>\$ 3,632,500</u>

As a member bank, our stock requirement with the Federal Reserve is based on our capital levels as reported on the most recent filing of our Consolidated Reports of Condition and Income and is subject to change when our capital levels increase or decrease. Our stock requirements with the Federal Home Loan Bank consists of two levels; membership stock based on total assets as of December 31st of each year, and collateral stock based on our highest borrowing levels which is evaluated for release on a periodic basis. The stock we hold with Community Bankers Bank is membership stock.

NOTE 9 – DEPOSITS

Interest-bearing deposits for the years ending December 31, 2015 and December 31, 2014 are as follows:

	2015	2014
Interest bearing demand	\$ 68,963,364	\$ 66,681,905
Money market accounts	364,893,441	369,221,343
Savings accounts	19,516,673	20,003,086
Certificates of deposit \$250,000 and over	23,069,895	20,581,794
Other time deposits	242,570,667	207,624,614
Total interest-bearing deposits	<u>\$ 719,014,040</u>	<u>\$ 684,112,742</u>

Scheduled maturities for time deposits as of December 31, 2015 are as follows:

Year Maturing	
2016	\$ 221,960,807
2017	41,470,682
2018	954,233
2019	726,279
2020	447,681
Thereafter	80,880
	<u>\$ 265,640,562</u>

Brokered money market balances included in money markets totaled \$34,310,395 and \$42,420,532 at December 31, 2015 and 2014, respectively. There were no CDARS balances over \$250,000 at year end 2015 or 2014.

NOTE 10 – BORROWINGS

We have federal funds arrangements with five financial institutions that provide approximately \$68.0 million of unsecured short-term borrowing capacity. As of December 31, 2015 and 2014, there were no outstanding balances on these federal funds lines of credits. Information concerning federal funds purchased is summarized, as follows:

	2015	2014
Average balance during the year	\$ 365,562	\$ 100,699
Average interest rate during the year	0.61%	1.26%
Maximum month end balance during the year	\$ 20,000	\$ —

We are a member of the Federal Home Loan Bank of Atlanta ("FHLB") and as such, may borrow funds based on criteria established by the FHLB. We are allowed under our lines of credit to borrow up to 30% of assets, or approximately \$348,436,240, if collateralized, as of December 31, 2015. This line of credit is secured by loans held for investment, investment securities and loans held for sale. The loans held for investment consists of blanket liens on our portfolio of 1-4 family residential loans, home equity lines of credit/loans portfolio and qualifying commercial real estate loans. The investment securities are pledged with collateral fair values of \$78,649 at December 31, 2015 and \$97,249 at December 31, 2014. The loans held for sale portfolio is pledged daily under the Residential Available For Sale ("RAFS") program which uses loans that have been sold to FHLB approved investors. We are allowed to borrow up to 90% of the pledged loan amount. The RAFS program went into effect in February 2014 after the previous program was sundowned.

As of December 31, 2015 we could borrow approximately \$107.3 million, and as of December 31, 2014 we could borrow approximately \$120.7 million, under our line based upon collateral pledged. In both years this line is reduced by \$8.0 million, which has been pledged as collateral for public funds. There were no fixed rate advances outstanding on the line as of December 31, 2015.

There was one fixed rate advance, which totaled \$1,075,497 in 2014 that matured September 28, 2015.

Should we ever desire to increase the line of credit beyond the 30% limit, the FHLB would allow borrowings of up to 40% of total assets once we met specific eligibility criteria.

Other information concerning FHLB advances is summarized below:

	2015	2014
Average balance during the year	\$ 16,442,629	\$ 1,912,203
Average interest rate during the year	0.52%	3.02%
Maximum month end balance during the year	\$ 46,025,500	\$ 11,075,497
Outstanding balance at December 31,	\$ 16,000,000	\$ 11,075,497

NOTE 11 – TRUST PREFERRED SUBORDINATED DEBT

Monarch Financial Holdings Trust is a wholly-owned special purpose finance subsidiary of Monarch Financial Holdings, Inc., operating in the form of a grantor trust (the Trust). The Trust was created in June 2006 to issue capital securities and remit the proceeds to the Company. We are the sole owner of the common stock securities of the Trust. On July 5, 2006 the Trust issued 10,000 shares of preferred stock capital securities with a stated value of \$1,000 per share, bearing a variable dividend rate, reset per quarter, equal to 90 day LIBOR plus 1.60%. The Trust securities have a mandatory redemption date of September 30, 2036, and were subject to varying call provisions at our option beginning September 30, 2011.

We unconditionally guarantee the stated value of the Trust preferred stock on a subordinated basis. Through an inter-company lending transaction, proceeds received by the Trust from the sale of securities were lent to the Company for general corporate purposes.

The Trust preferred stock is senior to our common stock in event of claims against Monarch, but is subordinated to all senior and subordinated debt securities. The shares of the Trust preferred stock are capital securities, which are distinct from the common stock or preferred stock of the Company, and the dividends thereon are tax-deductible. Dividends accrued for payment by the Trust are classified as interest expense on long-term debt in our consolidated statement of income. The Trust preferred stock is shown as “Trust preferred subordinated debt” and classified as a liability in the consolidated balance sheets.

NOTE 12 – DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

We entered into an interest rate swap agreement with PNC Bank (“PNC”) of Pittsburgh, PA on July 29, 2009, for our \$10,000,000 Trust preferred borrowing, which carries a floating interest rate of 90 day LIBOR plus 160 basis points. The terms of this hedge allowed us to mitigate our exposure to interest-rate fluctuations by swapping our floating rate obligation for a fixed rate obligation. The notional amount of the swap agreement was \$10,000,000, and expired on September 30, 2014. Under the terms of our agreement, at the end of each quarter we swapped our floating rate for a fixed rate of 3.26%. Including the additional 160 basis points, the effective fixed rate of interest cost was 4.86% on our \$10,000,000 Trust Preferred borrowing for five years.

The fixed-rate payment feature of this swap was structured to mirror the provisions of the hedged borrowing agreement. The swap qualified as a cash flow hedge and the underlying liability was carried at fair value in other liabilities, with the tax-effective changes in the fair value of the instrument included in Stockholders’ Equity in accumulated other comprehensive income (loss). This swap was not renewed when it expired on September 30, 2014.

Commitments to fund certain mortgage loans (interest rate locks) to be sold into the secondary market and forward commitments for the future delivery of mortgage loans to third party investors are considered derivatives. It is the Company's practice to enter into forward commitments for the future delivery of residential mortgage loans when interest rate lock commitments are entered into in order to economically hedge the effect of changes in interest rates resulting from its commitments to fund the loans. These mortgage derivatives are not designated in hedge relationships. At year-end 2015, the Company had approximately \$131 million of interest rate lock commitments and \$244 million of forward commitments for the future delivery of residential mortgage loans. The fair value of these mortgage banking derivatives was reflected by a derivative asset of \$2,105,204 and a derivative liability of \$368,577. At year-end 2014, the Company had approximately \$113 million of interest rate lock commitments and \$216 million of forward commitments for the future delivery of residential mortgage loans. The fair value of these mortgage banking derivatives was reflected by a derivative asset of \$1,514,083 and a derivative liability of \$1,195,405. Fair values were estimated based on changes in mortgage interest rates from the date of the commitments. Changes in the fair values of these mortgage banking derivatives are included in net gains on sales of loans.

The net gains (losses) relating to free-standing derivative instruments used for risk management are summarized below as of December 31:

	<u>Location</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>
Forward contracts related to mortgage loans held for sale	Mortgage banking revenue	\$ (342,948)	\$ 180,903	\$ —
Interest rate lock commitments	Mortgage banking revenue	\$ 829,648	\$ 540,374	\$ —

The following table reflects the amount and market value of mortgage banking derivatives included in the Consolidated Statements of Condition as of December 31:

	<u>2015</u>		<u>2014</u>	
	<u>Notional Amount</u>	<u>Fair Value</u>	<u>Notional Amount</u>	<u>Fair Value</u>
Included in other assets (1)				
Forward contracts related to mortgage loans held for sale (2)	\$ 145,232,095	\$ 615,123	\$ 54,955,693	\$ 153,506
Interest rate lock commitments	130,510,306	1,370,022	113,867,190	1,115,944
Loans held for sale (2)	57,475,606	120,059	70,013,297	244,633
Total included in other assets		\$ 2,105,204		\$ 1,514,083
Included in other liabilities (1)				
Forward contracts related to mortgage loans held for sale (2)	\$ 98,680,765	\$ 238,583	\$ 161,072,280	\$ 757,906
Loans held for sale (2)	38,765,086	76,856	23,030,231	42,833
Hedge positions	\$ 76,632,817	53,138	\$ 49,280,193	\$ 394,666
Total included in other assets		\$ 368,577		\$ 1,195,405

- (1) The Notional amount of mortgage banking derivatives is an off balance sheet time and only the fair value of the derivatives is recorded within the Consolidated Statements of Condition.
- (2) Loans held for sale and certain forward sales commitments do not qualify under applicable accounting guidance as derivative instruments; however, the Company has elected the fair value option under ASC 825-10-15-4(b) for the loans held for sale portfolio and thus fair value adjustments have been recorded in the derivative asset and derivative liability as presented above.

NOTE 13 – INCOME TAXES

The principal components of income tax expense for 2015, 2014 and 2013 are as follows:

	<u>2015</u>	<u>2014</u>	<u>2013</u>
Current			
Federal	\$ (7,218,432)	\$ (6,351,028)	\$ (5,051,832)
State	(414,297)	(444,024)	(485,148)
	<u>(7,632,729)</u>	<u>(6,795,052)</u>	<u>(5,536,980)</u>
Deferred			
Federal	63,218	318,422	(846,636)
State	(14,309)	(13,643)	(2,424)
	<u>48,909</u>	<u>304,779</u>	<u>(849,060)</u>
Total			
Federal	(7,155,214)	(6,032,606)	(5,898,468)
State	(428,606)	(457,667)	(487,572)
	<u>\$ (7,583,820)</u>	<u>\$ (6,490,273)</u>	<u>\$ (6,386,040)</u>

Differences between income tax expense calculated at the statutory rate and that shown in the statement of income for 2015, 2014 and 2013 are summarized, as follows:

	2015	2014	2013
Federal income tax expense at statutory rate	\$ (7,279,524)	\$ (6,195,743)	\$ (6,116,966)
Tax effect of:			
BOLI cash surrender value (decrease) increase	99,949	86,578	82,732
Meals and entertainment	(131,015)	(121,212)	(115,058)
State and local income taxes	(287,635)	(305,893)	(321,475)
Other	14,405	45,997	84,727
Income tax expense	<u>\$ (7,583,820)</u>	<u>\$ (6,490,273)</u>	<u>\$ (6,386,040)</u>

We have the following deferred tax assets and liabilities at December 31, 2015, 2014 and 2013:

	December 31,		
	2015	2014	2013
Deferred tax assets:			
Bad debt provision	\$ 3,223,241	\$ 3,257,838	\$ 3,320,139
Available for sale securities	84,301	55,163	225,883
Deferred compensation	1,035,137	777,567	651,386
Reserve for available for sale loan repurchase	1,192,383	1,097,032	1,162,199
Premium amortization on securities	10,608	9,640	8,557
Other	1,040,870	1,171,886	744,806
Total deferred tax assets	<u>6,586,540</u>	<u>6,369,126</u>	<u>6,112,970</u>
Deferred tax liabilities:			
Fixed assets	(1,208,541)	(1,426,903)	(1,644,419)
Other	(827,124)	(469,393)	(129,781)
Total deferred tax liabilities	<u>(2,035,665)</u>	<u>(1,896,296)</u>	<u>(1,774,200)</u>
Net deferred tax assets	<u>\$ 4,550,875</u>	<u>\$ 4,472,830</u>	<u>\$ 4,338,770</u>

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amount of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered in income. Deferred tax assets are reduced by a valuation allowance if it is more likely than not that the tax benefits will not be realized. Management has evaluated the effect of the guidance provided by U.S. GAAP on Accounting for Uncertainty in Income Taxes, and all other tax positions that could have a significant effect on the financial statements and determined the Company had no uncertain material income tax positions at December 31, 2015 or 2014.

We file income tax returns in the U.S. federal jurisdiction and the states of Virginia, Maryland, North Carolina and South Carolina. With few possible exceptions, we are no longer subject to U.S. or state income tax examinations by tax authorities for the years prior to 2012.

NOTE 14 – COMMITMENTS, CONTINGENCIES AND CONSIDERATIONS

We have outstanding at any time a significant dollar amount of commitments to extend credit. To accommodate major customers, we also provide standby letters of credit and guarantees to third parties. Those arrangements are subject to strict credit control assessments. Guarantees and standby letters of credit specify limits to our obligations. The amounts of loan commitments, guarantees and standby letters of credit are set out in the following table as of December 31, 2015 and 2014. Because many commitments and almost all standby letters of credit and guarantees expire without being funded, in whole or in part, the contract amounts are not estimates of future cash flows. The majority of commitments to extend credit have terms up to one year. Interest rates on fixed-rate commitments range from 2.5% to 21.0%. All of the guarantees written and the standby letters of credit at December 31, 2015 expire during 2016.

	Commitments	
	2015	2014
Commitments to grant loans	\$ 157,554,990	\$ 205,003,879
Interest Rate Lock Commitments	\$ 108,635,768	\$ 79,415,083
Unfunded commitments under lines of credit and similar arrangements	\$ 149,977,483	\$ 148,660,017
Standby letters of credit and guarantees written	\$ 33,062,276	\$ 29,328,041

Loan commitments, standby letters of credit and guarantees written have off-balance-sheet credit risk because only origination fees and accruals for probable losses, if any, are recognized in the statement of financial position, until the commitments are fulfilled or the standby letters of credit or guarantees expire. Credit risk represents the accounting loss that would be recognized at the reporting date if counterparties failed completely to perform as contracted. The credit risk amounts are equal to the contractual amounts, assuming that the amounts are fully advanced and that, in accordance with the requirements of FASB guidance for Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk, collateral or other security is of no value. Our policy is to require customers to provide collateral prior to the disbursement of approved loans. For retail loans, we usually retain a security interest in the property or products financed, which provides repossession rights in the event of default by the customer. For business loans and financial guarantees, collateral is usually in the form of inventory or marketable securities (held in trust) or property (notations on title).

Concentrations of credit risk relative to capital (whether on or off balance sheet) arising from financial instruments exist in relation to certain groups of customers. A group concentration arises when a number of counterparties have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. At December 31, 2015, we had two loan concentrations which exceeded 10% in the area of loans to borrowers who are principally engaged in acquisition, development and construction of residential homes and developments. A geographic concentration arises because we operate primarily in southeastern Virginia.

The credit risk amounts represent the maximum accounting loss that would be recognized at the reporting date if counterparties failed completely to perform as contracted and any collateral or security proved to be of no value. We have experienced little difficulty in accessing collateral when required. The amounts of credit risk shown, therefore, greatly exceed expected losses, which are included in the allowance for loan losses.

Various legal claims also arise from time to time in the normal course of business that, in the opinion of management, will have no material effect on our consolidated financial statements.

NOTE 15 – STOCK COMPENSATION AND BENEFIT PLANS

In May 2014, Monarch shareholders ratified the adoption of the Monarch Bank 2014 Equity Incentive Plan ("2014EIP"), a stock-based compensation plan which succeeds the Monarch Bank 2006 Equity Incentive Plan ("2006EIP"). The 2006EIP had succeeded the 1999 Incentive Stock Plan ("99ISO") and was the only plan under which equity-based compensation could be awarded. Like the 2006EIP, the 2014EIP authorizes the compensation committee to grant options, stock appreciation rights, stock awards, performance stock awards, and stock units to designated directors, officers, key employees, consultants and advisers to the Company and its subsidiaries.

The 2014EIP authorized the Company to issue up to 1,100,000 shares of Monarch Common Stock plus the number of shares of our Common Stock outstanding under the predecessor plans. The Plan provides that no award may be granted more than 10 years after the May 2014 ratification. As of December 31, 2015, 114,299 shares were available for grants under the predecessor plans. A total of 441,040 shares are subject to outstanding awards under the 2006EIP and 1999ISO, including 0 stock options and 441,040 shares of non-vested restricted stock.

The following is a summary of our stock option activity, and related information. All shares and per share prices have been restated for stock splits and dividends in the years presented:

<u>Options</u>	2015			2014	
	Number of Options	Weighted Average Exercise Price	Aggregate Intrinsic Value	Number of Options	Weighted Average Exercise Price
Outstanding - Beginning of year	114,526	7.13		161,181	6.95
Granted	—	—		—	—
Exercised	(114,526)	(7.13)		(46,655)	6.53
Forfeited	—	—		—	—
Outstanding - End of year	—	—	\$ —	114,526	7.13
Options exercisable at year-end	—	—	\$ —	114,526	7.13

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying awards and the quoted price of our common stock for those awards that have an exercise price currently below the closing price. There were 114,526 options exercised during the year ended December 31, 2015 and 46,655 options exercised during the year ended December 31, 2014. All remaining options were exercised prior to December 31, 2015. The total intrinsic value of options exercised during the year ended December 31, 2015 was \$484,860. No options were granted under the plan in 2015 or 2014.

Cash received for option exercise under share-based payment arrangements for 2015 and 2014 was \$756,238 and \$304,673, respectively. Tax benefits of \$170,415 and \$251,452 were recognized in 2015 and 2014, respectively. There were no options outstanding at December 31, 2015.

A summary of the status of the our non-vested shares in relation to our restricted stock awards as of December 31, 2015 and 2014, and changes during the years ended December 31, 2015 and 2014, is presented below; the weighted average price is the weighted average fair value at the date of grant:

	2015		2014	
	Shares	Weighted Average Price	Shares	Weighted Average Price
Restricted Share Awards				
Non-vested - Beginning of year	360,525	\$ 7.50	355,036	\$ 6.45
Granted	152,180	11.96	96,525	10.12
Vested	(54,065)	6.06	(84,216)	6.11
Forfeited	(17,600)	7.21	(6,820)	7.45
Non-vested - End of year	441,040	\$ 9.84	360,525	\$ 7.50

Compensation expense related to the restricted stock awards was \$833,251, \$824,497 and \$593,721 for 2015, 2014 and 2013, respectively. The total fair value of awards vested during 2015 and 2014 was \$689,773 and \$1,010,592, respectively. As of December 31, 2015 and 2014, there was \$2,469,548 and \$1,587,427, respectively, of total unrecognized cost related to the non-vested share-based compensation arrangements granted under the 2006EIP. That cost is expected to be recognized over a weighted-average period of 2.6 years. The grant date fair value of common stock is used in determining unused compensation cost.

Other information pertaining to restricted stock at December 31, 2015 is as follows:

Range of Issuance Prices	Number Outstanding	Remaining Contractual Life
\$5.83 to \$12.79	441,040	2.47

We have a 401(k) defined contribution plan applicable to all eligible employees. Contributions to the plan are made at the employee's election. Employees may contribute up to 91% of their salaries up to IRS limits. We began making contributions in April 2001. We match 37.5% of the first 6.0% of employee contributions in 2015. We matched 50% of the first 6.0% of employee contributions in 2014 and 2013. Our expense for 2015, 2014 and 2013 was \$740,848, \$893,516 and \$960,102, respectively.

In addition, Monarch has supplemental retirement benefits provided to its executives under a supplemental executive retirement plan ("SERP") executed in 2006. Although technically unfunded, insurance policies on the lives of the covered executives are also available to finance future benefits. The Bank is the owner and beneficiary of these policies. The expense for 2015 and 2014 was \$384,750 and \$381,993, respectively. Total expected expense for 2016 is \$278,003. The following were significant actuarial assumptions used to determine benefit obligations:

	December 31, 2015	December 31, 2014
Actuarial Assumptions		
Weighted average assumed discount rate	4.50%	4.50%
Changes in Projected Benefit Obligation		
Projected benefit obligation, January 1	\$ 2,110,746	\$ 1,777,773
Service cost	278,004	322,080
Interest cost	101,869	90,893
Benefits paid	(125,000)	(80,000)
Projected benefit obligation, December 31,	<u>\$ 2,365,619</u>	<u>\$ 2,110,746</u>
Amounts Recognized in Accumulated Other Comprehensive Income		
Actuarial gain due to change in discount rate	\$ 18,765	\$ 7,920
Deferred income tax expense	(6,568)	(2,772)
	<u>\$ 12,197</u>	<u>\$ 5,148</u>

The SERP liability, equal to the projected benefit obligation above, is included in other liabilities on the Company's consolidated statements of condition. SERP payments for executives or their beneficiaries are in pre-determined fixed annual payments that begin at age 65 and continue for 10 years.

In July 2014, Monarch established an executive savings plan. A grantor or Rabbi Trust was established as a vehicle for accumulating assets to pay benefits under the plan. The balance in Rabbi Trust was \$2,780,642 at December 31, 2015 and \$2,018,154 at December 31, 2014. Participants in the executive savings plan are allowed to defer up to 70% of their base salary and 100% of bonuses, which can be invested in a pre-determined list of investments. Participants may also defer up to 100% of vested restricted stock into the plan. These shares remain in share form and move with the market value of the shares. The table below summarizes the activities associated with the executive savings plan in 2015 and 2014.

Deferred Liability	2015	2014
Balance January 1,	\$ 29,914	\$ —
Employee deferrals	535,930	29,469
Employer contributions	566,790	—
Employee distributions	(24,311)	—
Gain (loss) in value of investments	139,481	445
Balance December 31,	<u>\$ 1,247,804</u>	<u>\$ 29,914</u>
Rabbi Trust		
Balance January 1,	\$ 2,018,154	\$ —
Additional asset purchases	704,068	2,000,000
Gain in asset value	58,240	18,154
	<u>\$ 2,780,462</u>	<u>\$ 2,018,154</u>

NOTE 16 – RELATED PARTY TRANSACTIONS

We have loan transactions with our executive officers and directors, and with companies in which our executive officers and directors have a financial interest. Management believes these transactions occurred in the ordinary course of business on substantially the same terms as those prevailing at the time for persons not related to the lender. A summary of related party loan activity is as follows during 2015 and 2014.

	2015	2014
Outstanding - Beginning of year	\$ 27,802,991	\$ 26,514,743
Originations	21,749,863	23,634,933
Repayments	(18,003,462)	(22,346,685)
Outstanding - End of year	\$ 31,549,392	\$ 27,802,991

Commitments to extend credit and letters of credit to related parties amounted to \$16,435,765 and \$14,816,690 at December 31, 2015 and 2014, respectively.

At December 31, 2015 and 2014 total deposits held by related parties were \$10,061,209 and \$7,515,201, respectively.

NOTE 17 – REGULATORY CAPITAL REQUIREMENTS

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

The Bank, as a Virginia banking corporation, may only pay dividends from retained earnings. In addition, regulatory authorities may limit payment of dividends by any bank, when it is determined that such limitation is in the public interest and necessary to ensure financial soundness of the Bank. Regulatory agencies place certain restrictions on dividends paid and loans and loans or advances made by the Bank to the Company. The amount of dividends the Bank may pay to the Company, without prior approval, is limited to current year earnings, plus retained net profits for the two preceding years. At December 31, 2015, the amount available was approximately \$30.0 million. Loans and advances are limited to 15% of the Bank's common stock and capital surplus plus estimated allowance for loan losses. As of December 31, 2015, funds available for loans or advances by the Bank to the Company were approximately \$20.3 million.

Quantitative measures established by regulation to ensure capital adequacy require that the Bank maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2015, the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2015 the Bank was categorized as "well capitalized", the highest level of capital adequacy. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, Common Equity Tier I Capital and Tier 1 leverage ratios as set forth in the table. The Company is also subject to certain capital adequacy ratio requirements. The Company and Bank's actual capital amounts and ratios are also presented in the table as of December 31, 2015 and 2014.

The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks ("Basel III rules") became effective on January 1, 2015, with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2016. As part of the new requirements, the Common Equity Tier I Capital ("CETI") is calculated and utilized in the assessment of capital for all institutions. Capital amounts and ratios for December 31, 2014 were calculated using the Basel I rules, which were effective until January 1, 2015.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action	
	Amounts	Ratio	Amounts	Ratio	Amounts	Ratio
(Dollars in Thousands)						
As of December 31, 2015						
Total Risk-Based Capital Ratio						
Consolidated Company	\$ 135,955	13.69%	\$ 79,411	8.00%	N/A	N/A
Bank	\$ 134,953	13.60%	\$ 79,386	8.00%	\$ 99,230	10.00%
<i>(Total Risk-Based Capital to Risk-Weighted Assets)</i>						
Tier 1 Risk-Based Capital Ratio						
Consolidated Company	\$ 127,068	12.80%	\$ 59,558	6.00%	N/A	N/A
Bank	\$ 126,066	12.70%	\$ 59,539	6.00%	\$ 79,411	8.00%
<i>(Tier 1 Capital to Risk-Weighted Assets)</i>						
Common Equity Risk-Based Capital (CET1)						
Consolidated Company	\$ 117,068	11.79%	\$ 44,669	4.50%	N/A	N/A
Bank	\$ 126,066	12.70%	\$ 44,655	4.50%	\$ 64,501	6.50%
<i>(Total Common Equity to Risk-Weighted Assets)</i>						
Tier 1 Leverage Ratio						
Consolidated Company	\$ 127,068	11.56%	\$ 43,968	4.00%	N/A	N/A
Bank	\$ 126,066	11.48%	\$ 43,925	4.00%	\$ 54,907	5.00%
<i>(Tier 1 Capital to Average Assets)</i>						
As of December 31, 2014						
Total Risk-Based Capital Ratio						
Consolidated Company	\$ 125,728	13.79 %	\$ 72,925	8.00 %	N/A	N/A
Bank	\$ 125,807	13.81 %	\$ 72,900	8.00 %	\$ 91,125	10.00 %
<i>(Total Risk-Based Capital to Risk-Weighted Assets)</i>						
Tier 1 Risk-Based Capital Ratio						
Consolidated Company	\$ 116,779	12.81 %	\$ 36,462	4.00 %	N/A	N/A
Bank	\$ 116,858	12.82 %	\$ 36,450	4.00 %	\$ 54,675	6.00 %
<i>(Tier 1 Capital to Risk-Weighted Assets)</i>						
Tier 1 Leverage Ratio						
Consolidated Company	\$ 116,779	11.44 %	\$ 40,821	4.00 %	N/A	N/A
Bank	\$ 116,858	11.45 %	\$ 40,821	4.00 %	\$ 51,026	5.00 %
<i>(Tier 1 Capital to Average Assets)</i>						

NOTE 18 – FAIR VALUE OF FINANCIAL INSTRUMENTS

Fair Value Hierarchy and Fair Value Measurement

We group our assets and liabilities that are recorded 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 – Valuations based on quoted prices in active markets for identical assets or liabilities. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuation of these products does not entail a significant degree of judgment.
- Level 2 – Valuations based on quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-based valuations for which all significant assumptions are observable or can be corroborated by observable market data.
- Level 3 – Valuations based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Valuations are determined using pricing models and discounted cash flow models and includes management judgment and estimation which may be significant.

The methods we use to determine fair value on an instrument specific basis are detailed in the section titled “Valuation Methods” below.

The following table presents the carrying amounts and fair value of our financial instruments at December 31, 2015 and December 31, 2014. GAAP defines the fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than through a forced or liquidation sale for purposes of this disclosure. The carrying amounts in the table are included in the consolidated balance sheet under the indicated captions.

Estimation of Fair Values

		Fair Value Measurements at December 31, 2015 using								
		Carrying Value	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Fair Value				
			Level 1	Level 2	Level 3					
<u>Assets</u>										
Cash and cash equivalents	\$	73,879,510	\$	73,879,510	\$	—	\$	—	\$	73,879,510
Investment securities available for sale		30,213,130		—		30,213,130		—		30,213,130
Mortgage loans held for sale		169,345,205		—		169,345,205		—		169,345,205
Loans held for investment (net)		820,382,106		—		—		834,345,931		834,345,931
Accrued interest receivable		2,110,108		—		2,110,108		—		2,110,108
Bank owned life insurance		10,634,814		—		10,634,814		—		10,634,814
Derivative financial assets		2,105,204		—		2,105,204		—		2,105,204
<u>Liabilities</u>										
Deposits	\$	999,093,598	\$	—	\$	996,519,992	\$	—	\$	996,519,992
Borrowings		26,000,000		—		16,000,000		6,184,750		22,184,750
Accrued interest payable		104,517		—		104,517		—		104,517
Derivative financial liability		368,577		—		368,577		—		368,577

		Fair Value Measurements at December 31, 2014 using								
		Carrying Value	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Fair Value				
			Level 1	Level 2	Level 3					
<u>Assets</u>										
Cash and cash equivalents	\$	65,428,974	\$	65,428,974	\$	—	\$	—	\$	65,428,974
Investment securities available for sale		23,725,362		—		23,725,362		—		23,725,362
Mortgage loans held for sale		147,690,276		—		147,690,276		—		147,690,276
Loans held for investment (net)		763,640,698		—		—		776,974,812		776,974,812
Accrued interest receivable		2,087,880		—		2,087,880		—		2,087,880
Bank owned life insurance		9,656,803		—		9,656,803		—		9,656,803
Derivative financial assets		1,514,083		—		1,514,083		—		1,514,083
<u>Liabilities</u>										
Deposits	\$	919,413,913	\$	—	\$	917,008,847	\$	—	\$	917,008,847
Borrowings		21,075,497		—		11,109,566		5,641,087		16,750,653
Accrued interest payable		43,280		—		43,280		—		43,280
Derivative financial liability		1,195,405		—		1,195,405		—		1,195,405

The following notes summarize the significant assumptions used in estimating the fair value of financial instruments:

Short-term financial instruments are valued at their carrying amounts included in the Company's statement of condition, which are reasonable estimates of fair value due to the relatively short period to maturity of the instruments. This approach applies to *cash and cash equivalents* and *overnight borrowings*.

Loans held for sale are recorded at their fair value when originated, based on our expected return from the secondary market.

Loans held for investment are valued on the basis of estimated future receipts of principal and interest, which are discounted at various rates. Loan prepayments are assumed to occur at the same rate as in previous periods when interest rates were at levels similar to current levels. Future cash flows for homogeneous categories of consumer loans, such as motor vehicle loans, are estimated on a portfolio basis and discounted at current rates offered for similar loan terms to new borrowers with similar credit profiles.

The carrying amounts of *accrued interest* approximate fair value.

Interest rate lock commitments ("IRLC") are recorded at fair value, which is based on estimated future receipts net of estimated future expenses when the underlying loan is sold on the secondary market, using observable Level 2 market inputs, reflecting current market inputs as of the measurement date.

Bank owned life insurance represents insurance policies on officers of the Bank. The cash values of the policies are estimated using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the fair value.

The fair value of *demand deposits and deposits with no defined maturity* is taken to be the amount payable on demand at the reporting date. The fair value of *fixed-maturity deposits* is estimated using rates currently offered for deposits of similar remaining maturities. The intangible value of long-term relationships with depositors is not taken into account in estimating the fair values disclosed.

The fair value of *all borrowings* is based on discounting expected cash flows at the interest rate of debt with the same or similar remaining maturities and collateral requirements.

Derivative financial instruments are recorded at fair value, which is based on the income approach using observable Level 2 market inputs related to:

Loans held for sale forward sales commitments are recorded at their fair value based on the estimated number of days remaining in the IRLC at the measurement date and expected return from the secondary market. Forward mortgage loan sales commitments are recorded at their fair value based on the gain or loss that would occur if the loan were paired off with an investor at measurement date.

It is not practicable to separately estimate the fair values for off-balance-sheet credit commitments, including standby letters of credit and guarantees written, due to the lack of cost-effective reliable measurement methods for these instruments.

The following table presents our assets and liabilities, which are measured at fair value on a recurring basis for each of the fair value hierarchy levels, as of December 31, 2015 and December 31, 2014:

Description	Fair Value Measurements at Reporting Date Using			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2015				
Investment securities - available for sale				
U.S. government agency obligations	\$ 26,236,245	\$ —	\$ 26,236,245	\$ —
Mortgage-backed securities	998,389	—	998,389	—
Municipal securities	2,978,496	—	2,978,496	—
Loans held for sale	169,345,205	—	169,345,205	—
Derivative financial asset	2,105,204	—	2,105,204	—
Derivative financial liability	\$ 368,577	\$ —	\$ 368,577	\$ —
December 31, 2014				
Investment securities - available for sale				
U.S. government agency obligations	\$ 20,453,875	\$ —	\$ 20,453,875	\$ —
Mortgage-backed securities	1,283,633	—	1,283,633	—
Municipal securities	1,987,854	—	1,987,854	—
Loans held for sale	147,690,276	—	147,690,276	—
Derivative financial asset	1,514,083	—	1,514,083	—
Derivative financial liability	\$ 1,195,405	\$ —	\$ 1,195,405	\$ —

The following table provides quantitative disclosures about the fair value measurements of our assets related to continuing operations which are measured at fair value on a nonrecurring basis as of December 31, 2015 and 2014:

Description	Fair Value Measurements at Reporting Date Using			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
At December 31, 2015				
Restructured and impaired loans	\$ 3,097,747	\$ —	\$ —	\$ 3,097,747
At December 31, 2014				
Real estate owned	\$ 144,000	\$ —	\$ —	\$ 144,000
Restructured and impaired loans	\$ 6,381,231	\$ —	\$ —	\$ 6,381,231

The following table displays quantitative information about Level 3 Fair Value Measurements for December 31, 2015 and 2014.

Fair Value Measurement at December 31, 2015				
	Fair Value	Valuation Technique	Unobservable Inputs	Weighted Average
Commercial	\$ —	Market comparables	Discount applied to market comparables (1)	100%
Real Estate				
Construction	104,445	Market comparables	Discount applied to market comparables (1)	35%
Residential (1-4 family)	1,324,407	Market comparables	Discount applied to market comparables (1)	18%
Home equity lines	306,147	Market comparables	Discount applied to market comparables (1)	20%
Multifamily	—	Market comparables	Discount applied to market comparables (1)	100%
Commercial	1,362,748	Market comparables	Discount applied to market comparables (1)	30%
Consumers				
Consumer and installment loans	—	Market comparables	Discount applied to market comparables (1)	100%
Total restructures and impaired loans	\$ 3,097,747			
Fair Value Measurement at December 31, 2014				
	Fair Value	Valuation Technique	Unobservable Inputs	Weighted Average
Commercial	\$ 1,108,698	Market comparables	Discount applied to market comparables (1)	34%
Real Estate				
Construction	236,754	Market comparables	Discount applied to market comparables (1)	36%
Residential (1-4 family)	3,231,952	Market comparables	Discount applied to market comparables (1)	22%
Home equity lines	438,500	Market comparables	Discount applied to market comparables (1)	22%
Multifamily	—	Market comparables	Discount applied to market comparables (1)	—%
Commercial	1,365,327	Market comparables	Discount applied to market comparables (1)	13%
Consumers				
Consumer and installment loans	—	Market comparables	Discount applied to market comparables (1)	—%
Total restructures and impaired loans	\$ 6,381,231			
Real estate owned	\$ 144,000	Market comparables	Discount applied to market comparables (1)	11%

(1) A discount percentage is applied based on age of independent appraisals, current market conditions, and experience within the local markets.

Valuation Methods

Investment securities – available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data (Level 2). If the inputs used to provide the evaluation for certain securities are unobservable and/or there is little, if any, market activity then the security would fall to the lowest level of hierarchy (Level 3).

The Company's investment portfolio is primarily valued using fair value measurements that are considered to be Level 2. The Company has contracted a third party portfolio accounting service vendor for valuation of its securities. The vendor's primary source for security valuation is Interactive Data Corporation ("IDC"), which evaluates securities based on market data. IDC utilizes evaluated pricing models that vary by asset class and include available trade, bid, and other market information.

Generally, the methodology includes broker quotes, proprietary models, vast descriptive terms and conditions databases, as well as extensive quality control programs.

The vendor utilized proprietary valuation matrices for valuing all municipal securities. The initial curves for determining the price, movement, and yield relationships within the municipal matrices are derived from industry benchmark curves or sourced from a municipal trading desk. The securities are further broken down according to issuer, credit support, state of issuance and rating to incorporate additional spreads to the industry benchmark curves.

Real estate owned is carried at the lower of carrying value or fair value less estimated selling costs. Upon foreclosure and through liquidation, we evaluate the property's fair value as compared to its carrying amount and record a valuation adjustment when the carrying amount exceeds fair value less selling costs. Any valuation adjustments at the time a loan becomes real estate owned is charged to the allowance for loan losses. Fair value is determined through an appraisal conducted by an independent, licensed appraiser outside of the Bank using observable market data. When evaluating fair value, management may discount the appraisal further if, based on their understanding of the market conditions, it is determined the collateral is further impaired below the appraised value (Level 3). Any subsequent valuation adjustments are applied to earnings in our consolidated statements of income. We recorded \$0 losses due to valuation adjustments on real estate owned within foreclosed property expense in non-interest expense in December 31, 2015 and 2014, respectively. The Company had no properties in real estate owned at December 31, 2015 and one property in real estate owned at December 31, 2014.

Restructured and impaired loans are generally valued based on the present value of expected future cash flows discounted at the loan's effective interest rate, unless in the case of collateral-dependent loans, the observable market price, or the fair value of the collateral can be readily determined. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Bank using observable market data. When evaluating fair value, management may discount the appraisal further if, based on their understanding of the market conditions, it is determined the collateral is further impaired below the appraised value (Level 3). The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business's financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Restructured and impaired loans are periodically reevaluated to determine if additional adjustments to the carrying value are necessary.

NOTE 19 – EARNINGS PER SHARE RECONCILIATION

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations.

	2015	2014	2013
Net Income available for common stock (numerator, basic)	\$ 13,214,821	\$ 11,211,850	\$ 11,091,007
Weighted average shares outstanding (denominator)	11,840,837	11,681,387	11,183,871
Income per common share - basic	\$ 1.12	\$ 0.96	\$ 0.99
Net income	\$ 13,214,821	\$ 11,211,850	\$ 11,091,007
Weighted average shares - diluted (denominator)	11,853,128	11,724,460	11,329,418
Income per common share - diluted	\$ 1.11	\$ 0.96	\$ 0.98
Dilutive effect - average number of common shares	12,291	43,073	67,099
Dilutive effect - average number of convertible non-cumulative perpetual preferred, if converted	—	—	78,448
Dilutive effect - average number of shares	12,291	43,073	145,547

Share and per share amounts have been restated to include the 11 for 10 stock dividend announced October 22, 2015 and payable December 4, 2015. The dilutive effect of stock options is 12,291, 43,073 and 67,099 shares for 2015, 2014 and 2013 respectively. The dilutive effect of the conversion to common stock of our convertible non-cumulative perpetual preferred stock was 78,448 in 2013. There were no anti-dilutive options excluded from the dilutive earnings per share calculation in 2015, 2014 and 2013.

NOTE 20 – SEGMENT REPORTING

Reportable segments include community banking and mortgage banking services. Community banking involves making loans to and generating deposits from individuals and businesses in the markets where the Bank has offices. Mortgage banking originates residential loans and subsequently sells them to investors. The mortgage banking segment is a strategic business unit that offers different products and services. It is managed separately because the segment appeals to different markets and, accordingly, requires different technology and marketing strategies.

The financial presentation for reportable segments has been modified to assist the reader in understanding the components of the segments. Funding for mortgage banking services' loans held for sale (LHFS) portfolio is provided by community banking services. For segmentation purposes the community banking segment charges the mortgage banking segment interest on average LHFS balances outstanding at a rate of the three month average 30 day London Interbank Offered Rate (LIBOR) plus 250 basis points.

The mortgage banking segment's most significant revenue and expense is non-interest income and non-interest expense, respectively. Under the mortgage banking segment we have broken out "forward rate commitments and unrealized hedge gain (loss)" because these represent changes in our derivative position. Our derivative position is impacted by the number and dollar volume of loans locked with a borrower but not closed, changes in the market value of notional security sales, and the delivery method utilized for closed but not committed loans.

In the event of early payment default, mortgage banking services has recorded a reserve for loan repurchases which was \$3,287,667 at December 31, 2015 and \$3,013,396 at December 31, 2014, which is not a part of our loan loss reserve and is carried in other liabilities. This reserve is an estimate of the potential for losses at any given time based on investor contracts and are not an indication such loss will occur.

The Bank does not have other reportable operating segments. The accounting policies of the segment are the same as those described in the summary of significant accounting policies. All inter-segment sales prices are market based.

Segment information for the years 2015, 2014 and 2013 is shown in the following table.

Selected Financial Information

Community Banking Segment Twelve Months Ended December 31,

Income:	2015	2014	2013
Interest income	\$ 45,674,497	\$ 41,252,559	\$ 43,282,961
Non-interest income	5,535,631	4,639,228	4,697,595
Total operating income	51,210,128	45,891,787	47,980,556
Expenses:			
Interest expense	(3,147,136)	(3,661,164)	(4,786,458)
Provision for loan losses	—	—	—
Personnel expense	(18,250,993)	(15,178,262)	(14,118,094)
Other non-interest expenses	(13,392,789)	(11,775,699)	(10,357,092)
Total operating expenses	(34,790,918)	(30,615,125)	(29,261,644)
Income before income taxes	16,419,210	15,276,662	18,718,912
Provision for income taxes	(5,947,629)	(5,530,091)	(6,449,951)
Less: Net income attributable to non-controlling interests	(62,957)	(29,287)	(47,305)
Net income attributable to community banking segment	\$ 10,408,624	\$ 9,717,284	\$ 12,221,656

Mortgage Banking Segment

Twelve Months Ended December 31,

Income:	2015	2014	2013
Interest income	\$ 5,963,440	\$ 4,866,818	\$ 7,021,186
Non-interest income	78,891,711	60,613,538	65,184,676
Total operating income	84,855,151	65,480,356	72,205,862
Expenses:			
Interest expense	(4,242,754)	(3,128,470)	(5,955,710)
Personnel expense	(57,829,528)	(42,980,683)	(48,339,087)
Other non-interest expenses	(18,698,351)	(17,440,014)	(18,096,545)
Total operating expenses	(80,770,633)	(63,549,167)	(72,391,342)
Net operating income	4,084,518	1,931,189	(185,480)
Forward rate commitments and hedge gain	486,700	721,277	—
Income before income taxes	4,571,218	2,652,466	(185,480)
Provision for income taxes	(1,655,859)	(960,182)	63,911
Less: Net income attributable to non-controlling interests	(128,830)	(197,718)	(1,009,080)
Net income (loss) attributable to mortgage banking segment	\$ 2,786,529	\$ 1,494,566	\$ (1,130,649)

Consolidated Statements of Income

Twelve Months Ended December 31,

Income:	2015	2014	2013
Interest income	\$ 47,395,183	\$ 42,990,907	\$ 44,348,437
Non-interest income	85,114,092	67,079,241	69,882,271
Total operating income	132,509,275	110,070,148	114,230,708
Expenses:			
Interest expense	(3,147,136)	(3,661,164)	(4,786,458)
Provision for loan losses	—	—	—
Personnel expense	(76,344,608)	(58,889,631)	(62,457,181)
Other non-interest expenses	(32,027,103)	(29,590,225)	(28,453,637)
Total operating expenses	(111,518,847)	(92,141,020)	(95,697,276)
Income before income taxes	20,990,428	17,929,128	18,533,432
Provision for income taxes	(7,583,820)	(6,490,273)	(6,386,040)
Less: Net income attributable to non-controlling interests	(191,787)	(227,005)	(1,056,385)
Net income attributable to Monarch Financial Holdings, Inc.	\$ 13,214,821	\$ 11,211,850	\$ 11,091,007

Elimination entries:

Interest income	(4,242,754)	(3,128,470)	(5,955,710)
Interest expense	4,242,754	3,128,470	5,955,710
Non-interest income	(686,750)	(1,825,475)	—
Personnel expense	264,087	730,686	—
Other non-interest expenses	(64,037)	374,512	—
Forward rate commitments and hedge gain	486,700	721,277	—

	Community Banking	Mortgage Banking	Elimination entries	Consolidated
Segment Assets				
December 31, 2015	\$ 996,432,802	\$ 192,062,857	\$ (27,047,504)	\$ 1,161,448,155
December 31, 2014	\$ 915,521,105	\$ 162,761,389	\$ (11,545,520)	\$ 1,066,736,974
Capital Expenditures				
December 31, 2015	\$ 1,359,215	\$ 424,271	\$ —	\$ 1,783,486
December 31, 2014	\$ 3,932,268	\$ 352,505	\$ —	\$ 4,284,773

NOTE 21 – CONDENSED PARENT COMPANY ONLY FINANCIAL INFORMATION

The condensed financial position as of December 31, 2015 and December 31, 2014 and the condensed results of operations and cash flows for Monarch Financial Holdings, Inc., parent company only, for the years ended December 31, 2015, 2014 and 2013 are presented below.

CONDENSED BALANCE SHEET

	December 31, 2015	December 31, 2014
ASSETS		
Cash	\$ 999,929	\$ 76,549
Investment in Monarch Bank	126,632,039	117,444,721
Investment in Trust	310,000	310,000
Other assets	1,511	1,436
Total assets	\$ 127,943,479	\$ 117,832,706
LIABILITIES AND STOCKHOLDERS' EQUITY		
Floating rate subordinated debenture (trust preferred securities)	\$ 10,310,000	\$ 10,310,000
Valuation adjustment for trust preferred securities	—	—
Due to related parties	—	71,373
Other liabilities	—	—
Total stockholders' equity	117,633,479	107,451,333
Total liabilities and stockholders' equity	\$ 127,943,479	\$ 117,832,706

CONDENSED STATEMENT OF INCOME STATEMENT AND COMPREHENSIVE INCOME

	December 31, 2015	December 31, 2014	December 31, 2013
INCOME			
Dividends from subsidiaries	\$ 3,956,969	\$ 3,710,806	\$ 2,932,006
Dividend from non-bank subsidiary	5,923	5,773	5,906
Total income	3,962,892	3,716,579	2,937,912
EXPENSES			
Interest on borrowings	196,994	422,017	552,548
Miscellaneous expense	—	14	2,500
Total expenses	196,994	422,031	555,048
INCOME BEFORE EQUITY IN UNDISTRIBUTED NET INCOME OF SUBSIDIARIES	3,765,898	3,294,548	2,382,864
Equity in undistributed net income of subsidiaries	9,448,923	7,917,302	8,708,143
NET INCOME	\$ 13,214,821	\$ 11,211,850	\$ 11,091,007

(1) Refer to the consolidated statements of comprehensive income for other comprehensive income details.

CONDENSED STATEMENTS OF CASH FLOWS

	December 31, 2015	December 31, 2014	December 31, 2013
Operating activities:			
Net income	\$ 13,214,821	\$ 11,211,850	\$ 11,091,007
Adjustments to reconcile net cash provided by operating activities:			
Equity in undistributed net income of subsidiaries	(9,448,923)	(7,917,302)	(8,708,143)
Stock-based compensation	833,251	824,497	593,721
Changes in:			
Other assets and other liabilities	135,800	(2,127,248)	3,209,616
Net cash from operating activities	4,734,949	1,991,797	6,186,201
Investing activities:			
None noted	—	—	—
Net cash from investing activities	—	—	—
Financing activities:			
Dividends paid on common stock	(3,765,897)	(3,294,562)	(2,440,096)
Cash in lieu of fractional shares on common stock dividend	(3,991)	—	(253)
Repurchase of common stock	(797,919)	—	—
Net (decrease) increase in short term borrowing	—	—	(5,000,000)
Proceeds from issuance of common stock	756,238	874,136	1,151,325
Net cash from financing activities	(3,811,569)	(2,420,426)	(6,289,024)
CHANGE IN CASH AND CASH EQUIVALENTS	923,380	(428,629)	(102,823)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	76,549	505,178	608,001
CASH AND CASH EQUIVALENTS AT END OF YEAR	\$ 999,929	\$ 76,549	\$ 505,178

NOTE 22 - SUBSEQUENT EVENTS - COMMON STOCK DIVIDEND

On January 26, 2016 the Company announced that the Board of Monarch Financial Holdings, Inc., had approved a quarterly cash dividend of \$0.09 per share for shareholders of record on February 12, 2016, payable on February 26, 2016. The total dollar value of this dividend was \$1,069,282.

MONARCH FINANCIAL HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF CONDITION

	(Unaudited) March 31, 2016	December 31, 2015
ASSETS:		
Cash and due from banks	\$ 13,184,880	\$ 13,945,507
Interest bearing bank balances	59,694,005	58,637,565
Federal funds sold	13,918,719	1,296,438
Total cash and cash equivalents	86,797,604	73,879,510
Investment securities available-for-sale, at fair value	26,869,270	30,213,130
Mortgage loans held for sale, net at fair value	189,131,150	169,345,205
Loans held for investment, net of unearned income	850,054,301	829,269,305
Less: allowance for loan losses	(8,901,032)	(8,887,199)
Loans, net	841,153,269	820,382,106
Property and equipment, net	28,354,996	28,971,862
Restricted equity securities	3,672,350	3,881,200
Bank owned life insurance	10,795,735	10,634,814
Goodwill	775,000	775,000
Other assets	24,957,994	23,365,328
Total assets	\$ 1,212,507,368	\$ 1,161,448,155
LIABILITIES:		
Deposits:		
Demand deposits—non-interest bearing	\$ 296,512,383	\$ 280,079,558
Demand deposits—interest bearing	69,752,990	68,963,364
Savings deposits	18,409,890	19,516,673
Money market savings	363,938,741	364,893,441
Time deposits	314,797,222	265,640,562
Total deposits	1,063,411,226	999,093,598
Borrowings:		
Trust preferred subordinated debt	10,000,000	10,000,000
Federal Home Loan Bank advances	—	16,000,000
Total borrowings	10,000,000	26,000,000
Other liabilities	18,055,588	18,632,147
Total liabilities	1,091,466,814	1,043,725,745
STOCKHOLDERS' EQUITY:		
Common stock, \$5 par value; 20,000,000 shares authorized; issued and outstanding - 11,877,309 shares (includes non-vested shares of 437,440) at March 31, 2016 and 11,880,909 shares (includes non-vested shares of 441,040) at December 31, 2015	57,199,345	57,199,345
Additional paid-in capital	17,457,044	17,241,281
Retained earnings	46,336,873	43,349,447
Accumulated other comprehensive loss	(54,070)	(156,594)
Total Monarch Financial Holdings, Inc. stockholders' equity	120,939,192	117,633,479
Non-controlling interest	101,362	88,931
Total equity	121,040,554	117,722,410
Total liabilities and stockholders' equity	\$ 1,212,507,368	\$ 1,161,448,155

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

MONARCH FINANCIAL HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	For the Three Months Ended March 31,	
	2016	2015
Interest income:		
Interest and fees on loans held for investment	\$ 10,689,745	\$ 9,840,336
Interest on mortgage loans held for sale	1,411,908	1,307,037
Interest on investment securities	110,358	88,915
Interest on federal funds sold	3,632	8,253
Dividends on equity securities	45,229	39,000
Interest on other bank accounts	156,954	102,029
Total interest income	12,417,826	11,385,570
Interest expense:		
Interest on deposits	854,044	668,060
Interest on trust preferred subordinated debt	55,689	46,415
Interest on borrowings	2,386	22,606
Total interest expense	912,119	737,081
Net interest income	11,505,707	10,648,489
Provision for loan losses	—	250,000
Net interest income after provision for loan losses	11,505,707	10,398,489
Non-interest income:		
Mortgage banking income	19,018,308	21,063,679
Service charges and fees	500,139	516,554
Title income	215,603	232,771
Investment and insurance income	478,576	344,126
(Loss) gain on disposition of property and equipment	(97)	35,011
Other	116,905	74,022
Total non-interest income	20,329,434	22,266,163
Non-interest expenses:		
Salaries and employee benefits	10,142,860	9,594,276
Commissions and incentives	7,730,892	9,445,138
Loan origination expense	1,793,662	2,458,663
Occupancy expense	2,273,481	2,288,508
Marketing expense	774,401	746,227
Data processing expense	613,954	629,750
Telephone	351,731	325,746
Professional fees	525,258	258,601
Foreclosed property expense	—	53,326
Other expenses	1,165,546	1,377,597
Total non-interest expenses	25,371,785	27,177,832
Income before income taxes	6,463,356	5,486,820
Income tax provision	(2,363,340)	(1,993,340)
Net income	4,100,016	3,493,480
Less: Net income attributable to non-controlling interests	(43,307)	(32,273)
Net income attributable to Monarch Financial Holdings, Inc.	\$ 4,056,709	\$ 3,461,207
Basic net income per share (1)	\$ 0.34	\$ 0.29
Diluted net income per share (1)	\$ 0.34	\$ 0.29

(1) Per share information has been restated in all periods to reflect the 11 for 10 stock dividend paid December 4, 2015.

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

MONARCH FINANCIAL HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

	Three Months Ended	
	March 31,	
	2016	2015
Net Income	\$ 4,100,016	\$ 3,493,480
Other comprehensive income:		
Change in unrealized gain on securities available for sale, net of income taxes	98,866	77,526
Change in unrealized gain on supplemental executive's retirement plan, net of income taxes	3,049	3,049
Change in unrealized gain on deferred compensation asset	609	7,238
Other comprehensive income	102,524	87,813
Total comprehensive income	4,202,540	3,581,293
Less: Comprehensive income attributable to non-controlling interests	(43,307)	(32,273)
Comprehensive income attributable to Monarch Financial Holdings, Inc.	\$ 4,159,233	\$ 3,549,020
Unrealized holding gain on securities available for sale	\$ 152,102	\$ 119,271
Income taxes	(53,236)	(41,745)
Net unrealized gain on securities available for sale	\$ 98,866	\$ 77,526
Unrealized gain on supplemental executive's retirement plan	\$ 4,691	\$ 4,691
Income taxes	(1,642)	(1,642)
Net unrealized gain on supplemental executive's retirement plan	\$ 3,049	\$ 3,049
Unrealized gain on deferred compensation asset	\$ 609	\$ 7,238
Income taxes	—	—
Net unrealized gain on deferred compensation asset	\$ 609	\$ 7,238

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

MONARCH FINANCIAL HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
(unaudited)

	Common Stock		Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Non- controlling Interest	Total
	Shares	Amount					
Balance—December 31, 2014	10,372,725	\$ 51,863,625	\$ 8,335,538	\$ 47,354,407	\$ (102,237)	\$ 85,984	\$ 107,537,317
Net income for the three months ended March 31, 2015				3,461,207		32,273	3,493,480
Other comprehensive income					87,813		87,813
Stock-based compensation expense, net of forfeitures and income taxes	—	—	171,643				171,643
Stock options exercised	17,272	86,360	47,786				134,146
Cash dividend declared on common stock (\$0.08 per share)				(858,261)			(858,261)
Distributions to non-controlling interests						(28,877)	(28,877)
Balance - March 31, 2015	<u>10,389,997</u>	<u>\$ 51,949,985</u>	<u>\$ 8,554,967</u>	<u>\$ 49,957,353</u>	<u>\$ (14,424)</u>	<u>\$ 89,380</u>	<u>\$ 110,537,261</u>
 Balance—December 31, 2015	11,439,869	\$ 57,199,345	\$ 17,241,281	\$ 43,349,447	\$ (156,594)	\$ 88,931	\$ 117,722,410
Net income for the three months ended March 31, 2016				4,056,709		43,307	4,100,016
Other comprehensive income					102,524		102,524
Stock-based compensation expense, net of forfeitures and income taxes	—	—	215,763				215,763
Cash dividend declared on common stock (\$0.09 per share)				(1,069,283)			(1,069,283)
Distributions to non-controlling interests						(30,876)	(30,876)
Balance - March 31, 2016	<u>11,439,869</u>	<u>\$ 57,199,345</u>	<u>\$ 17,457,044</u>	<u>\$ 46,336,873</u>	<u>\$ (54,070)</u>	<u>\$ 101,362</u>	<u>\$ 121,040,554</u>

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

MONARCH FINANCIAL HOLDINGS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

	Three Months Ended March 31,	
	2016	2015
Operating activities:		
Net income	\$ 4,100,016	\$ 3,493,480
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Provision for loan losses	—	250,000
Depreciation	722,952	723,205
Accretion of discounts and amortization of premiums, net	1,549	684
Deferral of loan fees, net of deferred (costs)	18,023	147,656
Stock-based compensation	215,763	171,643
Appreciation of bank-owned life insurance	(39,989)	(67,954)
Net loss (gain) on disposition of property and equipment	97	(35,011)
Net loss on sale of other real estate	—	38,879
Deferred income tax expense	2,363,340	334,565
Changes in:		
Loans held for sale	(19,785,945)	(12,208,390)
Interest receivable	(62,752)	(129,050)
Other assets	(1,578,450)	(3,310,447)
Other liabilities	(2,944,471)	554,788
Net cash used in operating activities	<u>(16,989,867)</u>	<u>(10,035,952)</u>
Investing activities:		
Purchases of available-for-sale securities	—	(2,000,000)
Proceeds from sales and maturities of available-for-sale securities	3,500,393	5,561,191
Proceeds from sale of other real estate	—	105,121
Purchase of bank owned life insurance and company owned life insurance	(120,932)	(225,000)
Purchases of premises and equipment	(108,633)	(536,468)
Redemption of restricted equity securities	208,850	389,600
Loan originations, net of principal repayments	(20,789,186)	(15,216,358)
Net cash used in investing activities	<u>(17,309,508)</u>	<u>(11,921,914)</u>
Financing activities:		
Net increase in non-interest-bearing deposits	16,432,825	35,145,090
Net increase in interest-bearing deposits	47,884,803	82,580,062
Cash dividends paid on common stock	(1,069,283)	(858,261)
Net decrease in FHLB advances and federal funds purchased	(16,000,000)	(10,024,998)
Distributions to non-controlling interests	(30,876)	(28,877)
Proceeds from exercise of stock options	—	134,146
Net cash provided by financing activities	<u>47,217,469</u>	<u>106,947,162</u>
CHANGE IN CASH AND CASH EQUIVALENTS	<u>12,918,094</u>	<u>84,989,296</u>
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	<u>73,879,510</u>	<u>65,428,974</u>
CASH AND CASH EQUIVALENTS AT END OF PERIOD	<u>\$ 86,797,604</u>	<u>\$ 150,418,270</u>
SUPPLEMENTAL SCHEDULES AND CASH FLOW INFORMATION		
Cash paid for:		
Interest on deposits and other borrowings	\$ 945,414	\$ 716,831
Income taxes	\$ —	\$ 1,239,900
Loans transferred to foreclosed real estate during the year	\$ —	\$ 100,000
Unrealized gain on securities available for sale	\$ 152,102	\$ 119,271
Unrealized gain on supplemental executive's retirement plan	\$ 4,691	\$ 4,691
Unrealized gain on deferred compensation asset	\$ 609	\$ 7,238

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

MONARCH FINANCIAL HOLDINGS, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. BASIS OF PRESENTATION

In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments consisting of normal recurring accruals necessary to present fairly Monarch Financial Holdings, Inc.'s financial position as of March 31, 2016; the consolidated statements of income for the three months ended March 31, 2016 and 2015; the consolidated statements of comprehensive income for the three months ended March 31, 2016 and 2015; the consolidated statements of changes in stockholders' equity for the three months ended March 31, 2016 and 2015; and the consolidated statements of cash flows for the three months ended March 31, 2016 and 2015. These financial statements have been prepared in accordance with the instructions to Form 10-Q and therefore, do not include all of the disclosures required by generally accepted accounting principles. The financial statements include the accounts of Monarch Financial Holdings, Inc. and its subsidiaries, and all significant inter-company accounts and transactions have been eliminated. Operating results for the three month period ended March 31, 2016 are not necessarily indicative of the results that may be expected for the year ended December 31, 2016.

Recent Accounting Pronouncements

In August 2014, the FASB issued ASU No. 2014-15, "Presentation of Financial Statements - Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern." This update is intended to provide guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. Management is required under the new guidance to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date the financial statements are issued when preparing financial statements for each interim and annual reporting period. If conditions or events are identified, the ASU specifies the process that must be followed by management and also clarifies the timing and content of going concern footnote disclosures in order to reduce diversity in practice. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. Early adoption is permitted. The Company does not expect the adoption of ASU 2014-15 to have a material impact on its consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." The amendments in ASU 2016-01, among other things: 1) Requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. 2) Requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. 3) Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables). 4) Eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The amendments in this ASU are effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently assessing the impact that ASU 2016-01 will have on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Company is currently assessing the impact that ASU 2016-02 will have on its consolidated financial statements.

During March 2016, the FASB issued ASU No. 2016-05, "Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships." The amendments in this ASU clarify that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedge accounting criteria remain intact. The amendments are effective for public business entities for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within

those fiscal years. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of ASU 2016-05 to have a material impact on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-07, "Investments - Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting." The amendments in this ASU eliminate the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The amendments require that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor's previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required. In addition, the amendments in this ASU require that an entity that has an available-for-sale equity security that becomes qualified for the equity method of accounting recognize through earnings the unrealized holding gain or loss in accumulated other comprehensive income at the date the investment becomes qualified for use of the equity method. The amendments are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Early Adoption is permitted. The Company does not expect the adoption of ASU 2016-07 to have a material impact on its consolidated financial statements.

During March 2016, the FASB issued ASU No. 2016-09, "Compensation - Stock Compensation (Topic 718): Improvements to Employee Shares-Based Payment Accounting." The amendments in this ASU simplify several aspects of the accounting for share-based payment award transactions including: (a) income tax consequences; (b) classification of awards as either equity or liabilities; and (c) classification on the statement of cash flows. The amendments are effective for public companies for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Company is currently assessing the impact that ASU 2016-09 will have on its consolidated financial statements.

NOTE 2. GENERAL

Monarch Financial Holdings, Inc. (the "Company" or "Monarch") is a Virginia-chartered, single bank holding company engaged in business and consumer banking, investment and insurance sales, and mortgage origination and brokerage. The Company was created on June 1, 2006 through a reorganization plan, under the laws of the Commonwealth of Virginia, in which Monarch Bank (the "Bank") became a wholly-owned subsidiary. Monarch Bank was incorporated on May 1, 1998, and opened for business on April 14, 1999. The Company's corporate office and main office are both located in the Greenbrier area of Chesapeake. In addition there are nine other Virginia banking offices – in the Great Bridge area in Chesapeake, the Lynnhaven area, the Town Center area, the Oceanfront area, the Kempsville area, and the Hilltop area in Virginia Beach, the Ghent area and in the downtown area in Norfolk, and the New Town area in Williamsburg. In North Carolina, our banking division operates as OBX Bank through two offices in Kitty Hawk and Nags Head. In July 2014, the Company closed its branch located in Suffolk, Virginia.

In August 2001, we formed Monarch Investment, LLC, to enable us to offer additional services to our clients. The Bank owns 100% of Monarch Investment, LLC. In August 2012, the Company formed an affiliation with Raymond James Financial Services, Inc., a broker-dealer headquartered in St. Petersburg, Florida, and launched Monarch Bank Private Wealth ("MBPW"). MBPW is a division of Monarch Bank that offers private banking to high net worth individuals. In addition, through its affiliation with Raymond James Financial Services, Inc., MBPW is able to offer these same individuals financial planning, trust and investment services. Monarch Investment, LLC, continues to provide non-deposit investment services under the name of Monarch Investments.

In January 2003, Monarch Investment, LLC, purchased a non-controlling interest in Bankers Insurance, LLC, in a joint venture with the Virginia Bankers Association and many other community banks. Bankers Insurance, LLC, is a full service property/casualty and life/health insurance agency that ranks as one of the largest agencies in Virginia. Bankers Insurance, LLC, provides insurance to our customers and to the general public.

In February 2004, we formed Monarch Capital, LLC, for the purpose of engaging in the commercial real estate brokerage business. The Bank owns 100% of Monarch Capital, LLC.

In May 2007, Monarch expanded banking operations into northeastern North Carolina with the opening of a banking office in the town of Kitty Hawk, under the name of OBX Bank (OBX). We opened a second office in the town of Nags Head in December 2009. OBX Bank, which operates as a division of Monarch, is led by a local management team and a local advisory board of directors.

In June 2007, we announced the expansion of mortgage operations through the acquisition of a team of experienced mortgage bankers, and the formation of a division operating as Monarch Mortgage ("MM"). MM originates and sells conventional, FHA,

VA and VHDA residential loans and offers additional mortgage products such as construction-permanent loans for the Bank's loan portfolio. Monarch Mortgage's primary office is in Virginia Beach with additional offices in Abingdon, Alexandria, Chesapeake, Fairfax, Fredericksburg, Glen Allen, Midlothian, Norfolk, Newport News, Oakton, and Woodbridge, Virginia; Annapolis, Bel Air, Crofton, Dunkirk, Frederick, Greenbelt, Rockville, Towson and Waldorf, Maryland; Charlotte, Fayetteville, Indian Trail, Kitty Hawk, Mint Hill, Mooresville, Nags Head, Pittsboro, and Wilmington, North Carolina; and Greenwood, South Carolina.

In July 2007, Monarch Investment, LLC, purchased a 50.01% ownership in Coastal Home Mortgage, LLC, from another bank. This joint venture provides residential loan services through Monarch Mortgage. The 49.99% ownership is shared by two companies involved in commercial and residential construction in the Hampton Roads area.

In October 2007, Monarch Investment, LLC, formed a title insurance company, Real Estate Security Agency, LLC (RESA), along with TitleVentures, LLC. Monarch Investment, LLC, owns 75% of RESA and TitleVentures, LLC, owns 25%. RESA offers residential and commercial title insurance to the clients of Monarch Mortgage and Monarch Bank.

In March 2011, Monarch Investment, LLC formed Crossways Holdings, LLC in Chesapeake, Virginia. Crossways Holdings, LLC is a single member limited liability company, formed for the purpose of acquiring, maintaining, utilizing and disposing of assets for Monarch Bank.

In January 2015, Monarch Investment, LLC purchased a non-controlling interest in Atlantic Real Estate Capital, a commercial real estate brokerage business located in Richmond, Virginia.

Proposed Merger with TowneBank

On December 17, 2015, the Company and Bank entered into a definitive agreement with TowneBank ("Towne"), pursuant to which Towne will acquire all of the common stock of Monarch in a stock transaction valued at approximately \$221 million, based on Towne's closing price December 16, 2015. Upon completion of the transaction, Town is expected to have approximately \$7.3 billion in assets, \$5.4 billion in loans and \$5.8 billion in deposits.

Under the terms of the agreement, which has been approved by the Board of Directors of both companies, Monarch shareholders will be entitled to receive 0.8830 shares of Towne common stock for each share of Monarch stock at the closing date. The transaction, which is subject to regulatory approval, the approval of the shareholders of Monarch and Towne, and other customary conditions, is expected to close in the second quarter of 2016.

NOTE 3. EARNINGS PER SHARE ("EPS")

Basic earnings per share (EPS) excludes dilution and is computed by dividing income available to common shareholders by the weighted-average number of shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised, converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. Non-vested restricted stock is included in the weighted average number of shares for both the basic and diluted earnings computations. The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations.

	For the Quarter Ended March 31,	
	2016	2015
Net income available to common shareholders (numerator, basic)	\$ 4,056,709	\$ 3,461,207
Weighted average shares outstanding - basic (denominator)	11,880,553	11,801,379
Income per common share—basic	\$ 0.34	\$ 0.29
Net income (numerator, diluted)	\$ 4,056,709	3,461,207
Weighted average shares—diluted (denominator)	11,880,553	11,837,888
Income per common share—diluted	\$ 0.34	\$ 0.29
Dilutive effect-average number of common shares	—	36,509

There were no options to purchase common stock excluded from the computation of earnings per common share for the three months ended March 31, 2016 or March 31, 2015. No options to purchase common stock remain outstanding at March 31, 2016.

Share and per share amounts for the quarter ended March 31, 2015 have been restated to include the 11 for 10 stock dividend announced October 22, 2015 and paid December 4, 2015.

NOTE 4. ACCUMULATED OTHER COMPREHENSIVE INCOME(LOSS)

The following table presents the changes in accumulated other comprehensive income (loss), by category, net of tax:

	Unrealized Loss on Supplemental Executive's Retirement Plan	Unrealized Gains (Loss) on Securities	Unrealized Loss on Deferred Compensation Asset	Accumulated Other Comprehensive Income (Loss)
December 31, 2015	\$ (121,970)	\$ (34,589)	\$ (35)	\$ (156,594)
Net change for the quarter ended March 31, 2016	3,049	98,866	609	102,524
Balance at March 31, 2016	\$ (118,921)	\$ 64,277	\$ 574	\$ (54,070)
Balance at December 31, 2014	\$ (134,167)	\$ 31,721	\$ 209	\$ (102,237)
Net change for the quarter ended March 31, 2015	3,049	77,526	7,238	87,813
Balance at March 31, 2015	\$ (131,118)	\$ 109,247	\$ 7,447	\$ (14,424)

An unrealized gain of \$609 on the deferred compensation asset associated with the Company's Executive Benefits Plan was recorded in other comprehensive income in the first quarter of 2016. An unrealized gain of \$7,238 on the deferred compensation asset associated with the Company's Executive Benefits Plan was recorded in other comprehensive income in the first quarter of 2015. Expenses totaling \$3,049 related to the SERP were re-classed out of other comprehensive income into salaries and employee benefits expense in earnings during the first quarter of 2016 and 2015.

NOTE 5. INVESTMENT SECURITIES

Securities available-for-sale consist of the following:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
March 31, 2016				
U.S. government agency obligations	\$ 22,924,198	\$ 33,471	\$ (38,317)	\$ 22,919,352
Mortgage-backed securities	946,946	9,596	(1,703)	954,839
Municipal securities	2,899,239	95,840	—	2,995,079
	<u>\$ 26,770,383</u>	<u>\$ 138,907</u>	<u>\$ (40,020)</u>	<u>\$ 26,869,270</u>
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2015				
U.S. government agency obligations	\$ 26,376,230	\$ 17,635	\$ (157,620)	\$ 26,236,245
Mortgage-backed securities	995,360	6,216	(3,187)	998,389
Municipal securities	2,900,734	90,294	(12,532)	2,978,496
	<u>\$ 30,272,324</u>	<u>\$ 114,145</u>	<u>\$ (173,339)</u>	<u>\$ 30,213,130</u>

Monarch did not own any held-to-maturity securities at March 31, 2016 or December 31, 2015.

The amortized cost and fair value of securities by contractual maturity date at March 31, 2016 were as follows:

Securities available-for-sale:	Amortized Cost	Fair Value
Due in one year or less	\$ 600,000	\$ 600,962
Due from one to five years	23,938,786	23,942,736
Due from five to ten years	793,137	831,160
Due after ten years	1,438,460	1,494,412
Total	<u>\$ 26,770,383</u>	<u>\$ 26,869,270</u>

There were twenty investments in our securities portfolio with unrealized losses as of March 31, 2016.

As of March 31, 2016	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. government agency obligations	\$ 12,468,032	\$ (31,968)	\$ 2,993,651	\$ (6,349)	\$ 15,461,683	\$ (38,317)
Mortgage-backed securities	378,113	(1,703)	—	—	378,113	(1,703)
Municipal securities	—	—	—	—	—	—
Total	<u>\$ 12,846,145</u>	<u>\$ (33,671)</u>	<u>\$ 2,993,651</u>	<u>\$ (6,349)</u>	<u>\$ 15,839,796</u>	<u>\$ (40,020)</u>

There were twenty-eight investments in our securities portfolio that had unrealized losses as of December 31, 2015.

As of December 31, 2015	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. government agency obligations	\$ 15,761,617	\$ (134,401)	\$ 2,976,782	\$ (23,219)	\$ 18,738,399	\$ (157,620)
Mortgage-backed securities	684,506	(3,187)	—	—	684,506	(3,187)
Municipal securities	498,715	(1,285)	504,170	(11,247)	1,002,885	(12,532)
Total	<u>\$ 16,944,838</u>	<u>\$ (138,873)</u>	<u>\$ 3,480,952</u>	<u>\$ (34,466)</u>	<u>\$ 20,425,790</u>	<u>\$ (173,339)</u>

As of March 31, 2016, six investments have been in a continuous unrealized loss position for more than twelve months. They are as follows:

	Count	Amortized Cost	Fair Value
U.S. government agency obligations	6	\$ 3,000,000	\$ 2,993,651
Total	6	\$ 3,000,000	\$ 2,993,651

At December 31, 2015, seven investments had been in a continuous unrealized loss position for more than twelve months. They were as follows:

	Count	Amortized Cost	Fair Value
U.S. government agency obligations	6	\$ 3,000,000	\$ 2,976,782
Municipal securities	1	515,417	504,170
Total	7	\$ 3,515,417	\$ 3,480,952

There were no realized gains or losses recorded on available-for-sale investments during the first quarter of 2016. We recorded \$22,801 in realized gains on available-for-sale investments in 2015.

We have the ability to carry these investments to the final maturity of the instruments. Other-than-temporarily impaired (OTTI) guidance for investments states that an impairment is OTTI if any of the following conditions exist: the entity intends to sell the security; it is more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis; or, the entity does not expect to recover the security's entire amortized cost basis (even if the entity does not intend to sell). An impaired security identified as OTTI should be separated and losses should be recognized in earnings.

We believe the unrealized losses in our portfolio are temporary impairments, caused by liquidity discounts and increases in the risk premiums required by market participants, rather than adverse changes in cash flows or fundamental weaknesses in the credit quality of the issuer or underlying assets as of March 31, 2016. There were no losses related to OTTI recognized in accumulated other comprehensive loss at either March 31, 2016 or December 31, 2015.

NOTE 6. LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSS

The following table provides a breakdown, by class of our loans held for investment at March 31, 2016 and December 31, 2015.

Loans held for Investment

	March 31, 2016	December 31, 2015
Commercial	\$ 156,582,498	\$ 158,072,698
Real estate		
Construction	209,408,683	190,422,992
Residential (1-4 family)	116,380,071	113,278,318
Home equity lines	58,221,283	59,097,607
Multifamily	9,503,347	11,590,641
Commercial	294,316,513	290,531,083
Real estate subtotal	687,829,897	664,920,641
Consumers		
Consumer and installment loans	5,813,500	6,356,473
Overdraft protection loans	48,153	121,217
Loans to individuals subtotal	5,861,653	6,477,690
Total gross loans	850,274,048	829,471,029
Unamortized loan fees net of deferred costs	(219,747)	(201,724)
Loans held for investment, net of unearned income	850,054,301	829,269,305
Allowance for loan losses	(8,901,032)	(8,887,199)
Total net loans	\$ 841,153,269	\$ 820,382,106

We have certain lending policies and procedures in place designed to balance loan growth and income with an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, credit concentrations, policy exceptions, loan delinquencies and non-performing and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions.

Our loan portfolio is divided into three loan types; commercial, real estate and consumer. Some of these loan types are further broken down into segments. The commercial loan portfolio, which is not broken down further, includes commercial and industrial loans which are usually secured by the assets being financed or other business assets. The real estate portfolio is broken down into construction, residential 1-4 family, home equity lines, multifamily, and commercial real estate loan segments. The consumer loan portfolio is segmented into consumer and installment loans and overdraft protection loans.

Commercial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and prudently expand their business. Underwriting standards are designed to promote relationship banking rather than transactional banking. Once it is determined the borrower's management possesses sound ethics and solid business acumen, we examine current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and normally incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial loans, in addition to those of real estate loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation or sale of the income producing property securing the loan, or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing our commercial real estate portfolio are diverse in terms of type. This diversity helps reduce our exposure to adverse economic events that could affect any single market or industry. Management monitors and evaluates commercial real estate loans based on purpose, collateral, geography, cash flow, loan to value, and risk grade criteria. As a general rule, we avoid financing special purpose projects unless other underwriting factors are present to help

mitigate risk. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At March 31, 2016 approximately 43% and at December 31, 2015 approximately 40% of the outstanding principal balance of our commercial real estate loans portfolio was secured by owner-occupied properties.

With respect to loans to developers and builders, secured by non-owner occupied properties we may originate from time to time, we generally require the borrower to have an existing relationship with the Company and a record of success. Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews, sensitivity analysis of absorption and lease rates and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and value associated with the complete project. These estimates may be inaccurate. Construction loans often involve the disbursement of considerable funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, supply and demand, government regulation of real property, general economic conditions and the availability of long-term financing.

We generally require multifamily real estate loan borrowers to have an existing relationship with the Company, a record of success and guarantor financial strength, commensurate with the project size. The underlying feasibility of a multifamily project is stress tested for sensitivity to both capitalization and interest rate changes. Each project is underwritten separately and additional underwriting standards are required for the guarantors, which include, but are not limited to, a maximum loan-to-value percentage, global cash flow analysis and contingent liability analysis. Sources of repayment for these types of loans may be rent rolls or sales of the developed property, either by unit or as a whole.

Consumer and residential loan originations utilize analytics to supplement the underwriting process. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed. This monitoring, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk. Additionally, trend, sensitivity analysis, shock analysis and outlook reports are reviewed by management on a regular basis. Underwriting standards for home equity loans are heavily influenced by statutory requirements, which include, but are not limited to, a maximum loan-to-value percentage, collection remedies, the number of such loans a borrower can have at one time and documentation requirements.

We perform periodic reviews on various segments of our loan portfolio in addition to presenting our larger loan relationships for loan committee review. We utilize an independent company to perform a periodic review to evaluate and validate our credit risk program. Results of these reviews are presented to management and our board. Additionally, we are subject to annual examination by our regulators. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as our policies and procedures.

We have an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. This methodology begins with a look at the three loan types; commercial, real estate, and consumer. Loans within the commercial and real estate categories are evaluated on an individual or relationship basis and assigned a risk grade based on the characteristics of the loan or relationship. Loans within the consumer type are assigned risk grades and evaluated as a pool, unless specifically identified through delinquency or other signs of credit deterioration, at which time the identified loan would be individually evaluated.

We designate loans within our loans held for investment portfolio as either "pass" or "watch list" based on nine numerical risk grades which are assigned to the loans. A loan classified as "pass" is fundamentally sound with risk factors that are considered reasonable and acceptable. Loans classified as "watch list" fall into two categories; special mention and substandard. Special mention loans are the highest level of "watch list". These loans have the capacity to perform but contain certain characteristics that require continual supervision and attention from the lender. Loans classified as substandard typically have a well-defined weakness or weaknesses that could jeopardize the orderly liquidation of the debt, leaving the Bank with potential exposure to loss. The numeric designations in the "pass" category, from highest to lowest are: minimal, modest, average, acceptable, and acceptable with care. The "watch list" category from highest to lowest are: special mention, substandard, doubtful and loss.

"Pass"

- 1 Minimal
- 2 Modest
- 3 Average
- 4 Acceptable
- 5 Acceptable with care

"Watch List"

- 6 Special mention
- 7 Substandard
- 8 Doubtful
- 9 Loss

Special mention loans and substandard loans may or may not be classified as nonaccrual, based on current performance. A loan risk graded as doubtful is classified as nonaccrual. A loan risk graded as loss is generally charged-off when identified. There were no loans in our portfolio classified as doubtful or loss at March 31, 2016 or December 31, 2015. Watch list graded loans or relationships are evaluated individually to determine if all, or a portion, of our investment in the borrower is at risk. If a risk is quantified, a specific loss allowance is assigned to the identified loan or relationship. We evaluate our investment in the borrower using either the present value of expected future cash flows, discounted at the historical effective interest rate of the loan, or for a collateral-dependent loan, the fair value of the underlying collateral.

We evaluate additional risk inherent in our satisfactory risk grade groups through a methodology that looks at these loans on a pool basis by loan segment which is further delineated by purpose. Each segment is assigned an expected loss factor based on a moving average "look-back" at our historical losses for that particular segment. At March 31, 2016 and December 31, 2015 the "look-back" period was twenty quarters. We believe this methodology provides an accurate evaluation of the potential risk in our portfolio because delineation by purpose establishes a direct correlation to areas of weakness and strength within the portfolio.

Additional metrics, in the form of environmental risk factors, may be applied to a specific class or risk grade of loans within the portfolio based on local or national trends, identifiable events or other economic factors. For the periods presented, five internal and four external environmental factors were applied to the general risk grade groups. The five internal factors are specific to Monarch with regard to lending policies and practices, nature, volume and term of various portfolios, experience level and depth of management, changes in loan quality and concentrations of credits. The four external environmental factors focus on legal and regulatory impacts, changes in economic conditions, competitive pressures and uncertainties surrounding pending governmental actions and their impact on areas within our footprint. The assumptions used to determine the allowance are reviewed to ensure their theoretical foundation, data integrity, computational processes, and reporting practices are appropriate and properly documented.

We utilize various sources in assessing the economic conditions in our target markets and areas of concentration. We track unemployment trends in both Hampton Roads and Virginia compared to the national average. We monitor trends in our industry and among our peers through reports such as the Uniform Bank Performance Report which are made available to us through the Federal Financial Institutions Examination Council. Additionally, we utilize various industry sources that include information published by CB Richard Ellis, an international firm specializing in commercial real estate reporting and Costar, a provider of commercial real estate information and analytics to monitor local, state and national trends.

We evaluate the adequacy of our allowance for loan losses quarterly. A degree of imprecision or uncertainty is inherent in our allowance estimates because it requires that we incorporate a range of probable outcomes which may change from period to period. It requires that we exercise judgment as to the risks inherent in our portfolios, economic uncertainties, historical loss and other subjective factors, including industry trends. No single statistic or measurement determines the adequacy of the allowance for loan loss. Changes in the allowance for loan loss and the related provision expense can materially affect net income.

The following table segregates our portfolio between pass and watch list loans, delineated by segments, within loan type for March 31, 2016 and December 31, 2015. The "Weighted Average Risk Grade" looks at the dollar value per risk grade within a segment compared to the total value of that segment. All segments fall within the average to acceptable range.

March 31, 2016					
	Pass	Watch List		Total	Weighted Average Risk Grade
		Special Mention	Substandard		
Commercial	\$ 155,809,274	\$ 616,174	\$ 157,050	\$ 156,582,498	3.25
Real estate					
Construction	208,218,113	837,448	353,122	209,408,683	3.17
Residential (1-4 family)	111,566,983	1,626,704	3,186,384	116,380,071	3.67
Home equity lines	56,846,979	—	1,374,304	58,221,283	4.14
Multifamily	9,503,347	—	—	9,503,347	3.31
Commercial	291,299,163	2,005,623	1,011,727	294,316,513	3.36
Real estate subtotal	677,434,585	4,469,775	5,925,537	687,829,897	3.42
Consumers					
Consumer and installment loans	5,750,898	—	62,602	5,813,500	4.03
Overdraft protection loans	48,153	—	—	48,153	4.26
Loans to individuals subtotal	5,799,051	—	62,602	5,861,653	4.03
Total gross loans	\$ 839,042,910	\$ 5,085,949	\$ 6,145,189	\$ 850,274,048	3.39
December 31, 2015					
	Pass	Watch List		Total	Weighted Average Risk Grade
		Special Mention	Substandard		
Commercial	\$ 157,818,177	\$ 233,073	\$ 21,448	\$ 158,072,698	3.24
Real estate					
Construction	189,254,940	710,758	457,294	190,422,992	3.18
Residential (1-4 family)	108,692,612	1,075,477	3,510,229	113,278,318	3.71
Home equity lines	57,657,772	—	1,439,835	59,097,607	4.15
Multifamily	11,590,641	—	—	11,590,641	3.56
Commercial	288,533,180	1,007,152	990,751	290,531,083	3.39
Real estate subtotal	655,729,145	2,793,387	6,398,109	664,920,641	3.46
Consumers					
Consumer and installment loans	6,291,430	—	65,043	6,356,473	4.03
Overdraft protection loans	118,690	—	2,527	121,217	4.76
Loans to individuals subtotal	6,410,120	—	67,570	6,477,690	4.04
Total gross loans	\$ 819,957,442	\$ 3,026,460	\$ 6,487,127	\$ 829,471,029	3.42

An aging of our loan portfolio by class as of March 31, 2016 and December 31, 2015 is as follows:

Age Analysis of Past Due Loans

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Recorded Investment > 90 days and Accruing	Recorded Investment Nonaccrual Loans
March 31, 2016							
Commercial	\$ 26,963	\$ —	\$ —	\$ 26,963	\$ 156,555,535	\$ —	\$ —
Real estate							
Construction	—	—	—	—	209,408,683	—	—
Residential (1-4 family)	2,493,943	—	471,347	2,965,290	113,414,781	104,285	991,340
Home equity lines	357,282	350,502	249,987	957,771	57,263,512	—	481,562
Multifamily	—	—	—	—	9,503,347	—	—
Commercial	—	—	370,757	370,757	293,945,756	—	370,757
Real estate subtotal	2,851,225	350,502	1,092,091	4,293,818	683,536,079	104,285	1,843,659
Consumers							
Consumer and installment loans	32,989	8,826	—	41,815	5,771,685	—	—
Overdraft protection loans	—	—	—	—	48,153	—	—
Loans to individuals subtotal	32,989	8,826	—	41,815	5,819,838	—	—
Total gross loans	\$ 2,911,177	\$ 359,328	\$ 1,092,091	\$ 4,362,596	\$ 845,911,452	\$ 104,285	\$ 1,843,659
December 31, 2015							
Commercial	\$ 99,291	\$ —	\$ 21,448	\$ 120,739	\$ 157,951,959	\$ —	\$ 21,448
Real estate							
Construction	—	101,677	—	101,677	190,321,315	—	101,677
Residential (1-4 family)	1,195,961	31,885	622,770	1,850,616	111,427,702	248,326	1,008,650
Home equity lines	316,425	—	249,987	566,412	58,531,195	—	483,859
Multifamily	—	—	—	—	11,590,641	—	—
Commercial	—	153,349	220,775	374,124	290,156,959	—	374,125
Real estate subtotal	1,512,386	286,911	1,093,532	2,892,829	662,027,812	248,326	1,968,311
Consumers							
Consumer and installment loans	97,135	56,287	—	153,422	6,203,051	—	—
Overdraft protection loans	64	—	—	64	121,153	—	—
Loans to individuals subtotal	97,199	56,287	—	153,486	6,324,204	—	—
Total gross loans	\$ 1,708,876	\$ 343,198	\$ 1,114,980	\$ 3,167,054	\$ 826,303,975	\$ 248,326	\$ 1,989,759

At March 31, 2016, we had nine loans totaling \$3,073,874 classified as restructured loans: two commercial real estate loans totaling \$1,547,792, six residential 1-4 family loans totaling \$1,463,480, and one consumer loan for \$62,602. At March 31, 2016, three of the residential 1-4 family loans totaling \$685,009 and one of the commercial real estate loans totaling \$218,208 included in our restructured loans are classified as nonaccrual. The remaining five loans are performing. We restructured one loan during the first quarter of 2016 and zero loans during the same period of 2015. We did not have any defaults on restructured loans within twelve months of restructuring during the quarter ended March 31, 2016 or 2015.

Additional information on loans restructured during the three months ended March 31, 2016 is as follows:

Troubled Debt Restructurings

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Type of Concession
Quarter Ended March 31, 2016	One	\$98,787	\$98,787	Rate and Term
Quarter Ended March 31, 2015	None	—	—	—

Troubled Debt Restructurings That Subsequently Defaulted

	Number of Contracts	Recorded Investment
Quarter Ended March 31, 2016	None	—
Quarter Ended March 31, 2015	None	—

A summary of the activity in the allowance for loan losses account is as follows:

Allocation of the Allowance for Loan Losses

March 31, 2016	Real Estate					
	Commercial	Construction	Residential	Home Equity	Multifamily	Commercial
Allowance for loan losses:						
Beginning balance	\$ 855,813	\$ 1,797,301	\$ 1,876,528	\$ 1,654,545	\$ 52,158	\$ 2,177,890
Charge-offs	—	—	(16,919)	—	—	—
Recoveries	2,800	4,023	3,820	26,217	—	—
Provision	62,291	53,086	(9,819)	(153,113)	(9,393)	7,633
Ending balance	\$ 920,904	\$ 1,854,410	\$ 1,853,610	\$ 1,527,649	\$ 42,765	\$ 2,185,523
 Individually evaluated for impairment	\$ 49,051	\$ 25,291	\$ 585,786	\$ 633,148	\$ —	\$ 640,384
Collectively evaluated for impairment	871,853	1,829,119	1,267,824	894,501	42,765	1,545,139
Loans:						
Ending balance	\$ 156,582,498	\$ 209,408,683	\$ 116,380,071	\$ 58,221,283	\$ 9,503,347	\$ 294,316,513
Ending balance: individually evaluated for impairment	157,051	1,042,070	3,555,423	1,374,304	—	2,914,022
Ending balance: collectively evaluated for impairment	\$ 156,425,447	\$ 208,366,613	\$ 112,824,648	\$ 56,846,979	\$ 9,503,347	\$ 291,402,491

	Consumers			
	Consumer and Installment loans	Overdraft Protection	Unallocated	Total
Allowance for loan losses:				
Beginning balance	\$ 96,025	\$ 3,037	\$ 373,902	\$ 8,887,199
Charge-offs	(3,581)	(2,527)	—	(23,027)
Recoveries	—	—	—	36,860
Provision	1,136	(304)	48,483	—
Ending balance	\$ 93,580	\$ 206	\$ 422,385	\$ 8,901,032
 Individually evaluated for impairment	\$ 62,602	\$ —	\$ —	\$ 1,996,262
Collectively evaluated for impairment	30,978	206	422,385	6,904,770
Loans:				
Ending balance	\$ 5,813,500	\$ 48,153	\$ —	\$ 850,274,048
Ending balance: individually evaluated for impairment	62,602	—	—	9,105,472
Ending balance: collectively evaluated for impairment	\$ 5,750,898	\$ 48,153	\$ —	\$ 841,168,576

December 31, 2015	Real Estate					
	Commercial	Construction	Residential	Home Equity	Multifamily	Commercial
Allowance for loan losses:						
Beginning balance	\$ 1,157,867	\$ 1,678,022	\$ 2,456,418	\$ 1,911,634	\$ 85,056	\$ 1,458,664
Charge-offs	(207,059)	(17,500)	(658,953)	(70,042)	—	—
Recoveries	599,359	69,624	27,941	194,861	—	—
Provision	(694,354)	67,155	51,122	(381,908)	(32,898)	719,226
Ending balance	\$ 855,813	\$ 1,797,301	\$ 1,876,528	\$ 1,654,545	\$ 52,158	\$ 2,177,890
Individually evaluated for impairment	\$ 21,448	\$ 112,963	\$ 568,424	\$ 688,596	\$ —	\$ 644,162
Collectively evaluated for impairment	834,365	1,684,338	1,308,104	965,949	52,158	1,533,728
Loans:						
Ending balance	\$ 158,072,698	\$ 190,422,992	\$ 113,278,318	\$ 59,097,607	\$ 11,590,641	\$ 290,531,083
Ending balance: individually evaluated for impairment	21,448	1,148,363	3,743,313	1,439,835	—	2,901,513
Ending balance: collectively evaluated for impairment	\$ 158,051,250	189,274,629	\$ 109,535,005	\$ 57,657,772	\$ 11,590,641	\$ 287,629,570
Consumers						
	Consumer and Installment loans	Overdraft Protection	Unallocated	Total		
Allowance for loan losses:						
Beginning balance	\$ 104,661	\$ 260	\$ 96,255	\$ 8,948,837		
Charge-offs	(1,869)	—	—	(955,423)		
Recoveries	—	2,000	—	893,785		
Provision	(6,767)	777	277,647	—		
Ending balance	\$ 96,025	\$ 3,037	\$ 373,902	\$ 8,887,199		
Individually evaluated for impairment	\$ 65,043	\$ 2,527	—	\$ 2,103,163		
Collectively evaluated for impairment	30,982	510	373,902	6,784,036		
Loans:						
Ending balance	\$ 6,356,473	\$ 121,217	\$ —	\$ 829,471,029		
Ending balance: individually evaluated for impairment	65,043	2,527	—	9,322,042		
Ending balance: collectively evaluated for impairment	\$ 6,291,430	\$ 118,690	\$ —	\$ 820,148,987		

A loan is considered impaired when, based on current information and events; it is probable a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. In addition to loans 90 days past due and still accruing, nonaccrual loans and restructured loans, all loans risk graded doubtful or substandard qualify, by definition, as impaired. Loans 90 days past due and accruing totaling \$104,285 and nonaccrual loans totaling \$1,843,659 are included in impaired loans at March 31, 2016. Loans 90 days past due and still accruing totaling \$248,326 and nonaccrual loans totaling \$1,989,759 are included in impaired loans at December 31, 2015.

There was one residential real estate property totaling \$14,886 in the process of foreclosure at March 31, 2016 and one residential real estate property totaling \$45,844 in process of foreclosure at December 31, 2015.

The following table sets forth our impaired loans at March 31, 2016 and December 31, 2015.

Impaired Loans							
		With No Related Allowance					
		Recorded Investment	Unpaid Principal Balance	Average Recorded Investment	Interest Income Recognized		
March 31, 2016							
Commercial		\$	—	\$	—	\$	—
Real estate							
Construction			926,779		926,779		928,999
Residential (1-4 family)			1,846,940		1,912,394		1,859,892
Home equity lines			428,009		446,348		428,211
Multifamily			—		—		—
Commercial			913,458		918,844		919,299
Consumers							
Consumer and installment loans			—		—		—
Overdraft protection loans			—		—		—
Total		\$	4,115,186	\$	4,204,365	\$	4,136,401
December 31, 2015							
Commercial		\$	—	\$	—	\$	—
Real estate							
Construction			930,955		930,955		947,162
Residential (1-4 family)			1,850,482		1,912,515		1,942,407
Home equity lines			445,092		461,134		456,349
Multifamily			—		—		—
Commercial			894,603		899,189		921,147
Consumers							
Consumer and installment loans			—		—		—
Overdraft protection loans			—		—		—
Total		\$	4,121,132	\$	4,203,793	\$	4,267,065
		With Related Allowance					
		Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	
March 31, 2016							
Commercial		\$	157,051	\$	157,051	\$	49,051
Real estate							
Construction			115,291		115,291		25,291
Residential (1-4 family)			1,708,483		1,857,841		585,786
Home equity lines			946,295		946,295		633,148
Multifamily			—		—		—
Commercial			2,000,564		2,012,409		640,384
Consumers							
Consumer and installment loans			62,602		62,602		64,157
Overdraft protection loans			—		—		—
Total		\$	4,990,286	\$	5,151,489	\$	1,996,262
December 31, 2015							
Commercial		\$	21,448	\$	21,448	\$	21,448
Real estate							
Construction			217,408		244,963		112,963
Residential (1-4 family)			1,892,831		2,032,255		568,424
Home equity lines			994,743		994,743		688,596
Multifamily			—		—		—
Commercial			2,006,910		2,016,187		644,162
Consumers							
Consumer and installment loans			65,043		65,043		65,043
Overdraft protection loans			2,527		2,527		2,527
Total		\$	5,200,910	\$	5,377,166	\$	2,103,163

NOTE 7. FAIR VALUE ACCOUNTING

Fair Value Hierarchy and Fair Value Measurement

We group our assets and liabilities that are recorded 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 – Valuations based on quoted prices in active markets for identical assets or liabilities. Since valuations are based on quoted prices that are readily and regularly available in an active market, valuation of these products does not entail a significant degree of judgment.
- Level 2 – Valuations based on quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-based valuations for which all significant assumptions are observable or can be corroborated by observable market data.
- Level 3 – Valuations based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Valuations are determined using pricing models and discounted cash flow models and includes management judgment and estimation which may be significant.

The following table presents our assets and liabilities related to continuing operations, which are measured at fair value on a recurring basis for each of the fair value hierarchy levels, as of March 31, 2016 and December 31, 2015:

<u>Description</u>	Fair Value Measurements at Reporting Date Using			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets at March 31, 2016				
Investment securities—available for sale				
U.S. government agency obligations	\$ 22,919,352	\$ —	\$ 22,919,352	\$ —
Mortgage-backed securities	954,839	—	954,839	—
Municipal securities	2,995,079	—	2,995,079	—
Mortgage loans held for sale	189,131,150	—	189,131,150	—
Derivative financial asset	3,440,793	—	3,440,793	—
Derivative financial liability	\$ 1,545,380	\$ —	\$ 1,545,380	\$ —
Assets at December 31, 2015				
Investment securities—available for sale				
U.S. government agency obligations	\$ 26,236,245	\$ —	\$ 26,236,245	\$ —
Mortgage-backed securities	998,389	—	998,389	—
Municipal securities	2,978,496	—	2,978,496	—
Mortgage loans held for sale	169,345,205	—	169,345,205	—
Derivative financial asset	2,105,204	—	2,105,204	—
Derivative financial liability	\$ 368,577	\$ —	\$ 368,577	\$ —

The following table provides quantitative disclosures about the fair value measurements of our assets related to continuing operations which are measured at fair value on a nonrecurring basis as of March 31, 2016 and December 31, 2015.

<u>Description</u>	Fair Value Measurements at Reporting Date Using			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
At March 31, 2016				
Restructured and impaired loans, net	\$ 2,994,024	\$ —	\$ —	\$ 2,994,024
At December 31, 2015				
Restructured and impaired loans, net	\$ 3,097,747	\$ —	\$ —	\$ 3,097,747

There were no residential real estate properties classified as other real estate at March 31, 2016, or December 31, 2015.

The following table displays quantitative information about Level 3 Fair Value Measurements for March 31, 2016 and December 31, 2015.

Fair Value Measurement at March 31, 2016				
	Fair Value	Valuation Technique	Unobservable Inputs	Weighted Average
Commercial	\$ 108,000	Market comparables	Discount applied to market comparables (1)	20%
Real Estate				
Construction	90,000	Market comparables	Discount applied to market comparables (1)	30%
Residential (1-4 family)	1,122,697	Market comparables	Discount applied to market comparables (1)	17%
Home equity lines	313,147	Market comparables	Discount applied to market comparables (1)	20%
Multifamily	—	Market comparables	—	100%
Commercial	1,360,180	Market comparables	Discount applied to market comparables (1)	30%
Consumer				
Consumer and installment loans	—	—	—	100%
Total restructures and impaired loans	\$ 2,994,024			

Fair Value Measurement at December 31, 2015				
	Fair Value	Valuation Technique	Unobservable Inputs	Weighted Average
Commercial	\$ —	Market comparables	Discount applied to market comparables (1)	100%
Real Estate				
Construction	104,445	Market comparables	Discount applied to market comparables (1)	35%
Residential (1-4 family)	1,324,407	Market comparables	Discount applied to market comparables (1)	18%
Home equity lines	306,147	Market comparables	Discount applied to market comparables (1)	20%
Multifamily	—	Market comparables	Discount applied to market comparables (1)	100%
Commercial	1,362,748	Market comparables	Discount applied to market comparables (1)	30%
Consumer				
Consumer and installment loans	—	Market comparables	Discount applied to market comparables (1)	100%
Total restructures and impaired loans	\$ 3,097,747			

(1) A discount percentage is applied based on age of independent appraisals, current market conditions, and experience within the local markets.

For the three months ended March 31, 2016, we recorded \$0 gains and losses on the sale of other real estate owned. For the three months ended March 31, 2015, we reported no gains and a loss of \$38,879. Gains or losses on sale of other real estate owned are included in foreclosed property expense.

At the time a loan secured by real estate becomes real estate owned, we record the property at fair value net of estimated selling costs. Upon foreclosure and through liquidation, we evaluate the property's fair value as compared to its carrying amount and record a valuation adjustment when the carrying amount exceeds fair value. Any valuation adjustments at the time a loan becomes real estate owned is charged to the allowance for loan losses. Any subsequent valuation adjustments are applied to earnings in our consolidated statements of income. No valuation adjustments related to other real estate owned were recorded in the three months ended March 31, 2016 or 2015. Adjustments, when necessary, are included in foreclosed property expense.

Valuation Methods

The following notes summarize the significant assumptions used in estimating the fair value of financial instruments:

Short-term financial instruments are valued at their carrying amounts and included in the Company's balance sheet, which are reasonable estimates of fair value due to the relatively short period to maturity of the instruments. This approach applies to *cash and cash equivalents* and *overnight borrowings*.

Investment securities – available-for-sale are valued at quoted market prices, if available. For securities for which no quoted market price is available, we estimate the fair value on the basis of quotes for similar instruments or other available information. Investment securities classified as available-for-sale are reported at their estimated fair value with unrealized gains and losses

reported in accumulated other comprehensive income. To the extent that the cost basis of investment securities exceeds the fair value and the unrealized loss is considered to be other than temporary, an impairment charge is recognized and the amount recorded in accumulated other comprehensive income or loss is reclassified to earnings as a realized loss. The specific identification method is used in computing realized gains or losses.

Mortgage loans held for sale are recorded at their fair value when originated and reevaluated quarterly, based on our expected return from the secondary market.

Loans held for investment are valued on the basis of estimated future receipts of principal and interest, which are discounted at various rates. Loan prepayments are assumed to occur at the same rate as in previous periods when interest rates were at levels similar to current levels. Future cash flows for homogeneous categories of consumer loans, such as motor vehicle loans, are estimated on a portfolio basis and discounted at current rates offered for similar loan terms to new borrowers with similar credit profiles.

The carrying amounts of *accrued interest* approximate fair value.

Interest rate lock commitments ("IRLC") are recorded at fair value, which is based on estimated future receipts net of estimated future expenses when the underlying loan is sold on the secondary market, using observable Level 2 market inputs, reflecting current market inputs as of the measurement date.

Bank owned life insurance represents insurance policies on officers of the Bank. The cash values of the policies are estimated using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the fair value.

The fair value of *demand deposits and deposits with no defined maturity* is taken to be the amount payable on demand at the reporting date. The fair value of *fixed-maturity deposits* is estimated using rates currently offered for deposits of similar remaining maturities. The intangible value of long-term relationships with depositors is not taken into account in estimating the fair values disclosed.

The fair value of Level 2 *borrowings* is determined based on quoted prices from FHLB for borrowings with similar characteristics and maturities. The determination of the fair value of Level 3 borrowings is made using pricing models and discounted cash flow models, and includes management judgment and estimation, which may be significant.

Derivative financial instruments are recorded at fair value using observable Level 2 market inputs related to:

- Loans held for sale *forward sales commitments* are recorded at their fair value based on the estimated number of days remaining in the IRLC at the measurement date and expected return from the secondary market. *Forward mortgage loan sales commitments* are recorded at their fair value based on the gain or loss that would occur if the loan were paired off with an investor at measurement date. A derivative asset of \$3,440,793 and a derivative liability of \$1,545,380 related to loans held for sale were recorded at March 31, 2016. At December 31, 2015, a derivative asset of \$1,514,083 and a derivative liability of \$1,195,405 were recorded.

Real Estate Owned is carried at the fair value less estimated selling costs. Upon foreclosure and through liquidation, we evaluate the property's fair value as compared to its carrying amount and record a valuation adjustment when the carrying amount exceeds fair value less selling costs. Any valuation adjustments at the time a loan becomes real estate owned is charged to the allowance for loan losses. Fair value is determined through an appraisal conducted by an independent, licensed appraiser outside of the Bank using observable market data (Level 2). When evaluating fair value, management may discount the appraisal further if, based on their understanding of the market conditions, it is determined the collateral is further impaired below the appraisal value (Level 3). Any subsequent valuation adjustments are applied to earnings in our consolidated statements of income. We did not record any losses due to valuation adjustments for the three months ended March 31, 2016 or 2015. We recorded no losses due to valuation adjustments on real estate owned within foreclosed property expense in the year ended December 31, 2015.

Restructured and Impaired Loans measurement is generally based on the present value of expected future cash flows discounted at the loan's effective interest rate, unless in the case of collateral-dependent loans, the observable market price, or the fair value of the collateral can be readily determined. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Bank using observable market data (Level 2). When evaluating fair value, management may discount the appraisal further if, based on their understanding of the market conditions, it is determined the collateral is further impaired below the appraised value (Level 3). The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts

receivables collateral are based on financial statement balances or aging reports (Level 3). Restructured and impaired loans are periodically reevaluated to determine if additional adjustments to the carrying value are necessary.

It is not practicable to separately estimate the fair values for off-balance-sheet credit commitments, including standby letters of credit and guarantees written, due to the lack of cost-effective reliable measurement methods for these instruments.

Fair Value of Financial Instruments

The following table presents the carrying amounts and fair value of our financial instruments at March 31, 2016 and December 31, 2015. GAAP defines the fair value of a financial instrument as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than through a forced or liquidation sale for purposes of this disclosure. The carrying amounts in the table are included in the balance sheet under the indicated captions.

Fair Value Measurements at March 31, 2016, using					
	Carrying Value	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Balance
Assets					
Cash and cash equivalents	\$ 86,797,604	\$ 86,797,604	\$ —	\$ —	\$ 86,797,604
Investment securities available for sale	26,869,270	—	26,869,270	—	26,869,270
Mortgage loans held for sale	189,131,150	—	189,131,150	—	189,131,150
Loans held for investment (net)	841,153,269	—	—	852,849,014	852,849,014
Accrued interest receivable	2,172,860	—	2,172,860	—	2,172,860
Bank owned life insurance	10,795,735	—	10,795,735	—	10,795,735
Derivative financial assets	3,440,793	—	3,440,793	—	3,440,793
Liabilities					
Deposits	\$ 1,063,411,226	\$ —	\$ 1,061,154,192	\$ —	\$ 1,061,154,192
Borrowings	10,000,000	—	—	6,243,249	6,243,249
Accrued interest payable	71,222	—	71,222	—	71,222
Derivative financial liabilities	1,545,380	—	1,545,380	—	1,545,380

Fair Value Measurements at December 31, 2015 using					
	Carrying Value	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Balance
Assets					
Cash and cash equivalents	\$ 73,879,510	\$ 73,879,510	\$ —	\$ —	\$ 73,879,510
Investment securities available for sale	30,213,130	—	30,213,130	—	30,213,130
Loans held for sale	169,345,205	—	169,345,205	—	169,345,205
Loans held for investment (net)	820,382,106	—	—	834,345,931	834,345,931
Accrued interest receivable	2,110,108	—	2,110,108	—	2,110,108
Bank owned life insurance	10,634,814	—	10,634,814	—	10,634,814
Derivative financial assets	2,105,204	—	2,105,204	—	1,514,083
Liabilities					
Deposits	\$ 999,093,598	\$ —	\$ 996,519,992	\$ —	\$ 996,519,992
Borrowings	26,000,000	—	16,000,000	6,184,750	22,184,750
Accrued interest payable	104,517	—	104,517	—	104,517
Derivative financial liability	368,577	—	368,577	—	368,577

NOTE 8. STOCK-BASED COMPENSATION

In May 2014, Monarch stockholders ratified the adoption of the Monarch Bank 2014 Equity Incentive Plan (2014EIP), a stock-based compensation plan which succeeds the Monarch Bank 2006 Equity Incentive Plan (2006EIP). The 2006EIP had succeeded the Monarch Bank 1999 Incentive Stock Option Plan (1999ISO) and was the only plan under which equity-based compensation could be awarded. Like the 2006EIP, the 2014EIP authorizes the compensation committee to grant options, stock

appreciation rights, stock awards, performance stock awards, and stock units to designated directors, officers, key employees, consultants and advisers to the Company and its subsidiaries.

The 2014EIP authorized the Company to issue up to 1,100,000 shares of Monarch Common Stock plus the number of shares of our common stock outstanding under the predecessor plans. The Plan also provides that no award may be granted more than 10 years after the May 2014 ratification date.

As of March 31, 2016, 1,818,460 shares were available for grants under all plans. A total of 437,440 shares are outstanding, all of which are non-vested restricted stock, subject to outstanding awards under the 2006EIP and 1999ISO. Restricted stock typically vests over a 60 month period. Total compensation costs are recognized over the service period to vesting.

No additional options were granted in the periods covered. There were no options outstanding in the first quarter of 2016. There were 18,999 options exercised in the first quarter of 2015. No options on shares were forfeited in the first quarter of 2016 or 2015.

Compensation expense related to our restricted stock totaled \$215,763 in the first quarter of 2016. Remaining vesting periods are between 3 and 57 months with unrecognized remaining compensation expense of \$2,224,025. We issued no shares of restricted stock in the first quarter of 2016. No shares vested in the first quarter of 2016. There were 3,600 shares forfeited in the first quarter of 2016.

Share amounts have been restated to include the 11 for 10 stock dividend announced October 22, 2015 and payable December 4, 2015.

NOTE 9. SEGMENT REPORTING

Reportable segments include community banking and mortgage banking services. Community banking involves making loans to and generating deposits from individuals and businesses in the markets in which we have offices. Mortgage banking originates residential loans and subsequently sells them to investors. Our mortgage banking segment is a strategic business unit that offers different products and services. It is managed separately because the segment appeals to different markets and, accordingly, requires different technology and marketing strategies.

Beginning with the third quarter of 2015 and for all periods reported, the financial presentation for reportable segments has been modified to assist the reader in understanding the components of the segments. Funding for mortgage banking services' loans held for sale (LHFS) portfolio is provided by community banking services. For segmentation purposes the community banking segment charges the mortgage banking segment interest on average LHFS balances outstanding at a rate of the three month average 30 day London Interbank Offered Rate (LIBOR) plus 250 basis points.

The mortgage banking segment's most significant revenue and expense is non-interest income and non-interest expense, respectively. Under the mortgage banking segment we have broken out "forward rate commitments and unrealized hedge gain (loss)" because these represent changes in the our derivative position. Our derivative position is impacted quarterly by the number and dollar volume of loans locked with a borrower but not closed, changes in the market value of notional security sales, and the delivery method utilized for closed but not committed loans.

In the event of early payment default, Monarch has recorded a reserve for loan repurchases which totaled \$3,270,361 at March 31, 2016 and \$3,287,667 at December 31, 2015. Our reserve for loan repurchases is not a part of our loan loss reserve and is carried in other liabilities. This reserve, which is an estimate of the potential for losses based on investor contracts, is not an indication that losses will occur and is periodically analyzed and adjusted through income.

We do not have other reportable operating segments. (The accounting policies of the segments are the same as those described in the summary of significant accounting policies in Note 1 of our annual 10-K.) All inter-segment sales prices are market based.

Segment information for the three months ended March 31, 2016 and 2015 is shown in the following tables.

Selected Financial Information

Community Banking Segment

	Quarter Ended March 31,	
	2016	2015
Income:		
Interest income	\$ 12,106,934	\$ 10,999,638
Non-interest income	1,311,126	1,214,983
Total operating income	13,418,060	12,214,621
Expenses:		
Interest expense	(912,119)	(737,081)
Provision for loan losses	—	(250,000)
Personnel expense	(4,239,267)	(4,673,468)
Other non-interest expenses	(3,061,018)	(3,047,925)
Total operating expenses	(8,212,404)	(8,708,474)
Income before income taxes	5,205,656	3,506,147
Provision for income taxes	(1,903,459)	(1,273,769)
Less: Net income attributable to non-controlling interests	(12,430)	(15,905)
Net income attributable to community banking segment	\$ 3,289,767	\$ 2,216,473

Mortgage Banking Segment

	Quarter Ended March 31,	
	2016	2015
Income:		
Interest income	\$ 1,411,908	\$ 1,307,036
Non-interest income	17,742,535	18,294,663
Total operating income	19,154,443	19,601,699
Expenses:		
Interest expense	(1,101,016)	(921,104)
Personnel expense	(13,158,454)	(13,471,018)
Other non-interest expenses	(4,302,382)	(4,496,033)
Total operating expenses	(18,561,852)	(18,888,155)
Net operating income	592,591	713,544
Forward rate commitments and unrealized hedge gain	665,109	1,267,129
Income before income taxes	1,257,700	1,980,673
Provision for income taxes	(459,881)	(719,571)
Less: Net income attributable to non-controlling interests	(30,877)	(16,368)
Net income attributable to mortgage banking segment	\$ 766,942	\$ 1,244,734

Consolidated Statements of Income

	Quarter Ended March 31,	
	2016	2015
Income:		
Interest income	\$ 12,417,826	\$ 11,385,570
Non-interest income	20,329,434	22,266,163
Total operating income	32,747,260	33,651,733
Expenses:		
Interest expense	(912,119)	(737,081)
Provision for loan losses	—	(250,000)
Personnel expense	(17,873,752)	(19,039,414)
Other non-interest expenses	(7,498,033)	(8,138,418)
Total operating expenses	(26,283,904)	(28,164,913)
Income before income taxes	6,463,356	5,486,820
Provision for income taxes	(2,363,340)	(1,993,340)
Less: Net income attributable to non-controlling interests	(43,307)	(32,273)
Net income attributable to Monarch Financial Holdings, Inc.	\$ 4,056,709	\$ 3,461,207

Elimination entries:

Interest income	(1,101,016)	(921,104)
Interest expense	1,101,016	921,104
Non-interest income	(1,275,773)	(2,756,517)
Personnel expense	476,031	894,928
Other non-interest expenses	134,633	594,460
Forward rate commitments and unrealized hedge gain (loss)	(665,109)	(1,267,129)

	Community Banking	Mortgage Banking	Elimination entries	Consolidated
Segment Assets				
March 31, 2016	\$ 1,028,854,561	\$ 215,838,288	\$ (32,185,481)	\$ 1,212,507,368
December 31, 2015	\$ 996,432,802	\$ 192,062,857	\$ (27,047,504)	\$ 1,161,448,155
Capital Expenditures				
March 31, 2016	\$ 26,434	\$ 82,199	\$ —	\$ 108,633
December 31, 2015	\$ 1,359,215	\$ 424,271	\$ —	\$ 1,783,486

NOTE 10. GOODWILL AND INTANGIBLE ASSETS

Goodwill and intangible assets with indefinite lives are recorded at cost and reviewed at least annually for impairment based on evidence of certain impairment indicators. Intangible assets with identifiable lives are amortized over their estimated useful lives. There were no intangible assets at March 31, 2016.

Information concerning goodwill is presented in the following table:

	March 31, 2016	December 31, 2015
Goodwill	\$ 775,000	\$ 775,000

Goodwill is related to the acquisition of a Maryland mortgage office plus certain other mortgage related assets in August 2007. Intangible assets related to this acquisition were fully amortized in 2014.

NOTE 11. DERIVATIVE FINANCIAL INSTRUMENTS AND HEDGING ACTIVITIES

Commitments to fund certain mortgage loans (interest rate locks) to be sold into the secondary market and forward commitments for the future delivery of mortgage loans to third party investors are considered derivatives. It is the Company's practice to enter into forward commitments for the future delivery of residential mortgage loans when interest rate lock commitments are entered into in order to economically hedge the effect of changes in interest rates resulting from its commitments to fund the loans. These mortgage derivatives are not designated in hedge relationships. At March 31, 2016, the Company had approximately \$251 million of interest rate lock commitments and \$369 million of forward commitments for the future delivery of residential mortgage loans. The fair value of these mortgage banking derivatives was reflected by a derivative asset of \$3,440,793 and a derivative liability of \$1,545,380. At year-end 2015, the Company had approximately \$227 million of interest rate lock commitments and \$244 million of forward commitments for the future delivery of residential mortgage loans. The fair value of these mortgage banking derivatives was reflected by a derivative asset of \$2,105,204 and a derivative liability of \$368,577. Fair values were estimated based on changes in mortgage interest rates from the date of the commitments. Changes in the fair values of these mortgage banking derivatives are included in net gains on sales of loans.

The net gains (losses) relating to free-standing derivative instruments used for risk management are summarized below as of March 31:

	Location	March 31, 2016	March 31, 2015
Forward contracts related to mortgage loans held for sale	Mortgage banking revenue	\$ (570,179)	\$ (394,324)
Interest rate lock commitments	Mortgage banking revenue	\$ 1,235,290	\$ 1,661,453

The following table reflects the amount and market value of mortgage banking derivatives included in the Consolidated Statements of Condition as of the period end:

	March 31, 2016		December 31, 2015	
	Notional	Fair	Notional	Fair
	Amount	Value	Amount	Value
Included in other assets (1)				
Forward contracts related to interest rate lock commitments and mortgage loans held for sale (2)	\$ 73,880,034	\$ 263,199	\$ 145,232,095	\$ 615,123
Interest rate lock commitments	246,671,447	3,154,781	210,260,999	1,490,081
Hedge positions	55,750,000	22,813	—	—
Total included in other assets		\$ 3,440,793		\$ 2,105,204
Included in other liabilities (1)				
Forward contracts related to interest rate lock commitments and mortgage loans held for sale (2)	\$ 295,314,954	\$ 994,010	\$ 98,680,765	\$ 238,583
Interest rate lock commitments	4,510,785	58,831	16,489,999	76,856
Hedge positions	78,358,191	492,539	76,632,817	53,138
Total included in other assets		\$ 1,545,380		\$ 368,577

- (1) The Notional amount of mortgage banking derivatives is an off balance sheet item and only the fair value of the derivatives is recorded within the Consolidated Statements of Condition.
- (2) Certain forward sales commitments do not qualify under applicable accounting guidance as derivative instruments; however, the Company has elected the fair value option under ASC 825-10-15-4(b) for the loans held for sale portfolio and thus fair value adjustments have been recorded in the derivative asset and derivative liability as presented above.

NOTE 12. LOW INCOME HOUSING TAX CREDITS

The Company has invested in two housing equity funds at March 31, 2016 and December 31, 2015. The general purpose of these funds is to encourage and assist participants in investing in low-income residential rental properties located in the Commonwealth of Virginia, develop and implement strategies to maintain projects as low-income housing, deliver Federal Low Income Housing Credits to investors, allocate tax losses and other possible tax benefits to investors, and to preserve and protect project assets. One housing equity investment is still in the formation stages so annual capital calls and tax credits are undetermined at this date. The Company accounts for these investments under the proportional amortization method and at March 31, 2016 and December 31, 2015, the investment in these funds, recorded in other assets on the consolidated statement of condition, was \$933,842 and \$944,475, respectively, with \$10,633 of tax credits and other tax benefits related to these investments recognized on the consolidated statements of income in the first quarter of 2016, and \$0 as of March 31, 2015. Total projected tax credits to be received for 2016 are \$41,267, based on the most recent quarterly estimates received for the fully established fund. Additional capital calls expected for the funds totals \$949,000 at March 31, 2016 and December 31, 2015, and are included in other liabilities on the consolidated statement of condition.

NOTE 13. COMMON STOCK REPURCHASE

On September 24, 2015 we announced the Board of Monarch Financial Holdings, Inc., had approved the repurchase of up to five percent, or approximately 653,400 shares, of the Company's outstanding common stock. The repurchase program, which will expire September 22, 2016, may be conducted through open market purchases or privately negotiated transactions. The timing and actual number of shares repurchased will depend on market conditions and other factors.

Actual repurchase activity was conducted between October 1, 2015 and December 31, 2015 at a total cost of \$797,919. There were 0 shares of common stock repurchased in the first quarter of 2016 and 65,590 shares of common stock repurchased through December 31, 2015. There were 587,810 shares of common stock available for future purchase at March 31, 2016 and December 31, 2015.

Period 2015	Total Number of Common Shares Repurchased	Total Remaining Common Shares Available for Repurchase
October 1 through October 31	23,290	630,110
November 1 through November 23	42,300	587,810

NOTE 14. SUBSEQUENT EVENT

On April 21, 2016, we announced the Board had approved a quarterly common stock cash dividend of \$0.09 per share for common shareholders of record on May 10, 2016, payable on May 27, 2016.

UNAUDITED PRO FORMA CONDENSED COMBINED FINANCIAL INFORMATION

The following unaudited pro forma condensed combined financial statements are based on the separate historical financial statements of TowneBank and Monarch Financial Holdings, Inc. ("Monarch"), and give effect to the acquisition by TowneBank of Monarch using the acquisition method of accounting, including pro forma assumptions and adjustments related to the acquisition, as described in the accompanying notes to the unaudited pro forma condensed combined financial statements. The unaudited pro forma condensed combined balance sheet as of March 31, 2016 is presented as if the merger with Monarch had occurred on March 31, 2016. The unaudited pro forma condensed combined income statements for the year ended December 31, 2015 and the three months ended March 31, 2016 are presented as if the merger had occurred on January 1, 2015.

Under the acquisition method of accounting, the assets and liabilities of Monarch are recorded by TowneBank at their respective fair values as of the date the merger was completed, June 24, 2016. These unaudited pro forma condensed combined financial statements reflect the merger based upon estimated preliminary acquisition accounting adjustments. Actual adjustments are made as of the effective date of the merger and, therefore, may differ from those reflected in the unaudited pro forma condensed combined financial information.

In connection with the plan to integrate the operations of Monarch, TowneBank will incur nonrecurring charges, such as costs associated with systems implementation, severance, professional fees and other costs directly related to the merger. Such merger-related after-tax expenses for TowneBank will be recorded in results of operations in the period in which they are incurred. The unaudited pro forma condensed combined financial statements do not include the effects of the costs associated with any restructuring or integration activities that have not already been incurred, resulting from the transaction, as they are nonrecurring in nature. Additionally, the unaudited pro forma adjustments do not give effect to any nonrecurring or unusual restructuring charges that may be incurred as a result of the merger and integration of TowneBank and Monarch or any anticipated disposition of assets or prepayment of liabilities that may result from such merger and integration. The actual final amounts recorded may differ materially from the information presented in these unaudited pro forma condensed consolidated financial statements as a result of material and significant information becoming known that was previously not expected or known; and changes in the financial results of the combined company, which could change the future discounted cash flow projections.

The unaudited pro forma condensed combined financial statements are presented for informational purposes only. The unaudited pro forma condensed combined financial statements are not necessarily, and should not be assumed to be, an indication of the results that would have been achieved had the Monarch acquisition been completed as of the dates indicated or that may be achieved in the future. The preparation of the unaudited pro forma condensed combined financial statements and related adjustments required management to make certain assumptions and estimates. The unaudited pro forma condensed combined financial statements should be read together with the accompanying notes to the unaudited pro forma condensed combined financial statements; TowneBank's separate audited historical consolidated financial statements and accompanying notes as of and for the year ended December 31, 2015, included in TowneBank's Annual Report on Form 10-K for the year ended December 31, 2015; TowneBank's separate unaudited historical consolidated financial statements and accompanying notes as of and for the three months ended March 31, 2016, included in TowneBank's Quarterly Report on Form 10Q for the quarter ended March 31, 2016; Monarch's separate audited historical consolidated financial statements and accompanying notes as of and for the year ended December 31, 2015, included in Monarch's Annual Report on Form 10-K for the year ended December 31, 2015; Monarch's separate unaudited historical consolidated financial statements and accompanying notes as of and for the three months ended March 31, 2016, included in Monarch's Quarterly Report on Form 10Q for the quarter ended March 31, 2016; other information pertaining to TowneBank contained in previous Federal Deposit Insurance Corporation filings; and other information pertaining to Monarch contained in previous Securities and Exchange Commission filings.

TOWNEBANK AND MONARCH
UNAUDITED PRO FORMA CONDENSED COMBINED BALANCE SHEET

As of March 31, 2016

(Dollars in thousands)

	TowneBank <i>(As Reported)</i>	Monarch <i>(As Reported)</i>	Merger Pro Forma Adjustments	Pro Forma Combined
ASSETS				
Cash and due from banks	\$ 195,161	\$ 13,185	\$ (5,950) (a)	\$ 202,396
Interest bearing deposits in financial institutions	1,006	73,613	—	74,619
Total Cash and Cash Equivalents	196,167	86,798	(5,950)	277,015
Securities available-for-sale, at fair value	821,551	26,869	—	848,420
Securities held-to-maturity, at amortized cost	66,921	—	—	66,921
Federal Home Loan Bank stock, at amortized cost	23,903	3,672	—	27,575
Total Securities	912,375	30,541	—	942,916
Mortgage loans held for sale	97,491	189,131	—	286,622
Loans, net of unearned income and deferred costs	4,552,260	850,054	(16,505) (b)	5,385,809
Less: Allowance for loan losses	(37,760)	(8,901)	8,901 (c)	(37,760)
Net Loans	4,514,500	841,153	(7,604)	5,348,049
Premises and equipment, net	178,154	28,355	(3,992) (d)	202,517
Goodwill	157,659	775	104,136 (e)	262,570
Other intangible assets, net	29,286	—	16,370 (f)	45,656
Bank-owned life insurance policies	150,623	10,796	—	161,419
Other assets	128,914	24,958	(586) (g)	153,286
TOTAL ASSETS	\$ 6,365,169	\$ 1,212,507	\$ 102,374	\$ 7,680,050
LIABILITIES AND EQUITY				
Liabilities				
Deposits:				
Noninterest-bearing demand	\$ 1,449,660	\$ 296,512	—	\$ 1,746,172
Interest-bearing	3,505,466	766,899	679 (h)	4,273,044
Total Deposits	4,955,126	1,063,411	679	6,019,216
Advances from the Federal Home Loan Bank	428,940	—	—	428,940
Repurchase agreements and other borrowings	39,442	10,000	42 (i)	49,484
Total Borrowings	468,382	10,000	42	478,424
Other liabilities	105,658	18,056	262 (j)	123,976
TOTAL LIABILITIES	5,529,166	1,091,467	983	6,621,616
Shareholders' Equity				
Common stock	86,151	57,199	(39,717) (k)(l)	103,633
Capital surplus	536,294	17,457	187,492 (k)(l)	741,243
Retained earnings	204,413	46,337	(46,337) (l)	204,413
Accumulated other comprehensive income (loss)	17	(54)	54 (l)	17
TOTAL SHAREHOLDERS' EQUITY	826,875	120,939	101,492	1,049,306
Noncontrolling interest	9,128	101	(101)	9,128
TOTAL EQUITY	836,003	121,040	101,391	1,058,434
TOTAL LIABILITIES AND EQUITY	\$ 6,365,169	\$ 1,212,507	\$ 102,374	\$ 7,680,050

See accompanying notes to condensed consolidated financial statements.

TOWNEBANK AND MONARCH
UNAUDITED PRO FORMA CONDENSED COMBINED STATEMENTS OF INCOME
For the Three Months Ended March 31, 2016

(Dollars and shares in thousands, except per share amounts)

	TowneBank <i>(As Reported)</i>	Monarch <i>(As Reported)</i>	Merger Pro Forma Adjustments	Pro Forma Combined
Interest and dividend income:				
Interest and fees on loans	\$ 50,247	\$ 12,102	\$ 292 (m)	\$ 62,641
Other interest income	4,487	316	—	4,803
Total interest and dividend income	54,734	12,418	292	67,444
Interest expense:				
Interest on deposits	5,213	854	(24) (n)	6,043
Other interest expense	3,185	58	—	3,243
Total interest expense	8,398	912	(24)	9,286
Net interest income	46,336	11,506	316	58,158
Provision for loan losses	(259)	—	—	(259)
Net interest income after provision for loan losses	46,595	11,506	316	58,417
Noninterest income:				
Residential mortgage banking income, net	7,118	19,018	—	26,136
Real estate brokerage and property management income, net	4,827	—	—	4,827
Insurance commissions and other title fees and income, net	14,033	694	—	14,727
Service charges on deposit accounts	2,176	500	—	2,676
Other operating income	4,261	117	—	4,378
Total noninterest income	32,415	20,329	—	52,744
Noninterest expenses:				
Salaries and benefits	30,187	17,874	—	48,061
Occupancy expenses	5,017	1,453	(18) (p)	6,452
Furniture and equipment expenses	2,357	820	—	3,177
Other expenses	14,600	5,225	861 (q)	20,686
Total noninterest expenses	52,161	25,372	843	78,376
Income before income taxes	26,849	6,463	(527)	32,785
Income tax expense	8,188	2,363	(184) (r)	10,367
Net income	\$ 18,661	\$ 4,100	\$ (343)	\$ 22,418
Net income attributable to noncontrolling interest	(842)	(43)	—	(885)
Net income attributable to TowneBank	\$ 17,819	\$ 4,057	\$ (343)	\$ 21,533
Preferred stock dividends	—	—	—	—
Net income available to common shareholders	\$ 17,819	\$ 4,057	\$ (343)	\$ 21,533
Earnings per common share, basic	\$ 0.35	\$ 0.34		\$ 0.35
Earnings per common share, diluted	\$ 0.35	\$ 0.34		\$ 0.35
Weighted average common shares outstanding, basic	51,290	11,881	10,491 (s)	61,781
Weighted average common shares outstanding, diluted	51,393	11,881	10,491 (s)	61,884

See accompanying notes to condensed consolidated financial statements.

TOWNEBANK AND MONARCH
UNAUDITED PRO FORMA CONDENSED COMBINED STATEMENTS OF INCOME
For the Year Ended December 31, 2015

(Dollars and shares in thousands, except per share amounts)

	TowneBank	Monarch	Merger	Pro Forma
	<i>(As Reported)</i>	<i>(As Reported)</i>	Pro Forma	Pro Forma
			Adjustments	Combined
Interest and dividend income:				
Interest and fees on loans	\$ 194,737	\$ 46,357	\$ 3,719 (m)	\$ 244,813
Other interest income	18,136	1,038	—	19,174
Total interest and dividend income	212,873	47,395	3,719	263,987
Interest expense:				
Interest on deposits	18,866	2,868	(562) (n)	21,172
Other interest expense	13,565	279	(42) (o)	13,802
Total interest expense	32,431	3,147	(604)	34,974
Net interest income	180,442	44,248	4,323	229,013
Provision for loan losses	3,027	—	—	3,027
Net interest income after provision for loan losses	177,415	44,248	4,323	225,986
Noninterest income:				
Residential mortgage banking income, net	34,211	79,578	—	113,789
Real estate brokerage and property management income, net	16,326	—	—	16,326
Insurance commissions and other title fees and income, net	39,641	2,575	—	42,216
Service charges on deposit accounts	9,165	2,227	—	11,392
Other operating income	17,940	734	—	18,674
Total noninterest income	117,283	85,114	—	202,397
Noninterest expenses:				
Salaries and benefits	113,959	76,345	—	190,304
Occupancy expenses	19,645	5,939	(130) (p)	25,454
Furniture and equipment expenses	9,339	3,503	—	12,842
Other expenses	59,214	22,585	3,985 (q)	85,784
Total noninterest expenses	202,157	108,372	3,855	314,384
Income before income taxes	92,541	20,990	468	113,999
Income tax expense	26,876	7,583	164 (r)	34,623
Net income	\$ 65,665	\$ 13,407	\$ 304	\$ 79,376
Net income attributable to noncontrolling interest	(3,283)	(192)	—	(3,475)
Net income attributable to TowneBank	\$ 62,382	\$ 13,215	\$ 304	\$ 75,901
Preferred stock dividends	13	—	—	13
Net income available to common shareholders	\$ 62,369	\$ 13,215	\$ 304	\$ 75,888
Earnings per common share, basic	\$ 1.22	\$ 1.12		\$ 1.23
Earnings per common share, diluted	\$ 1.22	\$ 1.11		\$ 1.23
Weighted average common shares outstanding, basic	51,065	11,841	10,455 (s)	61,520
Weighted average common shares outstanding, diluted	51,161	11,853	10,466 (s)	61,627

See accompanying notes to condensed consolidated financial statements.

NOTE A – BASIS OF PRESENTATION

On December 16, 2015, TowneBank entered into the merger agreement with Monarch and its wholly owned subsidiary, Monarch Bank. The merger agreement provides that at the effective date of the merger, each outstanding share of common stock of Monarch will be converted into the right to receive 0.883 shares of TowneBank common stock, par value \$1.667 per share. The transaction value of \$222.4 million reflects the issuance 10.49 million shares using TowneBank's closing stock price on June 24, 2016 of \$21.21.

The unaudited pro forma condensed combined financial information of TowneBank's financial condition and results of operations, including per share data, are presented after giving effect to the merger. The pro forma financial information assumes that the merger with Monarch was consummated on January 1, 2015 for purposes of the unaudited pro forma condensed combined statements of income and on March 31, 2016 for purposes of the unaudited pro forma condensed combined balance sheet and gives effect to the merger, for purposes of the unaudited pro forma condensed combined statement of income, as if it had been effective during the entire period presented.

The merger will be accounted for using the acquisition method of accounting; accordingly, the difference between the purchase price over the estimated fair value of the assets acquired (including identifiable intangible assets) and liabilities assumed will be recorded as goodwill.

The pro forma financial information includes estimated adjustments to record the assets and liabilities of Monarch at their respective fair values and represents management's estimates based on available information. The pro forma adjustments included herein may be revised as additional information becomes available and as additional analysis is performed. The final allocation of the purchase price will be determined after the merger is completed and after completion of a final analysis to determine the fair values of Monarch's tangible, and identifiable intangible, assets and liabilities as of the effective date of the merger.

NOTE B – PRO FORMA ADJUSTMENTS

The following pro forma adjustments have been reflected in the unaudited pro forma condensed combined financial information. All adjustments are based on current valuations, estimates and assumptions. Subsequent to the completion of the merger, TowneBank has engaged an independent third party valuation firm to determine the fair value of the assets acquired and liabilities assumed, which could significantly change the amount of the estimated fair values used in pro forma financial information presented.

- (a) Adjustment reflects cash consideration for merger related compensation of \$4.7 million to be paid to Monarch's executive officers, and a fee to be paid at closing by Monarch of \$1.2 million to a financial advisor, which represents approximately 0.05% of the aggregate merger consideration.
- (b) Estimated fair value adjustment of \$16.5 million to reflect credit deterioration, liquidity, and interest estimates of the acquired portfolio which represented a discount of 2.0% on Monarch's outstanding loan portfolio. Approximately \$8.6 million of the fair value adjustment is estimated to be an accretable adjustment. The fair value adjustment also includes a \$0.2 million adjustment for net deferred loan costs.
- (c) Elimination of Monarch's allowance for loan losses. Purchased loans acquired in a business combination are recorded at fair value and the recorded allowance of the acquired company is not carried over.
- (d) Estimated fair value adjustments of acquired premises (buildings and land) as of acquisition date.
- (e) The addition of goodwill generated as a result of the total purchase price and the fair value of assets acquired exceeding the fair value of liabilities assumed and reflects the elimination of Monarch's goodwill of \$0.8 million.
- (f) Estimated fair value of the core deposit intangible asset of \$11.1 million and mortgage-related intangible assets of \$5.3 million.

- (g) Adjustment of \$1.3 million for deferred taxes associated with the adjustments to record the assets and liabilities of Monarch at fair value based on TowneBank's statutory rate of 35%, combined with the elimination of a reserve for nonaccrual interest of \$0.7 million.
- (h) Estimated fair value adjustment on deposits at current market rates and spreads for similar products.
- (i) Adjustment to reflect borrowings at their estimated fair value.
- (j) Adjustment to reflect assumed leases at their estimated fair value.
- (k) Elimination of Monarch's shareholders' equity representing conversion of all of Monarch's common shares into TowneBank common shares.
- (l) Recognition of the equity portion of the merger consideration. The adjustment to common stock represents the \$1.667 par value of TowneBank's common stock issued to effect the transaction. The adjustment to surplus represents the amount of equity consideration above the par value of TowneBank's common stock issued.
- (m) Represents the net amortization and accretion of accounting adjustments on acquired loans.
- (n) Represents premium amortization on deposits assumed as part of the merger assuming the merger closed on January 1, 2015. Premium will be amortized over 5.1 years using the effective interest method.
- (o) Represents premium amortization on borrowings assumed as part of the merger assuming the merger closed on January 1, 2015. Premium will be amortized over the 90 day period prior to redemption.
- (p) Represents premium amortization on the fair value of leases assumed as part of the merger assuming the merger closed on January 1, 2015. Premium will be amortized over the remaining term of the leases on a straight-line basis.
- (q) Represents amortization of core deposit premium and mortgage intangibles assuming the merger closed on January 1, 2015. Premium will be amortized over 6.5 years using the sum-of-years digits method and mortgage intangibles will be amortized on a straight-line basis over 8 years.
- (r) Represents the income tax effect of pro forma adjustments at TowneBank's statutory tax rate of 35%.
- (s) Weighted average basic and diluted shares outstanding were adjusted to effect the transaction.

NOTE C – PRO FORMA ALLOCATION OF PURCHASE PRICE

The following table shows the pro forma allocation of the consideration paid for Monarch's common equity to the acquired identifiable assets and liabilities assumed and the pro forma goodwill generated from the transaction (*unaudited, dollars in thousands*):

Purchase Price:		
TowneBank common shares issued		10,487,069
Purchase price per share of TowneBank's common stock as of June 24, 2016		<u>\$ 21.21</u>
Fair value of total consideration transferred		\$ 222,431
Fair value of assets acquired:		
Cash and cash equivalents	\$ 80,848	
Securities available for sale	26,869	
Loans held for sale	189,131	
Loans held for investment	833,549	
Bank premise and equipment	24,363	
Intangible assets	16,370	
Other assets	38,840	
Total assets	<u>1,209,970</u>	
Fair value of liabilities assumed:		
Deposits	1,064,090	
Total borrowings	10,042	
Other liabilities	18,318	
Total liabilities	<u>1,092,450</u>	
Net assets acquired		\$ 117,520
Preliminary pro forma goodwill		\$ 104,911

NOTE D – ESTIMATED AMORTIZATION/ACCRETION OF ACQUISITION ACCOUNTING ADJUSTMENTS

The following table sets forth an estimate of the expected effects of the estimated aggregate acquisition accounting adjustments reflected in the unaudited pro forma condensed combined financial statements on the future pre-tax net income of TowneBank after the merger with Monarch (*unaudited, dollars in thousands*):

	Discount Accretion (Premium Amortization)					
	For the Years Ended December 31,					
	2015	2016	2017	2018	Thereafter	Total
Loans	\$ 3,719	\$ 1,168	\$ 908	\$ 859	\$ 1,929	\$ 8,583
Leases	130	71	11	11	39	262
Core Deposit Intangible	(3,160)	(2,630)	(2,099)	(1,569)	(1,602)	(11,060)
Mortgage Intangible	(825)	(812)	(798)	(575)	(2,300)	(5,310)
Deposits	(562)	(94)	(12)	(7)	(4)	(679)
Borrowings	(42)	—	—	—	—	(42)

The actual effect of purchase accounting adjustments on the future pre-tax income of TowneBank may differ from these estimates based on the closing date estimates of fair values and the use of different amortization methods than assumed above.

NOTE E – ESTIMATED COST SAVINGS AND MERGER – RELATED COSTS

Estimated cost savings, expected to approximate 20% of Monarch's annualized pre-tax operating expenses, are excluded from the pro forma analysis. Cost savings are estimated to be realized at 25% in the year of acquisition and 100% in the subsequent year. In addition, estimated merger-related costs are not included in the unaudited pro forma condensed combined statements of income since they will be recorded in the combined results of income as they are incurred prior to or after completion of the merger and not indicative of what historical results of the combined company would have been had the companies been actually combined during the periods presented. The Company reported merger-related expenses of \$16.8 million and \$17.1 million for the three- and six-month periods ended June 30, 2016. Total merger-related costs are estimated to be approximately \$21 million, pre-tax.