**Financial Statements** 

December 31, 2011 and 2010



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## **Independent Auditors' Report**

Board of Directors Colonial American Bank

We have audited the balance sheet of Colonial American Bank as of December 31, 2011, and the related statements of operations, shareholders' equity, and cash flows for the year then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of Colonial American Bank as of December 31, 2010, were audited by other auditors whose report dated February 17, 2011, expressed an unqualified opinion inclusive of an emphasis of a matter paragraph on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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 audit provide a reasonable basis for our opinion.

In our opinion, the 2011 financial statements referred to above, present fairly, in all material respects, the financial position of Colonial American Bank as of December 31, 2011, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Philadelphia, Pennsylvania

Parente Beard LLC

March 30, 2012

## COLONIAL AMERICAN BANK Balance Sheets

	At December 31,				
		2011		2010	
	(In	thousands, e	xcept sh	are data)	
Assets					
Cash and due from banks	\$	360	\$	118	
Interest-bearing deposits with banks		4,700		3,500	
Cash and cash equivalents	· · · · · · · · · · · · · · · · · · ·	5,060		3,618	
Securities available-for-sale, at estimated fair value		5,267		-	
Loans receivable, net of allowance for loan losses of \$466 at					
December 31, 2011 and \$225 at December 31, 2010		32,042		16,567	
Premises and equipment, net		563		140	
Foreclosed assets		189		69	
Accrued interest receivable and other assets		927		668	
Total assets	\$	44,048	\$	21,062	
Liabilities and Shareholders' Equity					
Liabilities					
Deposits:					
Noninterest-bearing demand	\$	1,265	\$	746	
Interest-bearing demand	Ψ	1,202	Ψ	1,361	
Money market deposit accounts		9,092		1,420	
Savings		7,001		8,759	
Time		10,802		7,085	
Total deposits		29,362	-	19,371	
A convert interest provided and other popular linking		0.40		470	
Accrued interest payable and other accrued liabilities		646		179	
Total liabilities		30,008		19,550	
Shareholders' Equity					
Non-cumulative perpetual preferred stock, \$1 par value,					
2,500,000 shares authorized;					
Series A - 5% for five years, 9% thereafter, \$1,000 liquidation					
preference, 0 and 574 shares issued and outstanding at December 31, 2011					
and December 31, 2010, respectively		-		1	
Series B - 9%, \$1,000 liquidation preference, 0 and 29 shares issued					
and outstanding at December 31, 2011 and December 21, 2010, respecitvely		-		-	
Common stock, \$1 par value, \$7,500,000 shares authorized;					
1,804,850 and 50,212 shares issued and outstanding at					
December 31, 2011 and 2010, respectively		1,805		50	
Additional paid-in-capital		22,989		8,520	
Accumulated deficit		(10,897)		(7,059)	
Accumulated other comprehensive income		143		-	
Total shareholders' equity		14,040		1,512	
Total liabilities and shareholders' equity	\$	44,048	\$	21,062	
• •					

# COLONIAL AMERICAN BANK Statements of Operations

	Years Ended December 31				
		2011		2010	
	(In	thousands, ex	xcept sh	are data)	
Interest Income					
Loans, including fees	\$	1,169	\$	1,245	
Securities	•	95	Ψ	60	
Deposits in other financial institutions		11		2	
Total interest income		1,275		1,307	
Interest Expense					
Deposits		320		388	
Total interest expense		320		388	
Net interest income		955		919	
Provision For Loan Losses		741		54	
Net interest income after provision for loan losses		214		865	
Non-Interest Income					
Service charges and fees		16		26	
Other		9		4	
Total non-interest income		25	-	30	
Non-Interest Expense					
Compensation and benefits, net		1,810		630	
Occupancy		284		283	
Data processing		336		264	
Professional services		610		154	
Other		1,037		232	
Total non-interest expense		4,077		1,563	
Income Tax Expense					
Net loss	\$	(3,838)	\$	(668)	
Preferred stock dividends and discount accretion	\$	(23)	\$	(27)	
Net loss attributable to common shareholders	\$	(3,861)	\$	(695)	
Net loss per share, basic and diluted	\$	(2.96)	\$	(13.84)	
Weighted average shares outstanding, basic and diluted		1,303,872		50,212	

## COLONIAL AMERICAN BANK Statements of Changes in Shareholders' Equity

Years Ended December 31, 2011 and 2010

	Prefer Stoc		 mmon Stock	P	ditional aid-in apital	umulated Defecit	O Compr	mulated ther ehensive le (Loss)	Total
Balance, January 1, 2010	\$	1 `	\$ 50	\$	8,539	\$ (6,387)	\$	(30)	\$ 2,173
Accretion of preferred stock discount					4	(4)			-
Dividends on preferred stock					(23)				(23)
Comprehensive loss: Net Loss Change in unrealized gain on securities available-for-sale						(668)		30	 (668)
Total comprehensive loss									(638)
Balance, December 31, 2010	\$	1	\$ 50	\$	8,520	\$ (7,059)	\$	-	\$ 1,512
Sale of 1,754,138 shares of common stock as part of the recapitalization			1,754		14,957				\$ 16,711
Common stock issued			1		4				\$ 5
Redemption of preferred stock (TARP)	1	(574)							\$ (574)
Accretion of discount on preferred stock and redemption charge		573			(602)				\$ (29)
Dividends on preferred stock					(20)				\$ (20)
Stock compensation expense					130				\$ 130
Comprehensive loss: Net Loss Change in unrealized gain on securities available-for-sale						(3,838)		143	\$ (3,838)
Total comprehensive loss									 (3,695)
Balance, December 31, 2011	\$		\$ 1,805	\$	22,989	\$ (10,897)	\$	143	\$ 14,040

## COLONIAL AMERICAN BANK Statements of Cash Flows

	Years Ended December 31			nber 31,
		2011		2010
Operating Activities				
Net loss	\$	(3,838)	\$	(668
Adjustments to reconcile net loss to net cash	Ψ	(3,030)	Ψ	(000)
used in operating activities:				
Depreciation & amortization		117		153
Provision for loan losses		741		54
Amortization (accretion) of premiums and discounts on		741		J-1
securities, and deferred loan fees and costs		13		3
Stock compensation expense		130		
Write-down of other real estate owned		21		6
(Increase) decrease in accrued interest receivable and other assets		(338)		112
Increase (decrease) in accrued interest payable and other accrued liabilities		467		(26
Net cash used in operating activities		(2,687)		(366
Investing Activities				
Purchases of securities available-for-sale		(5,959)		(1,000
Proceeds from maturities and principal repayments of		(3,333)		(1,000
securities available-for-sale		819		4,000
Proceeds from maturities and principal repayments of		019		4,000
securities held-to-maturity		_		1,000
Redemption of Federal Home Loan Bank of Pittsburgh stock, net		- 78		1,000
Net (increase) decrease in loans		(16,402)		2,723
Purchases of premises and equipment				2,720
Proceeds from sales of foreclosed assets		(540) 48		
Net cash (used in) provided by investing activities		(21,956)		6,723
Financing Activities				
		(000)		
Redemption of preferred stock		(603)		(00
Cash dividends on preferred stock  Net proceeds from sale of common stock		(20)		(23
		16,717		(2.000
Net increase (decrease) in deposits  Net cash provided by (used in) financing activities	-	9,991 <b>26,085</b>		(3,009
Net cash provided by (used iii) illiancing activities		20,005		(3,032
Net increase in cash and cash equivalents		1,442		3,325
Cash and Cash Equivalents, Beginning of Year		3,618		293
Cash and Cash Equivalents, End of Year	\$	5,060	\$	3,618
Supplementary Cash Flow Information				
Cash paid during the year for:				
Interest paid	\$	313	\$	407
Dividends	•	20	•	23
Non-cash transactions:				
Transfer of loan to other real estate owned		189		
Transier of loan to other real estate owner		109		-

Notes to Financial Statements December 31, 2011 and 2010

## 1. Nature of Operations

Colonial American Bank (the "Bank") is a state chartered bank, which was incorporated on September 1, 2006 under the laws of the Commonwealth of Pennsylvania. The Bank commenced operations on February 9, 2007. The Bank is chartered by the Pennsylvania Department of Banking and insured by the Federal Deposit Insurance Corporation ("FDIC"). The Bank maintains its principal branch office in Horsham, Pennsylvania and provides financial services primarily in Montgomery County and the surrounding counties of the Greater Delaware Valley. In January 2012, the Bank received regulatory approval to expand its branch network into the State of New Jersey, and opened a branch in Middletown, New Jersey in March 2012. In connection with the opening of the branch, the Bank established a second trade area in Monmouth County, New Jersey.

On September 7, 2010, the Bank executed a Securities Purchase Agreement (the "Agreement") with a group of investors unrelated to Colonial American Bank to purchase up to \$25.0 million of newly issued common stock of Colonial American Bank directly from the Bank. The Agreement was subject to certain terms and conditions as outlined in the Agreement, and subject to regulatory approvals. On April 15, 2011, the Bank closed upon the Agreement, with the investor group raising \$17.5 million in new capital for the Bank (the "Recapitalization"). In connection with the closing of the Recapitalization, the entire Board of Directors immediately prior to the closing resigned, and a new slate of directors was appointed to the Board. In addition, a new management team was hired subsequent to the Recapitalization.

## 2. Summary of Significant Accounting Policies

The following significant accounting and reporting policies of Colonial American Bank (the "Bank"), conform to accounting principles generally accepted in the United States of America, or ("GAAP"), and are used in preparing and presenting these financial statements.

## **Basis of Presentation**

In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting periods. Actual results may differ significantly from those estimates and assumptions. Material estimates that are particularly susceptible to significant change in the near term are the allowance for loan losses, other-than-temporary impairment of investment securities, and the realization of net deferred tax assets. In connection with the determination of this allowance, management generally obtains independent appraisals for significant properties. Judgments related to securities valuation and impairment, and deferred income taxes involve a higher degree of complexity and subjectivity and require estimates and assumptions about highly uncertain matters. Actual results may differ from the estimates and assumptions.

Certain prior year balances have been reclassified to conform to the current year presentation.

## **Cash and Cash Equivalents**

Cash and cash equivalents include cash on hand, interest bearing deposits with other banks, and federal funds sold, all of which mature within ninety days.

Notes to Financial Statements December 31, 2011 and 2010

## **Investment Securities**

In accordance with applicable accounting standards, the Bank classifies its investment securities into one of three portfolios: held to maturity; available for sale or trading. Investments in debt securities that we have the positive intent and ability to hold to maturity are classified as held to maturity securities and reported at amortized cost. Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized holding gains and losses included in earnings. Debt and equity securities not classified as trading securities or as held to maturity securities are classified as available for sale securities and reported at fair value, with unrealized holding gains or losses, net of deferred income taxes, reported in the accumulated other comprehensive income ("OCI") component of shareholders' equity.

If the fair value of a security is less than its amortized cost, the security is deemed to be impaired. Management evaluates all securities with unrealized losses quarterly to determine if such impairments are "temporary" or "other-than-temporary".

The Bank accounts for temporary impairments based upon their classification as either available for sale, held to maturity or managed within a trading portfolio. Temporary impairments on "available for sale" securities are recognized, on a tax-effected basis, through OCI with offsetting entries adjusting the carrying value of the security and the balance of deferred taxes. Conversely, the Bank does not adjust the carrying value of "held to maturity" securities for temporary impairments, although information concerning the amount and duration of impairments on held to maturity securities is generally disclosed in periodic financial statements. The carrying value of securities held in a trading portfolio is adjusted to their fair value through earning on a daily basis. However, the Bank did not maintain a trading or held-to-maturity portfolio at or during the periods presented in these financial statements.

The Bank accounts for other-than-temporary impairments based upon several considerations. First, other-than-temporary impairments on securities that the Bank has decided to sell as of the close of a fiscal period, or will, more likely than not, be required to sell prior to the full recovery of their fair value to a level equal to or exceeding their amortized cost, are recognized in earnings. If neither of these conditions regarding the likelihood of the securities' sale are applicable, then, for debt securities, the other-than-temporary impairment is bifurcated into credit-related and noncredit-related components. A credit-related impairment generally represents the amount by which the present value of the cash flows that are expected to be collected on a debt security fall below its amortized cost. The noncredit-related component represents the remaining portion of the impairment not otherwise designated as credit-related. The Bank recognizes credit-related, other-than-temporary impairments in earnings. However, noncredit-related related component is recognized in OCI.

Premiums and discounts on all securities are generally amortized/accreted to maturity by use of the level-yield method considering the impact of principal amortization and prepayments on mortgage-backed securities. Premiums on callable securities are generally amortized to the call date whereas discounts on such securities are accreted to the maturity date. Gain or loss on sales of securities is based on the specific identification method.

Notes to Financial Statements December 31, 2011 and 2010

## Federal Home Loan Bank and Atlantic Central Bankers Bank Stock

Federal law requires a member institution of the Federal Home Loan Bank ("FHLB") system to hold restricted stock of its district Federal Home Loan Bank according to a predetermined formula. Restricted stock of the Federal Home Loan Bank of Pittsburgh in the amount of \$345,000 and \$423,000 is carried at cost at December 31, 2011 and 2010, respectively.

Management's determination of whether these investments are impaired is based on an assessment of the ultimate recoverability of their cost, rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLB.

The Bank also held \$50,000 of stock in the Atlantic Central Bankers Bank ("ACBB"), at December 31, 2011 and 2010. Management believes no impairment charge is necessary related to the FHLB restricted stock or the ACBB stock as of December 31, 2011 or 2010.

#### Loans Receivable and Allowance for Loan Losses

Loans receivable, which management has the intent and ability to hold for the foreseeable future or until maturity or payoff, are stated at unpaid principal balance, adjusted by unamortized premiums and unearned discounts, deferred origination fees and certain direct origination costs, and the allowance for loan losses. Interest income on loans is accrued and credited to income as earned. Net loan origination fees/costs are deferred and accreted/amortized to interest income over the loan's contractual life using the level-yield method, adjusted for actual prepayments.

The Bank defines an impaired loan as a loan for which it is probable, based on current information, that the Bank will not collect all amounts due in accordance with the contractual terms of the loan agreement. The Bank has defined the population of impaired loans to be all non-accrual loans, loans risk rated 8 (Doubtful) or 9 (Loss), and all loans subject to a troubled debt restructuring. Impaired loans are individually assessed to determine that the loan's carrying value is not in excess of the expected future cash flows, discounted at the loan's original effective interest rate, or the underlying collateral (less estimated costs to sell) if the loan is collateral dependent. Impairments are recognized through a charge to the provision for loan losses for the amount that the loan's carrying value exceeds the discounted cash flow analysis or estimated fair value of collateral (less estimated costs to sell) if the loan is collateral dependent. Homogeneous loans are collectively evaluated for impairment.

Notes to Financial Statements December 31, 2011 and 2010

> The allowance for loan losses is increased by the provision for loan losses charged against income and is decreased by charge-offs, net of recoveries. Loan losses are charged-off in the period the loans, or portion thereof, are deemed uncollectible. Generally, the Bank will record a loan charge-off (including a partial charge-off) to reduce a loan to the estimated fair value of the underlying collateral, less cost to sell, if it is determined that it is probable that recovery will come primarily from the sale of such collateral. The provision for loan losses is based on management's evaluation of the adequacy of the allowance which considers, among other things, impaired loans, past loan loss experience, known and inherent risks in the portfolio, existing adverse situations that may affect the borrower's ability to repay, and estimated fair value of any underlying collateral securing loans. Additionally, management evaluates changes, if any, in underwriting standards, collection, charge-off and recovery practices, the nature or volume of the portfolio, lending staff, concentration of loans, as well as current economic conditions, and other relevant factors. Management believes the allowance for loan losses is adequate to provide for probable and reasonably estimable losses at the date of the balance sheets. The Bank also maintains an allowance for estimated losses on off-balance sheet credit risks related to loan commitments and standby letters of credit. Management utilizes a methodology similar to its allowance for loan loss adequacy methodology to estimate losses on these commitments. The allowance for estimated credit losses on off-balance sheet commitments is included in other liabilities and any changes to the allowance are recorded as a component of other non-interest expense.

> While management uses available information to recognize probable and reasonably estimable losses on loans, future additions may be necessary based on changes in conditions, including changes in economic conditions, particularly in the counties in which the Bank operates. Accordingly, as with most financial institutions in the market area, the ultimate collectibility of a substantial portion of the Bank's loan portfolio is susceptible to changes in conditions in the Bank's marketplace. In addition, future changes in laws and regulations could make it more difficult for the Bank to collect all contractual amounts due on its loans and mortgage-backed securities.

In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

A loan modification is deemed a troubled debt restructuring ("TDR") when two conditions are met: 1) the borrower is experiencing financial difficulty and 2) a concession is made by the Bank that would not otherwise be considered for a borrower or collateral with similar credit risk characteristics. Once an obligation has been restructured, it continues to be considered restructured until paid in full or, if the obligation yields a market rate (a rate equal to or greater than the rate the Bank was willing to accept at the time of the restructuring for a new loan with comparable risk), until the year subsequent to the year in which the restructuring takes place, provided the borrower has performed under the modified terms for a six-month period. The Bank records an impairment charge equal to the difference between the present value of estimated future cash flows under the restructured terms discounted at the original loan's effective interest rate, or the underlying collateral value less costs to sell, if the loan is collateral dependent. Changes in present values attributable to the passage of time are recorded as a component of the provision for loan losses.

Notes to Financial Statements December 31, 2011 and 2010

A loan is considered past due when it is not paid in accordance with its contractual terms. The accrual of income on loans, including impaired loans, and other loans in the process of foreclosure, is generally discontinued when a loan becomes 90 days or more delinquent, or when certain factors indicate that the ultimate collection of principal and interest is in doubt. Loans on which the accrual of income has been discontinued are designated as non-accrual loans. All previously accrued interest is reversed against interest income, and income is recognized subsequently only in the period that cash is received, provided no principal payments are due and the remaining principal balance outstanding is deemed collectible. A non-accrual loan is not returned to accrual status until both principal and interest payments are brought current and factors indicating doubtful collection no longer exist, including performance by the borrower under the loan terms for a six-month period.

## **Premises and Equipment**

Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method and charged to expense over the estimated useful lives of the assets. Leasehold improvements are amortized to expense over the shorter of the term of the respective lease or the estimated useful life of the improvements. The estimated useful lives of furniture and equipment is five to fifteen years.

#### **Foreclosed Assets**

Foreclosed assets are comprised of property acquired through a foreclosure proceeding or acceptance of a deed-in-lieu of foreclosure. Foreclosed assets are held for sale and are initially recorded at estimated fair value, net of estimated selling costs, at the date of foreclosure establishing a new cost basis. Costs after acquisition are generally expensed. If the estimated fair value of the asset declines, a write-down is recorded through other non-interest expense.

#### **Income Taxes**

The Bank accounts for income taxes in accordance with income tax accounting guidance (Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 740, *Income Taxes*).

Federal and state income taxes have been provided on the basis of reported income or loss. The amounts reflected on the tax returns differ from these provisions due principally to temporary differences in the reporting of certain items for financial reporting and income tax reporting purposes. The tax effect of these temporary differences is accounted for as deferred taxes applicable to future periods. Deferred income tax expense or benefit is determined by recognizing deferred tax assets and liabilities for the estimated future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. 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 or settled. The effect on deferred assets and liabilities of a change in tax rates is recognized in earnings in the period that includes the enactment date. The realization of deferred tax assets is assessed and a valuation allowance provided for the full amount which is not more likely than not to be realized.

Notes to Financial Statements December 31, 2011 and 2010

The Bank had no material unrecognized tax benefits or accrued interest and penalties as of December 31, 2011 and 2010. The Bank's policy is to account for interest as a component of interest expense and penalties as a component of other expense.

The Bank files a both federal and state income tax returns. The Bank is no longer subject to examination by taxing authorities for the years before January 1, 2008.

## **Earnings (Loss) Per Common Share**

Basic earnings (loss) per common share are computed by dividing net income (loss) attributable to common shareholders by the weighted average number of common shares outstanding during the period. Loss attributable to common shareholders has been increased by preferred stock dividends and discount accretion related to the Bank's participation in the Capital Purchase Program, as described in Note 12. Diluted earnings (loss) per common share considers common stock equivalents (when dilutive) outstanding during the period such as options and warrants. In computing diluted earnings (loss) per share for 2011 and 2010, options and warrants to purchase an aggregate of 698,145 and 22,742 shares of common stock, respectively, were excluded from the computation because the effect of these instruments would be antidilutive.

## **Stock-Based Compensation**

The Bank accounts for its stock based compensation plans under the provisions of FASB ASC Topic 718, Compensation — Stock Compensation, which requires recognizing expense for options granted equal to the grant-date fair value of the unvested amounts over their remaining vesting period. The expense related to stock options is based on the estimated fair value of the options at the date of the grant using the Black-Scholes pricing model. The awards are fixed in nature and compensation cost related to stock based awards is recognized on a straight-line basis over the requisite service periods. Excess tax benefits arising from increases in the value of equity instruments issued under stock-based payment arrangements are treated as cash inflows from financing activities.

## **Comprehensive Income (Loss)**

Comprehensive income (loss) consists of net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains or losses on securities available-for-sale which are also recognized as a separate component of shareholders' equity.

## **Fair Value of Financial Instruments**

For information on the fair value of the Bank's financial instruments refer to Note 11 – "Fair Value Measurement" of the financial statements.

## **Restrictions on Cash and Amounts Due from Banks**

The Bank does not have any requirements to maintain balances with the Federal Reserve Bank at December 31, 2011 and 2010.

Notes to Financial Statements December 31, 2011 and 2010

## **Recent Accounting Pronouncements**

In December 2011, the FASB issued Accounting Standard Update ("ASU") 2011-12, "Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05". The amendments in ASU 2011-12 effectively defer only those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments out of accumulated other comprehensive income. The amendments will be temporary to allow the Board time to redeliberate the presentation requirements for reclassifications out of accumulated other comprehensive income for annual and interim financial statements for public, private, and non-profit entities. All other requirements in ASU 2011-05 are not affected by ASU 2011-12, including the requirement to report comprehensive income either in a single continuous financial statement or in two separate but consecutive financial statements. The provisions of ASU No. 2011-12 are effective for the Bank's fiscal years ending after December 15, 2012, and is not expected to have a significant impact on the Bank's financial statements.

In December 2011, the FASB issued ASU 2011-11, "Disclosures about Offsetting Assets and Liabilities" which amends ASC Topic 210 "Balance Sheet". Because of the significant differences in requirements under U.S. GAAP and International Financial Reporting Standards ("IFRS"), FASB and the International Accounting Standards Board ("IASB") are issuing joint requirements that will enhance current disclosures. Entities are required to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. The objective of this disclosure is to facilitate comparison between those entities that prepare their financial statements on the basis of U.S. GAAP and those entities that prepare their financial statements on the basis of IFRS. ASU 2011-11 is effective for annual periods beginning on or after January 1, 2013 and interim periods within those annual periods. An entity should provide the disclosures required by these amendments retrospectively for all comparative periods presented. The adoption of ASU 2011-11 is not expected to have a significant impact on the Bank's financial statements.

In June 2011, the FASB issued ASU 2011-05, "Presentation of Comprehensive Income" which amends ASC Topic 220 "Comprehensive Income". To increase the prominence of items reported in other comprehensive income and to facilitate convergence of U.S. GAAP and IFRS, the FASB decided to eliminate the option to present components of other comprehensive income as part of the statement of changes in stockholders' equity, among other amendments in ASU 2011-05. The amendments require that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In the two-statement approach, the first statement should present total net income and its components followed consecutively by a second statement that should present total other comprehensive income, the components of other comprehensive income, and the total of comprehensive income. The provisions of ASU No. 2011-05 are effective for the Bank's fiscal years ending after December 15, 2012, with retrospective application required. The adoption of ASU No. 2011-05 is expected to result in presentation changes to the Bank's statements of operation and the addition of a statement of comprehensive income. The adoption of ASU No. 2011-05 will have no effect on the Bank's balance sheets.

Notes to Financial Statements December 31, 2011 and 2010

In May 2011, the FASB issued ASU 2011-04, "Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS" which generally clarifies guidance in ASC Topic 820 "Fair Value Measurements and Disclosures". The amendments in ASU 2011-004 explain how to measure fair value and change the wording used to describe the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. ASU 2011-04 does not require additional fair value measurements and is not intended to establish valuation standards or affect valuation practices outside of financial reporting. For non-public entities, ASU 2011-04 is effective for the annual periods beginning after December 15, 2011. The adoption of ASU 2011-04 is not expected to have a significant impact on the Bank's financial statements.

In April 2011, the FASB issued ASU 2011-02, "A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring" which is intended to amend guidance related to troubled debt restructurings ("TDRs"). ASU 2011-02 provides additional guidance to assist creditors in concluding whether the restructuring has granted a concession to the borrower and that the borrower is experiencing financial difficulties. The Bank adopted the requirements of this Accounting Standard Update as of December 31, 2011. The adoption of ASU 2011-02 did not have a significant impact on the Bank's financial statements.

In July 2010, the FASB issued ASU No. 2010-20, "Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses", which is intended to help investors assess the credit risk of a company's receivables portfolio and the adequacy of its allowance for credit losses held against the portfolios by expanding credit risk disclosures. ASU 2010-20 requires more information about the credit quality of financing receivables in the disclosures to financial statements, such as aging information and credit quality indicators. Both new and existing disclosures must be disaggregated by portfolio segment or class. The disaggregation of information is based on how a company develops its allowance for credit losses and how it manages its credit exposure. The disclosure requirements as of December 31, 2011 are included in "Note 6 – Loans" to the Financial Statements. These disclosures, as of the end of a reporting period and about activity that occurs during a reporting period, are effective for interim and annual reporting periods ending on or after December 15, 2011. The Bank adopted these requirements as of December 31, 2011, and has provided the applicable disclosures.

In January 2010, the FASB issued ASU No. 2010-06, "Improving Disclosures about Fair Value Measurements", which updates ASC Topic 820 "Fair Value Measurements and Disclosures". ASU 2010-06 is intended to provide a greater level of disaggregated information and more robust disclosures about valuation techniques and inputs to fair value measurements. A reporting entity should disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers. Additionally, a reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either Level 2 or Level 3. The new disclosures and clarifications of existing disclosures are effective for interim and annual reporting periods beginning after December 15, 2009. The disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements were effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The adoption of ASU 2010-06 did not have a significant impact on the Bank's financial statements.

Notes to Financial Statements December 31, 2011 and 2010

#### Subsequent Events

The Bank has evaluated subsequent events for potential recognition and/or disclosure through March 19, 2012, the date the financial statements were available to be issued, and has determined that no recognized or non-recognized subsequent events warranted inclusion or disclosure in these financial statements.

## 3. Consent Order with the Federal Deposit Insurance Corporation

On August 11, 2010 the Bank entered into a Consent Order with the Federal Deposit Insurance Corporation. Under the terms of the Consent Order the Bank has agreed to take certain actions relating to management, capital levels, policies, and planning. Specifically, the Consent Order is requiring the following actions:

- a) Strengthen board oversight, management and operations of the Bank;
- b) Enhance the capital levels of the Bank;
- c) Develop a comprehensive strategic plan;
- d) Develop a profit plan;
- e) Review and enhance the liquidity and funds management plan;
- f) Review and enhance the audit program;
- g) Review and enhance the loan policy;
- h) Develop a concentrations plan;
- i) Review and enhance the interest rate risk policy;
- j) No dividends shall be paid; and
- k) Form a Compliance Committee.

The Consent Order includes time frames to implement the foregoing and on-going compliance requirements to report to the FDIC. The Consent Order also requires quarterly progress reports be sent by the Bank to the FDIC. The Bank has taken numerous steps to comply with all of the requirements of the Consent Order. On April 15, 2011, the recapitalization of the Bank closed, and the Bank realized a net increase in capital of \$16.7 million. Concurrent with the recapitalization, a new Board of Directors and management team was approved by the Bank's regulators (the FDIC) and installed at the Bank. As of December 31, 2011, management is working closely with the Bank's regulators to satisfy the requirements of the Consent Order.

## 4. Cash and Due from Banks

The Bank maintains various deposit accounts with other banks to meet normal funds transaction requirements, to satisfy minimum deposit requirements, and to compensate other banks for certain correspondent services. The Federal Deposit Insurance Corporation insures these accounts up to \$250,000 per account. Management is responsible for assessing the credit risk of its correspondent banks. The withdrawal or usage restrictions of these balances did not have a significant impact on the operations of the Bank as of December 31, 2011 and 2010.

## 5. Securities Available-for-Sale

The amortized cost and estimated fair value of securities at December 31, 2011 is summarized below (in thousands). All of the Bank's securities are classified as available-for-sale. The Bank had no securities at December 31, 2010.

Notes to Financial Statements December 31, 2011 and 2010

	2011									
		nortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	E	Estimated Fair Value				
Mortgage-backed securities:										
U.S. government agencies	\$	5,124	145	2	\$	5,267				
Total securities available-for-sale	\$	5,124	145	2	\$	5,267				

Expected maturities on mortgage-backed securities will differ from contractual maturities as borrowers may have the right to call or prepay obligations with or without penalties.

No securities were pledged to secure borrowings at December 31, 2011 and 2010.

There were no sale of securities available-for-sale during the years ended December 31, 2011 and 2010.

At December 31, 2011, there was one GNMA mortgage-backed security in a gross unrealized loss position of \$2,000. This security was purchased in December 2011 and, as a result, was in a loss position for a period of less than twelve months. The unrealized loss on this investment in a U.S. Government sponsored entity was caused by movement in interest rates. As the Bank does not intend to sell this security, and it is not more likely than not that the Bank would be required to sell this security before recovery of its amortized cost basis, which may be at maturity, the Bank does not consider this investment to be other-than-temporarily impaired at December 31, 2011.

#### 6. Loans

Loans receivable, net of allowance for loan losses, consist of the following at December 31, 2011 and 2010 (in thousands):

		2011		2010
		(in thou	sands)	
Residential mortgages	\$	12,361	\$	5,696
Home equity and lines of credit		3,044		3,409
Commercial real estate		13,967		6,618
Commercial and industrial		3,124		-
Construction		-		996
Consumer		23		65
		32,519		16,784
Deferred loan (fees) costs, net		(11)		8
Total loans receivable		32,508		16,792
Allowance for loan losses		(466)		(225)
Loans receivable, net	\$	32,042	\$	16,567

Notes to Financial Statements December 31, 2011 and 2010

The Bank provides for loan losses based on the consistent application of our documented allowance for loan loss methodology. Loan losses are charged to the allowance for loans losses and recoveries are credited to it. Additions to the allowance for loan losses are provided by charges against income based on various factors which, in our judgment, deserve current recognition in estimating probable losses. Loan losses are charged-off in the period the loans, or portion thereof, are deemed uncollectible. Generally, the Bank will record a loan charge-off (including a partial charge-off) to reduce a loan to the estimated fair value of the underlying collateral, less cost to sell, for collateral dependent loans. Management regularly reviews the loan portfolio and makes adjustments for loan losses in order to maintain the allowance for loan losses in accordance with U.S. generally accepted accounting principles ("GAAP"). The allowance for loan losses consists primarily of the following two components:

- (1) Specific allowances are established for impaired loans, generally defined by the Bank to be all nonaccrual loans, loans risk rated 8 (Doubtful) or 9 (Loss), and all loans subject to a troubled debt restructuring. The amount of impairment provided for as an allowance is represented by the deficiency, if any, between the present value of expected future cash flows discounted at the original loan's effective interest rate or the underlying collateral value (less estimated costs to sell,) if the loan is collateral dependent, and the carrying value of the loan. Impaired loans that have no impairment losses are not considered for general valuation allowances described below.
- (2) General allowances are established for loan losses on a portfolio basis for loans that do not meet the definition of impaired. The portfolio is grouped into similar risk characteristics, primarily loan segment and internal credit risk ratings. We apply an estimated loss rate to each loan group. The loss rates applied are based on our cumulative prior two year loss experience adjusted, as appropriate, for the environmental factors discussed below. This evaluation is inherently subjective, as it requires material estimates that may be susceptible to significant revisions based upon changes in economic and real estate market conditions. Actual loan losses may be significantly more than the allowance for loan losses we have established, which could have a material negative effect on our financial results. Within general allowances is an unallocated reserve established to recognize losses related to the inherent subjective nature of the appraisal process and the internal credit risk rating process.

In underwriting a loan secured by real property, the Bank requires an appraisal (or an automated valuation model) of the property by an independent licensed appraiser approved by the Bank's board of directors. The appraisal is subject to review by an independent third party hired by the Bank. Management reviews and inspects properties before disbursement of funds during the term of a construction loan. Generally, management obtains updated appraisals when a loan is deemed impaired. These appraisals may be more limited than those prepared for the underwriting of a new loan. In addition, when the Bank acquires other real estate owned, it generally obtains a current appraisal to substantiate the net carrying value of the asset at the time of foreclosure.

The adjustments to the Bank's loss experience is based on management's evaluation of several environmental factors, including:

 changes in local, regional, national, and international economic and business conditions and developments that affect the collectability of our portfolio, including the condition of various market segments;

Notes to Financial Statements December 31, 2011 and 2010

- changes in the nature and volume of the Bank's portfolio and in the terms of the Bank's loans;
- changes in the experience, ability, and depth of lending management and other relevant staff:
- changes in the volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans;
- changes in the quality of the Bank's loan review system;
- changes in the value of underlying collateral for collateral-dependent loans;
- the existence and effect of any concentrations of credit, and changes in the level of such concentrations; and
- the effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the Bank's existing portfolio.

In evaluating the estimated loss factors to be utilized for each loan segment, management also reviews actual loss history over an extended period of time as reported by the FDIC for institutions in the Bank's market area for periods that are believed to have experienced similar economic conditions.

Management evaluates the allowance for loan losses based on the combined total of the specific and general components. Generally when the loan portfolio increases, absent other factors, the Bank's allowance for loan loss methodology results in a higher dollar amount of estimated probable losses. Conversely, when the loan portfolio decreases, absent other factors, the Bank's allowance for loan loss methodology results in a lower dollar amount of estimated probable losses.

Each quarter management evaluates the allowance for loan losses and adjusts the allowance as appropriate through a provision for loan losses. While management uses the best information available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the information used in making the evaluations. In addition, as an integral part of their examination process, the Bank's regulators will periodically review the allowance for loan losses. The regulators may require the Bank to adjust the allowance based on their analysis of information available to them at the time of their examination. Based on management's comprehensive analysis of the loan portfolio, management believes the current level of the allowance for loan losses is adequate.

Notes to Financial Statements December 31, 2011 and 2010

A summary of changes in the allowance for loan losses for the years ended December 31, 2011 and 2010 follows (in thousands):

	December 31,								
	2	2010							
Balance at beginning of year	\$	225	\$	225					
Provision for loan losses		741		54					
Charge-offs		(502)		(180)					
Recoveries		2		126					
Balance at end of year	\$	466	\$	225					

The following table sets forth activity in the Bank's allowance for loan losses, by loan type, for the year ended December 31, 2011. The following table also details the amount of loans receivable, net of deferred loan fees and costs, that are evaluated individually, and collectively, for impairment, and the related portion of the allowance for loan losses that is allocated to each loan portfolio segment.

	sidential rtgages	a	e Equity and of Credit	 nmercial al Estate	Comm an Indus	d	Constr	ruction	Cor	nsumer	Unal	located	Total	
Allowance for loan losses:														
Beginning balance	111		13	86		-		13		2		-		225
Provisions	292		15	139		54		62		124		55		741
Charge-offs	(208)		(9)	(87)		-		(75)		(123)		-	(5	502)
Recoveries	 2			 		<del></del>								2
Ending Balance	\$ 197		19	 138		54				3		55	4	166
Ending balance: individually evaluated for impairment Ending balance: collectively evaluated for impairment	\$ - 197		- 19	 138		- 54		<u></u>		<u>-</u> 3		- 55	-	166
Loans receivable, net Ending balance	\$ 12,363	\$	3,048	\$ 13,951	\$	3,123	\$	-	\$	23	\$		32,5	508
Ending balance: individually evaluated for impairment Ending balance: collectively	\$ 		64	 1,641						6			1,7	711
evaluated for impairment	\$ 12,363		2,984	 12,310		3,123				17			30,7	797

During the year ended December 31, 2011, the Bank recorded charge-offs totaling \$502,000. The Bank recorded \$208,000 of charge-offs on two loan relationships that were subsequently sold or paid-off prior to December 31, 2011. In addition, the Bank wrote down one loan by \$75,000 prior to taking possession of the collateral. At December 31, 2011, this property is classified as other real estate owned. The remaining \$219,000 of charge-offs were recorded on three loans that currently remain in the Bank's portfolio at December 31, 2011.

The Bank continuously monitors the credit quality of its loan receivables in an ongoing manner. Credit quality is monitored by reviewing certain credit quality indicators. Management has determined that internally assigned credit risk ratings by loan segment are the key credit quality indicators that best help management monitor the credit quality of the Bank's loan receivables.

Notes to Financial Statements December 31, 2011 and 2010

The Bank has adopted a credit risk rating system as part of the risk assessment of its loan portfolio. The Bank's lending officers are required to assign a credit risk rating to each loan in their portfolio at origination. When the lender learns of important financial developments, the risk rating is reviewed accordingly, and adjusted if necessary. Monthly, management presents monitored assets to the loan committee and board of directors. In addition, the Bank engages a third party independent loan reviewer that performs semi-annual reviews of a sample of loans, validating the credit risk ratings assigned to such loans. The credit risk ratings play an important role in the establishment of the loan loss provision and to confirm the adequacy of the allowance for loan losses. After determining the general reserve loss factor for each portfolio segment (segregated by credit risk rating), the portfolio segment balance collectively evaluated for impairment (for each credit risk rating) is multiplied by the general reserve loss factor for the respective portfolio segment in order to determine the general reserve.

When assigning a risk rating to a loan, management utilizes the Bank's internal nine-point credit risk rating system.

- 1. Minimal
- 2. Modest
- 3. Average
- 4. Acceptable
- 5. Acceptable with care
- 6. Special mention
- 7. Substandard
- 8. Doubtful
- 9. Loss

Loans rated 1 — 5 are considered pass ratings. An asset is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets have well defined weaknesses based on objective evidence, and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all of the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses present make collection or liquidation in full highly questionable and improbable based on current circumstances. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets is not warranted. Assets which do not currently expose the Bank to sufficient risk to warrant classification in one of the aforementioned categories, but possess weaknesses, are required to be designated special mention.

The Bank also maintains an unallocated component related to the general loss allocation. Management does not target a specific unallocated percentage of the total general allocation, or total allowance for loan losses. The primary purpose of the unallocated component is to account for the inherent imprecision of the loss estimation process related primarily to periodic updating of appraisals on impaired loans, as well as periodic updating of commercial loan credit risk ratings by loan officers and the Bank's internal credit audit process.

The following table details the recorded investment of loans receivable, net of deferred fees and costs, by loan type and credit quality indicator at December 31, 2011 (in thousands).

	Residential Mortgages	Home Equity and Lines of Credit	Commercial Real Estate	Commercial and Industrial	Construction	Consumer	Total
Internal Risk Rating							
Pass	\$ 12,363	2,397	11,990	3,026	-	17	\$ 29,793
Special Mention	-	587	320	97	-	-	1,004
Substandard		64	1,641			6	 1,711
Total Loans Receivable, net	\$ 12,363	3,048	13,951	3,123	-	23	\$ 32,508

Notes to Financial Statements December 31, 2011 and 2010

Included in loans receivable are loans for which the accrual of interest income has been discontinued due to deterioration in the financial condition of the borrowers. The recorded investment of these nonaccrual loans was \$1.2 million and \$270,000 at December 31, 2011 and 2010, respectively. Generally, loans are placed on non-accruing status when they become 90 days or more delinquent, and remain on non-accrual status until they are brought current, have six months of performance under the loan terms, and factors indicating reasonable doubt about the timely collection of payments no longer exist. Therefore, loans may be current in accordance with their loan terms, or may be less than 90 days delinquent and still be on a non-accruing status. These non-accrual amounts were all deemed to be impaired at December 31, 2011 and 2010, respectively. There were no loans past due ninety days or more and still accruing interest December 31, 2011 and 2010.

The following table sets forth the detail, and delinquency status, of non-performing loans (non-accrual loans and loans past due ninety days or more and still accruing), net of deferred fees and costs, at December 31, 2011 (in thousands).

	 No	n-Accruing Loa	ans	> 90 Days		
	Days t Due	30-89 Days Past Due	, <u> </u>		Per	tal Non- forming oans
Home equity and lines of credit						
Substandard	\$ 64				\$	64
Total home equity and lines of credit	64	-	-	-		64
Commercial mortgage						
Substandard	-	1,082				1,082
Total commercial mortgage	-	1,082	-	-		1,082
Consumer						
Substandard	 6					6
Total consumer	6	-	-	-		6
Total Non-Performing Loans	\$ 70	1,082		_	\$	1,152

The following table sets forth the detail and delinquency status of loans receivable, net of deferred fees and costs, by performing and non-performing loans at December 31, 2011 (in thousands).

Notes to Financial Statements December 31, 2011 and 2010

	Perform	ming (Accruing)	Loans	Non-	
	0-29 Days	30-89 Days		Performing	Total Loans
	Past Due	Past Due	Total	Loans	Receivable, net
Residential mortgages					
Pass	\$ 12,363	-	12,363	-	\$ 12,363
Special mention	-	-	-	-	-
Substandard			-	-	-
Total residential mortgages	12,363	-	12,363	-	12,363
Home equity and lines of credit					
Pass	2,397	-	2,397	-	2,397
Special mention	97	490	587	-	587
Substandard	-	-	-	64	64
Total home equity and lines of credit	2,494	490	2,984	64	3,048
Commercial real estate					
Pass	11,748	242	11,990	-	11,990
Special mention	98	222	320	-	320
Substandard	559	-	559	1,082	1,641
Total commercial real estate	12,405	464	12,869	1,082	13,951
Commericial and industrial					
Pass	3,026	-	3,026	-	3,026
Special mention	97	-	97	-	97
Substandard	-	-	-	-	_
Total commercial and industrial	3,123	-	3,123	=	3,123
Consumer					
Pass	17	-	17	-	17
Special mention	-	-	-	-	_
Substandard	-	-	-	6	6
Total consumer	17	-	17	6	23
Total	\$ 30,402	954	31,356	1,152	\$ 32,508

The following table summarizes impaired loans as of December 31, 2011 (in thousands):

	Red	corded	Principal	Related
	Inve	stment	Balance	Allowance
With No Allowance Recorded:				
Home equity and lines of credit Substandard	\$	64	73	- -
Commercial mortgage Substandard		1,641	1,728	-
Consumer Substandard		6	128	- -
Total				
Home equity and lines of credit		64	73	<del>-</del>
Commercial mortgage		1,641	1,728	-
Consumer		6	128	
	\$	1,711	1,929	

Notes to Financial Statements December 31, 2011 and 2010

At December 31, 2010, the recorded investment of impaired loans was \$270,000, with \$0 of related allowances.

Included in the table above at December 31, 2011 are loans with carrying balances of \$1.5 million that were not written down by either charge-offs or specific reserves in the Bank's allowance for loan losses. At December 31, 2010, \$0 of impaired loans were not written down either by charge-offs or specific reserves in the Bank's allowance for loan losses. Loans not written down by charge-offs or specific reserves at December 31, 2011 have sufficient collateral values, less costs to sell, supporting the carrying balances of the loans.

The average recorded balance of impaired loans for the years ended December 31, 2011 and 2010 was approximately \$1.0 million and \$270,000, respectively. The Bank recorded interest income of \$32,000 on one impaired loan during the year ended December 31, 2011. The Bank did not record any interest income on impaired loans during the year ended December 31, 2010. The Bank would have recorded additional interest income \$60,000 and \$39,000 on impaired loans during the year ended December 31, 2011 and 2010, respectively, were the loans not classified as non-accrual.

The following table summarizes loans that were modified in a troubled debt restructuring during the year ended December 31, 2011 (in thousands).

	Number of Relationships		Pre-Modification Outstanding Recorded Investment		Post-Modification Outstanding Recorded Investment	
Troubled Debt Restructurings						
Residential mortgage						
Substandard		1	\$	574	\$	450
Commercial real estate						
Substandard		1		559		559
Consumer						
Substandard		1_		149		149
Total troubled debt restructurings		3	\$	1,282	\$	1,158

The residential mortgage loan amounting to \$574,000 (pre-modification) was supported by a one- to four-family residential home and was restructured during the year ended December 31, 2011. This loan was charged-down by \$124,000 as part of the restructuring. This loan was extended and re-amortized over an extended term to reduce the payment owed by the borrower. This loan subsequently defaulted after the restructuring. This loan was subsequently paid off during the year ended December 31, 2011 as a result of the sale of the underlying collateral. An additional charge-off of \$83,000 was recorded prior to the sale of the collateral.

The commercial real estate loan amounting to \$559,000 (pre-modification) was supported by a retail center, and was restructured during the year ended December 31, 2011. This loan received an extension of interest-only payments, when the loan was set to begin principal amortization as well as interest payments. This loan has not subsequently defaulted after its restructuring.

Notes to Financial Statements December 31, 2011 and 2010

The consumer loan amounting to \$149,000 (pre-modification) was an unsecured line of credit. The maturity date of this loan was extended for two years during the year ended December 31, 2011. Subsequent to restructuring, the Bank received a \$20,000 pay-down on the loan. Also subsequent to the restructuring, the Bank recorded a charge-off of \$123,000 during the year ended December 31, 2011 as discussions with the borrower indicated that the outstanding principal balance of the loan would not be fully collectible upon maturity of the loan. This charge-off was recorded based on a change in circumstances regarding this credit, not as a result of a subsequent default after restructuring.

Management classifies all troubled debt restructurings as impaired loans. Impaired loans are individually assessed to determine that the loan's carrying value is not in excess of the fair value of the collateral (less costs to sell), if the loan is collateral dependent, or the present value of the expected future cash flows, if the loan is not collateral dependent. Management performs a detailed evaluation of each impaired loan and generally obtains updated appraisals as part of the evaluation. In addition, management adjusts estimated fair values down to appropriately consider recent market conditions, our willingness to accept a lower sales price to effect a quick sale, and costs to dispose of any supporting collateral. Determining the estimated fair value of underlying collateral (and related costs to sell) can be difficult in illiquid real estate markets and is subject to significant assumptions and estimates. Management employs an independent third party expert in appraisal preparation and review to ascertain the reasonableness of updated appraisals. Projecting the expected cash flows under troubled debt restructurings is inherently subjective and requires, among other things, an evaluation of the borrower's current and projected financial condition. Actual results may be significantly different than our projections and our established allowance for loan losses on these loans, which could have a material effect on our financial results.

## 7. Premises and Equipment, Net

A summary of the cost and accumulated depreciation of bank premises and equipment as of December 31, 2011 and 2010 is as follows:

	December 31,			
	2	2011	2	2010
	(ar	sands)		
Leasehold improvements	\$	285	\$	297
Furniture and equipment		584		511
Construction-in-process		479		-
		1,348		808
Less: accumulated depreciation and amortization		(785)		(668)
Premises and equipment, net	\$	563	\$	140

Depreciation expense for the years ended December 31, 2011 and 2010 was \$117,000 and \$153,000, respectively.

Notes to Financial Statements December 31, 2011 and 2010

## 8. Deposits

Deposits at December 31, 2011 and 2010 consisted of the following:

	 December 31,				
	2011		2010		
	(in thou	usand	s)		
Non-interest bearing demand	\$ 1,265	\$	746		
Interest-bearing demand	1,202		1,361		
Money market	9,092		1,420		
Savings	7,001		8,759		
Time (under \$100,000)	5,796		4,619		
Time (\$100,000 or more)	 5,006		2,466		
	\$ 29,362	\$	19,371		

Scheduled maturities of time deposits at December 31, 2011 are summarized as follows:

	Dece	December 31,			
	2	2011			
	(in th	ousands)			
2012	\$	7,754			
2013		2,115			
2014		904			
2015		-			
2016		29			
	\$	10,802			

Interest expense on deposits for the years ended December 31, 2011 and 2010 is summarized as follows:

	Y	Years Ended December 31,					
		2011	20	10			
		(in thou	sands)				
Interest-bearing demand	\$	5	\$	10			
Money market		30		16			
Savings		55		131			
Time		230		231			
	\$	320	\$	388			
				-			

## 9. Borrowings

At December 31, 2011 and 2010 the Bank had no outstanding borrowings. The Bank maintains a \$2.5 million line of credit with Atlantic Central Bankers Bank. The Bank also has borrowing capacity of \$8.5 million with the Federal Home Loan Bank of Pittsburgh.

Notes to Financial Statements December 31, 2011 and 2010

## 10. Income Taxes

The Bank, during its pre-opening period and subsequent to commencement of banking operations, has incurred cumulative net losses which has caused there to be no provision for income taxes, net deferred taxes and income taxes payable as of and for the years ended December 31, 2011 and 2010 because of related valuation allowances.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 2011 and 2010, are as follows (in thousands):

	December 31,				
	2	2011		2010	
Deferred tax assets:					
Allowance for loan losses	\$	133	\$	66	
Organizational and Start-up Costs		284		312	
Premises and equipment		89		82	
Stock Compensation expense		253		247	
Other		58		22	
Net operating loss carryforwards		934		1,695	
		1,751		2,424	
Valuation allowance		(1,689)		(2,413)	
Total Deferred Tax Assets, Net of Valuation Allowance		62		11	
Deferred tax liabilities:					
Unrealized Gains on AFS securities		(49)		-	
Deferred Loan Costs		(13)		(11)	
		(62)		(11)	
Net Deferred Tax Asset	\$		\$		

At December 31, 2011, the Bank has federal net operating losses available to offset future income in the amount of approximately \$2.7 million. Net operating losses generated prior to the recapitalization that occurred on April 15, 2011 are currently subject to limitation under Code Section 382. The annual limitation is approximately \$21,000 per year. These net operating losses will expire between 2027 and 2031.

Notes to Financial Statements December 31, 2011 and 2010

#### 11. Fair Value Measurement

The following table presents the assets reported on the balance sheet at their estimated fair value as of December 31, 2011 and 2010, by level within the Fair Value Measurements and Disclosures Topic of the FASB Accounting Standards Codification – ASC 820. Financial assets and liabilities are classified in their entirety based on the level of input that is significant to the fair value measurement. The fair value hierarchy is as follows:

- Level 1 Inputs Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- Level 2 Inputs Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (for example, interest rates, volatilities, prepayment speeds, loss severities, credit risks and default rates) or inputs that are derived principally from or corroborated by observable market data by correlations or other means.
- Level 3 Inputs Significant unobservable inputs that reflect the Bank's own assumptions that market participants would use in pricing the assets or liabilities.

The following table summarizes financial assets and liabilities measured at fair value on a recurring and non-recurring basis as of December 31, 2011 and 2010, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value. There were no financial assets and liabilities measured at fair value on a recurring basis at December 31, 2010.

	_Decemb	er 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Measured on a recurring basis:			(in thou	usands)	
Assets:					
Mortgage-backed securities available-for-sale	\$	5,267		5,267	
Total	\$	5,267		5,267	<del>-</del>
Measured on a non-recurring basis: Assets: Impaired Loans					
Home equity	\$	8	-	-	8
Commercial real estate (CRE)		227	-	-	227
Consumer		6			66_
Total impaired loans	-	241			241
Foreclosed assets (Construction)		189			189
Total	\$	430	-	<del>-</del>	430
	Decemb	er 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Measured on a non-recurring basis: Assets:			(in thou	usands)	
Impaired Loans	•	070			070
Construction	_\$	270 270		<u> </u>	270
Total impaired loans		69	-		270
Foreclosed assets (Residential) Total	\$	339			69 339
IUIAI	φ	339			339

Notes to Financial Statements December 31, 2011 and 2010

**Securities Available-for-Sale:** The estimated fair value for mortgage-backed securities, are obtained from a nationally recognized third-party pricing service. The estimated fair values are derived primarily from cash flow models, which include assumptions for interest rates, credit losses, and prepayment speeds. The significant inputs utilized in the cash flow models are based on market data obtained from sources independent of the Bank (observable inputs,) and are therefore classified as Level 2 within the fair value hierarchy. There were no transfers of securities between Levels during the year ended December 31, 2011.

Impaired Loans: At December 31, 2011 and 2010, the Bank had impaired loans with outstanding principal balances of \$241,000 and \$270,000, respectively, that were recorded at their estimated fair value of \$241,000 and \$270,000, respectively. The Bank recorded charge-offs of \$218,000 and \$0, for the years ended December 31, 2011 and 2010, respectively, and impairment charges of \$0 for the years ended December 31, 2011 and 2010, utilizing Level 3 inputs. For purposes of estimating fair value of impaired loans, management utilizes independent appraisals, if the loan is collateral dependent, adjusted downward by management, as necessary, for changes in relevant valuation factors subsequent to the appraisal date, or the present value of expected future cash flows for non-collateral dependent loans and troubled debt restructurings.

**Foreclosed Assets:** At December 31, 2011 and 2010, the Bank had assets acquired through foreclosure of \$189,000 and \$69,000, respectively, recorded at estimated fair value, less estimated selling costs when acquired, thus establishing a new cost basis. Fair value is generally based on independent appraisals. These appraisals include adjustments to comparable assets based on the appraisers' market knowledge and experience, and are considered level 3 inputs. When an asset is acquired, the excess of the loan balance over fair value, less estimated selling costs, is charged to the allowance for loan losses. If the estimated fair value of the asset declines, a write down is recorded through expense. The valuation of foreclosed assets is subjective in nature and may be adjusted in the future because of changes in the economic conditions.

During 2011, the Bank transferred a loan with a principal balance of \$265,000 and an estimated fair value, less costs to sell, of \$189,000 to foreclosed assets. During the year ended December 31, 2011, the Bank recorded impairment charges of \$76,000 prior to the transfer of the loan to foreclosed assets utilizing Level 3 inputs. During 2011 the Bank made subsequent valuation adjustments to foreclosed assets totaling \$21,000, reflecting continued deterioration in estimated fair values. The remaining reduction to REO was a result of sales. During the year ended December 31, 2010, the Bank made subsequent valuation adjustments to foreclosed assets totaling \$6,000, reflective of continued deterioration in estimated fair values. Operating costs after acquisition are expensed.

## 12. Employee Benefit Plans

The Bank has a 401(k) Plan whereby eligible employees may contribute up to 15% of their compensation subject to certain limits based on federal tax laws. The Bank makes matching contributions equal to 50% of the first 7% of an employee's compensation contributed to the Plan. Matching contributions vest to the employee equally over a five-year period. The Bank's contribution to this plan amounted to \$7,000 for each of the years ended December 31, 2011 and 2010.

Notes to Financial Statements December 31, 2011 and 2010

## 13. Shareholders' Equity

#### Stock Warrants

In connection with the initial offering, each shareholder was also granted one stock purchase warrant for every five shares of common stock purchased. Each warrant was issued at a price of \$187.50 and expires on March 23, 2012. There were 10,159 warrants outstanding and exercisable at December 31, 2011 and 2010.

In connection with the recapitalization of the Bank that closed on April 15, 2011, a total of 460,403 warrants were granted to new shareholders. Each warrant was issued at a price of \$10.00 and expires April 14, 2021. There were 460,403 warrants outstanding and exercisable at December 31, 2011.

## **Employee and Director Stock Compensation Plan**

The Bank's original Board of Directors had approved the 2008 Colonial American Stock Compensation Plan that will have a term of 10 years. Pursuant to the Plan, 15% of the common stock shares that were issued in the initial offering, or 7,511, were reserved for future issuance. To grant incentive stock options under the Plan, the shareholders must approve the Plan. On December 30, 2008 the shareholders approved the Plan. As of December 31, 2011 and 2010, there were no awards under the Plan.

Subsequent to the recapitalization that closed on April 15, 2011, the Bank's newly appointed Board of Directors approved the Colonial American Bank 2011 Stock Award and Incentive Plan. The Plan provides for the issuance or delivery of up to 900,000 shares of Colonial American Bank common stock. On August 17, 2011, certain officers and employees of the Bank were granted an aggregate of 155,000 stock options, and non-employee directors received an aggregate of 55,000 stock options. On September 12, 2011 an employee was granted 5,000 stock options. All employee and director options granted to date vest in equal installments over a three year period beginning one year from the date of grant. Three executive officers received stock options that vest in equal installments over a three year period beginning on the date of grant. The vesting of options may accelerate in accordance with the term of the Plan. Stock options were granted an exercise price equal to \$10.00 per share, and have an expiration period of ten years. The fair value of the stock options granted on August 17, 2011 and September 12, 2011 was estimated utilizing the Black-Scholes option pricing model using the following assumptions: an expected life of 5.75 years for those options granted to executive officers and 6 years for all other options granted utilizing the simplified method, risk-free rate of return of 1.125%, volatility of 30.06%, and a dividend yield of 0.0%. The Bank is expensing the grant date fair value of all employee and director share-based compensation over the requisite service periods on a straight-line basis.

During the years ended December 31, 2011 and 2010, the Bank recorded \$130,000 and \$0, respectively, of stock-based compensation.

Notes to Financial Statements December 31, 2011 and 2010

The following table is a summary of the Bank's non-vested stock options as of December 31, 2011, and changes therein during the year then ended:

	Number of Stock Options	Weighted Average Grant Date Fair Value		Weighted Average Exercise Price		Weighted Average Contractual Life (Years)	
Outstanding - December 31, 2010	-	\$	-	\$	-	-	
Granted	215,000		2.82		10.00	10.00	
Outstanding - December 31, 2011	215,000	\$	2.82	\$	10.00	9.63	
Exercisable - December 31, 2011	22,500	\$	2.77	\$	10.00	9.63	

Expected future stock option expense related to the non-vested options outstanding as of December 31, 2011 is \$476,000 over an average period of 2.4 years.

#### **Preferred Stock**

On October 3, 2008 Congress passed the Emergency Economic Stabilization Act of 2008 ("EESA"), which provided the U.S. Secretary of the Treasury with broad authority to implement certain actions to help restore stability and liquidity to the U.S. markets. One of the provisions resulting from the Act was the Treasury Capital Purchase Program ("CPP") which provided direct equity investment of preferred stock by the U.S. Treasury in qualified financial institutions. This program was voluntary and required an institution to comply with several restrictions and provisions, including limits on executive compensation, stock redemptions, and declaration of dividends. The CPP provided for a minimum investment of 1 percent of Risk-Weighted-Assets, with a maximum investment of the lesser of 3 percent of Risk-Weighted Assets or \$25 Billion. On March 27, 2009, the Bank received an investment in preferred stock of \$574,000. The non-cumulative perpetual preferred stock, Series A has a dividend rate of 5 percent per year until the fifth anniversary of the Treasury investment and a dividend of 9 percent, thereafter. The CPP also requires the Treasury to receive warrants for the purchase of fixed rate non-cumulative perpetual preferred stock, Series B with liquidation value equal to 5 percent of the capital invested by the Treasury. On March 27, 2009, the warrants issued to Treasury for the non-cumulative perpetual preferred stock, Series B were exercised. The exercise price of the warrants was \$1.00. The Series B preferred stock has a dividend rate of 9 percent per year.

The proceeds for the preferred stock were allocated between the Series A and Series B preferred stock based on their relative fair value, using a discount rate of 12%. The original net discount was being accreted over the expected term of five years using the effective interest method. In accordance with state law, because the Bank is in an accumulated deficit position, the preferred stock dividends were declared from additional paid-in capital.

On October 24, 2011, after obtaining the appropriate approvals from the its banking regulators, the Bank redeemed all of the 603 shares of Series A and Series B preferred stock originally issued to the U.S. Department of Treasury.

Notes to Financial Statements December 31, 2011 and 2010

## Stock Split

A one-for-fifteen reverse common stock split became effective December 1, 2010. Numbers of shares and related financial statement amounts have been restated to reflect the impact of the reverse stock split. Shareholders' equity reflects the split by reclassifying from common stock to additional paid in capital \$701,000, an amount equal to the par value of the reduced shares arising from the split.

## 14. Commitments and Contingencies

The Bank, in the normal course of business, is party to commitments that involve, to varying degrees, elements of risk in excess of the amounts recognized in the financial statements. These commitments include unused lines of credit and commitments to extend credit.

At December 31, 2011, the following commitment and contingent liabilities existed that are not reflected in the accompanying financial statements (in thousands):

	December 31, 20			
Commitments to extend credit	\$	5,845		
Unused lines of credit		301		

The Bank's maximum exposure to credit losses in the event of nonperformance by the other party to these commitments is represented by the contractual amount. The Bank uses the same credit policies in granting commitments and conditional obligations as it does for amounts recorded in the balance sheets. These commitments and obligations do not necessarily represent future cash flow requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary, is based on management's assessment of risk. The Bank maintains an allowance for estimated losses on commitments to extend credit. At December 31, 2011 and 2010, the allowance was \$10,000 and \$0, respectively, and is recorded as a component of other non-interest expense.

At December 31, 2011, the Bank was obligated under non-cancellable operating leases on property used for banking purposes. Most leases contain escalation clauses and renewal options which provide for increases in certain property costs including real estate taxes, common area maintenance, and insurance.

Notes to Financial Statements December 31, 2011 and 2010

The projected minimum annual rental payments under operating leases, are as follows (in thousands):

	Rental	
	Payments	
	Operating	
	Leases	
Year ending December 31,		
2012	\$	145
2013		145
2014		96
2015		88
2016		88
Thereafter		326
Total minimum lease payments	\$	888

The Bank has signed a lease agreement for an additional branch to be located in Shrewsbury, NJ, however, this branch and lease is subject to regulatory approval. As such, the future minimum lease payments for this branch are not included in the table above.

Net rental expense included in occupancy expense was approximately \$137,000 and \$84,000 for the years ended December 31, 2011 and 2010, respectively.

In the normal course of business, the Bank may be a party to various outstanding legal proceedings and claims. In the opinion of management, the financial statements will not be materially affected by the outcome of such legal proceedings and claims.

The Bank has entered into employment agreements with its Chief Executive Officer and certain other executive officers of the Bank to ensure the continuity of executive leadership, to clarify roles and responsibilities of executives, and to make explicit the terms and conditions of executive employment. These agreements are for a term of three-years subject to review and annual renewal, and provide for certain level of base annual salary and in the event of a change in control, as defined, or in the event of termination, as defined, certain levels of base salary, and bonus payments.

## 15. Regulatory Matters

## **Capital Ratios**

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

Notes to Financial Statements December 31, 2011 and 2010

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier I capital (as defined in the regulations) to risk- weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). The Bank cannot be considered "well-capitalized" while under the Consent Order (see Note 3) dated August 11, 2010 and must maintain the following capital levels as of December 31, 2011: Tier I capital greater than or equal to 8% of total assets and total risk-based capital greater than or equal to 12% of total risk-weighted assets. At December 31, 2011, the Bank's capital ratios complied with those stipulated in the Consent Order.

The Bank's actual capital amounts and ratios are presented in the following table (in thousands) as of December 31, 2011 and 2010:

	Minimum Capital						equately Cap	itlized Under	
	 Actua	al		Requirements			Terms of the Consent Order		
	 mount	Ratio		mount	Ratio		Amount	Ratio	
As of December 31, 2011 Total Risk Based Capital (to Risk Weighted Assets) Tier I Capital	\$ 14,311	43.27%	\$	2,646	8.0%	\$	3,969	12.0%	
(to Risk Weighted Assets) Tier I Capital	13,897	42.01%		1,323	4.0%		2,646	8.0%	
(to Average Assets)	13,897	33.51%		1,659	4.0%		3,317	8.0%	
As of December 31, 2010 Total Risk Based Capital									
(to Risk Weighted Assets) Tier I Capital	\$ 1,720	10.3%	\$	1,334	8.0%	\$	2,001	12.0%	
(to Risk Weighted Assets) Tier I Capital	1,512	9.1%		664	4.0%		1,334	8.0%	
(to Average Assets)	1,512	7.1%		847	4.0%		1,693	8.0%	

Banking regulations limit the amount of dividends that may be paid without prior regulatory agency approval. Since the Bank's deposits are insured by the FDIC, no dividends may be paid if the Bank is in default on any assessment due the FDIC. In addition, dividends paid by the Bank would be prohibited if the effect thereof would cause the Bank's capital to be reduced below applicable minimum capital requirements. Lastly, dividends are precluded under terms of the Consent Order.

## 16. Related Parties

The Bank has entered into consulting agreements with two of its directors. One director has extensive experience in banking, finance and capital markets. This director advised the Bank on business strategy, capital raising plans, and potential investment opportunities. The Bank has recognized consulting expenses totaling \$97,000 during the year ended December 31, 2011 for this director, and will incur consulting expenses of \$58,000 during the year ended December 31, 2012. The second director also has extensive experience in banking and real estate markets. This director advised the Bank on business strategy, capital raising plans, and loan portfolio reviews. The Bank has recognized consulting expenses of \$120,000 during the year ended December 31, 2011 for this director, and will incur consulting expenses of \$60,000 during the year ended December 31, 2012.

Notes to Financial Statements December 31, 2011 and 2010

The Bank also utilized the services of a board member's consulting firm to review the Bank's loan portfolio subsequent to the recapitalization that closed on April 15, 2011. Consulting expenses recognized during the year ended December 31, 2011 related to this board member amounted to \$63,000. In addition, the Bank has its directors and officers liability insurance with an insurance firm at which another board of director is employed. The annual policy amounts to approximately \$50,000.