

BANK OF SOUTH CAROLINA CORP  
Form 10-Q  
August 13, 2013

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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended June 30, 2013

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission file number: 0-27702

Bank of South Carolina Corporation

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

South Carolina	M7-1021355
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)

256 Meeting Street, Charleston, SC 29401

(Address of principal executive offices)

(843) 724-1500

(Registrant's telephone number)

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

Yes  No

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

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company.

Large accelerated filer  Accelerated Filer   
Non-accelerated filer  Smaller reporting Company

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

Yes  No

As of August 13, 2013 there were 4,453,528 Common Shares outstanding.

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BANK OF SOUTH CAROLINA CORPORATION

AND SUBSIDIARY

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## PART I - ITEM 1 - FINANCIAL STATEMENTS

## BANK OF SOUTH CAROLINA CORPORATION AND SUBSIDIARY

## CONSOLIDATED BALANCE SHEETS

Assets:	(Unaudited) June 30, 2013	(Audited) December 31, 2012
Cash and due from banks	\$6,496,553	\$5,137,888
Interest bearing deposits in other banks	36,651,317	25,903,960
Investment securities available for sale	71,932,964	58,514,216
Mortgage loans to be sold	10,249,167	18,479,878
Loans	214,338,102	217,128,624
Less: Allowance for loan losses	(3,359,915 )	(3,432,844 )
Net loans	210,978,187	213,695,780
Premises and equipment, net	2,480,930	2,486,792
Accrued interest receivable	1,180,544	1,124,613
Other assets	532,716	67,519
Total assets	\$340,502,378	\$325,410,646
Liabilities and Shareholders' Equity:		
Liabilities		
Deposits:		
Non-interest bearing demand	86,445,804	83,447,675
Interest bearing demand	84,876,741	77,441,588
Money market accounts	53,911,655	54,450,828
Certificates of deposit \$100,000 and over	45,171,414	40,903,886
Other time deposits	15,499,830	15,909,164
Other savings deposits	19,082,903	18,920,702
Total deposits	304,988,347	291,073,843
Accrued interest payable and other liabilities	1,087,507	406,361
Total liabilities	306,075,854	291,480,204
Common Stock - No par value; 12,000,000 shares authorized; Shares issued 4,672,979 at June 30, 2013 and 4,665,690 at December 31, 2012; Shares outstanding 4,453,528 at June 30, 2013 and 4,446,239 shares at December 31, 2012		
Additional paid in capital	28,574,151	28,474,951
Retained earnings	6,132,426	5,157,839
Treasury stock	(1,902,439 )	(1,902,439 )
Accumulated other comprehensive income, net of income taxes	1,622,386	2,200,091

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Total shareholders' equity	34,426,524	33,930,442
Total liabilities and shareholders' equity	\$340,502,378	\$325,410,646

See accompanying notes to consolidated financial statements

## BANK OF SOUTH CAROLINA CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Three Months Ended June 30,	
	2013	2012
Interest and fee income		
Interest and fees on loans	\$2,885,100	\$2,727,358
Interest and dividends on investment securities	345,581	334,138
Other interest income	24,567	20,268
Total interest and fee income	3,255,248	3,081,764
Interest expense		
Interest on deposits	104,169	112,400
Total interest expense	104,169	112,400
Net interest income	3,151,079	2,969,364
Provision for loan losses	95,000	80,000
Net interest income after provision for loan losses	3,056,079	2,889,364
Other income		
Service charges, fees and commissions	234,536	232,381
Mortgage banking income	382,426	311,429
Other non-interest income	7,196	18,934
Total other income	624,158	562,744
Other expense		
Salaries and employee benefits	1,285,942	1,251,695
Net occupancy expense	340,873	336,584
Other operating expenses	534,863	616,279
Total other expense	2,161,678	2,204,558
Income before income tax expense	1,518,559	1,247,550
Income tax expense	474,485	357,283
Net income	\$1,044,074	\$890,267
Basic earnings per share	\$0.23	\$0.20
Diluted earnings per share	\$0.23	\$0.20
Weighted average shares outstanding		
Basic	4,451,333	4,445,520
Diluted	4,451,333	4,445,520
Cash Dividend Per Share	\$0.12	\$0.11





## BANK OF SOUTH CAROLINA CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Six Months Ended	
	June 30,	
	2013	2012
Interest and fee income		
Interest and fees on loans	\$5,593,847	\$5,485,345
Interest and dividends on investment securities	678,874	677,060
Other interest income	44,613	47,012
Total interest and fee income	6,317,334	6,209,417
Interest expense		
Interest on deposits	205,595	244,459
Total interest expense	205,595	244,459
Net interest income	6,111,739	5,964,958
Provision for loan losses	170,000	200,000
Net interest income after provision for loan losses	5,941,739	5,764,958
Other income		
Service charges, fees and commissions	466,838	463,930
Mortgage banking income	876,438	626,301
Other non-interest income	12,301	25,561
Total other income	1,355,577	1,115,792
Other expense		
Salaries and employee benefits	2,568,026	2,478,077
Net occupancy expense	668,411	670,283
Other operating expenses	1,091,998	1,209,986
Total other expense	4,328,435	4,358,346
Income before income tax expense	2,968,881	2,522,404
Income tax expense	926,002	741,411
Net income	\$2,042,879	\$1,780,993
Basic earnings per share	\$0.46	\$0.40
Diluted earnings per share	\$0.46	\$0.40
Weighted average shares outstanding		
Basic	4,449,131	4,445,232
Diluted	4,449,131	4,445,232
Cash Dividend Per Share	\$0.24	\$0.22

See accompanying notes to consolidated financial statements

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BANK OF SOUTH CAROLINA CORPORATION AND SUBSIDIARY  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

	THREE MONTHS ENDED JUNE 30,	
	2013	2012
Net income	\$1,044,074	\$890,267
Other comprehensive (loss) gain, (net of tax: \$243,620 and \$246,588, respectively)		
Unrealized (loss) gain on securities	(414,812 )	419,866
Other comprehensive (loss) gain, net of tax	(414,812 )	419,866
Total Comprehensive income	\$629,262	\$1,310,133

BANK OF SOUTH CAROLINA CORPORATION AND SUBSIDIARY  
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

	SIX MONTHS ENDED JUNE 30,	
	2013	2012
Net income	\$2,042,879	\$1,780,993
Other comprehensive (loss) gain, (net of tax: \$339,286 and \$152,260, respectively)		
Unrealized (loss) gain on securities	(577,705 )	259,251
Other comprehensive (loss) gain, net of tax	(577,705 )	259,251
Total Comprehensive income	\$1,465,174	\$2,040,244

## BANK OF SOUTH CAROLINA CORPORATION AND SUBSIDIARY

## CONSOLIDATED STATEMENTS OF SHAREHOLDER'S EQUITY

FOR THE SIX MONTHS ENDED JUNE 30, 2013 AND 2012 (UNAUDITED)

	ADDITIONAL PAID IN CAPITAL	RETAINED EARNINGS	TREASURY STOCK	ACCUMULATED OTHER COMPREHENSIVE INCOME	TOTAL
December 31, 2011	\$ 28,390,929	\$ 3,491,678	\$(1,902,439 )	\$ 2,013,701	\$ 31,993,869
Net income	—	1,780,993	—	—	1,780,993
Other comprehensive income due to unrealized gain on investment securities	—	—	—	259,251	259,251
Exercise of stock options	11,094	—	—	—	11,094
Stock-based compensation expense	35,886	—	—	—	35,886
Cash dividends (\$0.22 per common share)	—	(978,033 )	—	—	(978,033 )
June 30, 2012	28,437,909	4,294,638	(1,902,439 )	2,272,952	33,103,060
December 31, 2012	28,474,951	5,157,839	(1,902,439 )	2,200,091	33,930,442
Net income	—	2,042,879	—	—	2,042,879
Other comprehensive loss due to unrealized loss on investment securities	—	—	—	(577,705 )	(577,705 )
Exercise of stock options	62,248	—	—	—	62,248
Stock-based compensation expense	36,952	—	—	—	36,952
Cash dividends (\$0.24 per common share)	—	(1,068,292 )	—	—	(1,068,292 )
June 30, 2013	\$ 28,574,151	\$ 6,132,426	\$(1,902,439 )	\$ 1,622,386	\$ 34,426,524

See accompanying notes to consolidated financial statements.

BANK OF SOUTH CAROLINA CORPORATION AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Six months Ended June 30,	
	2013	2012
Cash flows from operating activities:		
Net income	\$2,042,879	\$1,780,993
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	93,729	108,072
Provision for loan losses	170,000	200,000
Stock-based compensation expense	36,952	35,886
Net amortization of unearned discounts and premiums on investments	214,496	189,027
Origination of mortgage loans held for sale	(49,460,592)	(43,840,121)
Proceeds from sale of mortgage loans held for sale	57,691,303	44,910,307
Increase in accrued interest receivable and other assets	(181,841 )	(6,189 )
Increase (decrease) in accrued interest payable and other liabilities	146,723	(138,023 )
Net cash provided by operating activities	10,753,649	3,239,952
Cash flows from investing activities:		
Purchase of investment securities available for sale	(16,715,236)	—
Maturities of investment securities available for sale	2,165,000	3,590,000
Net decrease in loans	2,547,593	2,993,611
Loss on disposal of fixed assets	—	1,628
Purchase of premises, equipment and leasehold improvements, net	(87,867 )	(36,553 )
Net cash (used) provided by investing activities	(12,090,510)	6,548,686
Cash flows from financing activities:		
Net increase (decrease) in deposit accounts	13,914,504	(23,697,419)
Dividends paid	(533,869 )	(977,890 )
Stock options exercised	62,248	11,094
Net cash provided (used) by financing activities	13,442,883	(24,664,215)
Net increase (decrease) in cash and cash equivalents	12,106,022	(14,875,577)
Cash and cash equivalents at beginning of period	31,041,848	52,063,476
Cash and cash equivalents at end of period	\$43,147,870	\$37,187,899
Supplemental disclosure of cash flow data:		
Cash paid during the period for:		
Interest	\$198,066	\$286,417
Income taxes	\$494,725	\$566,730

Supplemental disclosure for non-cash investing and financing activity:

Change in dividends payable	\$534,423	\$143
Change in unrealized (losses) gains on available for sale securities	\$(577,705)	) \$259,251

See accompanying notes to consolidated financial statements.

BANK OF SOUTH CAROLINA CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

JUNE 30, 2013

**NOTE 1: Basis of Presentation**

The Bank of South Carolina (the "Bank") was organized on October 22, 1986 and opened for business as a state-chartered financial institution on February 26, 1987, in Charleston, South Carolina. The Bank was reorganized into a wholly-owned subsidiary of Bank of South Carolina Corporation (the "Company"), effective April 17, 1995. At the time of the reorganization, each outstanding share of the Bank was exchanged for two shares of Bank of South Carolina Corporation Stock. The Company operates as a commercial bank from its four banking houses located at: 256 Meeting Street, Charleston, SC, 100 North Main Street, Summerville, SC, 1337 Chuck Dawley Boulevard, Mt. Pleasant, SC and 2027 Sam Rittenberg Boulevard, Charleston, SC.

The consolidated financial statements in this report are unaudited, except for the December 31, 2012 consolidated balance sheet. All adjustments consisting of normal recurring accruals which are, in the opinion of management, necessary for fair presentation of the interim consolidated financial statements have been included and fairly and accurately present the financial position, results of operations and cash flows of the Company. The results of operations for the three and six months ended June 30, 2013, are not necessarily indicative of the results which may be expected for the entire year.

The preparation of the consolidated financial statements are in conformity with accounting principles generally accepted in the United States of America (GAAP) which requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from these estimates and assumptions. Material estimates that are generally susceptible to significant change relate to the determination of the allowance for loan losses, impaired loans, other real estate owned, asset prepayment rates and other-than-temporary impairment of investment securities.

In preparing these financial statements, the Company has evaluated events and transactions for potential recognition or disclosure through the date the financial statements were available to be issued.

**NOTE 2: Investment Securities**

The Company classifies investments into three categories as follows: (1) Held to Maturity - debt securities that the Company has the positive intent and ability to hold to maturity, which are reported at amortized cost, adjusted for the amortization of any related premiums or the accretion of any related discounts into interest income using a methodology which approximates a level yield of interest over the estimated remaining period until maturity; (2) Trading - debt and equity securities that are bought and held principally for the purpose of selling them in the near term, which are reported at fair value, with unrealized gains and losses included in earnings; and (3) Available for Sale - debt and equity securities that may be sold under certain conditions, which are reported at fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of shareholders' equity, net of income taxes. Unrealized losses on securities due to fluctuations in fair value are recognized when it is determined that an other than temporary decline in value has occurred. Realized gains or losses on the sale of investments are recognized on a specific identification, trade date basis. All securities were classified as available for sale for the three and six months ended June 30, 2013 and 2012. The Company does not have any mortgage-backed securities nor has it ever invested in mortgage-backed securities.

**NOTE 3: Mortgage Loans to be Sold**

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated market value in the aggregate. Net unrealized losses are provided for in a valuation allowance by charges to operations as a component of mortgage banking income. At June 30, 2013 and December 31, 2012, the Company had approximately \$10.2 million and \$18.5 million in mortgage loans held for sale, respectively. Gains or losses on sales of loans are recognized when control over these assets has been surrendered and are included in mortgage banking income in the consolidated statements of income.



The Company originates fixed and variable rate residential mortgage loans on a servicing released basis in the secondary market. Loans closed but not yet settled with an investor are carried in the Company's loans held for sale portfolio.

These loans are fixed and variable rate residential mortgage loans that have been originated in the Company's name and have closed. Virtually all of these loans have commitments to be purchased by investors and the majority of these loans were locked in by price with the investors on the same day or shortly thereafter that the loan was locked in with the Company's customers. Therefore, these loans present very little market risk for the Company. The Company usually delivers to, and receives funding from, the investor within 30 to 60 days. Commitments to sell these loans to the investor are considered derivative contracts and are sold to investors on a "best efforts" basis. The Company is not obligated to deliver a loan or pay a penalty if a loan is not delivered to the investor. As a result of the short-term nature of these derivative contracts, the fair value of the mortgage loans held for sale in most cases is the same as the value of the loan amount at its origination.

NOTE 4: Loans and Allowance for Loan Losses

Loans are carried at principal amounts outstanding. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment to yield. Interest income on all loans is recorded on an accrual basis. The accrual of interest and the amortization of net loan fees are generally discontinued on loans which 1) are maintained on a cash basis because of deterioration in the financial condition of the borrower; 2) for which payment in full of principal is not expected; or 3) upon which principal or interest has been in default for a period of 90 days or more. The accrual of interest however, may continue on these loans if they are well secured, in the process of collection, and management deems it appropriate. Non-accrual loans are reviewed individually by management to determine if they should be returned to accrual status. The Company defines past due loans based on contractual payment and maturity dates.

The Company accounts for nonrefundable fees and costs associated with originating or acquiring loans by requiring that loan origination fees be recognized over the life of the related loan as an adjustment on the loan's yield. Certain direct loan origination costs shall be recognized over the life of the related loan as a reduction of the loan's yield.

The Company accounts for impaired loans by requiring that all loans for which it is estimated that the Company will be unable to collect all amounts due according to the terms of the loan agreement be recorded at the loan's fair value. Fair value may be determined based upon the present value of expected future cash flows discounted at the loan's effective interest rate, or the fair value of the collateral if the loan is collateral dependent.

Additional accounting guidance allows the Company to use existing methods for recognizing interest income on an impaired loan and by requiring additional disclosures about how a Company estimates interest income related to impaired loans.

When the ultimate collectability of an impaired loan's principal is in doubt, wholly or partially, all cash receipts are applied to principal. Once the recorded principal balance has been reduced to zero, future cash receipts are applied to interest income, to the extent that any interest has been foregone. Further cash receipts are recorded as recoveries of any amounts previously charged off. When this doubt does not exist, cash receipts are applied under the contractual terms of the loan agreement first to interest income and then to principal.

A loan is also considered impaired if its terms are modified in a troubled debt restructuring ("TDR"). For these accruing impaired loans, cash receipts are typically applied to principal and interest receivable in accordance with the terms of the restructured loan agreement. Interest income is recognized on these loans using the accrual method of accounting, provided they are performing in accordance with their restructured terms.

Management believes that the allowance is adequate to absorb inherent losses in the loan portfolio; however, assessing the adequacy of the allowance is a process that requires considerable judgment. Management's judgments are based on numerous assumptions about current events which management believes to be reasonable, but which may or may not be valid. Thus there can be no assurance that loan losses in future periods will not exceed the current allowance amount or that future increases in the allowance will not be required. No assurance can be given that management's ongoing evaluation of the loan portfolio, in light of changing economic conditions and other relevant circumstances, will not require significant future additions to the allowance, thus adversely affecting the operating results of the Company.

The allowance is also subject to examination by regulatory agencies, which may consider such factors as the methodology used to determine adequacy and the size of the allowance relative to that of peer institutions, and other adequacy tests. In addition, such regulatory agencies could require the Company to adjust its allowance based on information available to them at the time of their examination.

The methodology used to determine the reserve for unfunded lending commitments, which is included in other liabilities, is inherently similar to that used to determine the allowance for loan losses adjusted for factors specific to binding commitments, including the probability of funding and historical loss ratio.

The following is a summary of the non-accrual loans as of June 30, 2013 and December 31, 2012.

June 30, 2013	
Loans Receivable on Non-Accrual	
Commercial	\$ 1,989
Commercial Real Estate:	
Commercial Real Estate - Construction	—
Commercial Real Estate - Other	1,503,109
Consumer:	
Consumer Real Estate	95,211
Consumer - Other	—
Total	\$ 1,600,309

December 31, 2012	
Loans Receivable on Non-Accrual	
Commercial	\$4,085
Commercial Real Estate:	
Commercial Real Estate - Construction	—
Commercial Real Estate - Other	3,921,750
Consumer:	
Consumer Real Estate	67,981

Consumer - Other	—
Total	\$3,993,816

The following is a schedule of the Bank's delinquent loans, excluding mortgage loans held for sale, as of June 30, 2013 and December 31, 2012.

June 30, 2013

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable	Recorded Investment > 90 Days and Accruing
Commercial	\$1,472,749	—	—	1,472,749	51,461,244	52,933,993	—
Commercial Real Estate:							
Commercial Real Estate	—	—	—	—	1,725,535	1,725,535	—
-Construction							
Commercial Real Estate	687,700	—	744,455	1,432,155	101,082,029	102,514,184	—
-Other							
Consumer:							
Consumer- Real Estate	85,003	150,000	—	235,003	52,635,362	52,870,365	—
Consumer-Other	27,392	2,511	1,616	31,519	4,262,506	4,294,025	—
Total	\$2,272,844	152,511	746,071	3,171,426	211,166,676	214,338,102	—

December 31, 2012

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans Receivable	Recorded Investment > 90 Days and Accruing
Commercial	\$104,766	—	—	104,766	54,559,520	54,664,286	—
Commercial Real Estate:							
Commercial Real Estate	—	—	—	—	2,276,532	2,276,532	—
-Construction							
Commercial Real Estate	93,487	336,315	3,074,397	3,504,199	105,071,216	108,575,415	—
-Other							
Consumer:							
Consumer- Real Estate	—	—	—	—	46,703,454	46,703,454	—
Consumer-Other	6,549	—	985	7,534	4,901,403	4,908,937	—
Total	\$204,802	336,315	3,075,382	3,616,499	213,512,125	217,128,624	—

As of June 30, 2013 and December 31, 2012, loans individually evaluated and considered impaired are presented in the following table:



Impaired and Restructured Loans  
As of June 30, 2013

	Unpaid Principal Balance	Recorded Investments	Related Allowance
With no related allowance recorded:			
Commercial	\$443,525	\$443,525	\$—
Commercial Real Estate	3,077,366	3,077,366	—
Consumer Real Estate	334,688	334,688	—
Consumer Other	2,001	2,001	—
Total	\$3,857,580	\$3,857,580	\$—
With an allowance recorded:			
Commercial	\$1,221,009	\$1,221,009	\$1,221,009
Commercial Real Estate	725,848	725,848	267,836
Consumer Real Estate	872,532	872,532	454,111
Consumer Other	47,238	47,238	47,238
Total	\$2,866,627	\$2,866,627	\$1,990,194
Grand Total	\$6,724,207	\$6,724,207	\$1,990,194

Impaired and Restructured Loans  
As of December 31, 2012

	Unpaid Principal Balance	Recorded Investments	Related Allowance
With no related allowance recorded:			
Commercial	\$140,575	\$140,575	\$—
Commercial Real Estate	5,578,231	5,578,231	—
Consumer Real Estate	311,543	311,543	—
Consumer Other	—	—	—
Total	\$6,030,349	\$6,030,349	\$—
With an allowance recorded:			
Commercial	\$1,251,462	\$1,251,462	\$1,251,462
Commercial Real Estate	3,287,773	3,287,773	169,243
Consumer Real Estate	879,252	879,252	528,510
Consumer Other	49,443	49,443	49,443
Total	\$5,467,930	\$5,467,930	\$1,998,658
Grand Total	\$11,498,279	\$11,498,279	\$1,998,658

The following presents by class, information related to the average recorded investment and interest income recognized on impaired loans for the three and six months ended June 30, 2013 and 2012, respectively.

Impaired and Restructured Loans  
For the Three Months Ended

	June 30, 2013		June 30, 2012	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Commercial	\$458,260	\$ 3,307	\$14,190	\$ 1,575
Commercial Real Estate	3,820,467	35,421	8,748,383	1,503,410
Consumer Real Estate	339,948	7,418	317,031	29,316
Consumer Other	2,001	1,713	—	—
Total	\$4,620,676	\$ 47,859	\$9,079,604	\$ 1,534,301
With an allowance recorded:				
Commercial	\$1,282,037	\$ 15,153	\$1,295,565	\$ 29,849
Commercial Real Estate	744,505	8,918	277,873	72,156
Consumer Real Estate	877,942	10,517	819,425	268,044
Consumer Other	49,425	604	49,637	3,902
Total	\$2,953,909	\$ 35,192	\$2,442,500	\$ 373,951
Grand Total	\$7,574,585	\$ 83,051	\$11,522,104	\$ 1,908,252

Impaired and Restructured Loans  
For the Six Months Ended

	June 30, 2013		June 30, 2012	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Commercial	\$456,225	\$22,077	\$14,044	\$ 3,769
Commercial Real Estate	3,751,096	1,326,406	8,747,715	1,738,669
Consumer Real Estate	339,691	72,557	316,787	56,446
Consumer Other	2,001	1,713	—	—
Total	\$4,549,013	\$ 1,422,753	\$9,078,546	\$ 1,798,884
With an allowance recorded:				
Commercial	\$1,279,849	\$ 198,396	\$1,294,481	\$ 140,833
Commercial Real Estate	743,928	203,804	277,250	90,249
Consumer Real Estate	876,495	148,258	819,423	317,948
Consumer Other	49,303	7,073	49,610	4,815
Total	\$2,949,575	\$ 557,531	\$2,440,764	\$ 553,845



Grand Total	\$7,498,588	\$1,980,284	\$11,519,310	\$2,352,729
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The following table illustrates credit risks by category and internally assigned grades at June 30, 2013 and December 31, 2012.

## June 30, 2013

	Commercial	Commercial Real Estate Construction	Commercial Real Estate Other	Consumer Real Estate	Consumer Other	Total
Pass	\$47,244,984	\$ 1,260,268	\$93,176,907	\$49,339,670	\$3,826,577	\$ 194,848,406
Watch	2,622,076	—	1,755,207	1,613,067	201,223	6,191,573
OAEM	895,785	465,267	3,198,873	574,235	116,505	5,250,665
Sub-Standard	2,171,148	—	4,383,197	1,343,393	149,720	8,047,458
Doubtful	—	—	—	—	—	—
Loss	—	—	—	—	—	—
Total	\$52,933,993	\$ 1,725,535	\$ 102,514,184	\$52,870,365	\$4,294,025	\$ 214,338,102

## December 31, 2012

	Commercial	Commercial Real Estate Construction	Commercial Real Estate Other	Consumer Real Estate	Consumer Other	Total
Pass	\$47,803,837	\$ 1,806,765	\$94,779,321	\$41,738,572	\$4,197,256	\$ 190,325,751
Watch	4,551,804	—	2,554,099	2,971,631	344,583	10,422,117
OAEM	561,563	469,767	4,957,130	650,412	205,638	6,844,510
Sub-Standard	1,747,082	—	6,284,865	1,342,839	161,460	9,536,246
Doubtful	—	—	—	—	—	—
Loss	—	—	—	—	—	—
Total	\$54,664,286	\$ 2,276,532	\$ 108,575,415	\$46,703,454	\$4,908,937	\$ 217,128,624

The following table sets forth the changes in the allowance and an allocation of the allowance by loan category for the three and six months ended June 30, 2013 and 2012, respectively, and December 31, 2012. The allocation of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. The general component covers non-impaired loans and is based on historical loss experience adjusted for current economic factors in Management's Discussion and Analysis.

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For the Three Months Ended  
June 30, 2013

	Commercial	Commercial Real Estate	Consumer Real Estate	Consumer Other	Unallocated	Total
Allowance for Loan Losses						
Beginning Balance	\$ 1,500,055	\$ 654,283	\$ 841,411	\$ 82,330	\$ 340,874	\$ 3,418,953
Charge-offs	(141,063 )	—	—	(17,831 )	—	(158,894 )
Recoveries	1,445	3,000	—	411	—	4,856
Provisions	103,204	42,478	4,921	21,811	(77,414 )	95,000
Ending Balance	\$ 1,463,641	\$ 699,761	\$ 846,332	\$ 86,721	\$ 263,460	\$ 3,359,915

As of and for the Six Months Ended  
June 30, 2013

	Commercial	Commercial Real Estate	Consumer Real Estate	Consumer Other	Unallocated	Total
Allowance for Loan Losses						
Beginning Balance	\$ 1,478,450	\$ 584,646	\$ 890,728	\$ 102,953	\$ 376,067	\$ 3,432,844
Charge-offs	(235,016 )	—	—	(17,831 )	—	(252,847 )
Recoveries	2,934	6,000	—	984	—	9,918
Provisions	217,273	109,115	(44,396 )	615	(112,607 )	170,000
Ending Balance	1,463,641	699,761	846,332	86,721	263,460	3,359,915
Ending Balances:						
Individually evaluated for impairment	1,221,009	267,836	454,111	47,238	—	1,990,194
Collectively evaluated for impairment	242,632	431,925	392,221	39,483	263,460	1,369,721
Ending Balances:						
Individually evaluated for impairment	1,664,534	3,803,214	1,207,220	49,239	—	6,724,207
Collectively evaluated for impairment	\$ 51,269,459	\$ 100,436,505	\$ 51,663,145	\$ 4,244,786	\$ —	\$ 207,613,895

For the Three Months Ended  
June 30, 2012

	Commercial	Commercial Real Estate	Consumer Real Estate	Consumer Other	Unallocated	Total
Allowance for Loan Losses						
Beginning Balance	\$ 1,693,265	\$ 525,030	\$ 677,329	\$ 95,920	\$ 242,970	\$ 3,234,514
Charge-offs	—	(43,734 )	(26,488 )	—	—	(70,222 )
Recoveries	93,588	3,597	—	102	—	97,287
Provisions	(235,296 )	23,510	20,496	(4,127 )	275,417	80,000
Ending Balance	\$ 1,551,557	\$ 508,403	\$ 671,337	\$ 91,895	\$ 518,387	\$ 3,341,579



For the Six Months Ended  
June 30, 2012

	Commercial	Commercial Real Estate	Consumer Real Estate	Consumer Other	Unallocated	Total
Allowance for Loan Losses						
Beginning Balance	\$ 1,586,510	\$ 420,367	\$ 450,338	\$ 91,402	\$ 558,267	\$ 3,106,884
Charge-offs	(17,152 )	(43,734 )	(26,488 )	(230 )	—	(87,604 )
Recoveries	104,968	7,229	10,000	102	—	122,299
Provisions	(122,769 )	124,541	237,487	621	(39,880 )	200,000
Ending Balance	1,551,557	508,403	671,337	91,895	518,387	3,341,579

For the Year Ended  
December 31, 2012

	Commercial	Commercial Real Estate	Consumer Real Estate	Consumer Other	Unallocated	Total
Allowance for Loan Losses						
Beginning Balance	\$ 1,586,510	\$ 420,367	\$ 450,338	\$ 91,402	\$ 558,267	\$ 3,106,884
Charge-offs	(60,042 )	(43,734 )	(56,487 )	(12,025 )	—	(172,288 )
Recoveries	109,569	13,228	10,000	15,451	—	148,248
Provisions	(157,587 )	194,785	486,877	8,125	(182,200 )	350,000
Ending Balance	1,478,450	584,646	890,728	102,953	376,067	3,432,844
Ending Balances:						
Individually evaluated for impairment	1,251,462	169,243	528,510	49,443	—	1,998,658
Collectively evaluated for impairment	226,988	415,403	362,218	53,510	376,067	1,434,186
Ending Balance:						
Individually evaluated for impairment	1,392,037	8,866,004	1,190,795	49,443	—	11,498,279
Collectively evaluated for impairment	\$ 53,272,249	\$ 101,985,943	\$ 45,512,659	\$ 4,859,494	\$ —	\$ 205,630,345

Restructured loans (loans, still accruing interest, which have been renegotiated at below-market interest rates or for which other concessions have been granted) were \$1,589,622 and \$1,618,278 at June 30, 2013 and December 31, 2012, respectively, and are illustrated in the following table. At June 30, 2013 and December 31, 2012, all restructured loans were performing as agreed.

## Modification

As of June 30, 2013

	Number of Contracts	Outstanding Recorded Investment
Troubled Debt Restructurings		
Commercial	1	\$ 120,703
Commercial Real Estate	3	\$ 1,359,610
Commercial Real Estate Construction	—	\$—
Consumer Real Estate –Prime	1	\$ 109,309
Consumer Real Estate-Subprime	—	\$—
Consumer Other	—	\$—
Troubled Debt Restructurings That Subsequently Defaulted		
Commercial	—	\$—
Commercial Real Estate	—	\$—
Commercial Real Estate Construction	—	\$—
Consumer Real Estate -Prime	—	\$—
Consumer Real Estate-Subprime	—	\$—
Consumer Other	—	\$—

## Modification

As of December 31, 2012

	Number of Contracts	Outstanding Recorded Investment
Troubled Debt Restructurings		
Commercial	1	\$ 134,814
Commercial Real Estate	3	\$ 1,371,983
Commercial Real Estate Construction	—	\$—
Consumer Real Estate –Prime	1	\$ 111,481
Consumer Real Estate-Subprime	—	\$—
Consumer Other	—	\$—
Troubled Debt Restructurings That Subsequently Defaulted		
Commercial	—	\$—
Commercial Real Estate	—	\$—
Commercial Real Estate Construction	—	\$—
Consumer Real Estate -Prime	—	\$—
Consumer Real Estate-Subprime	—	\$—
Consumer Other	—	\$—

There were no additional loans identified as a TDR during the six months ended June 30, 2013.

NOTE 5: Premises, Equipment and Leasehold Improvements and Depreciation

Buildings and equipment are carried at cost less accumulated depreciation, calculated on the straight-line method over the estimated useful life of the related assets - 40 years for buildings and 3 to 15 years for equipment. Amortization of leasehold improvements is recorded using the straight-line method over the lesser of the estimated useful life of the asset or the term of the lease. Maintenance and repairs are charged to operating expenses as incurred.

**NOTE 6: Income Taxes**

The Company accounts for income taxes under the asset and liability method. Deferred tax assets and liabilities are recognized for 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 the 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 tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Net deferred tax assets are included in other assets in the consolidated balance sheet.

Accounting standards require the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. These standards also prescribe a recognition threshold and measurement of a tax position taken or expected to be taken in an enterprise's tax return. The Company believes it has no uncertain tax positions as of June 30, 2013.

NOTE 7: Stock Based Compensation

The shareholders of the Company voted at the Company's Annual Meeting, April 13, 2010 to approve the 2010 Omnibus Stock Incentive Plan, including 330,000 shares (adjusted for a 10% stock dividend declared on August 26, 2010) reserved under the plan (copy of the plan was filed with 2010 Proxy Statement). This plan is intended to assist the Company in recruiting and retaining employees with ability and initiative by enabling employees to participate in its future success and to associate their interest with those of the Company and its shareholders. Under the Omnibus Stock Incentive Plan, options are periodically granted to employees at an exercise price not less than 100% of the fair market value of the shares at the date of the grant. All employees are eligible to participate in this plan if the Executive Committee, in its sole discretion, determines that such person has contributed or can be expected to contribute to the profits or growth of the Company or its subsidiary. Options may be exercised in whole at any time or in part from time to time at such times and in compliance with such requirements as the Executive Committee shall determine. The maximum period in which an option may be exercised is determined at the date of grant and shall not exceed 10 years from the date of grant. The options are not transferable except by will or by the laws of descent and distribution.

On June 27, 2013, the Executive Committee granted options to purchase an aggregate of 5,000 shares to five employees. Fair value was estimated at the date of grant using the Black-Scholes option pricing model with the following assumptions: dividend yield 3.98%, historical volatility 36.34%, risk free interest rate of 2.49%, and an expected life of ten years.

On June 28, 2012, the Executive Committee granted options to purchase an aggregate of 9,000 shares to five employees. Fair value was estimated at the date of grant using the Black-Scholes option pricing model with the following assumptions: dividend yield 3.97%, historical volatility 33.94%, risk free interest rate of 1.60%, and an expected life of ten years.

On April 14, 1998 the Company adopted the 1998 Omnibus Stock Incentive Plan which expired on April 14, 2008. Options can no longer be granted under the 1998 Plan. Options granted before April 14, 2008, shall remain valid in accordance with their terms. There are currently options to purchase 28,325 shares outstanding under this plan with options to purchase 13,915 shares exercisable.

Under both plans employees become 20% vested after five years and vest 20% each year until fully vested. The right to exercise each such 20% of the options is cumulative and will not expire until the tenth anniversary of the date of the grant.



The following is a summary of the activity under the 1998 and 2010 Omnibus Stock Incentive Plan for the three and six months ended June 30, 2013 and the three and six months ended June 30, 2012.

<u>Three Months Ended June 30, 2013</u>	Options	Weighted Average Exercise Price
Balance at April 1, 2013	168,208	\$ 11.22
Granted	5,000	12.84
Forfeited	(2,500 )	10.77
Exercised	(4,630 )	8.54
Balance at June 30, 2013	166,075	\$ 11.35

<u>Six Months Ended June 30, 2013</u>	Options	Weighted Average Exercise Price
Balance at January 1, 2013	174,467	\$ 11.20
Granted	5,000	12.84
Forfeited	(6,100 )	11.55
Exercised	(7,292 )	8.54
Balance at June 30, 2013	166,075	\$ 11.35

<u>Three months Ended June 30, 2012</u>	Options	Weighted Average Exercise Price
Balance at April 1, 2012	167,746	\$ 11.23
Granted	9,000	11.11
Exercised	(1,279 )	8.54
Balance at June 30, 2012	175,467	\$ 11.25

<u>Six months Ended June 30, 2012</u>	Options	Weighted Average Exercise Price
Balance at January 1, 2012	168,266	\$ 11.23
Granted	9,000	11.11
Forfeited	(500 )	10.77
Exercised	(1,299 )	8.54
Balance at June 30, 2012	175,467	\$ 11.25

Options exercisable at June 30, 2013    13,915    \$ 14.79

#### **NOTE 8: Shareholders' Equity**

Regular quarterly cash dividends of \$.12 per share were declared on March 28, 2013 and June 27, 2013 for shareholders of record on April 8, 2013, and July 8, 2013, respectively. The cash dividends were payable on April 30, 2013 and July 31, 2013. The dividends were an increase of \$.01 per share from the quarterly dividends declared on March 22, 2012, and June 28, 2012, for shareholders of record on April 6, 2012, and July 13, 2012, respectively. The cash dividends were payable on April 30, 2012 and July 31, 2012. Income per common share for the three and six months ended June 30, 2013 and for the three and six months ended June 30, 2012 was calculated as follows:

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FOR THE THREE MONTHS ENDED JUNE  
30, 2013

	INCOME (NUMERATOR)	SHARES (DENOMINATOR)	PER SHARE AMOUNT
Net income	\$1,044,074		
Basic income available to common shareholders	\$1,044,074	4,451,333	\$ .23
Effect of dilutive options		—	
Diluted income available to common shareholders	\$1,044,074	4,451,333	\$ .23

FOR THE SIX MONTHS ENDED JUNE 30,  
2013

	INCOME (NUMERATOR)	SHARES (DENOMINATOR)	PER SHARE AMOUNT
Net income	\$2,042,879		
Basic income available to common shareholders	\$2,042,879	4,449,131	\$ .46
Effect of dilutive options		—	
Diluted income available to common shareholders	\$2,042,879	4,449,131	\$ .46

FOR THE THREE MONTHS ENDED JUNE  
30, 2012

	INCOME (NUMERATOR)	SHARES (DENOMINATOR)	PER SHARE AMOUNT
Net income	\$890,267		
Basic income available to common shareholders	\$890,267	4,445,520	\$ .20
Effect of dilutive options		—	
Diluted income available to common shareholders	\$890,267	4,445,520	\$ .20

FOR THE SIX MONTHS ENDED JUNE 30,  
2012

	INCOME (NUMERATOR)	SHARES (DENOMINATOR)	PER SHARE AMOUNT
Net income	\$1,780,993		
Basic income available to common shareholders	\$1,780,993	4,445,232	\$ .40
Effect of dilutive options		—	
Diluted income available to common shareholders	\$1,780,993	4,445,232	\$ .40

The Basic shares outstanding were greater than the dilutive shares outstanding and therefore, there was no effect from the dilutive shares during the three and six months ended June 30, 2013 and 2012, respectively.

The future payment of cash dividends is subject to the discretion of the Board of Directors and depends upon a number of factors, including future earnings, financial condition, cash requirements, and general business conditions. Cash dividends, when declared, are paid by the Bank to the Company for distribution to shareholders of the Company. Certain regulatory requirements restrict the amount of dividends which the Bank can pay to the Company.

NOTE 9: Comprehensive Income

The Company applies accounting standards which establish guidance for the reporting and display of comprehensive income and its components in a full set of general purpose financial statements. Comprehensive income consists of net income and net unrealized gains or losses on securities and is presented in the consolidated statements of income and comprehensive income.

Comprehensive income totaled \$629,262 and \$1,310,133 for the three months ended June 30, 2013 and June 30, 2012, respectively, and \$1,465,174 and \$2,040,244 for the six months ended June 30, 2013 and June 30, 2012, respectively.

**NOTE 10: Fair Value Measurements**

The Company applies the accounting standards which define fair value, establish a framework for measuring fair value, and expand disclosures about fair value. The standards define fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the assets or liability in an orderly transaction between market participants on the measurement date. The standards also establish a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of input that may be used to measure fair value:

Valuation is based upon quoted prices (unadjusted) in active markets for identical assets or liabilities that the Level Company has the ability to access. Level 1 assets and liabilities include debt and equity securities and  
 1 derivative contracts that are traded in an active exchange market, as well as US Treasuries and money market funds.

Valuation is based upon quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the asset or liability (other than quoted prices), such as interest rates, foreign exchange rates, and yield curves that are observable at commonly quoted intervals. Level 2 assets and liabilities include debt  
 Level 2 securities with quoted prices that are traded less frequently than exchange-traded instruments, mortgage-backed securities, municipal bonds, corporate debt securities and derivative contracts whose value is determined using a pricing model with inputs that are observable in the market or can be derived principally from or corroborated by observable market data. This category generally includes certain derivative contracts and impaired loans.

Valuation is generated from model-based techniques that use at least one significant assumption based on unobservable inputs for the asset or liability, which are typically based on an entity's own assumptions, as there is little, if any, related market activity. In instances where the determination of the fair value measurement is  
 Level 3 based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

The guidance requires disclosures about the fair value of assets and liabilities recognized in the balance sheet in periods subsequent to initial recognition, whether the measurements are made on a recurring basis (for example, available-for-sale investment securities) or on a nonrecurring basis (for example, impaired loans). Fair value estimates, methods, and assumptions are set forth below.

### Investment Securities Available for Sale

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

Assets and liabilities measured at fair value on a recurring basis at June 30, 2013 and December 31, 2012 are as follows:

	Quoted Market Price in active markets (Level 1)	Significant Other Observable Inputs (Level 2)	Balance at June 30, 2013	
			Significant Unobservable Inputs (Level 3)	Total
US Treasury Note	\$6,159,375	\$—	\$	— \$6,159,375
Government Sponsored Enterprises	\$—	\$31,300,631	\$	— \$31,300,631
Municipal Securities	\$—	\$34,472,958	\$	— \$34,472,958
Total	\$6,159,375	\$65,773,589	\$	— \$71,932,964

2012	Quoted Market Price in active markets	Significant Other Observable Inputs (Level 2)	Balance at December 31,	
			Significant Unobservable Inputs (Level 3)	Total

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	(Level 1)			
US Treasury Note	\$6,213,750	\$—	\$	— \$6,213,750
Government Sponsored Enterprises	\$—	\$18,344,032	\$	— \$18,344,032
Municipal Securities	\$—	\$33,956,434	\$	— \$33,956,434
Total	\$6,213,750	\$52,300,466	\$	— \$58,514,216



Other Real Estate Owned (OREO)

Loans, secured by real estate, are adjusted to fair value upon transfer to other real estate owned (OREO). Subsequently, OREO is carried at the lower of carrying value or fair value. Fair value is based upon independent market prices, appraised values of the collateral or management’s estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraisal, the Company records the OREO as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the asset as nonrecurring Level 3.

Impaired Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans are reviewed for impairment on a quarterly basis if any of the following criteria are met:

- 1) Any loan on non-accrual
- 2) Any loan that is a troubled debt restructuring
- 3) Any loan over 60 days past due
- 4) Any loan rated sub-standard, doubtful, or loss
- 5) Excessive principal extensions are executed

6) If the Bank is provided information that indicates the Bank will not collect all principal and interest as scheduled

Once a loan is identified as individually impaired, management measures the impairment in accordance with Accounting Standards Codification (ASC) 310-10, “Accounting by Creditors for Impairment of a Loan”.

In accordance with this standard, the fair value is estimated using one of the following methods: fair value of the collateral less estimated costs to sell, discounted cash flows, or market value of the loan based on similar debt. The fair value of the collateral less estimated costs to sell is the most frequently used method. Typically, the Company reviews the most recent appraisal and if it is over 12 to 18 months old will request a new third party appraisal. Depending on the particular circumstances surrounding the loan, including the location of the collateral, the date of the most recent appraisal and the value of the collateral relative to the recorded investment in the loan, management may order an independent appraisal immediately or, in some instances, may elect to perform an internal analysis. Specifically as an example, in situations where the collateral on a nonperforming commercial real estate loan is out of the Company’s primary market area, management would typically order an independent appraisal immediately, at the earlier of the date the loan becomes nonperforming or immediately following the determination that the loan is impaired. However, as a second example, on a nonperforming commercial real estate loan where management is familiar with the property and surrounding areas and where the original appraisal value far exceeds the recorded investment in the loan, management may perform an internal analysis whereby the previous appraisal value would be

reviewed considering recent current conditions, and known recent sales or listings of similar properties in the area, and any other relevant economic trends. This analysis may result in the call for a new appraisal. These valuations are reviewed on a quarterly basis.

Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At June 30, 2013 and December 31, 2012, substantially all of the total impaired loans were evaluated based on the fair value of the collateral. In accordance with ASC 820, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. The Company records the impaired loan as nonrecurring Level 3.

Mortgage Loans Held for Sale

The Company originates fixed and variable rate residential mortgage loans on a servicing released basis in the secondary market. Loans closed but not yet settled with an investor are carried in the Company's loans held for sale portfolio. These loans are fixed and variable rate residential mortgage loans that have been originated in the Company's name and have closed. Virtually all of these loans have commitments to be purchased by investors and the majority of these loans were locked in by price with the investors on the same day or shortly thereafter that the loan was locked in with the Company's customers. Therefore, these loans present very little market risk for the Company. The Company usually delivers to, and receives funding from, the investor within 30 to 60 days. Commitments to sell these loans to the investor are considered derivative contracts and are sold to investors on a "best efforts" basis. The Company is not obligated to deliver a loan or pay a penalty if a loan is not delivered to the investor. As a result of the short-term nature of these derivative contracts, the fair value of the mortgage loans held for sale in most cases is the same as the value of the loan amount at its origination. These loans are classified as Level 2.

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following table presents the assets and liabilities carried on the balance sheet by caption and by level within the valuation hierarchy (as described above) as of June 30, 2013 and December 31, 2012, for which a nonrecurring change in fair value has been recorded during the six months ended June 30, 2013 and twelve months ended December 31, 2012.

	June 30, 2013			
	Quoted Market Price in active markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Impaired loans	\$ —	\$ —	\$ 4,734,013	\$ 4,734,013
Mortgage loans held for sale	—	10,249,167	—	10,249,167
Total	\$ —	\$ 10,249,167	\$ 4,734,013	\$ 14,983,180

  

	December 31, 2012			
	Quoted Market Price in active markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at December 31, 2012

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Impaired loans	\$	—	\$—	\$ 9,499,621	\$ 9,499,621
Mortgage loans held for sale		—	18,479,878	—	18,479,878
Total	\$	—	\$ 18,479,878	\$ 9,499,621	\$ 27,979,499

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	Valuation Technique	Inputs	
		Unobservable Input	General Range of Inputs
Nonrecurring measurements:			
Impaired Loans	Discounted Appraisals	Collateral Discounts	0-25%

Accounting standards require disclosure of fair value information about financial instruments whether or not recognized on the balance sheet, for which it is practicable to estimate fair value. Fair value estimates are made as of a specific point in time based on the characteristics of the financial instruments and the relevant market information. When available, quoted market prices are used. In other cases, fair values are based on estimates using present value or other valuation techniques. These techniques involve uncertainties and are significantly affected by the assumptions used and the judgments made regarding risk characteristics of various financial instruments, discount rates, prepayments, estimates of future cash flows, future expected loss experience and other factors. Changes in assumptions could significantly affect these estimates. Derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, may or may not be realized in an immediate sale of the instrument.

Under the accounting standard, fair value estimates are based on existing financial instruments without attempting to estimate the value of anticipated future business and the value of the assets and liabilities that are not financial instruments. Accordingly, the aggregate fair value amounts of existing financing instruments do not represent the underlying value of those instruments on the books of the Company.

The following describes the methods and assumptions used by the Company in estimating the fair values of financial instruments:

a. Cash and due from banks, interest bearing deposits in other banks and federal funds sold

The carrying value approximates fair value. All mature within 90 days and do not present unanticipated credit concerns.

b. Investment securities available for sale

The fair value of investment securities is derived from quoted market prices.

c. Loans

The carrying values of variable rate consumer and commercial loans and consumer and commercial loans with remaining maturities of three months or less, approximate fair value. The fair values of fixed rate consumer and commercial loans with maturities greater than three months are determined using a discounted cash flow analysis and assume the rate being offered on these types of loans by the Company at June 30, 2013 and December 31, 2012, approximate market.

The carrying value of mortgage loans held for sale approximates fair value.

For lines of credit, the carrying value approximates fair value.

d. Deposits

The estimated fair value of deposits with no stated maturity is equal to the carrying amount. The fair value of time deposits is estimated by discounting contractual cash flows, by applying interest rates currently being offered on the deposit products. The fair value estimates for deposits do not include the benefit that results from the low cost funding provided by the deposit liabilities as compared to the cost of alternative forms of funding (deposit base intangibles).

e. Short-term borrowings

The carrying amount approximates fair value due to the short-term nature of these instruments.

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Company's financial instruments as of June 30, 2013 and December 31, 2012. This table excludes financial instruments for which the carrying amount approximates fair value. For short-term financial assets such as cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization.

June 30, 2013

Fair Value Measurement

	Carrying Amount	Fair Value	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Instruments- Assets Loans	\$214,338,102	\$214,555,687	\$ —	\$ —	\$214,555,687
Financial Instruments- Liabilities Deposits	\$304,988,347	\$305,008,955	\$ —	\$305,008,955	\$ —

December 31, 2012

Fair Value Measurement

	Carrying Amount	Fair Value	Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Financial Instruments- Assets Loans	\$217,128,624	\$217,432,537	\$ —	\$ —	\$217,432,537
Financial Instruments- Liabilities Deposits	\$291,073,843	\$291,094,742	\$ —	\$291,094,742	\$ —

	June 30, 2013	
	Notional Amount	Fair Value
Off Balance Sheet Financial Instruments:		
Commitments to extend credit	\$54,342,605	\$ —
Standby letters of credit	722,729	—
	December 31, 2012	
	Notional Amount	Fair Value
Off Balance Sheet Financial Instruments:		
Commitments to extend credit	\$51,444,731	\$ —
Standby letters of credit	749,712	—

**NOTE 11: Recently Issued Accounting Pronouncements**

The following is a summary of recent authoritative pronouncements.

The Comprehensive Income topic of the ASC was amended in June 2011. The amendment eliminates the option to present other comprehensive income as a part of the statement of changes in stockholders' equity and required consecutive presentation of the statement of net income and other comprehensive income. The amendments were applicable to the Company on January 1, 2012 and have been applied retrospectively. In December 2011, the topic was further amended to defer the effective date of presenting reclassification adjustments from other comprehensive income to net income on the face of the financial statements while the FASB redeliberated the presentation requirements for the reclassification adjustments. In February 2013, the FASB further amended the Comprehensive Income topic clarifying the conclusions from such redeliberations. Specifically, the amendments do not change the current requirements for reporting net income or other comprehensive income in financial statements. However, the amendments do require an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, in certain circumstances an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income. The amendments became effective for the Company on a prospective basis for reporting periods beginning after December 15, 2012. These amendments did not have a material effect on the Company's financial statements.



On February 28, 2013, the FASB amended the liabilities topic to address obligations resulting from joint and several liability arrangements. The guidance addresses recognition of financial commitments arising from joint and several liability arrangements. Specifically, the amendments require recognition of financial commitments arising from loans, contracts, and legal rulings if the Company can be held liable for the entire claim. The amendments will be effective for the Company for reporting periods beginning after December 15, 2013. The Company does not expect these amendments to have a material effect on its financial statements.

On April 22, 2013, the FASB issued guidance addressing application of the liquidation basis of accounting. The guidance is intended to clarify when an entity should apply the liquidation basis of accounting. In addition, the guidance provides principles for recognition and measurement of assets and liabilities and requirements for financial statements prepared using the liquidation basis of accounting. The amendments will be effective for entities that determine liquidation is imminent during annual reporting periods beginning after December 15, 2013, and interim reporting periods therein and those requirements should be applied prospectively from the day that liquidation becomes imminent. Early adoption is permitted. The Company does not expect these amendments to have any effect on its financial statements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

#### **NOTE 12: Subsequent Events**

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Nonrecognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through the date the financial statements and noted there were no subsequent events requiring accrual or disclosure.

## **ITEM 2**

### **MANAGEMENT'S DISCUSSION AND ANALYSIS**

#### **OR PLAN OF OPERATION**

Management's discussion and analysis is included to assist shareholders in understanding the Company's financial condition, results of operations, and cash flow. This discussion should be reviewed in conjunction with the consolidated financial statements (unaudited) and notes included in this report and the supplemental financial data

appearing throughout this report. Since the primary asset of the Company is its wholly-owned subsidiary, most of the discussion and analysis relates to the Bank.

Management's Discussion and Analysis of Financial Condition and Results of Operations and other portions of this quarterly report contain certain "forward-looking statements" concerning the future operations of the Bank of South Carolina Corporation. Management desires to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1996 and is including this statement for the express purpose of availing the Company of protections of such safe harbor with respect to all "forward-looking statements" contained in this Form 10-Q. The Company has used "forward-looking statements" to describe future plans and strategies including its expectations of the Company's future financial results. The following are cautionary statements. Management's ability to predict results or the effect of future plans or strategies is inherently uncertain. A variety of factors may affect the operations, performance, business strategy and results of the Company including, but not limited to the following:

Risk from changes in economic, monetary policy, and industry conditions

Changes in interest rates, shape of the yield curve, deposit rates, the net interest margin and funding sources

Market risk (including net income at risk analysis and economic value of equity risk analysis) and inflation

Risk inherent in making loans including repayment risks and changes in the value of collateral

Loan growth, the adequacy of the allowance for loan losses, provisions for loan losses, and the assessment of problem loans

Level, composition, and re-pricing characteristics of the securities portfolio

Deposit growth, change in the mix or type of deposit products and services

Continued availability of senior management

Technological changes

Ability to control expenses

Changes in compensation

Risks associated with income taxes including potential for adverse adjustments

Changes in accounting policies and practices

Changes in regulatory actions, including the potential for adverse adjustments

Recently enacted or proposed legislation

Current weakness in the financial service industry.

These risks are exacerbated by the development over the last four years in national and international financial markets, and Management is unable to predict what effect continued uncertainty in market conditions will have on the Company. There can be no assurance that the unprecedented developments experienced over the last four years will not materially and adversely affect the Company's business, financial condition and results of operations

All forward-looking statements in this report are based on information available to the Company as of the date of this report. Although Management believes that the expectations reflected in the forward-looking statements are reasonable, Management cannot guarantee that these expectations will be achieved. The Company will undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made to reflect the occurrence of unanticipated events. In addition, certain statements in future filings by the Company with the SEC, in press releases, and in oral and written statements made by or with the approval of the Company, which are not statements of historical fact, constitute forward looking statements.

## Overview

Bank of South Carolina Corporation (the Company) is a financial institution holding company headquartered in Charleston, South Carolina, with \$340.5 million in assets as of June 30, 2013 and net income of \$1,044,074 and

\$2,042,879 for the three and six months ended June 30, 2013, respectively. The Company offers a broad range of financial services through its wholly-owned subsidiary, The Bank of South Carolina (the Bank). The Bank is a state-chartered commercial bank which operates primarily in the Charleston, Dorchester and Berkeley counties of South Carolina. The Bank's original and current concept is to be a full service financial institution specializing in personal service, responsiveness, and attention to detail to foster long standing relationships.

The following is a discussion of the Company's financial condition as of June 30, 2013 as compared to December 31, 2012 and the results of operations for the three and six months ended June 30, 2013 as compared to the three and six months ended June 30, 2012. The discussion and analysis identifies significant factors that have affected the Company's financial position and operating results and should be read in conjunction with the financial statements and the related notes included in this report.

The Company derives most of its income from interest on loans and investments (interest bearing assets). The primary source of funding for making these loans and investments is the Company's interest and non-interest bearing deposits. Consequently, one of the key measures of the Company's success is the amount of net interest income, or the difference between the income on interest earning assets, such as loans and investments, and the expense on its interest bearing liabilities, such as deposits. Another key measure is the spread between the yield the Company earns on these interest bearing assets and the rate the Company pays on its interest bearing liabilities.

There are risks inherent in all loans; therefore, the Company maintains an allowance for loan losses to absorb estimated losses on existing loans that may become uncollectible. The Company established and maintains this allowance based on a methodology representing the environment it operates within. For a detailed discussion on the allowance for loan losses see "Provision for Loan Losses".

In addition to earning interest on loans and investments, the Company earns income through fees and other expenses charged to customers. The various components of non-interest income as well as non-interest expense are described in the following discussion.

For six months ended June 30, 2013, the Bank has paid \$1,075,000 to the Company for dividend payments.

### **CRITICAL ACCOUNTING POLICIES**

The Company has adopted various accounting policies that govern the application of principles generally accepted in the United States and with general practices within the banking industry in the preparation of its financial statements. The Company's significant accounting policies are described in the footnotes to its unaudited consolidated financial statements as of June 30, 2013 and its notes included in the consolidated financial statements in its 2012 Annual Report on Form 10-K as filed with the SEC.

Certain accounting policies involve significant judgments and assumptions by the Company that have a material impact on the carrying value of certain assets and liabilities. The Company considers these accounting policies to be critical accounting policies. The judgment and assumptions the Company uses are based on historical experience and other factors, which the Company believes to be reasonable under the circumstances. Because of the number of the judgments and assumptions the Company makes, actual results could differ from these judgments and estimates that could have a material impact on the carrying values of its assets and liabilities and its results of operations.

The Company considers its policies regarding the allowance for loan losses to be its most subjective accounting policy due to the significant degree of management judgment. The Company has developed what it believes to be appropriate policies and procedures for assessing the adequacy of the allowance for loan losses, recognizing that this process requires a number of assumptions and estimates with respect to its loan portfolio. The Company's assessments may be impacted in future periods by changes in economic conditions, the impact of regulatory examinations and the discovery of information with respect to borrowers which were not known by management at the time of the issuance of the consolidated financial statements. For additional discussion concerning the Company's allowance for loan losses and related matters, see "Allowance for Loan Losses."

**BALANCE SHEET**

**CASH AND CASH EQUIVALENTS**

Cash and cash equivalents include working cash funds, due from banks, interest bearing deposits in other banks, items in process of collection and Federal Funds sold. In order to improve the Company's yield on daily liquidity, the Company terminated all of its Federal Funds positions and moved the money to the Federal Reserve as the Company was able to earn .25% - approximately ten basis points more than the Company was making on Federal Funds. Therefore, there were no Federal Funds sold at June 30, 2013 or December 31, 2012. Total cash and cash equivalents increased 39.00% or \$12,106,022 to \$43,147,870 at June 30, 2013, from \$31,041,848 at December 31, 2012. This increase was primarily due to the growth of the Company's core deposits.

Regulations set by the Federal Reserve require the Company to maintain certain average cash reserve balances. For the year ended December 31, 2012 the average reserve requirement was \$700,000. For the six months ended June 30, 2013 the reserve requirement was satisfied by vault cash resulting in a zero reserve requirement at the Federal Reserve.

**LOANS**

The Company focuses its lending activities on small and middle market businesses, professionals and individuals in its geographic markets. At June 30, 2013, outstanding loans (plus deferred loan fees of \$62,691) totaled \$214,338,102 which equaled 70.28% of total deposits and 62.95% of total assets. Substantially all loans were to borrowers located in the Company's market areas in the counties of Charleston, Dorchester and Berkeley in South Carolina.

Because lending activities comprise such a significant source of revenue, the Company's main objective is to adhere to sound lending practices. The Loan Committee of the Board of Directors meets monthly to evaluate the adequacy of the Allowance for Loan Losses and to review all loans resulting in credit exposure of \$10,000 or more.

The breakdown of total loans by type and the respective percentage of total loans are as follows:

	June 30, 2013	2012	December 31, 2012
Commercial loans	\$52,933,993	\$53,021,600	\$54,664,286
Commercial real estate:			
Commercial real estate construction	1,725,535	3,685,093	2,276,532
Commercial real estate other	102,514,184	105,840,164	108,575,415
Consumer:			
Consumer real estate	52,870,365	43,427,930	46,703,454
Consumer other	4,294,025	4,775,408	4,908,937
	214,338,102	210,750,195	217,128,624
Allowance for loan losses	(3,359,915 )	(3,341,579 )	(3,432,844 )
Loans, net	\$210,978,187	\$207,408,616	\$213,695,780

Percentage of Loans	June 30,		December 31,	
	2013	2012	2012	
Commercial loans	24.70 %	25.16 %	25.18	%
Commercial real estate construction	0.80 %	1.75 %	1.05	%
Commercial real estate other	47.83 %	50.22 %	50.00	%
Consumer real estate	24.67 %	20.61 %	21.51	%
Consumer other	2.00 %	2.26 %	2.26	%
Total	100.00%	100.00%	100.00	%

The Company's customers indicate that business conditions are improving; however, loan demand continues to remain low.



**INVESTMENT SECURITIES AVAILABLE FOR SALE**

The Company uses the investment securities portfolio for several purposes. It serves as a vehicle to manage interest rate and prepayment risk, to generate interest and dividend income from investment of funds, to provide liquidity to meet funding requirements, and to provide collateral for pledges on public funds. Investments are classified into three categories (1) Held to Maturity (2) Trading and (3) Available for Sale. Management believes that maintaining its securities in the Available for Sale category provides greater flexibility in the management of the overall investment portfolio. The average yield on investments at June 30, 2013 was 2.23% compared to 2.54% at June 30, 2012, and 2.46% at December 31, 2012. The fair value of the investments available for sale at June 30, 2013, June 30, 2012 and December 31, 2012 and percentage of each category to total investments are as follows:

## INVESTMENT PORTFOLIO

	June 30, 2013	June 30, 2012	December 31, 2012			
US Treasury Notes	\$6,159,375	\$6,260,625	\$6,213,750			
Government-Sponsored Enterprises	31,300,631	18,440,831	18,344,032			
Municipal Securities	34,472,958	31,483,188	33,956,434			
	\$71,932,964	\$56,184,644	\$58,514,216			
US Treasury Notes	8.56	% 11.14	% 10.62	%		
Government-Sponsored Enterprises	43.51	% 32.82	% 31.35	%		
Municipal Securities	47.93	% 56.04	% 58.03	%		
	100.00	% 100.00	% 100.00	%		

All investment securities were classified as Available for Sale (debt and equity securities that may be sold under certain conditions), at June 30, 2013 and 2012, and at December 31, 2012. The securities were reported at fair value, with unrealized gains and losses excluded from earnings and reported as a separate component of shareholders' equity, net of income taxes. Unrealized losses on securities due to fluctuations in fair value are recognized when it is determined that an other than temporary decline in value has occurred. Gains or losses on the sale of securities are recognized on a specific identification, trade date basis.

The amortized cost and fair value of investment securities available for sale are summarized as follows as of June 30, 2013 and December 31, 2012:

	JUNE 30, 2013			
	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	ESTIMATED FAIR VALUE

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U.S. Treasury Notes	\$6,070,279	\$ 89,096	\$ —	\$6,159,375
Government-Sponsored Enterprises	30,981,127	399,779	80,275	31,300,631
Municipal Securities	32,306,342	2,208,566	41,950	34,472,958
Total	\$69,357,748	\$ 2,697,441	\$ 122,225	\$71,932,964

	DECEMBER 31, 2012			ESTIMATED
	AMORTIZED COST	GROSS UNREALIZED GAINS	GROSS UNREALIZED LOSSES	FAIR VALUE
U.S. Treasury Notes	\$6,097,750	\$ 116,000	\$ —	\$6,213,750
Government-Sponsored Enterprises	17,822,858	521,174	—	18,344,032
Municipal Securities	31,101,401	2,858,625	3,592	33,956,434
Total	\$55,022,009	\$ 3,495,799	\$ 3,592	\$ 58,514,216

The amortized cost and fair value of investment securities available for sale at June 30, 2013, and December 31, 2012, by contractual maturity are as follows:

June 30, 2013

	AMORTIZED COST	ESTIMATED FAIR VALUE
Due in one year or less	\$ 1,928,831	\$ 1,941,784
Due in one year to five years	43,156,732	44,087,609
Due in five years to ten years	14,936,988	16,038,302
Due in ten years and over	9,335,197	9,865,269
Total	\$ 69,357,748	\$ 71,932,964

December 31, 2012

	AMORTIZED COST	ESTIMATED FAIR VALUE
Due in one year or less	\$ 2,331,067	\$ 2,336,933
Due in one year to five years	32,183,058	33,321,740
Due in five years to ten years	11,407,945	12,718,115
Due in ten years and over	9,099,939	10,137,428
Total	\$ 55,022,009	\$ 58,514,216

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The fair value of investment securities available for sale with unrealized losses at June 30, 2013, and December 31, 2012, are as follows:

<u>Description of Securities</u>	<b>JUNE 30, 2013</b>					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Government-Sponsored Enterprises	\$7,427,738	80,275	—	—	7,427,738	80,275
Municipal Securities	3,159,603	41,950	—	—	3,159,603	41,950
Total	\$10,587,341	\$ 122,225	\$ —	\$ —	\$10,587,341	\$ 122,225

**DECEMBER 31, 2012**

<u>Description of Securities</u>	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Municipal Securities	\$ 1,973,303	\$ 3,592	\$ —	\$ —	\$ 1,973,303	\$ 3,592

At June 30, 2013, there were five Municipal Securities and two Government-Sponsored Enterprises with an unrealized loss of \$41,950 and \$80,275, respectively, as compared to one Municipal Security with an unrealized loss of \$3,592, at December 31, 2012. The unrealized losses on investments were caused by interest rate increases. The contractual terms of these investments did not permit the issuer to settle the securities at a price less than the amortized cost of the investment. Because the Company had the ability to hold these investments until a market price recovery or maturity, these investments were not considered other-than-temporarily impaired.

DEPOSITS

Deposits remain the Company's primary source of funding for loans and investments. Average interest bearing deposits provided funding for 64.64% of average earning assets for the six months ended June 30, 2013, and 66.07% for the twelve months ended December 31, 2012. The Company encounters strong competition from other financial institutions as well as consumer and commercial finance companies, insurance companies and brokerage firms located in the primary service area of the Bank. However, the percentage of funding provided by deposits has remained stable. The breakdown of total deposits by type and the respective percentage of total deposits are as follows:

	June 30,		December 31,
	2013	2012	2012
Non-interest bearing demand	\$86,445,804	\$79,672,270	\$83,447,675
Interest bearing demand	84,876,741	63,505,499	77,441,588
Money market accounts	53,911,655	57,934,606	54,450,828
Certificates of deposit \$100,000 and over	45,171,414	39,784,530	40,903,886
Other time deposits	15,499,830	16,369,208	15,909,164
Other savings deposits	19,082,903	20,163,983	18,920,702
<b>Total Deposits</b>	<b>\$304,988,347</b>	<b>\$277,430,096</b>	<b>\$291,073,843</b>

Percentage of Deposits	June 30,		December 31,	
	2013	2012	2012	
Non-interest bearing demand	28.34 %	28.72 %	28.67	%
Interest bearing demand	27.83 %	22.89 %	26.60	%
Money Market accounts	17.68 %	20.88 %	18.71	%

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Certificates of deposit \$100,000 and over	14.81	%	14.34	%	14.05	%
Other time deposits	5.08	%	5.90	%	5.47	%
Other savings deposits	6.26	%	7.27	%	6.50	%
Total Deposits	100.00	%	100.00	%	100.00	%

Deposits increased 9.93% from June 30, 2012 to June 30, 2013 and increased 4.78% from December 31, 2012 to June 30, 2013.

Deposits increased as the result of business development efforts and not as a result of the Company offering special rates. The Company does not have any internet or brokered deposits.

### **SHORT-TERM BORROWINGS**

At June 30, 2013 and December 31, 2012, the Company had no outstanding federal funds purchased with the option to borrow up to \$19,000,000 on short term lines of credit. In March 2012, the Company established a \$6 million REPO Line with Raymond James. There have been no borrowings under this agreement. The Company has also established a Borrower-In-Custody arrangement with the Federal Reserve. This arrangement permits the Company to retain possession of loans pledged as collateral to secure advances from the Federal Reserve Discount Window. The Company established this arrangement as an additional source of liquidity. As of June 30, 2013 and December 31, 2012 the Company could borrow up to \$67.5 million and \$62.6 million, respectively. There have been no borrowings under this arrangement.

### **Comparison of Three Months Ended June 30, 2013 to Three Months Ended June 30, 2012**

Net income increased \$153,807 or 17.28% to \$1,044,074, or basic and diluted earnings per share of \$.23 and \$.23, respectively, for the three months ended June 30, 2013, from \$890,267, or basic and diluted earnings per share of \$.20 and \$.20, respectively, for the three months ended June 30, 2012. The increase was primarily due to an increase in interest and fees on loans, an increase in interest and dividends on investment securities, an increase in mortgage banking income, coupled with a decrease in both the provision for loan losses and non-interest bearing expenses.

### **Net Interest Income**

Net interest income increased \$181,715 or 6.12% to \$3,151,079 for the three months ended June 30, 2013 from \$2,969,364 for the three months ended June 30, 2012. Net interest income is a primary source of revenue. Net interest income is the difference between income earned on assets and interest paid on deposits and borrowings used to support such assets. Net interest income is determined by the rates earned on interest earning assets and the rates paid on interest bearing liabilities, the relative amounts of interest earning assets and interest bearing liabilities, and the degree of mismatch and maturity and repricing characteristics of its interest earning assets and interest bearing liabilities. The increase in net interest income was primarily due to an increase in interest and fees on loans and an increase in interest and dividends from investment securities. Interest and fees on loans increased primarily due to the payoff of three impaired loans totaling \$4.05 million. The payoff resulted in the collection of \$79,623 in non-accrual interest and fees and \$36,994 in interest and fees. Average loans increased \$27.75 million or 12.79% to \$244,704,708 for the three months ended June 30, 2013, from \$216,954,693 for the three months ended June 30, 2012. The yield on average loans decreased 33 basis points from 5.06% for the three months ended June 30, 2012 to 4.73% for the three months ended June 30, 2013.

The Company also experienced an increase of \$11,443 on interest and dividends earned on investment securities. Average investments increased \$4.24 million or 7.51% to \$60,730,098 for the three months ended June 30, 2013, from \$56,488,683 for the three months ended June 30, 2012. The yield on the average investments decreased 10 basis points from 2.38% at June 30, 2012 to 2.28% at June 30, 2013. During the three months ended June 30, 2013, the Company purchased \$12.54 million in Government Agency Enterprises with yielding between 1.17% and 1.41%, and \$1.00 million in Municipal securities yielding between 2.00% and 2.30%. Average interest bearing assets increased \$38.72 million for the three months ended June 30, 2013 to \$344,204,915. Average interest bearing deposits increased \$10.80 million or 5.42%, to \$209,840,218 for the three months ended June 30, 2013, from \$199,044,224 for the three months ended June 30, 2012. This increase allowed the Company to not only purchase additional investments but also to increase its interest bearing deposits in other banks, including the Federal Reserve. Average interest bearing deposits in other banks increased \$6.73 million or 21.02% to \$38,770,109 for the three months ended June 30, 2013, from \$32,037,313 at June 30, 2012.

#### Allowance for Loan Losses

The allowance for loan losses represents management's estimate of probable losses inherent in the loan portfolio. The adequacy of the allowance for loan losses (the "allowance") is reviewed monthly by the Loan Committee and on a quarterly basis by the Board of Directors. For purposes of this analysis, adequacy is defined as a level sufficient to absorb estimated losses in the loan portfolio as of the balance sheet date presented. The methodology employed for this analysis has had various modifications since 2007 to better reflect the economic environment and to implement regulatory guidance. This allowance is validated on a monthly basis by Credit Personnel (who have no lending authority nor complete the allowance). The revised methodology is based on a Reserve Model that is comprised of the three components listed below:

- 1) Specific Reserve analysis for impaired loans based on Financial Accounting Standards Board (FASB) ASC 310-10-35.
- 2) General reserve analysis applying historical loss rates based on FASB ASC 450-20.
- 3) Qualitative or environmental factors.

Loans are reviewed for impairment on a quarterly basis if any of the following criteria are met:

- 1) Any loan on non-accrual
- 2) Any loan that is a troubled debt restructuring
- 3) Any loan over 60 days past due
- 4) Any loan rated sub-standard, doubtful, or loss
- 5) Excessive principal extensions are executed



6) If the Bank is provided information that indicates the Bank will not collect all principal and interest as scheduled

These loans are measured in accordance with FASB ASC 310-10-35. This applies to both secured and unsecured loans, yet it does not apply to large groups of smaller balance loans that are collectively evaluated. Impairment is measured by the present value of the future cash flow discounted at the loan's effective interest rate, or, alternatively the fair value of the collateral if the loan is collateral dependent. An impaired loan may not represent an expected loss.

A general reserve analysis is performed on all loans, excluding impaired loans, based on FASB ASC 450-20. This includes a pool of loans that are reviewed for impairment but are not found to be impaired. Historical losses are segregated into risk-similar groups and a loss ratio is determined for each group over a three year period. The three year average loss ratio by type is then used to calculate the estimated loss based on the current balance of each group. The three year historical loss percentage was .23% and .25% at June 30, 2013 and June 30, 2012, respectively.

Qualitative and environmental factors include external risk factors that management believes are representative of the overall lending environment of the Company. Management believes that the following factors create a more comprehensive system of controls in which the Company can monitor the quality of the loan portfolio.

- 1) Portfolio risk
  - a. Levels and trends in delinquencies and impaired loans
  - b. Trends in volume and terms of loans
  - c. Over-margined real estate lending risk
- 2) National and local economic trends and conditions
- 3) Effects of changes in risk selection and underwriting practices
- 4) Experience, ability and depth of lending management staff
- 5) Industry conditions
- 6) Effects of changes in credit concentrations
  - a. Loan concentration
  - b. Geographic concentration
  - c. Regulatory concentration
- 7) Loan and credit administration risk
  - a. Collateral documentation
  - b. Insurance Risk

c. Maintenance of financial information risk

The sum of each component's analysis results represents the "estimated loss" within the Company's total portfolio.

Portfolio risk includes the levels and trends in delinquencies, impaired loans and changes in the loan rating matrix, trends in volume and terms of loans and overmargined real estate lending. Management is satisfied with the stability of the past due and non-performing loans and believes there has been no decline in the quality of the loan portfolio due to any trend in delinquent or adversely classified loans. Sizable unsecured principal balances on a non-amortizing basis are monitored. Within the portfolio risk factor the Company elected to increase the risk percentage for "trend in volume and term of loan". In addition, the Company elected to increase the risk percentage for "over margined real estate lending risk". Although the vast majority of the Company's real estate loans are underwritten on a cash flow basis, the secondary source of repayment is typically tied to the Company's ability to realize on the collateral. Given the contraction in real estate values, the Company closely monitors loan to value. The maximum collateral advance rate is 80% on all real estate transactions, with the exception of raw land at 65% and land development at 70%.

Occasionally, the Company extends credit beyond its normal collateral advance margins in real estate lending. Although infrequent, the aggregate of these loans represent a notable part of the Company's portfolio. Accordingly these loans are monitored and the balances reported to the Board every quarter. An excessive level of this practice (as a percentage of capital) could result in additional regulatory scrutiny, competitive disadvantages and potential losses if forced to convert the collateral. The consideration of overmargined real estate loans directly relates to the capacity of the borrower to repay. Management often requests additional collateral to bring the loan to value ratio within the policy guidelines and also requires a strong secondary source of repayment in addition to the primary source of repayment.

Although significantly under the threshold of 100% of capital (currently approximately \$34 million), the Company's list and number of over-margined real estate loans currently totals approximately \$19.4 million or approximately 9.04% of its loan portfolio at June 30, 2013 compared to \$15.8 million or approximately 7.26% of the loan portfolio at June 30, 2012. This increase was primarily due to the reappraisal of twelve loans at the time of their renewal. While over margined, these loans are performing as agreed.

A credit rating matrix is used to rate all extensions of credit and to provide a more specified picture of the risk each loan poses to the quality of the loan portfolio. There are eight possible ratings used to determine the quality of each loan based on nine different qualifying characteristics: cash flow, collateral quality, guarantor strength, financial condition, management quality, operating performance, the relevancy of the financial statements, historical loan performance, and the borrower's leverage position. The matrix is designed to meet management's standards and expectations of loan quality. One hundred percent of the Company's loans are graded.

National and local economic trends and conditions are constantly changing and result in both positive and negative impact on borrowers. Most macroeconomic conditions are not controllable by the Company and are incorporated into the qualitative risk factors. Natural and environmental disasters, wars and the recent fallout of the subprime lending market as well as problems in the traditional mortgage market are a few of the trends and conditions that are currently affecting the national and local economies. Changes in the national and local economy have impacted borrowers' ability, in many cases, to repay loans in a timely manner. On occasion a loan's primary source of repayment (i.e., personal income, cash flow, or lease income) may be eroded as a result of unemployment, lack of revenues, or the inability of a tenant to make rent payments.

The quality of the Company's loan portfolio is contingent upon its risk selection and underwriting practices. Every credit with over \$100,000 in exposure is summarized by the Bank's Credit Department and reviewed by the Loan Committee on a monthly basis. The Board of Directors reviews credits over \$500,000 monthly with an annual credit analysis conducted on these borrower's upon the receipt of updated financial information. Prior to any extension of credit, every significant commercial loan goes through sound credit underwriting. The Credit Department conducts detailed cash flow analysis on each proposal using the most current financial information. Relevant trends and ratios are evaluated.

The Company has over 350 years of lending management experience among twelve members of its lending staff. In addition to the lending staff the Company has an Advisory Board for each branch comprised of business and community leaders from the specific branch's market area. An additional Advisory Board was created during the year ended December 31, 2012, to support the Company's business efforts in the North Charleston area of South Carolina. Management meets with these boards quarterly to discuss the trends and conditions in each respective market. Management is aware of the many challenges currently facing the banking industry. As other banks look to increase earnings in the short term, the Company will continue to emphasize the need to maintain its sound lending practices and core deposit growth.

There continues to be an influx of new banks over the last several years within the Company's geographic area. This increase has decreased the local industry's overall margins as a result of pricing competition. Management believes that the borrowing base of the Company is well established and therefore unsound price competition is not necessary.

The risks associated with the effects of changes in credit concentration include loan concentration, geographic concentration and regulatory concentration.

As of June 30, 2013, there were only four Standard Industrial Code groups that comprised more than 2% of the Bank's total outstanding loans. The four groups are activities related to real estate, offices and clinics of doctors, real estate agents and managers, and legal services.

The Company is located along the coast and on an earthquake fault, increasing the chances that a natural disaster may impact the Company and its borrowers. The Company has a Disaster Recovery Plan in place; however, the amount of time it would take for its customers to return to normal operations is unknown.

Loan and credit administration risk includes collateral documentation, insurance risk and maintaining financial information risk.

The majority of the Company's loan portfolio is collateralized with a variety of its borrower's assets. The execution and monitoring of the documentation to properly secure the loan is the responsibility of the Company's lenders and Loan Department. The Company requires insurance coverage naming the Company as the mortgagee or loss payee. Although insurance risk is also considered collateral documentation risk, the actual coverage, amounts of coverage and increased deductibles are important to management.

Risk includes a function of time during which the borrower's financial condition may change; therefore, keeping financial information up to date is important to the Company. The policy of the Company is that all new loans, regardless of the customer's history with the Company, should have updated financial information. In addition, the Company is monitoring appraisals closely as real estate values continue to fluctuate.

Based on the evaluation described above, the Company recorded a provision for loan loss of \$95,000 for the three months ended June 30, 2013 compared to \$80,000 for the three months ended June 30, 2012. At June 30, 2013 the three year average loss ratios were: .171% Commercial, .633% Consumer, .495% 1-4 Residential, .000% Real Estate Construction and .142% Real Estate Mortgage. The three year historical loss ratio used at June 30, 2013 was .23% compared to .25% at June 30, 2012.

During the three months ended June 30, 2013 charge-offs of \$158,894 and recoveries of \$4,856 were recorded to the allowance for loan losses, resulting in an allowance for loan losses of \$3,359,915 or 1.57% of total loans at June 30, 2013, compared to charge-offs of \$70,222 and recoveries of \$97,287 resulting in an allowance for loan losses of \$3,341,579 or 1.59% of total loans at June 30, 2012.

The Bank had impaired loans totaling \$6,724,207 as of June 30, 2013 compared to \$11,505,446 at June 30, 2012. The impaired loans include non-accrual loans with balances at June 30, 2013, and 2012, of \$1,600,309 and \$3,271,484, respectively. As previously discussed, (see "net interest income") \$4.09 million in impaired loans were paid off during the three months ended June 30, 2013. The Bank had five restructured loans ("TDR") at June 30, 2013 and four restructured loans at June 30, 2012. According to GAAP, the Bank is required to account for certain loan modifications or restructuring as a troubled debt restructuring, when appropriate. In general, the modification or restructuring of a debt is considered a TDR if the Bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that the Bank would not otherwise consider. At June 30, 2013 the five restructured loans had an aggregate balance of \$1,589,622 compared to the four restructured loans with an aggregate balance of \$2,514,489 at June 30, 2012. Management does not know of any loans which will not meet their contractual obligations that are not otherwise discussed herein.

The accrual of interest is generally discontinued on loans, which become 90 days past due as to principal or interest. The accrual of interest on some loans, however, may continue even though they are 90 days past due if the loans are well secured or in the process of collection and management deems it appropriate. If non-accrual loans decrease their past due status to less than 30 days for a period of 6 to 9 months, they are reviewed individually by management to determine if they should be returned to accrual status. There were no loans over 90 days past due still accruing interest at June 30, 2013 and two over 90 days past due still accruing interest at June 30, 2012.

Net charge-offs for the three months ended June 30, 2013, were \$154,038 as compared to net recoveries of \$27,065 for the three months ended June 30, 2012. Although uncertainty in the economic outlook still exists, management

believes loss exposure in the portfolio is identified, reserved against and closely monitored to ensure that changes are promptly addressed in the analysis of reserve adequacy.

The following table represents the net charge-offs by loan type.

Net charge-offs	June 30, 2013	June 30, 2012
Commercial Loans	\$(139,618)	\$93,589
Commercial Real Estate	3,000	(40,139)
Consumer real estate	—	(26,488)
Consumer other	(17,420 )	103
Total	\$(154,038)	\$27,065

The Company had \$263,460, in unallocated reserves at June 30, 2013 related to other inherent risk in the portfolio compared to unallocated reserves of \$518,387 at June 30, 2012. Management believes this amount is appropriate and properly supported through the environmental factors of its allowance for loan losses. Management believes the allowance for loan losses at June 30, 2013 is adequate to cover estimated losses in the loan portfolio; however, assessing the adequacy of the allowance is a process that requires considerable judgment. Management's judgments are based on numerous assumptions about current events which it believes to be reasonable, but which may or may not be valid. Thus, there can be no assurance that loan losses in future periods will not exceed the current allowance amount or that future increases in the allowance will not be required. No assurance can be given that management's ongoing evaluation of the loan portfolio in light of changing economic conditions and other relevant circumstances will not require significant future additions to the allowance, thus adversely affecting the operating results of the Company.

The following table presents a breakdown of the allowance for loan losses as of June 30, 2013 and 2012, respectively.

	June 30, 2013		June 30, 2012			
	Allowance by loan type	Percentage of loans to total loans	Allowance by loan type	Percentage of loans to total loans		
Commercial Loans	\$1,463,641	25	% \$1,551,539	25	%	
Commercial Real Estate	699,761	49	% 508,128	52	%	
Consumer real estate	846,332	24	% 671,337	21	%	
Consumer other	86,721	2	% 91,895	2	%	
Unallocated	263,460	0	% 518,680	0	%	
Total	\$3,359,915	100	% \$3,341,579	100	%	

The allowance is also subject to examination testing by regulatory agencies, which may consider such factors as the methodology used to determine adequacy and the size of the allowance relative to that of peer institutions, and other adequacy tests. In addition, such regulatory agencies could require the Company to adjust its allowance based on information available to them at the time of their examination.

The methodology used to determine the reserve for unfunded lending commitments, which is included in other liabilities, is inherently similar to that used to determine the allowance for loan losses described above adjusted for factors specific to binding commitments, including the probability of funding and historical loss ratio. No provision was recorded during the three months ended June 30, 2013 or the three months ended June 30, 2012, resulting in no change to the balance of \$20,825.

#### Non-interest Income

Non-interest income for the three months ended June 30, 2013, increased \$61,414 or 10.91% to \$624,158 from \$562,744 for the three months ended June 30, 2012. This increase is primarily due to an increase in mortgage banking



income of \$70,997 or 22.80% to \$382,426 for the three months ended June 30, 2013 as compared to \$311,429 for the three months ended June 30, 2012. Mortgage loan originations for the three months ended June 30, 2013 increased \$7.3 million to \$28.4 million from \$21.1 million for the three months ended June 30, 2012.

### Non-interest Expense

Non-interest expense decreased \$42,880 or 1.95% to \$2,161,678 for the three months ended June 30, 2013, from \$2,204,558 for the three months ended June 30, 2012. This decrease was primarily due to decreases in other operating expenses offset by an increase in salaries and employee benefits. Wages increased \$34,247 or 2.74% from \$1,251,695 for the three months ended June 30, 2012 to \$1,285,942 for the three months ended June 30, 2013, as a result of annual merit increases and the addition of a mortgage loan originator and a risk management officer. Data processing fees decreased \$53,127 or 36.15% for the three months ended June 30, 2013. This decrease was primarily a result of price negotiations. The expense for courier service also decreased \$21,599 or 46.63% as the result of offering remote deposit capture to business customers which reduced the need for customer deposit pick-up. Professional legal fees decreased \$52,937 or 82.36% for the three months ended June 30, 2013 compared to the three months ended June 30, 2012. During the three months ended June 30, 2012, a large portion of the Company's legal fees were used on the defense of a case before the South Carolina Supreme Court. (See "Legal Matters" for further discussion). The other changes in non-interest expense reflect normal fluctuations between two periods.

### Income Tax Expense

For the three months ended June 30, 2013, the Company's effective tax rate was 31.25% compared to 28.64% during the three months ended June 30, 2012.

### Comparison of Six Months Ended June 30, 2013 to Six Months Ended June 30, 2012

Net income increased \$261,886 or 14.70% to \$2,042,879 or basic and diluted earnings per share of \$.46 and \$.46, respectively, for the six months ended June 30, 2013 from \$1,780,993 or basic and diluted of \$.40 and \$.40, respectively, for the six months ended June 30, 2012. The increase in net income between periods is primarily due to an increase in interest and fees on loans, an increase in mortgage banking income and a decrease in the cost of funds. For further discussion see "net interest income" and "non-interest income".

Average earning assets were \$320,058,861 for the six months ended June 30, 2013, an increase of \$6.6 million from \$313,475,010 for the six months ended June 30, 2012. Average loans increased \$6.9 million or 3.14% to \$225,154,567 for the six months ended June 30, 2013 as compared to \$218,297,638 for the six months ended June 30, 2012. Average investments increased \$1.42 million or 2.44% to \$59,498,243 for the six months ended June 30, 2013 from \$58,081,743 for the six months ended June 30, 2012. The average balance of other interest bearing deposits decreased \$1.7 million or 4.56% to \$35,406,051 for the six months ended June 30, 2013 from \$37,095,629 for the six months ended June 30, 2012.

### Net Interest Income

Net interest income, the major component of the Company's net income, increased \$146,781 or 2.46% to \$6,111,739 for the six months ended June 30, 2013 from \$5,964,958 for the six months ended June 30, 2012. This increase is

primarily due to an increase of \$108,502 or 1.98% in interest and fees on loans as well as a decrease of \$38,864 in the cost of funds. Interest and fees on loans increased primarily due to the payoff of three impaired loans totaling \$4.05 million. The payoff resulted in the collection of \$79,623 in non-accrual interest and fees and \$36,994 in interest and fees. Average loans increased \$6.9 million or 3.14%. Interest expense decreased \$38,864 or 15.89% to \$205,595 for the six months ended June 30, 2013, from \$244,459 for the six months ended June 30, 2012. The yield on average deposits decreased from .23% for the six months ended June 30, 2012, to .20% for the six months ended June 30, 2013. The decrease in interest expense is primarily due to the decrease in average interest bearing deposits of \$4.2 million or 1.97% for the six months ended June 30, 2013, to \$206,879,305.

#### Allowance for Loan Losses

The contribution to the allowance for loan losses for the six months ended June 30, 2013 was \$170,000 compared to \$200,000 for the six months ended June 30, 2012. Net charge-offs for the six months ended June 30, 2013 were \$242,929 compared to net recoveries of \$34,695 for the six months ended June 30, 2012. Charge-offs for the six months ended June 30, 2013 were \$252,847 with recoveries of \$9,918. The contribution to the allowance for loan losses and the net charge-offs resulted in an allowance for loan losses of \$3,359,915 or 1.57% of total loans at June 30, 2013.

### Non-Interest Income

Other income for the six months ended June 30, 2013, increased \$239,785 or 21.49% to \$1,355,577 from \$1,115,792 for the six months ended June 30, 2012. This increase is primarily due to an increase in mortgage banking income of \$250,137 or 39.94% to \$876,438 for the six months ended June 30, 2013 as compared to \$626,301 for the six months ended June 30, 2012. Mortgage originations increased \$5.6 million or 12.82% to \$49,460,592 for the six months ended June 30, 2013, from \$43,840,121 for the six months ended June 30, 2012, as the result of the low interest rate environment and an improving housing market. This increase was offset by a decrease of \$13,260 in other miscellaneous expenses. Rent collected on safe deposit boxes decreased \$2,413. In addition, during the six months ended June 30, 2012 the Company took into income \$13,302 in unclaimed credits from the Federal Reserve (over 1 year old).

### Non-Interest Expense

Non-interest expense decreased \$29,911 or 0.69% to \$4,328,435 for the six months ended June 30, 2013, from \$4,358,346 the six months ended June 30, 2012. This decrease was primarily due to decreases in professional legal fees, data processing fees, and courier services charges, coupled with an increase in salaries and wages. Wages increased \$89,949 or 3.63% from \$2,478,077 for the six months ended June 30, 2012 to \$2,568,026 for the six months ended June 30, 2013, as a result of annual merit increases and the addition of a mortgage loan originator and a risk management officer. This increase included the increase in the cost of providing insurance for employees of \$25,230 from \$210,133 for the six months ended June 30, 2012 to \$235,363 for the six months ended June 30, 2013. Data processing fees decreased \$86,897 or 29.32% for the six months ended June 30, 2013. This decrease was primarily a result of price negotiations. The expense for courier services also decreased in the amount of \$43,692 as the result of offering remote deposit capture to business customers which reduced the need for customer deposit pick-up. Professional legal fees decreased \$47,936. For the six months ended June 30, 2012 the Company obtained legal advice on two cases, one of which was heard by the South Carolina Supreme Court on June 19, 2012. The cost associated with these cases as well as legal review of the Company's filings with the Securities and Exchange Commission, resulted in legal fees of \$71,777 for the six months ended June 30, 2012 as compared to \$23,841 for the six months ended June 30, 2013. The other changes in non-interest expense reflect normal fluctuations between two periods.

### Income Tax Expense

For the six months ended June 30, 2013, the Company's effective tax rate was 31.19% compared to 29.39% during the six months ended June 30, 2012.

### Off Balance Sheet Arrangements

In the normal course of operations, the Company engages in a variety of financial transactions that, in accordance with generally accepted accounting principles, are not recorded in the financial statements, or are recorded in amounts that differ from the notional amounts. These transactions involve, to varying degrees, elements of credit, interest rate, and liquidity risk. Such transactions are used by the Company for general corporate purposes or for customer needs. Corporate purpose transactions are used to help manage credit, interest rate and liquidity risk or to optimize capital.

Customer transactions are used to manage customer's requests for funding.

The Company's off-balance sheet arrangements consist principally of commitments to extend credit described below. The Company estimates probable losses related to binding unfunded lending commitments and records a reserve for unfunded lending commitment in other liabilities on the consolidated balance sheet. The balance of the reserve was \$20,825 at June 30, 2013 and 2012. The Company had no interests in non-consolidated special purpose entities.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained if deemed necessary by the Company upon extension of credit is based on management's credit evaluation of the borrower. Collateral held varies, but may include accounts receivable, negotiable instruments, inventory, property, plant and equipment, and real estate. Commitments to extend credit, including unused lines of credit, amounted to \$54,342,605 and \$48,788,667 at June 30, 2013 and 2012, respectively.

Standby letters of credit represent an obligation of the Company to a third party contingent upon the failure of the Company's customer to perform under the terms of an underlying contract with the third party or obligates the Company to guarantee or stand as surety for the benefit of the third party. The underlying contract may entail either financial or nonfinancial obligations and may involve such things as the shipment of goods, performance of a contract, or repayment of an obligation. Under the terms of a standby letter, generally drafts will be drawn only when the underlying event fails to occur as intended. The Company can seek recovery of the amounts paid from the borrower. The majority of these standby letters of credit are unsecured. Commitments under standby letters of credit are usually for one year or less. The maximum potential amount of undiscounted future payments related to standby letters of credit at June 30, 2013 was \$722,729 and \$937,662 at June 30, 2012.

The Company originates certain fixed rate residential loans and commits these loans for sale. The commitments to originate fixed rate residential loans and the sale commitments are freestanding derivative instruments. The Company has forward sales commitments, totaling \$10.2 million at June 30, 2013, to sell loans held for sale of \$10.2 million. The fair value of these commitments was not significant at June 30, 2013. The Company has no embedded derivative instruments requiring separate accounting treatment.

Once the Company sells certain fixed rate residential loans, the loans are no longer reportable on the Company's balance sheet. With most of these sales, the Company has an obligation to repurchase the loan in the event of a default as defined in the loan documents. This recourse period ranges from three to six months with unlimited recourse against the bank as a result of fraud by the borrower. The unpaid principal balance of loans sold with recourse was \$64.5 million at June 30, 2013 and \$31.1 million at June 30, 2012. For the six months ended June 30, 2013 and June 30, 2012 there were no loans repurchased and no loans likely to be repurchased.

### Liquidity

The Company must maintain an adequate liquidity position in order to respond to the short-term demand for funds caused by withdrawals from deposit accounts, extensions of credit and for the payment of operating expenses. Primary liquid assets of the Company are cash and due from banks, federal funds sold, investments available for sale, other short-term investments and mortgage loans held for sale. The Company's primary liquid assets accounted for 36.81% and 32.08% of total assets at June 30, 2013 and 2012, respectively. Proper liquidity management is crucial to ensure that the Company is able to take advantage of new business opportunities as well as meet the credit needs of its existing customers. Investment securities are an important tool in the Company's liquidity management. Securities classified as available for sale, which are not pledged, may be sold in response to changes in interest rates and liquidity needs. All of the securities presently owned by the Bank are classified as available for sale. At June 30, 2013, the Bank had unused short-term lines of credit totaling approximately \$19,000,000 (which are withdrawable at the lender's option). Additional sources of funds available to the Bank for additional liquidity needs include borrowing on a short-term basis from the Federal Reserve System, increasing deposits by raising interest rates paid and selling mortgage loans for sale. In March 2012, the Company established a \$6 million REPO Line with Raymond James. There have been no borrowings under this agreement. The Company has also established a Borrower-In-Custody arrangement with the Federal Reserve. This arrangement permits the Company to retain possession of assets pledged as collateral to secure advances from the Federal Reserve Discount Window. As of June 30, 2013 the Company could

borrow up to \$67.5 million. There have been no borrowings under this arrangement.

The Company's core deposits consist of non-interest bearing accounts, NOW accounts, money market accounts, time deposits and savings accounts. The Company closely monitors its reliance on certificates of deposit greater than \$100,000 and other large deposits. The Company's management believes its liquidity sources are adequate to meet its operating needs and does not know of any trends, events or uncertainties that may result in a significant adverse effect on the Company's liquidity position. At June 30, 2013 and 2012, the Bank's liquidity ratio was 23.94% and 22.15%, respectively.

### Capital Resources

The capital needs of the Company have been met to date through the \$10,600,000 in capital raised in the Bank's initial offering, the retention of earnings less dividends paid and the exercise of stock options for total shareholders' equity at June 30, 2013 of \$34,426,524. The rate of asset growth since the Bank's inception has not negatively impacted this capital base. The current risk-based capital guidelines for financial institutions are designed to highlight differences in risk profiles among financial institutions and to account for off balance sheet risk. The current guidelines established require a minimum risk-based capital ratio of 8% for bank holding companies and banks. The risk based capital ratio at June 30, 2013, for the Bank is 13.62% and at June 30, 2012 was 13.94%. The Company's management does not know of any trends, events or uncertainties that may result in the Company's capital resources materially increasing or decreasing.

On June 23, 2011 the Board of Directors voted to file a shelf registration (Form S-3) with the SEC (Securities and Exchange Commission). This shelf registration statement on Form S-3 provides for the offer and sale from time to time over a three year period, in one or more public offerings, up to \$10 million in common stock or debt securities. Specific terms and prices will be determined at the time of each offering under a separate prospectus supplement, which will be filed with the SEC at the time of the offering. The registration statement was filed with the SEC on June 23, 2011. The filing of the shelf registration does not require the Company to issue securities. Although the Company has no current commitments to sell additional stock or securities, the shelf registration could provide the Company with a source of additional capital for acquisitions, capital expenditures, repayment of indebtedness the Company may incur in the future, working capital and other general corporate purposes.

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 material effect on the financial statements. Under current capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Current quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets and to average assets. Management believes, as of June 30, 2013, the Company and the Bank met all capital adequacy requirements to which they are subject.

At June 30, 2013 and 2012, the Company and the Bank were categorized as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized" the Company and the Bank must maintain minimum total risk based, Tier 1 risk based and Tier 1 leverage ratios of 10%, 6% and 5%, respectively, and



to be categorized as “adequately capitalized,” the Company and the Bank must maintain minimum total risk based, Tier 1 risk based and Tier 1 leverage ratios of 8%, 4% and 4%, respectively. There are no current conditions or events that management believes would change the Company’s or the Bank’s category.

On July 2, 2013, the Federal Reserve Board approved the final rules implementing the Basel Committee on Banking Supervision’s (“BCBS”) capital Guidelines for US Banks. Under the final rules, minimum requirements will increase for both the quantity and quality of capital held by the Company and the Bank. The rules include a new common equity Tier 1 capital to risk-weighted assets ratio of 4.5% and a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets. The final rule also raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4% to 6% and requires a minimum leverage ratio of 4%. The final rule also implements strict eligibility criteria for regulatory capital instruments and improves the methodology for calculating risk-weighted assets to enhance risk sensitivity.

On July 9, 2013 the FDIC also approved, as an interim final rule, the regulatory capital requirements for US banks, following the actions of the Federal Reserve Bank. The FDIC's rule is identical in substance to the final rules issued by the Federal Reserve Bank.

The phase-in-period for the final rules will begin for the Company and the Bank on January 1, 2015, with full compliance with all of the final rule requirements phased in over a multi-year schedule. Management is currently evaluating the provisions of the final rules and the expected impact to the Company and the Bank. In the meantime, management intends to continue to build capital through retained earnings.

### **ITEM 3**

#### **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Not required.

### **ITEM 4**

#### **CONTROLS AND PROCEDURES**

##### **Evaluation of disclosure controls and procedures and internal controls and procedures for financial reporting**

An evaluation was carried out under the supervision and with the participation of Bank of South Carolina Corporation's management (as defined in Section 13a-15(e) or 15d-15(e) of the Securities Exchange Act of 1934 (the "Act"), including its President/Chief Executive Officer and the Chief Financial Officer/Executive Vice President, of the effectiveness of Bank of South Carolina Corporation's disclosure controls and procedures as of June 30, 2013. Based on that evaluation, Bank of South Carolina Corporation's management, including the President/Chief Executive Officer and Chief Financial Officer/Executive Vice President, has concluded that Bank of South Carolina Corporation's disclosure controls and procedures are effective. During the period ending June 30, 2013, there was no change in Bank of South Carolina Corporation's internal control over financial reporting that has materially affected or is reasonably likely to materially affect, Bank of South Carolina Corporation's internal control over financial reporting.

The Company established a Disclosure Committee on December 20, 2002. The committee is made up of the President/Chief Executive Officer, Chief Financial Officer/Executive Vice President, Executive Vice President (Credit and Loan Administration), Chairman of the Board, Senior Vice President (Audit Compliance), Vice President (Accounting), Vice President (Credit Department), Senior Vice President (Operations and Technology) and Assistant Vice President/Risk Manager. This Committee meets quarterly to review the 10Q and/or the 10K, to assure that the financial statements, Securities and Exchange Commission filings, and all public releases are free of any material misstatements and correctly reflect the financial position, results of operations and cash flows of the Company. This Committee also assures that the Company is in compliance with the Sarbanes-Oxley Act.

The Disclosure Committee establishes a calendar each year to assure that all filings are reviewed and filed in a proper manner. The calendar includes the dates of the Disclosure Committee meetings, the dates that the 10Q and/or the 10K are sent to its independent accountants and to its independent counsel for review as well as the date for the Audit Committee of the Board of Directors to review the reports.

## PART II OTHER INFORMATION

### **Item 1. Legal Proceedings**

On February 3, 2012 the Company was served with pleadings with respect to a South Carolina State Supreme Court Case for the “unauthorized practice of the law” arising from the modifications of real estate loans. The South Carolina State Supreme Court heard this case on June 19, 2012 and rendered a decision on June 19, 2013. The South Carolina State Supreme Court ruled, under the facts presented, that the modification of a loan without the use of an attorney does not constitute an unauthorized practice of the law. There will be no further proceedings on this matter.

On April 8, 2013 the Company was served with a civil complaint for breach of contract. The Company's legal counsel responded to the suit. At this time the Company believes there will be no loss in the case.

In the Opinion of Management, there are no other legal proceedings pending other than routine litigation incidental to its business involving amounts which are not material to the financial condition of the Company or the Bank.

**Item 1A. Risk Factors**

Not required.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Removed and Reserved**

**Item 5. Other Information**

None.

**Item 6. Exhibits**

<sup>1</sup> The Consolidated Financial Statements are included in this Form 10-Q and listed on pages as indicated.

Page

(1)Consolidated Balance Sheets

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(5)Notes to Consolidated Financial Statements	9-29

2.Exhibits

2.0 Plan of Reorganization (Filed with 1995 10-KSB)	
3.0 Articles of Incorporation of the Registrant (Filed with 1995 10-KSB)	
3.1 By-laws of the Registrant (Filed with 1995 10-KSB)	
3.2 Amendments to the Articles of Incorporation of the Registrant (Filed with Form S on June 23, 2012)	
4.0 2012 Proxy Statement (Filed with 2012 10-K)	
10.0Lease Agreement for 256 Meeting Street (Filed with 1995 10-KSB)	
10.1 Sublease Agreement for Parking Facilities at 256 Meeting Street (Filed with 1995 10-KSB)	
10.2Lease Agreement for 100 N. Main Street, Summerville, SC (Filed with 1995 10-KSB)	
10.3Lease Agreement for 1337 Chuck Dawley Blvd., Mt. Pleasant, SC (Filed with 1995 10-KSB)	
10.4Lease Agreement for 1071 Morrison Drive, Charleston, SC (Filed with 2010 10-K)	
Lease Agreement for 1071 Morrison Drive, Charleston, SC (Filed with March 31, 2013 10-Q)	
10.51998 Omnibus Stock Incentive Plan (Filed with 2008 10-K/A)	
2010 Omnibus Stock Incentive Plan (Filed with 2010 Proxy Statement)	
10.6Employee Stock Ownership Plan (Filed with 2008 10-K/A)	
Employee Stock Ownership Plan, Restated (Filed with 2012 Proxy Statement)	
10.72010 Omnibus Incentive Stock Option Plan (Filed with 2010 Proxy Statement)	
14.0Code of Ethics (Filed with 2004 10-KSB)	
21.0List of Subsidiaries of the Registrant (Filed with 1995 10-KSB)	
The Registrant's only subsidiary is The Bank of South Carolina (Filed with 1995 10-KSB)	

<u>31.1</u>	Certification pursuant to Rule 13a-14(a)/15d-14(a) by Chief Executive Officer
<u>31.2</u>	Certification pursuant to Rule 13a-14(a)/15d-14(a) by Chief Financial Officer
<u>32.1</u>	Certification pursuant to Section 1350
<u>32.2</u>	Certification pursuant to Section 1350

SIGNATURES

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

BANK OF SOUTH CAROLINA  
CORPORATION

August 13, 2013

BY: /s/ Fleetwood S. Hassell  
Fleetwood S. Hassell  
President/Chief Executive Officer

BY: /s/ Sheryl G. Sharry  
Sheryl G. Sharry  
Chief Financial Officer/  
Executive Vice President