

Discovery Holding CO  
Form 10-K  
March 23, 2006

**Table of Contents**

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
Form 10-K**

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

**For the fiscal year ended December 31, 2005  
or**

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

**For the transition period from to**

**Commission File Number 000-51205**

**Discovery Holding Company**

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

**State of Delaware**

*(State or other jurisdiction of incorporation or organization)*

**20-2471174**

*(I.R.S. Employer Identification No.)*

**12300 Liberty Boulevard**

**Englewood, Colorado**

*(Address of principal executive offices)*

**80112**

*(Zip Code)*

**Registrant's telephone number, including area code: (720) 875-4000**

**Securities registered pursuant to Section 12(b) of the Act:**

<b>Title of each class</b>	<b>Name of exchange on which registered</b>
Series A Common Stock, par value \$.01 per share	Nasdaq
Series B Common Stock, par value \$.01 per share	Nasdaq

**Securities registered pursuant to Section 12(g) of the Act: None**

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act of 1933. Yes  No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Securities Exchange Act of 1934. Yes  No

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

## Edgar Filing: Discovery Holding CO - Form 10-K

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Act).

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

The aggregate market value of the voting stock held by nonaffiliates of Discovery Holding Company computed by reference to the last sales price of such stock, as of the closing of trading on February 28, 2006, was approximately \$4.1 billion.

The number of shares outstanding of Discovery Holding Company's common stock as of February 28, 2006 was:

Series A Common Stock 268,097,442; and

Series B Common Stock 12,106,093 shares.

### **DOCUMENTS INCORPORATED BY REFERENCE**

The Registrant's definitive proxy statement for its 2006 Annual Meeting of Shareholders is hereby incorporated by reference into Part III of this Annual Report on Form 10-K

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**DISCOVERY HOLDING COMPANY**  
**2005 ANNUAL REPORT ON FORM 10-K**  
**Table of Contents**

		<b>Page</b>
<b><u>Part I</u></b>		
<u>Item 1.</u>	<u>Business</u>	I-1
<u>Item 1A.</u>	<u>Risk Factors</u>	I-14
<u>Item 1B.</u>	<u>Unresolved Staff Comments</u>	I-21
<u>Item 2.</u>	<u>Properties</u>	I-21
<u>Item 3.</u>	<u>Legal Proceedings</u>	I-22
<u>Item 4.</u>	<u>Submission of Matters to a Vote of Security Holders</u>	I-22
<b><u>Part II</u></b>		
<u>Item 5.</u>	<u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	II-1
<u>Item 6.</u>	<u>Selected Financial Data</u>	II-1
<u>Item 7.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	II-2
<u>Item 7A.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	II-15
<u>Item 8.</u>	<u>Financial Statements and Supplementary Data</u>	II-15
<u>Item 9.</u>	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	II-15
<u>Item 9A.</u>	<u>Controls and Procedures</u>	II-15
<u>Item 9B.</u>	<u>Other Information</u>	II-15
<b><u>Part III</u></b>		
<u>Item 10.</u>	<u>Directors and Executive Officers of the Registrant</u>	III-1
<u>Item 11.</u>	<u>Executive Compensation</u>	III-1
<u>Item 12.</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	III-1
<u>Item 13.</u>	<u>Certain Relationships and Related Transactions</u>	III-1
<u>Item 14.</u>	<u>Principal Accounting Fees and Services</u>	III-1
<b><u>Part IV</u></b>		
<u>Item 15.</u>	<u>Exhibits and Financial Statement Schedules</u>	IV-1
	<u>Subsidiaries</u>	
	<u>Consent of KPMG LLP</u>	
	<u>Consent of PricewaterhouseCoopers LLP</u>	
	<u>Rule 13a-14(a)/15d-14(a) Certification</u>	
	<u>Rule 13a-14(a)/15d-14(a) Certification</u>	
	<u>Rule 13a-14(a)/15d-14(a) Certification</u>	
	<u>Section 1350 Certification</u>	

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**Table of Contents**

**PART I.**

**Item 1. Business.**

**(a) General Development of Business**

Discovery Holding Company was incorporated in the state of Delaware on March 9, 2005 as a wholly-owned subsidiary of Liberty Media Corporation, which we refer to as Liberty. On July 21, 2005, Liberty completed the spin off of Discovery Holding Company to Liberty's shareholders. In the spin off, each holder of Liberty common stock received 0.10 of a share of our Series A common stock for each share of Liberty Series A common stock held and 0.10 of a share of our Series B common stock for each share of Liberty Series B common stock held. Approximately 268.1 million shares of our Series A common stock and 12.1 million shares of our Series B common stock were issued in the spin off, which is intended to qualify as a tax-free transaction.

We are a holding company. Through our wholly owned subsidiary, Ascent Media Group, LLC, and our 50% owned equity affiliate Discovery Communications, Inc., we are engaged primarily in (1) the production, acquisition and distribution of entertainment, educational and information programming and software, (2) the retail sale and licensing of branded and other specialty products and (3) the provision of creative, media management and network services to the media and entertainment industries. Our subsidiaries and affiliates operate in the United States, Europe, Latin America and Asia.

The assets and operations of Ascent Media are composed primarily of the assets and operations of 13 companies acquired by Liberty from 2000 through 2004, including The Todd-AO Corporation, Four Media Company, certain assets of SounDelux Entertainment Group, Video Services Corporation, Group W Network Services, London Playout Centre and the systems integration business of Sony Electronics. The combination and integration of these and other acquired entities allow Ascent Media to offer integrated outsourcing solutions for the technical and creative requirements of its clients, from content creation and other post-production services to media management and transmission of the final product to broadcast television stations, cable system head-ends and other destinations and distribution points.

Discovery is a leading global media and entertainment company. Discovery has grown from the 1985 launch in the United States of its core property, Discovery Channel, to current global operations in over 160 countries across six continents, with over 1 billion total cumulative subscription units. Discovery operates its businesses in three groups: Discovery networks U.S., Discovery networks international, and Discovery commerce, education and other.

On January 27, 2006, we acquired AccentHealth LLC for cash consideration of \$45 million, plus working capital adjustments of \$2.0 million. Accent Health operates an advertising-supported captive audience television network in approximately 11,000 doctor office waiting rooms nationwide.

\* \* \* \* \*

Certain statements in this Annual Report on Form 10-K constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. To the extent that statements in this Annual Report are not recitations of historical fact, such statements constitute forward-looking statements which, by definition, involve risks and uncertainties. In some cases, you can identify these statements by our use of forward-looking words such as may, should, anticipate, estimate, expect, plan, believe, predict, potential, intend and other words of similar particular, statements under Item 1. Business, Item 1A. Risk Factors, Item 2. Properties, Item 3. Legal Proceedings, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and Item 7A.

Quantitative and Qualitative Disclosures About Market Risk contain forward-looking statements. Where, in any forward-looking statement, we express an expectation or belief as to future results or events, such expectation or belief is expressed in good faith and believed to have a reasonable basis, but there can be no assurance that

**Table of Contents**

the expectation or belief will result or be achieved or accomplished. The following include some but not all of the factors that could cause actual results or events to differ materially from those anticipated:

general economic and business conditions and industry trends including the timing of, and spending on, feature film and television production;

spending on domestic and foreign television advertising and spending on domestic and foreign first-run and existing content libraries;

the regulatory and competitive environment of the industries in which we, and the entities in which we have interests, operate;

continued consolidation of the broadband distribution and movie studio industries;

uncertainties inherent in the development and integration of new business lines, acquired operations and business strategies;

changes in the distribution and viewing of television programming, including the expanded deployment of personal video recorders and other technology, and their impact on television advertising revenue;

rapid technological changes;

uncertainties associated with product and service development and market acceptance, including the development and provision of programming for new television and telecommunications technologies;

future financial performance, including availability, terms and deployment of capital;

fluctuations in foreign currency exchange rates and political unrest in international markets;

the ability of suppliers and vendors to deliver products, equipment, software and services;

the outcome of any pending or threatened litigation;

availability of qualified personnel;

the possibility of an industry-wide strike or other job action affecting a major entertainment industry union;

changes in, or failure or inability to comply with, government regulations, including, without limitation, regulations of the Federal Communications Commission, and adverse outcomes from regulatory proceedings;

changes in the nature of key strategic relationships with partners and joint venturers;

competitor responses to our products and services, and the products and services of the entities in which we have interests; and

threatened terrorists attacks and ongoing military action in the Middle East and other parts of the world.

These forward-looking statements and such risks, uncertainties and other factors speak only as of the date of this Annual Report, and we expressly disclaim any obligation or undertaking to disseminate any updates or revisions to any forward-looking statement contained herein, to reflect any change in our expectations with regard thereto, or any

other change in events, conditions or circumstances on which any such statement is based. When considering such forward-looking statements, you should keep in mind the factors described in Item 1A, Risk Factors and other cautionary statements contained in this Annual Report. Such risk factors and statements describe circumstances which could cause actual results to differ materially from those contained in any forward-looking statement.

**(b) Financial Information About Operating Segments**

We identify our reportable segments based on financial information reviewed by our chief operating decision maker, or his designee. We report financial information for our consolidated business segments that

I-2

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**Table of Contents**

represent more than 10% of our consolidated revenue or earnings before taxes and equity affiliates whose share of earnings represent more than 10% of our earnings before taxes.

Based on the foregoing criteria, our four reportable segments are our Creative Services Group, Media Management Group and Network Services Group, which are all operating segments of Ascent Media, and Discovery, which is an equity affiliate. Financial information related to our operating segments can be found in note 18 to our consolidated financial statements found in Part II of this report.

**(c) Narrative Description of Business**

***ASCENT MEDIA***

Ascent Media provides a wide variety of creative, media management and network services to the media and entertainment industries. Ascent Media's clients include the major motion picture studios, independent producers, broadcast networks, programming networks, advertising agencies and other companies that produce, own and/or distribute entertainment, news, sports, corporate, educational, industrial and advertising content.

Ascent Media's operations are organized into three main categories: creative services, media management services and network services.

***Creative Services***

Ascent Media's creative services group provides various technical and creative services necessary to complete principal photography into final products, such as feature films, movie trailers, documentaries and independent films, episodic television, TV movies and mini-series, television commercials, music videos, interactive games and new digital media, promotional and identity campaigns and corporate communications. These services are referred to generally in the entertainment industry as post-production services.

Ascent Media markets its creative services under various well-known brand names, including *Company 3, Design Music Group (DMG), Digital Symphony, Encore Hollywood, FilmCore, Level 3 Post, Method, Modern Music, One Post, POP Sound, R!OT, Rushes, Soho Images, Soundelux, Sound One, St. Anne's Post, and Todd-AO*. The creative services client base comprises the major domestic film studios, independent television production companies, broadcast networks, advertising agencies, creative editorial companies and corporate media producers. The principal facilities of the creative services group are in Los Angeles, New York, Atlanta, San Francisco, Mexico City and London.

Key services provided by Ascent Media's creative services group include the following:

*Dailies.* Clients require daily screening of their previous day's recorded work in order to evaluate technical and aesthetic qualities of the production and to begin the creative editorial process. Ascent Media provides the film development, digital transfer from film to video and video processing necessary for clients to view principal photography on a daily basis, also known as dailies. For clients that record their productions on film, Ascent Media processes and prints film negatives for film projection. The company also delivers dailies that are transferred from film to digital media using telecine equipment. The transfer process is technically challenging and is used to integrate various forms of audio and encode the footage with feet and frame numbers from the original film. Dailies delivered as a digital file can be processed in high definition or standard definition video and can be screened in a nonlinear manner on a variety of playback equipment.

*Telecine.* Telecine is the process of transferring film into video (in either analog or digital medium). During this process, a variety of parameters can be manipulated, such as color and contrast. Because the color spectrum of film and digital media are different, Ascent Media has creative talent who utilize creative colorizing techniques, equipment and processes to enable its clients to achieve a desired visual look and feel for television commercials and music videos, as well as feature films and television shows. Ascent Media also provides live telecine services via satellite, using a secure closed network able



**Table of Contents**

to accurately transmit subtle color changes to connect its telecine artists with client offices or other affiliated post-production facilities.

*Digital intermediates.* Ascent Media's digital intermediates service provides customers with the ability to convert film to a high resolution digital master file for color correction, creative editorial and electronic assembly of masters in other formats. If needed, the digital file can then be converted back to film.

*Creative editorial.* After principal photography has been completed, Ascent Media's editors assemble the various elements into a cohesive story consistent with the messaging, branding and creative direction by Ascent Media's advertising agency clients. Ascent Media provides the tools and talent required to support its clients through all stages of the editing process, beginning with the low-resolution digital images and off-line editing workstations used to create an edit decision list, through the high-resolution editorial process used to complete a final product suitable for broadcast. In addition, Ascent Media is able to offer expanded communications infrastructure to provide digital images directly from the film-to-tape transfer process to a workstation through dedicated data lines.

*Visual effects.* Visual effects are used to enhance the viewing audience's experience by supplementing images obtained in principal photography with computer-generated imagery and graphical elements. Visual effects are typically used to create images that cannot be created by any other cost-effective means. Ascent Media also provides services on an array of graphics and animation workstations using a variety of software to accomplish unique effects, including three-dimensional animation.

*Assembly, formatting and duplication.* Ascent Media implements clients' creative decisions, including decisions regarding the integration of sound and visual effects, to assemble source material into its final form. In addition, Ascent Media uses sophisticated computer graphics equipment to generate titles and character imagery and to format a given program to meet specific network requirements, including time compression and commercial breaks. Finally, Ascent Media creates multiple master videotapes for delivery to the network for broadcast, archival and other purposes designated by the customer.

*Distribution.* Once a television commercial has been completed, Ascent Media provides broadcast and support services, including complete video and audio duplication, distribution, and storage and asset management, for advertising agencies, corporate advertisers and entertainment companies. Ascent Media uses domestic and international satellite, fiber and Integrated Services Digital Network, or ISDN, Internet access, and conventional air freight for the delivery of television and radio spots. Ascent Media currently houses over 85,000 commercial production elements in its vaults for future use by its clients. Ascent Media's commercial television distribution facilities in Los Angeles and San Francisco, California enable Ascent Media to service any regional or national client.

*Sound supervision, sound design and sound editorial.* Ascent Media provides creative talent, state of the art facilities and support services to create sound for feature films, television content, commercials and trailers, interactive multimedia games and special live venues. Sound supervisors ensure that all aspects of sound, dialogue, sound effects and music are properly coordinated. Ascent Media's sound services include, but are not limited to, sound editing, sound design, sound effect libraries, ADR (automated dialogue replacement, a process for recording dialogue in synchronization with previously recorded picture) and Foley (non-digital sound effects).

*Music services.* Music services are an essential component of post-production sound. Ascent Media has the technology and talent to handle all types of music-related services, including original music composition, music supervision, music editing, scoring/recording, temporary sound tracks, composer support and preparing music for soundtrack album release.

*Re-recording/Mixing.* Once sound editors, sound designers, composers, music editors, ADR and Foley crews, and many others, have prepared the elements that will make up the finished product, the final component of the creative sound post production process is the mix (or re-recording). Mixing a film involves the process of combining multiple elements, such as tracks of sound effects, dialogue and music,

I-4

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## **Table of Contents**

to complete the final product. Ascent Media maintains a significant number of mixing stages, purpose-built and provisioned with advanced recording equipment, capable of handling any type of project, from major motion pictures to smaller independent films.

*Sound effects and music libraries.* Through its Soundelux brand, Ascent Media maintains an extensive sound effects library with over 300,000 unique sounds, which editors and clients access through the company's intranet and remotely via the Internet. The company also owns several production music libraries through its Hollywood Edge brand. Ascent Media's clients use the sound effects and music libraries in feature films, television shows, commercials, interactive and multimedia games. The company actively continues to add new, original recordings to its library.

### *Media Management Services*

Ascent Media's media management services group provides owners of content libraries with a full complement of facilities and services necessary to optimize, archive, manage and repurpose media assets for global distribution via freight, satellite, fiber and the Internet. Ascent Media's media facilities are located in Burbank, Hollywood and Santa Monica, California; Northvale, New Jersey; and London, England. The media management services client base includes the major motion picture studios and their international divisions as well as independent owners of television and film libraries and emerging new media distribution channels.

In 2005, Ascent Media completed construction of its 100,000 square foot Digital Media Data Center, or DMDC, in Burbank, California. The DMDC now contains a significant portion of Ascent Media's media management services business in Southern California.

Key services provided by Ascent Media's media management services group include the following:

*Negative developing and cutting.* Ascent Media's film laboratories provide negative developing for television shows such as one-hour dramas and movie-length programming, including negative developing of dailies (the original negative shot during each production day), as well as the often complex and technically demanding commercial work and motion picture trailers. Ascent Media also provides negative cutting services for the distribution of commercials on film.

*Restoration, preservation and asset protection of existing and damaged content.* Through its recently-acquired facility, Cinetech, and its other laboratory facilities, Ascent Media provides film restoration, preservation and asset protection services. Ascent Media's technicians use photochemical and digital processes to clean, repair and rebuild a film's elements in order to return the content to its original and sometimes improved image quality. Ascent Media also protects film element content from future degradation by transferring the film's image to newer archival film stocks. Ascent Media also provides asset protection services for its client's color library titles, which is a preservation process whereby B/W, silver image, polyester, positive and color separation masters are created, sufficiently protecting the images of new and older films.

*Transferring film to analog video or digital media.* A considerable amount of film content is ultimately distributed to the home video, broadcast, cable or pay-per-view television markets. This requires film images to be transferred to an analog video or digital file format. Each frame must be color corrected and adapted to the size and aspect ratio of a television screen in order to ensure the highest level of conformity to the original film version. Because certain film formats require transfers with special characteristics, it is not unusual for a motion picture to be mastered in many different versions. Technological developments, such as the domestic introduction of television sets with a 16 X 9 aspect ratio and the implementation of advanced and high definition digital television systems for terrestrial and satellite broadcasting, are expected to contribute to the growth of Ascent Media's film transfer business. Ascent Media also digitally removes dirt and scratches from a damaged film master that is transferred to a digital file format.

*Professional duplication and standards conversion.* Ascent Media provides professional duplication, which is the process of creating broadcast quality and resolution independent sub-masters for distribution to professional

end users. Ascent Media uses master elements to make sub-masters in  
I-5

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**Table of Contents**

numerous domestic and international broadcast standards as well as up to 22 different tape formats. Ascent Media also provides standards conversion, which is the process of changing the frame rate of a video signal from one video standard, such as the United States standard (NTSC), to another, such as a European standard (PAL or SECAM). Content is regularly copied, converted and checked by quality control for use in intermediate processes, such as editing, on-air backup and screening and for final delivery to cable and pay-per-view programmers, broadcast networks, television stations, airlines, home video duplicators and foreign distributors. Ascent Media's duplication and standards conversion facilities are technically advanced with unique characteristics that significantly increase equipment capacity while reducing error rates and labor cost.

*Syndicated television distribution.* Ascent Media's syndication services provide AMOL-encoding and closed-captioned sub-mastering, commercial integration, library distribution, station list management and v-chip encoding. Ascent Media distributes syndicated television content by freight, satellite, fiber or the Internet, in formats ranging from low-resolution proxy streams to full-bandwidth high-definition television and streaming media.

*DVD compression and authoring and menu design.* Ascent Media provides all stages of DVD production, including creative menu design, special feature production, project management, encoding, 5.1 surround editing and quality control. Ascent Media also prepares and optimizes content for evolving formats of digital distribution, such as video-on-demand and interactive television.

*Storage of original elements and working masters.* Ascent Media's archives are designed to store working master videotapes and film elements in a highly controlled environment protected from temperature and humidity variation, seismic disturbance, fire, theft and other external events. In addition to the physical security of the archive, content owners require frequent and regular access to their libraries. Physical elements stored in Ascent Media's archive are uniquely bar-coded and maintained in a library management database offering rapid access to elements, concise reporting of element status and element tracking throughout its travel through Ascent Media's operations.

*Network Services*

Ascent Media's network services group provides services to broadcast, cable and satellite programming networks, local television channels, broadcast syndicators, satellite broadcasters, other broadband telecommunications companies and corporations that operate private networks. Ascent Media's network services group operates from facilities located in California, Connecticut, Florida, Minnesota, New York, New Jersey, Virginia and the United Kingdom and Singapore.

Key services provided by Ascent Media's network services group include the following:

*Network origination and master control.* The network services group provides videotape and file-based playback and origination to cable, satellite and pay-per-view programming networks. Ascent Media accepts daily program schedules, programs, promotional materials and advertising and transmits 24 hours of seamless daily programming to cable operators, direct broadcast satellite systems and other destinations, over fiber and satellite, using automated systems for broadcast playback. Ascent Media also operates industry-standard encryption and/or compression systems as needed for customer satellite transmission and offers quality control, tape storage and trafficking services. Ascent Media operates television production studios with live-to-satellite interview services, cameras, production and audio control rooms, videotape playback and record, multi-language prompters, computerized lighting, dressing and makeup rooms and field and teleconferencing services. Ascent Media offers complete post-production services for on-air promotions, including graphics, editing, voice-over record, sound effects editing, sound mixing and music composition. For programming designed for export to other markets, Ascent Media provides language translation, subtitling and voice dubbing. Currently, over two hundred 24/7 programming feeds are supported by Ascent Media's facilities in the United States, London and Singapore.

**Table of Contents**

*Satellite transport.* Ascent Media operates satellite earth station facilities in Singapore, California, New York, New Jersey, Minnesota, Connecticut and Florida. Ascent Media's facilities are staffed 24 hours a day and may be used for uplink, downlink and turnaround services. Ascent Media accesses various satellite neighborhoods, including basic and premium cable, broadcast syndication, direct-to-home and DBS markets. Ascent Media resells transponder capacity for occasional and full-time use and bundles its transponder capacity with other broadcast and syndication services to provide a complete broadcast package at a fixed price. Ascent Media's teleports are high-bandwidth communications gateways with video switches and facilities for satellite, optical fiber and microwave transmission. Ascent Media's facilities offer satellite antennae capable of transmitting and receiving feeds in both C-Band and Ku-Band frequencies. Ascent Media also provides transportable services, including point-to-point microwave transmission, transportable up-link and downlink transmission and broadcast quality teleconference services.

*Engineering and systems integration.* Ascent Media designs, builds, installs and services advanced video systems for the broadcast, cable television and other broadband telecommunications industries and other professional and corporate markets. Ascent Media's engineering and systems integration clients include major broadcast networks, numerous cable channels, corporate television networks, a major telecommunications company as well as multiple production and post-production facilities.

*Strategy*

The entertainment services industry has been historically fragmented with numerous providers offering discrete, geographically-limited, non-integrated services. Ascent Media's services, however, span the entirety of the value chain from the creation and management of content to the delivery of content via multiple transmission paths including satellite, fiber and Internet Protocol-based networks. Ascent Media believes the breadth and range of its services uniquely provide it the scale and flexibility necessary to realize significant operating and marketing efficiencies: a global, scalable media services platform integrating preparation, management and transmission services; common best practices operations management across the Ascent Media enterprise; and integration of financial and administrative functions. In Ascent Media's media management and network services businesses, and with large institutional clients that utilize a broad range of its services, Ascent Media intends to build brand awareness on a global basis and promote its integrated suites of services, while continuing to support the identity and customer loyalty associated with Ascent Media's established boutique brands in the creative services industry. Ascent Media intends to optimize its position in the market by pursuing the following strategies:

*Increase scale of operations.* Ascent Media intends to increase the scale of its operations through a combination of internal investment in facilities and capital expenditures plus external investment in companies and joint ventures. Its goal is to attract additional customers in its existing lines of business and expand its business operations geographically.

*Expand scope of services.* Ascent Media intends to expand the scope of its services by applying its core capabilities to new business activities, providing content management and distribution services based on electronic data files rather than physical tapes, participating in emerging high revenue-generating services such as re-formatting content for distribution to new platforms, and gradually attracting new customers with unique service needs that are less susceptible to competitive threats. One growth initiative is to expand Ascent Media's service offerings for a growing number of non-traditional networks, also referred to as captive audience networks. DHC's acquisition of AccentHealth—a health media company with a captive audience network that reaches 19 million consumers per month in over 11,000 physician waiting rooms nationwide—will be managed by Ascent Media and will help enhance Ascent Media's services to captive audience networks.

*Optimize the organization.* In order to reach the first two strategic goals described above, Ascent Media also plans to improve its internal organization. Specifically, Ascent Media intends to re-align its divisional structure to become more compatible with its diversified customer base and the integrated file-based solutions that they seek. Ascent Media also intends to focus on its content security initiative,



**Table of Contents**

creating greater efficiency when it provides parallel tape-based and file-based solutions, invest additional resources in its facilities, develop relationships with other companies and/or form joint ventures.

*Seasonality*

The demand for Ascent Media's core motion picture services, primarily in its creative services group, has historically been seasonal, with higher demand in the spring (second fiscal quarter) and fall (fourth fiscal quarter), and lower in the winter and summer. Similarly, demand for Ascent Media's television program services, primarily in its creative services group, is higher in the first and fourth quarters and lower in the summer, or third quarter. Demand for Ascent Media's commercial services, primarily in its creative services group, are fairly consistent with slightly higher activity in the third quarter. However, recent trends in the demand for television program services may result in increased business for Ascent Media in the summer. In addition, the timing of projects in Ascent Media's media management services group and network services group are beginning to offset the quarters in which there has been historically lower demand for Ascent Media's motion picture and television services. Accordingly, Ascent Media expects to experience less dramatic quarterly fluctuations in its operating performance in the future.

***DISCOVERY***

Discovery Communications, Inc. is a leading global media and entertainment company. Discovery has grown from the 1985 launch in the United States of its core property, Discovery Channel, to current global operations in over 160 countries across six continents, with over 1 billion total cumulative subscription units. Discovery operates its businesses in three groups: Discovery Networks U.S., Discovery Networks International, and Discovery Commerce, Education and Other.

Discovery's relationships and agreements with the distributors of its channels are critical to its business as they provide Discovery's subscription revenue stream and access to an audience for advertising sales purposes. There has been a great deal of consolidation among cable and satellite television operators in the United States in recent years, with over 90% of the pay television households in the country now controlled by the top eight distributors. Discovery also operates in certain overseas markets which have experienced similar industry consolidation. Industry consolidation has generally provided more leverage to the distributors in their relationships with programmers. Accordingly, as its affiliation agreements expire, Discovery may not be able to obtain terms in new affiliation agreements that are comparable to terms in its existing agreements.

Discovery earns revenue from the sale of advertising on its networks, from global delivery of its programming pursuant to affiliation agreements with cable television and direct-to-home satellite operators (which is described as distribution revenue throughout this report), and from product sales in its commerce and education outlets. Distribution revenue includes all components of revenue earned through affiliation agreements. Discovery's affiliation agreements typically have terms of 3 to 10 years and provide for payments based on the number of subscribers that receive Discovery's services. No single distributor represented more than 10% of Discovery's consolidated revenue for the year ended December 31, 2005. Discovery has grown its global network business by securing as broad a subscriber base as possible for each of its channels by entering into affiliation agreements. After obtaining scalable distribution of its networks, Discovery invests in programming and marketing in order to build a viewing audience to support advertising sales. In certain cases, Discovery has made cash payments to distributors in exchange for carriage or has entered into contractual arrangements that allow the distributors to show certain of Discovery's channels for extended free periods. In the United States, Discovery has developed the necessary audience and ratings for its programming such that advertising sales now provide more revenue than channel subscriptions. Distribution revenue still accounts for the majority of the international networks' revenue base, and this is anticipated to be the case for the foreseeable future. As a result, growing the distribution base for existing and newly launched international networks will continue to be the primary focus of the international division.

Discovery's principal operating costs consist of programming expense, sales and marketing expense, personnel expense and general and administrative expenses. Programming is Discovery's largest expense. Costs incurred and capitalized for the direct production of programming content are amortized over varying



**Table of Contents**

periods based on the expected realization of revenue from the underlying programs. Licensed programming is amortized over the contract period based on the expected realization of revenue. Discovery incurs sales and marketing expense to promote brand recognition and to secure quality distribution channels worldwide.

Discovery produces original programming and acquires content from numerous producers worldwide that is tailored to the specific needs of viewers around the globe. Discovery believes it is generally well positioned for continued access to a broad range of high-quality programming for both its U.S. and international networks. It has assembled one of the largest libraries of non-fiction programming and footage in the world, due both to the aggregate purchasing power of its many networks and a policy to own as many rights as possible in the programs aired on its networks. Discovery also has long-term relationships with some of the world's most significant non-fiction program producers, including the British Broadcasting Corporation, which we refer to as the BBC. Discovery believes the broad international appeal of its content combined with its ability to adapt its significant programming library to international markets for relatively low costs is one of its competitive advantages. Discovery is also developing programming applications designed to position the company to take advantage of emerging distribution technologies including video-on-demand, IP-delivered programming, wireless and mobile.

Discovery's other properties consist of Discovery.com and over 100 retail outlets that offer lifestyle, health, science and education oriented products, as well as products related to other programming offered by Discovery. Additionally, Discovery's newest division, Discovery Education, distributes video-based educational materials to schools in the United States and in many countries around the world.

Discovery is a leader in offering solutions to advertisers that allow them to reach a broad range of audience demographics in the face of increasing fragmentation of audience share. The overall industry is facing several issues with regard to its advertising revenue, including (1) audience fragmentation caused by the proliferation of other television networks, video-on-demand offerings from cable and satellite companies and broadband content offerings; (2) the deployment of digital video recording devices (DVRs), allowing consumers to time shift programming and skip or fast-forward through advertisements; and (3) consolidation within the advertising industry, shifting more leverage to the bigger agencies and buying groups.

*Discovery Networks U.S.*

Discovery networks U.S. currently operates 12 channels and provides distribution and advertising sales services for BBC America. The division's channels include Discovery Channel, TLC, Animal Planet, Travel Channel, Discovery Health Channel and the following emerging digital tier networks: The Science Channel, Discovery Kids, The Military Channel, Discovery Home, Discovery Times, Fit TV and Discovery HD Theater, which we refer to collectively as the emerging networks. All of these channels are wholly owned by Discovery other than Animal Planet, in which Discovery has a 60% ownership interest and Discovery Times, in which Discovery has a 50% ownership interest. The division also operates web sites related to its channel businesses and various other new media businesses, including a video-on-demand offering distributed by various cable operators.

*Discovery Networks International*

Discovery networks international, or the international networks, manages a portfolio of channels, led by Discovery Channel and Animal Planet, that are distributed in virtually every pay-television market in the world via an infrastructure that includes major operational centers in London, Singapore, New Delhi and Miami. Discovery networks international currently operates over 97 separate feeds in 33 languages with channel feeds customized according to language needs and advertising sales opportunities. Most of the division's channels are wholly owned by Discovery with the exception of (1) the international Animal Planet channels, which are generally 50-50 joint ventures with the BBC, (2) People + Arts, which operates in Latin America and Iberia as a 50-50 joint venture with the BBC and (3) several channels in Japan and Canada, which operate as joint ventures with strategically important local partners. As with the U.S. networks division, the international networks operate web sites and other new media businesses. In 2004, the group undertook a

**Table of Contents**

major new initiative to re-launch certain existing networks and launch several new networks to create a package of three lifestyle-focused networks for distribution on a global basis.

*Discovery Commerce, Education & Other*

This group includes Discovery commerce, which operates a chain of retail stores in the United States that offer lifestyle, health, science and education-oriented products, as well as products specifically related to programming on Discovery's networks. This division also operates a catalog and electronic commerce business selling products similar to that sold in the Discovery Channel Stores, as well as a licensing business that licenses Discovery trademarks and intellectual property to third parties for the purpose of creating and selling retail merchandise.

This group also includes Discovery education. Since 2003, Discovery has acquired three companies which were involved in the video streaming business. In 2004, the company expanded beyond its traditional education businesses of airing educational programming on its networks and selling hard copies of such programs to schools and began streaming educational video material into schools via the Internet. Discovery education now operates United Streaming, a leading educational broadband streaming service in the United States. This service earns revenue through annual subscription fees paid by schools and school districts which use the service.

*Discovery Stockholders' Agreement*

A subsidiary of ours, together with a subsidiary of Cox Communications, which we refer to as Cox Communications, and Advance/Newhouse Programming Partnership, which we refer to as Advance/Newhouse, and John Hendricks, the founder and Chairman of Discovery, are parties to a Stockholders' Agreement. We own 50%, and Cox Communications and Advance/Newhouse each own 25%, of Discovery. Mr. Hendricks is the record holder of one share of capital stock of Discovery; however, Mr. Hendricks cannot transfer this share, the share is subject to an irrevocable proxy in favor of Advance/Newhouse and the share is subject to a call arrangement pursuant to which Advance/Newhouse can purchase the share. Accordingly, we treat such share as being owned by Advance/Newhouse for purposes of Advance/Newhouse's percentage ownership of Discovery as described in this Annual Report. As a close corporation under Delaware law, the stockholders manage the business of Discovery, rather than a board of directors. The Stockholders' Agreement provides that a number of decisions affecting Discovery, such as, among other things, a decision to effect a fundamental change in its business, a merger or other business combination, issuance of Discovery's equity securities, approval of transactions between Discovery, on the one hand, and any of its stockholders, on the other hand, and adoption of Discovery's annual business plan, must be approved by the holders of 80% of its outstanding capital stock. In addition, other matters, such as the declaration and payment of dividends on its capital stock, require the approval of the holders of a majority of Discovery's outstanding capital stock.

Because we own 50%, Cox Communications owns 25% and Advance/Newhouse owns 25% of the stock of Discovery, any one of us may block Discovery from taking any action that requires 80% approval. In addition, because Cox Communications and Advance/Newhouse, on the one hand, and our company, on the other, each owns 50% of the outstanding stock of Discovery, there is the possibility that the stockholders could deadlock over various other matters, which require the approval of the holders of a majority of its capital stock. To reduce the possibility that this could occur, the stockholders have given John Hendricks, the founder and Chairman of Discovery, the right (but not the obligation), subject to certain limitations, to cast a vote to break a deadlock on certain matters requiring a majority vote for approval.

The Stockholders' Agreement also restricts, subject to certain exceptions, the ability of a stockholder to transfer its shares in Discovery to a third party. Any such proposed transfer is subject to a pro rata right of first refusal in favor of the other stockholders. If all of the offered shares are not purchased by the other stockholders, then the selling stockholder may sell all of the offered shares to the third party that originally offered to purchase such shares at the same price and on the same terms, provided that such third party agrees to be bound by the restrictions contained in the Stockholders' Agreement. In addition, in the event that either Cox Communications or Advance/Newhouse proposes to transfer shares, Cox Communications or Advance/

**Table of Contents**

Newhouse, whichever is not proposing to transfer, would have a preemptive right to buy the other's shares, and if it does not elect to purchase all such shares, then the remaining shares would be subject to the pro rata right of first refusal described above.

The Stockholders' Agreement also prohibits Cox Communications, Advance/Newhouse and our company from starting, or acquiring a majority of the voting power of, a basic programming service carried in the United States that consists primarily of documentary, science and nature programming, subject to certain exceptions.

In connection with the spin off, Liberty contributed to us 100% of an entity that owns a 10% interest in the Animal Planet limited partnership. Our partners in this entity include Discovery, Cox Communications, Advance/Newhouse and the BBC. The Stockholders' Agreement prohibits us from selling, transferring or otherwise disposing of either of the subsidiaries that hold the Discovery interest or Animal Planet interest, respectively, unless, after such transaction, such subsidiaries are controlled by the same person or entity.

The foregoing summary of the Discovery Stockholders' Agreement is qualified by reference to the full text of the agreement and amendments.

*Regulatory Matters*

***Ascent Media***

Some of Ascent Media's subsidiary companies hold licenses and authorizations from the Federal Communications Commission, or FCC, required for the conduct of their businesses, including earth station and various classes of wireless licenses and an authorization to provide certain services pursuant to Section 214 of the Communications Act. Most of the FCC licenses held by such subsidiaries are for transmit/receive earth stations, which cannot be operated without individual licenses. The licenses for these stations are granted for a period of fifteen years and, while the FCC generally renews licenses for satellite earth stations, there can be no assurance that these licenses will be renewed at their expiration dates. Registration with the FCC, rather than licensing, is required for receiving transmissions from domestic satellites from points within the United States. Ascent Media relies on third party licenses or authorizations when it and its subsidiaries transmit domestic satellite traffic through earth stations operated by third parties. The FCC establishes technical standards for satellite transmission equipment that change from time to time and requires coordination of earth stations with land-based microwave systems at certain frequencies to assure non-interference. Transmission equipment must also be installed and operated in a manner that avoids exposing humans to harmful levels of radio-frequency radiation. The placement of earth stations or other antennae also is typically subject to regulation under local zoning ordinances.

***Discovery***

In the United States, the FCC regulates the providers of satellite communications services and facilities for the transmission of programming services, the cable television systems that carry such services and, to some extent, the availability of the programming services themselves through its regulation of program licensing. Cable television systems in the United States are also regulated by municipalities or other state and local government authorities and are currently subject to federal rate regulation on the provision of basic service. Continued rate regulation or other franchise conditions could place downward pressure on the fees cable television companies are willing or able to pay for the Discovery networks. Regulatory carriage requirements also could adversely affect the number of channels available to carry the Discovery networks.

The Cable Television Consumer Protection and Competition Act of 1992 (the 1992 Cable Act) directed the FCC to promulgate regulations regarding the sale and acquisition of cable programming between multi-channel video programming distributors (including cable operators) and satellite-delivered programming services in which a cable operator has an attributable interest. Because cable operators have an attributable interest in Discovery, the Discovery networks are subject to these rules. The legislation and the implementing regulations adopted by the FCC preclude virtually all exclusive programming contracts between cable operators and satellite programmers affiliated with any cable operator and the 1992 Cable Act requires that

**Table of Contents**

such affiliated programmers make their programming services available to cable operators and competing multi-channel video programming distributors on terms and conditions that do not unfairly discriminate among distributors. As a result, Discovery has not been, and will not be, able to enter into exclusive distribution agreements, which could provide more favorable terms than non-exclusive agreements.

The 1992 Cable Act required the FCC, among other things, to prescribe rules and regulations establishing reasonable limits on the number of channels on a cable system that will be allowed to carry programming in which the owner of such cable system has an attributable interest. In 1993, the FCC adopted such channel carriage limits. However, in 2001, the United States Court of Appeals for the District of Columbia Circuit found that the FCC had failed to justify adequately the channel carriage limit, vacated the FCC's decision and remanded the rule to the FCC for further consideration. In response to the Court's decision, the FCC issued a further notice of proposed rulemaking in 2001 to consider channel carriage limitations. The FCC issued a Second Further Notice of Proposed Rulemaking on May 17, 2005, requesting comment on these issues. If such channel carriage limitations are implemented, the ability of Cox Communications and Advance/Newhouse to carry the full range of Discovery's networks could be limited.

The 1992 Cable Act granted broadcasters a choice of must carry rights or retransmission consent rights. The rules adopted by the FCC generally provided for mandatory carriage by cable systems of all local full-power commercial television broadcast signals selecting must carry rights and, depending on a cable system's channel capacity, non-commercial television broadcast signals. Such statutorily mandated carriage of broadcast stations coupled with the provisions of the Cable Communications Policy Act of 1984, which require cable television systems with 36 or more activated channels to reserve a percentage of such channels for commercial use by unaffiliated third parties and permit franchise authorities to require the cable operator to provide channel capacity, equipment and facilities for public, educational and government access channels, could adversely affect the Discovery networks by limiting their carriage of such services in cable systems with limited channel capacity. In 2001, the FCC adopted rules relating to the cable carriage of digital television signals. Among other things, the rules clarify that a digital-only television station can assert a right to analog or digital carriage on a cable system. The FCC initiated a further proceeding to determine whether television stations may assert rights to carriage of both analog and digital signals during the transition to digital television and to carriage of all digital signals. On February 10, 2005, the FCC denied mandatory dual carriage of a television station's analog and digital signals during the digital television transition and mandatory carriage of all digital signals, other than its primary signal. Television station owners have petitioned the FCC to reconsider its decision and are seeking legislative change.

In 2004, the FCC's Media Bureau conducted a notice of inquiry proceeding regarding the feasibility of selling video programming services à la carte, i.e. on an individual or small tier basis. The Media Bureau released a report in November 2004, which concluded that a la carte sales of video programming services would not result in lower video programming costs for most consumers and that they would adversely affect video programming networks. On February 9, 2006, the Media Bureau released a new report which stated that the 2004 report was flawed and which concluded that a la carte sales could be in the best interests of consumers. Although the FCC cannot mandate a la carte sales, its endorsement of the concept could encourage Congress to consider proposals to mandate a la carte sales or otherwise seek to impose greater regulatory controls on how a la carte programming is sold. The programming companies that distribute these services in tiers or packages of programming services could experience decreased distribution if a la carte carriage were mandated.

In general, authorization from the FCC must be obtained for the construction and operation of a communications satellite. Satellite orbital slots are finite in number, thus limiting the number of carriers that can provide satellite transponders and the number of transponders available for transmission of programming services. At present, however, there are numerous competing satellite service providers that make transponders available for video services to the cable industry. The FCC also regulates the earth stations uplinking to and/or downlinking from such satellites.

The regulation of programming services is subject to the political process and has been in constant flux over the past decade. Further material changes in the law and regulatory requirements must be anticipated

**Table of Contents**

and there can be no assurance that our business will not be adversely affected by future legislation, new regulation or deregulation.

***International Regulatory Matters***

Video distribution and content businesses are regulated in each of the countries in which we operate. The scope of regulation varies from country to country, although in some significant respects regulation in Western European markets is harmonized under the regulatory structure of the European Union, which we refer to as the EU. Adverse regulatory developments could subject our businesses to a number of risks. Regulations could limit growth, revenue and the number and types of services offered. In addition, regulation may restrict our operations and subject them to further competitive pressure, including restrictions imposed on foreign programming distributors that could limit the content they may carry in ways that affect us adversely. Failure to comply with current or future regulation of our businesses could expose our businesses to various penalties.

**Competition**

The creative media services industry is highly competitive, with much of the competition centered in Los Angeles, California, the largest and most competitive market, particularly for domestic television and feature film production as well as for the management of content libraries. We expect that competition will increase as a result of industry consolidation and alliances, as well as from the emergence of new competitors. In particular, major motion picture studios such as Paramount Pictures, Sony Pictures Corporation, Twentieth Century Fox, Universal Pictures, The Walt Disney Company, Metro-Goldwyn-Mayer and Warner Brothers, while Ascent Media's customers, can perform similar services in-house with substantially greater financial resources than Ascent Media's, and in some cases significant marketing advantages. These studios may also outsource their requirements to other independent providers like us or to other studios. Thomson, a French corporation, is also a major competitor of Ascent Media, particularly under its Technicolor brand, as is Kodak through its Laser Pacific division. Ascent Media also actively competes with certain industry participants that have a unique operating niche or specialty business. There is no assurance that Ascent Media will be able to compete effectively against these competitors.

The business of distributing programming for cable and satellite television is highly competitive, both in the United States and in foreign countries. Discovery competes with other programmers for distribution on a limited number of channels. Increasing concentration in the multichannel video distribution industry could adversely affect Discovery by reducing the number of distributors available to carry Discovery's networks, subjecting more of Discovery's subscriber fees to volume discounts and increasing the distributors' bargaining power in negotiating new affiliation agreements. Once distribution is obtained, Discovery's programming services compete, in varying degrees, for viewers and advertisers with other cable and off-air broadcast television programming services as well as with other entertainment media, including home video, pay-per-view services, online activities, movies and other forms of news, information and entertainment. Discovery also competes, to varying degrees, for creative talent and programming content. Our management believes that important competitive factors include the prices charged for programming, the quantity, quality and variety of the programming offered and the effectiveness of marketing efforts.

**Employees**

We currently have no corporate employees. Liberty provides us with certain management and administrative services pursuant to a services agreement, which includes the services of our executive officers some of whom remain executive officers of Liberty.

As of December 31, 2005, Ascent Media had approximately 3,800 employees, most of which worked on a full-time basis. Approximately 2,400 of Ascent Media's employees were employed in the United States, with the remaining 1,400 employed outside the United States, principally in the United Kingdom and the Republic of Singapore. Approximately 420 of Ascent Media's employees belong to either the International Alliance of Theatrical Stage Employees in the United States or the Broadcasting Entertainment Cinematograph and Theatre Union in the United Kingdom.

**Table of Contents**

As of December 31, 2005, Discovery had approximately 4,000 employees.

**(d) Financial Information About Geographic Areas**

For financial information related to the geographic areas in which we do business, see note 18 to our consolidated financial statements found in Part II of this report.

**(e) Available Information**

All of our filings with the Securities and Exchange Commission (the SEC), including our Form 10-Ks, Form 10-Qs and Form 8-Ks, as well as amendments to such filings are available on our Internet website free of charge generally within 24 hours after we file such material with the SEC. Our website address is [www.discoveryholdingcompany.com](http://www.discoveryholdingcompany.com).

Our corporate governance guidelines, code of ethics, compensation committee charter, and audit committee charter are available on our website. In addition, we will provide a copy of any of these documents, free of charge, to any shareholder who calls or submits a request in writing to Investor Relations, Discovery Holding Company, 12300 Liberty Boulevard, Englewood, Colorado 80112, Tel. No. (866) 876-0461.

The information contained on our website is not incorporated by reference herein.

**Item 1A. Risk Factors.**

An investment in our common stock involves risk. You should carefully consider the risks described below, together with all of the other information included in this annual report in evaluating our company and our common stock. Any of the following risks, if realized, could have a material adverse effect on the value of our common stock.

*We are a holding company, and we could be unable in the future to obtain cash in amounts sufficient to service our financial obligations or meet our other commitments.* Our ability to meet our financial obligations and other contractual commitments depends upon our ability to access cash. We are a holding company, and our sources of cash include our available cash balances, net cash from the operating activities of our subsidiaries, any dividends and interest we may receive from our investments, availability under any credit facilities that we may obtain in the future and proceeds from any asset sales we may undertake in the future. The ability of our operating subsidiaries to pay dividends or to make other payments or advances to us depends on their individual operating results and any statutory, regulatory or contractual restrictions to which they may be or may become subject.

*We do not have access to the cash that Discovery generates from its operating activities.* Discovery generated approximately \$69 million, \$125 million and \$154 million of cash from its operations during the years ended December 31, 2005, 2004 and 2003, respectively. Discovery uses the cash it generates from its operations to fund its investing activities and to service its debt and other financing obligations. We do not have access to the cash that Discovery generates unless Discovery declares a dividend on its capital stock payable in cash, redeems any or all of its outstanding shares of capital stock for cash or otherwise distributes or makes payments to its stockholders, including us. Historically, Discovery has not paid any dividends on its capital stock or, with limited exceptions, otherwise distributed cash to its stockholders and instead has used all of its available cash in the expansion of its business and to service its debt obligations. Covenants in Discovery's existing debt instruments also restrict the payment of dividends and cash distributions to stockholders. We expect that Discovery will continue to apply its available cash to the expansion of its business. We do not have sufficient voting control to cause Discovery to pay dividends or make other payments or advances to its stockholders, or otherwise provide us access to Discovery's cash.

*We have limited operating history as a separate company upon which you can evaluate our performance.* Although our subsidiary Ascent Media was a separate public company prior to June 2003 (when Liberty acquired the outstanding shares of Ascent Media that it did not already own), we have limited operating history as a separate public company. Additionally, the historical financial information included in this annual report for periods prior to our existence may not necessarily be representative of our results as a separate

**Table of Contents**

company. There can be no assurance that our business strategy will be successful on a long-term basis. We may not be able to grow our businesses as planned and may not be profitable.

*We do not have the right to manage Discovery, which means we cannot cause Discovery to operate in a manner that is favorable to us.* Discovery is managed by its stockholders rather than a board of directors. Generally, all actions to be taken by Discovery require the approval of the holders of a majority of Discovery's shares; however, pursuant to a Stockholders' Agreement, the taking of certain actions (including, among other things, a merger of Discovery, or the issuance of additional shares of Discovery capital stock or approval of annual business plans) require the approval of the holders of at least 80% of Discovery's shares. Because we do not own a majority of the outstanding equity interests of Discovery, we do not have the right to manage the businesses or affairs of Discovery. Although our status as a 50% stockholder of Discovery enables us to exercise influence over the management and policies of Discovery, such status does not enable us to cause any actions to be taken. Cox Communications and Advance/ Newhouse each hold a 25% interest in Discovery, which ownership interest enables each such company to prevent Discovery from taking actions requiring 80% approval.

Actions to be taken by Discovery that require the approval of a majority of Discovery's shares may, under certain circumstances, result in a deadlock. Because we own a 50% interest in Discovery and each of Cox Communications and Advance/ Newhouse own a 25% interest in Discovery, a deadlock may occur when the stockholders vote to approve an action that requires majority approval. Accordingly, unless either Cox Communications or Advance/ Newhouse elects to vote with us on items that require majority action, such actions may not be taken. Pursuant to the terms of the Stockholders' Agreement, if an action that requires approval by a majority of Discovery's shares is approved by 50%, but not more than 50%, of the outstanding shares then the proposed action will be submitted to an arbitrator designated by the stockholders. Currently, the arbitrator is John Hendricks, the founder and Chairman of Discovery. Mr. Hendricks, as arbitrator, is entitled to cast the deciding vote on matters where the stockholders have deadlocked because neither side has a majority. Mr. Hendricks, however, is not obligated to take action to break such a deadlock. In addition, Mr. Hendricks may elect to approve actions we have opposed, if such a deadlock exists. In the event of a dispute among the stockholders of Discovery, the possibility of such a deadlock could have a material adverse effect on Discovery's business.

*The liquidity and value of our interest in Discovery may be adversely affected by a Stockholders' Agreement to which we are a party.* Our 50% interest in Discovery is subject to the terms of a Stockholders' Agreement among the holders of Discovery capital stock. Among other things, the Stockholders' Agreement restricts our ability to directly sell or transfer our interest in Discovery or to borrow against its value. These restrictions impair the liquidity of our interest in Discovery and may make it difficult for us to obtain full value for our interest in Discovery should such a need arise. In the event we chose to sell all or a portion of our direct interest in Discovery, we would first have to obtain an offer from an unaffiliated third party and then offer to sell such interest to Cox Communications and Advance/ Newhouse on substantially the same terms as the third party had agreed to pay.

If either Cox Communications or Advance/ Newhouse decided to sell their respective interests in Discovery, then the other of such two stockholders would have a right to acquire such interests on the terms set by a third party offer obtained by the selling stockholder. If the non-selling stockholder elects not to exercise this acquisition right, then, subject to the terms of the Stockholders' Agreement, we would have the opportunity to acquire such interests on substantially the terms set by a third party offer obtained by the selling stockholder. We anticipate that the purchase price to acquire the interests held by Cox Communications or Advance/ Newhouse would be significant and could require us to obtain significant funding in order to raise sufficient funds to purchase one or both of their interests. This opportunity to purchase the Discovery interests held by Cox Communications and/or Advance/ Newhouse may arise (if at all) at a time when it would be difficult for us to raise the funds necessary to purchase such interests.

We do not have the ability to require Cox Communications or Advance/ Newhouse to sell their interests in Discovery to us, nor do they have the ability to require us to sell our interest to them. Accordingly, the current governance relationships affecting Discovery may continue indefinitely.

**Table of Contents**

*Because we do not control the business management practices of Discovery, we rely on Discovery for the financial information that we use in accounting for our ownership interest in Discovery. We account for our 50% ownership interest in Discovery using the equity method of accounting and, accordingly, in our financial statements we record our share of Discovery's net income or loss. Because we do not control Discovery's decision-making process or business management practices, within the meaning of U.S. accounting rules, we rely on Discovery to provide us with financial information prepared in accordance with generally accepted accounting principles, which we use in the application of the equity method. We have entered into an agreement with Discovery regarding the use by us of certain information regarding Discovery in connection with our financial reporting and disclosure requirements as a public company. However, such agreement limits the public disclosure by us of certain non-public information regarding Discovery (other than specified historical financial information), and also restricts our ability to enforce the agreement against Discovery with a lawsuit seeking monetary damages, in the absence of gross negligence, reckless conduct or willful misconduct on the part of Discovery. In addition, we cannot change the way in which Discovery reports its financial results or require Discovery to change its internal controls over financial reporting.*

*We cannot be certain that we will be successful in integrating acquired businesses, if any. Our businesses and those of our subsidiaries may grow through acquisitions in selected markets. Integration of new businesses may present significant challenges, including: realizing economies of scale in programming and network operations; eliminating duplicative overheads; and integrating networks, financial systems and operational systems. We or the applicable subsidiary cannot assure you that, with respect to any acquisition, we will realize anticipated benefits or successfully integrate any acquired business with our existing operations. In addition, while we intend to implement appropriate controls and procedures as we integrate acquired companies, we may not be able to certify as to the effectiveness of these companies' disclosure controls and procedures or internal control over financial reporting (as required by U.S. federal securities laws and regulations) until we have fully integrated them.*

*A loss of any of Ascent Media's large customers would reduce our revenue. Although Ascent Media serviced over 4,000 customers during the year ended December 31, 2005, its ten largest customers accounted for approximately 55% of its consolidated revenue and Ascent Media's single largest customer accounted for approximately 9% of its consolidated revenue during that period. The loss of, and the failure to replace, any significant portion of the services provided to any significant customer could have a material adverse effect on the business of Ascent Media.*

*Ascent Media's business depends on certain client industries. Ascent Media derives much of its revenue from services provided to the motion picture and television production industries and from the data transmission industry. Fundamental changes in the business practices of any of these client industries could cause a material reduction in demand by Ascent Media's clients for the services offered by Ascent Media. Ascent Media's business benefits from the volume of motion picture and television content being created and distributed as well as the success or popularity of an individual television show. Accordingly, a decrease in either the supply of, or demand for, original entertainment content would have a material adverse effect on Ascent Media's results of operations. Because spending for television advertising drives the production of new television programming, as well as the production of television commercials and the sale of existing content libraries for syndication, a reduction in television advertising spending would adversely affect Ascent Media's business. Factors that could impact television advertising and the general demand for original entertainment content include the growing use of personal video recorders and video-on-demand services, continued fragmentation of and competition for the attention of television audiences, and general economic conditions.*

*Changes in technology may limit the competitiveness of and demand for our services. The post-production industry is characterized by technological change, evolving customer needs and emerging technical standards, and the data transmission industry is currently saturated with companies providing services similar to Ascent Media's. Historically, Ascent Media has expended significant amounts of capital to obtain equipment using the latest technology. Obtaining access to any new technologies that may be developed in Ascent Media's industries will require additional capital expenditures, which may be significant and may have to be incurred in advance of any revenue that may be generated by such new technologies. In addition, the use of some technologies may require third party licenses, which may not be available on commercially reasonable*





**Table of Contents**

terms. Although we believe that Ascent Media will be able to continue to offer services based on the newest technologies, we cannot assure you that Ascent Media will be able to obtain any of these technologies, that Ascent Media will be able to effectively implement these technologies on a cost-effective or timely basis or that such technologies will not render obsolete Ascent Media's role as a provider of motion picture and television production services. If Ascent Media's competitors in the data transmission industry have technology that enables them to provide services that are more reliable, faster, less expensive, reach more customers or have other advantages over the data transmission services Ascent Media provides, then the demand for Ascent Media's data transmission services may decrease.

Technology in the video, telecommunications and data services industry is changing rapidly. Advances in technologies such as personal video recorders and video-on-demand and changes in television viewing habits facilitated by these or other technologies could have an adverse effect on Discovery's advertising revenue and viewership levels. The ability to anticipate changes in, and adapt to, changes in technology and consumer tastes on a timely basis and exploit new sources of revenue from these changes will affect the ability of Discovery to continue to grow, increase its revenue and number of subscribers and remain competitive.

*A labor dispute in our client industries may disrupt our business.* The cost of producing and distributing entertainment programming has increased substantially in recent years due to, among other things, the increasing demands of creative talent and industry-wide collective bargaining agreements.

A significant labor dispute in Ascent Media's client industries could have a material adverse effect on its business. An industry-wide strike or other job action by or affecting the Writers Guild, Screen Actors Guild or other major entertainment industry union could reduce the supply of original entertainment content, which would in turn, reduce the demand for Ascent Media's services.

Discovery airs certain entertainment programs that are dependent on specific on-air talent, and Discovery's ability to continue to produce these series is dependent on keeping that on-air talent under contract.

*Risk of loss from earthquakes or other catastrophic events could disrupt Ascent Media's business.* Some of Ascent Media's specially equipped and acoustically designed facilities are located in Southern California, a region known for seismic activity. Due to the extensive amount of specialized equipment incorporated into the specially designed recording and scoring stages, editorial suites, mixing rooms and other post-production facilities, Ascent Media's operations in this region may not be able to be temporarily relocated to mitigate the impacts of a catastrophic event. Ascent Media carries insurance for property loss and business interruption resulting from such events, including earthquake insurance, subject to deductibles, and has facilities in other geographic locations. Although we believe Ascent Media has adequate insurance coverage relating to damage to its property and the temporary disruption of its business from casualties, and that it could provide services at other geographic locations, there can be no assurance that such insurance and other facilities would be sufficient to cover all of Ascent Media's costs or damages or Ascent Media's loss of income resulting from its inability to provide services in Southern California for an extended period of time.

*Discovery is dependent upon advertising revenue.* Discovery earns a significant portion of its revenue from the sale of advertising time on its networks and web sites. Discovery's advertising revenue is affected by viewer demographics, viewer ratings and market conditions for advertising. The overall cable and broadcast television industry is facing several issues with regard to its advertising revenue, including (1) audience fragmentation caused by the proliferation of other television networks, video-on-demand offerings from cable and satellite companies and broadband content offering, (2) the deployment of digital video recording devices, allowing consumers to time shift programming and skip or fast-forward through advertisements and (3) consolidation within the advertising industry, shifting more leverage to the bigger agencies and buying groups. Expenditures by advertisers tend to be cyclical, reflecting overall economic conditions as well as budgeting and buying patterns. A decline in the economic prospects of advertisers or the economy in general could alter current or prospective advertisers' spending priorities. In addition, the public's reception toward programs or programming genres can decline. An adverse change in any of these factors could have a negative effect on Discovery's revenue in any given period. Ascent Media's business is also dependent in part on the



**Table of Contents**

advertising industry, as a significant portion of Ascent Media's revenue is derived from the sale of services to agencies and/or the producers of television advertising.

*Discovery's revenue is dependent upon the maintenance of affiliation agreements with cable and satellite distributors on acceptable terms.* Discovery earns a significant portion of its revenue from per-subscriber license fees paid by cable operators, direct-to-home (DTH) satellite television operators and other channel distributors. Discovery's five core networks, Discovery Channel, TLC, Animal Planet, Travel Channel and Discovery Health, and the other networks in which Discovery has an ownership interest, maintain affiliation arrangements that enable them to reach a large percentage of cable and direct broadcast satellite households across the United States, Asia, Europe and Latin America. These arrangements are generally long-term arrangements ranging from 3 to 10 years. These affiliation arrangements usually provide for payment to Discovery based on the numbers of subscribers that receive the Discovery networks. Discovery's core networks depend on achieving and maintaining carriage within the most widely distributed cable programming tiers to maximize their subscriber base and revenue. The loss of a significant number of affiliation arrangements on basic programming tiers could reduce the distribution of Discovery's networks, thereby adversely affecting such networks' revenue from per-subscriber fees and their ability to sell advertising or the rates they are able to charge for such advertising. Those Discovery networks that are carried on digital tiers are dependent upon the continued upgrade of cable systems to digital capability and the public's continuing acceptance of, and willingness to pay for upgrades to, digital cable, as well as Discovery's ability to negotiate favorable carriage agreements on widely accepted digital tiers.

*Our businesses are subject to risks of adverse government regulation.* Programming services, satellite carriers, television stations and Internet and data transmission companies are subject to varying degrees of regulation in the United States by the Federal Communications Commission and other entities and in foreign countries by similar entities. Such regulation and legislation are subject to the political process and have been in constant flux over the past decade. Moreover, substantially every foreign country in which our subsidiaries or business affiliates have, or may in the future make, an investment regulates, in varying degrees, the distribution, content and ownership of programming services and foreign investment in programming companies. Further material changes in the law and regulatory requirements must be anticipated, and there can be no assurance that our business and the business of our affiliates will not be adversely affected by future legislation, new regulation or deregulation.

*Failure to obtain renewal of FCC licenses could disrupt our business.* Ascent Media holds licenses, authorizations and registrations from the FCC required for the conduct of its network services business, including earth station and various classes of wireless licenses and an authorization to provide certain services. Most of the FCC licenses held by Ascent Media are for transmit/receive earth stations, which cannot be operated without individual licenses. The licenses for these stations are granted for a period of fifteen years and, while the FCC generally renews licenses for satellite earth stations routinely, there can be no assurance that Ascent Media's licenses will be renewed at their expiration dates. Registration with the FCC, rather than licensing, is required for receiving transmissions from satellites from points within the United States. Ascent Media relies on third party licenses or authorizations when it transmits domestic satellite traffic through earth stations operated by third parties. Our failure, and the failure of third parties, to obtain renewals of such FCC licenses could disrupt the network services segment of Ascent Media and have a material adverse effect on Ascent Media. Further material changes in the law and regulatory requirements must be anticipated, and there can be no assurance that our businesses will not be adversely affected by future legislation, new regulation, deregulation or court decisions.

*Our businesses operate in an increasingly competitive market, and there is a risk that our businesses may not be able to effectively compete with other providers in the future.* The entertainment and media services and programming businesses in which we compete are highly competitive and service-oriented. Ascent Media has few long-term or exclusive service agreements with its creative services and media management services customers. Business generation in these groups is based primarily on customer satisfaction with reliability, timeliness, quality and price. The major motion picture studios, which are Ascent Media's customers, such as Paramount Pictures, Sony Pictures Entertainment, Twentieth Century Fox, Universal Pictures, The Walt Disney Company, Metro-Goldwyn-Mayer and Warner Brothers, have the capability to perform similar



**Table of Contents**

services in-house. These studios also have substantially greater financial resources than Ascent Media s, and in some cases significant marketing advantages. Thus, depending on the in-house capacity available to some of these studios, a studio may be not only a customer but also a competitor. There are also numerous independent providers of services similar to Ascent Media s. Thomson, a French corporation, is also a major competitor of Ascent Media, particularly under its Technicolor brand, as is Kodak through its Laser Pacific division. We also actively compete with certain industry participants that have a unique operating niche or specialty business. If there were a significant decline in the number of motion pictures or the amount of original television programming produced, or if the studios or Ascent Media s other clients either established in-house post-production facilities or significantly expanded their in-house capabilities, Ascent Media s operations could be materially and adversely affected.

Discovery is primarily an entertainment and programming company that competes with other programming networks for viewers in general, as well as for viewers in special interest groups and specific demographic categories. In order to compete for these viewers, Discovery must obtain a regular supply of high quality category-specific programming. To the extent Discovery seeks third party suppliers of such programming, it competes with other cable and broadcast television networks for programming. The expanded availability of digital cable television and the introduction of direct-to-home satellite distribution has greatly increased the amount of channel capacity available for new programming networks, resulting in the launch of a number of new programming networks by Discovery and its competitors. This increase in channel capacity has also made competitive niche programming networks viable, because such networks do not need to reach the broadest possible group of viewers in order to be moderately successful.

Discovery s program offerings must also compete for viewers and advertisers with other entertainment media, such as home video, online activities and movies. Increasing audience fragmentation could have an adverse effect on Discovery s advertising and subscription revenue. In addition, the cable television and direct-to-home satellite industries have been undergoing a period of consolidation. As a result, the number of potential buyers of the programming services offered by Discovery is decreasing. In this more concentrated market, there can be no assurance that Discovery will be able to obtain or maintain carriage of its programming services by distributors on commercially reasonable terms or at all.

*We have overlapping directors and management with Liberty and Liberty Global, Inc., which may lead to conflicting interests.* Five of our six executive officers also serve as executive officers of Liberty and one of our executive officers serves as an executive officer of Liberty Global, Inc., or LGI. LGI is an independent, publicly traded company, which was formed in connection with the business combination between UnitedGlobalCom, Inc. and Liberty Media International, Inc., or LMI. All of the shares of LMI were distributed by Liberty to its shareholders in June 2004. Our board of directors includes persons who are members of the board of directors of Liberty and/or LGI. We do not own any interest in Liberty or LGI, and to our knowledge Liberty and LGI do not own any interest in us. The executive officers and the members of our board of directors have fiduciary duties to our stockholders. Likewise, any such persons who serve in similar capacities at Liberty and/or LGI have fiduciary duties to such company s stockholders. Therefore, such persons may have conflicts of interest or the appearance of conflicts of interest with respect to matters involving or affecting each company. For example, there may be the potential for a conflict of interest when we, Liberty or LGI look at acquisitions and other corporate opportunities that may be suitable for each of us. Moreover, most of our directors and officers, continue to own Liberty and/or LGI stock and options to purchase Liberty and/or LGI stock. These ownership interests could create, or appear to create, potential conflicts of interest when these individuals are faced with decisions that could have different implications for our company and Liberty or LGI. On June 1, 2005, the board of directors of Liberty adopted a policy statement that, subject to certain qualifications, including the fiduciary duties of Liberty s board of directors, Liberty will use its commercially reasonable efforts to make available to us any corporate opportunity relating to the acquisition of all or substantially all of the assets of, or equity securities representing control (as defined in the policy statement) of, any entity whose primary business is the acquisition, creation and/or distribution of television programming consisting primarily of science and nature programming for distribution primarily in the basic service provided by cable and satellite television distributors. This policy statement of Liberty s board of directors can be amended, modified or rescinded by Liberty s board of directors in its sole



**Table of Contents**

discretion at any time, and the policy automatically terminates without any further action of the board of directors of Liberty on the second anniversary of the distribution date. From time to time, Liberty or LGI or their respective affiliates may enter into transactions with us or our subsidiaries or other affiliates. Although the terms of any such transactions will be established based upon negotiations between employees of the companies involved, there can be no assurance that the terms of any such transactions will be as favorable to us or our subsidiaries or affiliates as would be the case where the parties are completely at arms length.

*We and Liberty or LGI may compete for business opportunities.* Liberty and LGI each own interests in various U.S. and international programming companies that have subsidiaries or controlled affiliates that own or operate domestic or foreign programming services that may compete with the programming services offered by our businesses. We have no rights in respect of U.S. or international programming opportunities developed by or presented to the subsidiaries or controlled affiliates of Liberty or LGI, and the pursuit of these opportunities by such subsidiaries or affiliates may adversely affect the interests of our company and its shareholders. In addition, a subsidiary of LGI operates a playout facility that competes with Ascent Media's London playout facility, and it is likely that other competitive situations will arise in the future. Because we, Liberty and LGI have some overlapping directors and officers, the pursuit of these opportunities may serve to intensify the conflicts of interest or appearance of conflicts of interest faced by our respective management teams. Our restated certificate of incorporation provides that no director or officer of ours will be liable to us or our stockholders for breach of any fiduciary duty by reason of the fact that any such individual directs a corporate opportunity to another person or entity (including LMI and LGI) instead of us, or does not refer or communicate information regarding such corporate opportunity to us, unless (x) such opportunity was expressly offered to such person solely in his or her capacity as a director or officer of our company or as a director or officer of any of our subsidiaries, and (y) such opportunity relates to a line of business in which our company or any of our subsidiaries is then directly engaged.

*If we are unable to satisfy the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, or our internal control over financial reporting is not effective, the reliability of our financial statements may be questioned and our stock price may suffer.* Section 404 of the Sarbanes-Oxley Act of 2002 requires any company subject to the reporting requirements of the U.S. securities laws to do a comprehensive evaluation of its and its consolidated subsidiaries internal control over financial reporting. To comply with this statute, we will be required to document and test our internal control procedures; our management will be required to assess and issue a report concerning our internal control over financial reporting; and our independent auditors will be required to issue an opinion on management's assessment of those matters. Our compliance with Section 404 of the Sarbanes-Oxley Act will first be tested in connection with the filing of our Annual Report on Form 10-K for the fiscal year ending December 31, 2006. The rules governing the standards that must be met for management to assess our internal control over financial reporting are new and complex and require significant documentation, testing and possible remediation to meet the detailed standards under the rules. During the course of its testing, our management may identify material weaknesses or deficiencies which may not be remedied in time to meet the deadline imposed by the Sarbanes-Oxley Act. If our management cannot favorably assess the effectiveness of our internal control over financial reporting or our auditors identify material weaknesses in our internal control, investor confidence in our financial results may weaken, and our stock price may suffer. In addition, our internal controls must necessarily rely in part upon the adequacy of Discovery's internal controls. However, Discovery, as a private company, is not subject to the requirements of the Sarbanes-Oxley Act in this regard, and we cannot control, or require Discovery to change, its internal controls.

*It may be difficult for a third party to acquire us, even if doing so may be beneficial to our shareholders.* Certain provisions of our restated certificate of incorporation and bylaws may discourage, delay or prevent a change in control of our company that a shareholder may consider favorable. These provisions include the following:

authorizing a capital structure with multiple series of common stock: a Series B that entitles the holders to ten votes per share, a Series A that entitles the holders to one vote per share and a Series C that, except as otherwise required by applicable law, entitles the holders to no voting rights;



**Table of Contents**

authorizing the issuance of blank check preferred stock, which could be issued by our board of directors to increase the number of outstanding shares and thwart a takeover attempt;

classifying our board of directors with staggered three-year terms, which may lengthen the time required to gain control of our board of directors;

limiting who may call special meetings of shareholders;

prohibiting shareholder action by written consent (subject to certain exceptions), thereby requiring shareholder action to be taken at a meeting of the shareholders;

establishing advance notice requirements for nominations of candidates for election to our board of directors or for proposing matters that can be acted upon by shareholders at shareholder meetings;

requiring shareholder approval by holders of at least 80% of our voting power or the approval by at least 75% of our board of directors with respect to certain extraordinary matters, such as a merger or consolidation of our company, a sale of all or substantially all of our assets or an amendment to our restated certificate of incorporation;

requiring the consent of the holders of at least 75% of the outstanding Series B common stock (voting as a separate class) to certain share distributions and other corporate actions in which the voting power of the Series B common stock would be diluted by, for example, issuing shares having multiple votes per share as a dividend to holders of Series A common stock; and

the existence of authorized and unissued stock which would allow our board of directors to issue shares to persons friendly to current management, thereby protecting the continuity of its management, or which could be used to dilute the stock ownership of persons seeking to obtain control of us.

Our company has adopted a shareholder rights plan in order to encourage anyone seeking to acquire us to negotiate with our board of directors prior to attempting a takeover. While the plan is designed to guard against coercive or unfair tactics to gain control of us, the plan may have the effect of making more difficult or delaying any attempts by others to obtain control of us.

*Holders of any single series of our common stock may not have any remedies if any action by our directors or officers has an adverse effect on only that series of our common stock.* Principles of Delaware law and the provisions of our restated certificate of incorporation may protect decisions of our board of directors that have a disparate impact upon holders of any single series of our common stock. Under Delaware law, the board of directors has a duty to act with due care and in the best interests of all of our shareholders, including the holders of all series of our common stock. Principles of Delaware law established in cases involving differing treatment of multiple classes or series of stock provide that a board of directors owes an equal duty to all common shareholders regardless of class or series and does not have separate or additional duties to any group of shareholders. As a result, in some circumstances, our directors may be required to make a decision that is adverse to the holders of one series of our common stock. Under the principles of Delaware law referred to above, you may not be able to challenge these decisions if our board of directors is disinterested and adequately informed with respect to these decisions and acts in good faith and in the honest belief that it is acting in the best interests of all of our shareholders.

**Item 1B. Unresolved Staff Comments.**

None

**Item 2. Properties.**

We share our executive offices in Englewood, Colorado under a services agreement with Liberty. All of our other real or personal property is owned or leased by our subsidiaries or affiliates.

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Ascent Media's operations are conducted at over 100 properties. In the United States, Ascent Media occupies owned and leased properties in California, Connecticut, Florida, Georgia, New Jersey, New York and Virginia; the network services group also operates a satellite earth station and related facilities in

I-21

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**Table of Contents**

Minnesota. Internationally, Ascent Media has owned and leased properties in London, England. In addition, the creative services group operates a leased facility in Mexico City, Mexico, the media management services group has a 50% owned equity affiliate with facilities in Barcelona and Madrid, Spain, and the network services group operates two leased facilities in the Republic of Singapore. Worldwide, Ascent Media leases approximately 1.4 million square feet and owns another 350,000 square feet. In the United States, Ascent Media's leased properties total approximately 1.1 million square feet and have terms expiring between March 2006 and April 2015. Several of these agreements have extension options. The leased properties are used for our technical operations, office space and media storage. Ascent Media's international leases have terms that expire between March 2006 and August 2019, and are also used for technical operations, office space and media storage. Over half of the international leases have extension clauses. Approximately 240,000 square feet of Ascent Media's owned properties are located in Southern California, with another 80,000 square feet located in Northvale, New Jersey, Atlanta, Georgia, Minneapolis, Minnesota and Stamford, Connecticut. In addition, Ascent Media owns approximately 50,000 square feet in London, England. Nearly all of Ascent Media's owned properties are purpose-built for its technical and creative service operations. Ascent Media's facilities are adequate to support its current near term growth needs.

**Item 3. Legal Proceedings.**

*Paul J. Dujardin v. Liberty Media Corporation and Ascent Media.* On November 30, 2001, Paul Dujardin filed a complaint against Liberty and Ascent Media in the U.S. District Court for the Southern District of New York, alleging violations of Section 10(b), Rule 10b-5 and Section 20(a) of the Securities Exchange Act of 1934, common law fraud, negligent misrepresentation, breach of the earnout provisions of an acquisition agreement involving the sale of Mr. Dujardin's company, Triumph Communications, Inc., to Ascent Media in July 2000, and breach of contract for failure to make Mr. Dujardin head of what was then known as Ascent Media's networks group. On March 15, 2005, the court dismissed with prejudice the securities fraud claims based on allegations that Ascent Media and Liberty engaged in transactions designed to conceal the value of Ascent Media's stock, and the breach of contract claim for failure to make Mr. Dujardin head of the networks group. The court then dismissed, but without prejudice, the securities fraud and common law fraud claims based on allegations that Ascent Media falsely promised to appoint Mr. Dujardin president of the networks group and granted Mr. Dujardin permission to reassert these fraud claims in an amended complaint. On April 4, 2005, Mr. Dujardin filed an amended complaint against Ascent Media and Liberty alleging a violation of Section 10(b), Rule 10b-5 and Section 20 of the Securities Exchange Act of 1934, and a common law fraud claim, each based solely on allegations that Ascent Media falsely promised to appoint Mr. Dujardin president of the networks group. On December 20, 2005, the parties executed a confidential settlement agreement. Ascent Media entered into the agreement without admission of liability. The Court dismissed the case with prejudice on January 4, 2006.

**Item 4. Submission of Matters to a Vote of Security Holders.**

None.

**Table of Contents****PART II.****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.****Market Information**

We have two series of common stock, Series A and Series B, which trade on the Nasdaq National Market under the symbols DISCA and DISCB, respectively. The following table sets forth the range of high and low sales prices of shares of our Series A and Series B common stock since our spin off on July 21, 2005.

	Series A		Series B	
	High	Low	High	Low
2005				
July 21, 2005 through September 30, 2005	\$ 16.30	\$ 13.51	\$ 16.77	\$ 14.40
Fourth quarter	\$ 16.23	\$ 13.69	\$ 16.80	\$ 13.59

**Holdings**

As of January 31, 2006, there were approximately 128,000 and 1,100 record and beneficial holders of our Series A common stock and Series B common stock, respectively.

**Dividends**

We have not paid any cash dividends on our Series A common stock and Series B common stock, and we have no present intention of so doing. Payment of cash dividends, if any, in the future will be determined by our Board of Directors in light of our earnings, financial condition and other relevant considerations.

**Securities Authorized for Issuance Under Equity Compensation Plans**

Information required by this item is incorporated by reference to our definitive proxy statement for our 2006 Annual Meeting of shareholders.

**Item 6. Selected Financial Data.**

Effective July 21, 2005, Liberty Media Corporation ( Liberty ) completed a spin off transaction pursuant to which our capital stock was distributed as a dividend to holders of Liberty's Series A and Series B common stock. Subsequent to the spin off, we are a separate publicly traded company and we and Liberty operate independently.

The following tables present selected historical information relating to our financial condition and results of operations for the past five years. The following data should be read in conjunction with our consolidated financial statements.

	December 31,				
	2005	2004	2003	2002	2001
<b>Amounts in thousands</b>					
<b>Summary Balance Sheet</b>					
<b>Data(1):</b>					
Investment in Discovery					
Communications, Inc.	\$ 3,018,622	\$ 2,945,782	\$ 2,863,003	\$ 2,816,513	\$ 2,899,824
Goodwill	\$ 2,133,518	\$ 2,135,446	\$ 2,130,897	\$ 2,104,705	\$ 2,034,102
Total assets	\$ 5,819,236	\$ 5,564,828	\$ 5,396,627	\$ 5,373,150	\$ 5,399,702
Long-term debt	\$	\$	\$	\$ 401,984	\$ 443,685
Subordinated notes payable to Liberty	\$	\$	\$	\$ 205,299	\$ 183,685

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Stockholders equity	\$ 4,575,425	\$ 4,347,279	\$ 4,260,269	\$ 3,617,417	\$ 3,578,364
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II-1

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**Table of Contents****Years Ended December 31,**

**2005                      2004                      2003                      2002                      2001**

**Amounts in thousands, except per share amounts**

Summary Statement of Operations Data:					
Revenue	\$ 694,509	\$ 631,215	\$ 506,103	\$ 539,333	\$ 592,732
Operating income (loss)(1)	\$ (1,402)	\$ 16,935	\$ (2,404)	\$ (61,452)	\$ (350,628)
Share of earnings (losses) of Discovery(2)	\$ 79,810	\$ 84,011	\$ 37,271	\$ (32,046)	\$ (277,919)
Net earnings (loss)(1)	\$ 33,276	\$ 66,108	\$ (52,394)	\$ (129,275)	\$ (608,261)
Basic and diluted earnings (loss) per common share(3)	\$ .12	\$ 0.24	\$ (0.19)	\$ (0.46)	\$ (2.17)

- (1) Includes impairment of goodwill and other long-lived assets of \$51,000, \$562,000, \$83,718,000 and \$307,932,000 for the years ended December 31, 2004, 2003, 2002 and 2001, respectively.
- (2) Effective January 1, 2002, we adopted Statement of Financial Accounting Standards No. 142, *Goodwill and Other Intangible Assets* ( Statement 142 ), which among other matters, provides that excess costs that are considered equity method goodwill no longer be amortized. Share of losses of Discovery includes excess basis amortization of \$188,570,000 for the year ended December 31, 2001.
- (3) Basic and diluted net earnings (loss) per common share is based on (1) 280,199,000 shares, which is the number of shares issued in the spin off, for all periods prior to the spin off and (2) the actual number of outstanding shares for all periods subsequent to the spin off.

**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

The following discussion and analysis provides information concerning our results of operations and financial condition. This discussion should be read in conjunction with our accompanying consolidated financial statements and the notes thereto.

**Overview**

Effective July 21, 2005, Liberty Media Corporation ( Liberty ) completed a spin off transaction pursuant to which our capital stock was distributed as a dividend to holders of Liberty's Series A and Series B common stock. Subsequent to the spin off, we are a separate publicly traded company and we and Liberty operate independently. The spin off did not involve the payment of any consideration by the holders of Liberty common stock and is intended to qualify as a tax-free spin off. The spin off has been accounted for at historical cost due to the pro rata nature of the distribution. We are a holding company and our businesses and assets include Ascent Media Group, LLC ( Ascent Media ), which we consolidate, and a 50% ownership interest in Discovery Communications, Inc. ( Discovery ), which we account for using the equity method of accounting. Accordingly, as described below, Discovery's revenue is not reflected in the revenue we report in our financial statements. In addition to the foregoing assets, immediately prior to the spin off, Liberty transferred to a subsidiary of our company \$200 million in cash.

Ascent Media provides creative, media management and network services to the media and entertainment industries. Ascent Media's clients include major motion picture studios, independent producers, broadcast networks, cable programming networks, advertising agencies and other companies that produce, own and/or distribute entertainment, news, sports, corporate, educational, industrial and advertising content. Ascent Media's operations are organized into the following four groups: creative services, media management services, network services and

corporate and other. Ascent Media has few long-term or exclusive agreements with its creative services and media management services customers.

In 2006, Ascent Media will continue to focus on leveraging its broad array of media services to market itself as a full service provider to new and existing customers within the feature film and television production industry. With facilities in the U.S., the United Kingdom and Asia, Ascent Media also hopes to increase its services to multinational companies. The challenges that Ascent Media faces include differentiating its

II-2

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## **Table of Contents**

products and services to help maintain or increase operating margins and financing capital expenditures for equipment and other items to satisfy customers' desire for services using the latest technology.

Our most significant asset is Discovery, in which we do not have a controlling financial interest. Discovery is a global media and entertainment company that provides original and purchased video programming in the United States and over 160 other countries. We account for our 50% ownership interest in Discovery using the equity method of accounting. Accordingly, our share of the results of operations of Discovery is reflected in our consolidated results as earnings or losses of Discovery. To assist the reader in better understanding and analyzing our business, we have included a separate discussion and analysis of Discovery's results of operations and financial condition below.

### **Acquisitions**

*Cinetech.* On October 20, 2004, Ascent Media acquired substantially all of the assets of Cinetech, Inc., a film laboratory and still image preservation and restoration company, for \$10,000,000 in cash plus contingent compensation of up to \$1,500,000 to be paid based on the satisfaction of certain contingencies as set forth in the purchase agreement. Cinetech is included in Ascent Media's media management services group.

*London Payout Centre.* On March 12, 2004, Ascent Media acquired the entire issued share capital of London Payout Centre Limited, for a cash purchase price of \$36,573,000. London Payout Centre, which we refer to as LPC, is a UK-based television channel origination facility. LPC is included in Ascent Media's network services group.

*Sony Electronics' System Integration Center.* On December 31, 2003, Ascent Media acquired the operations of Sony Electronics' systems integration center business and related assets, which we refer to as SIC. In exchange, Sony received the right to be paid in 2008 an amount equal to 20% of the value of the combined business of Ascent Media's wholly owned subsidiary, AF Associates, Inc. and SIC. The value of 20% of the combined business of AF Associates and SIC was estimated at \$6,000,000. SIC is included in Ascent Media's network services group.

### **Operating Cash Flow**

We evaluate the performance of our operating segments based on financial measures such as revenue and operating cash flow. We define operating cash flow as revenue less cost of services and selling, general and administrative expense (excluding stock and other equity-based compensation). We believe this is an important indicator of the operational strength and performance of our businesses, including the ability to invest in ongoing capital expenditures and service of any debt. In addition, this measure allows management to view operating results and perform analytical comparisons and identify strategies to improve performance. This measure of performance excludes depreciation and amortization, stock and other equity-based compensation, restructuring and impairment charges that are included in the measurement of operating income pursuant to U.S. generally accepted accounting principles, or GAAP. Accordingly, operating cash flow should be considered in addition to, but not as a substitute for, operating income, cash flow provided by operating activities and other measures of financial performance prepared in accordance with GAAP.

### **Results of Operations**

Our consolidated results of operations include general and administrative expenses incurred at the DHC corporate level, 100% of Ascent Media's results and our 50% share of earnings of Discovery.

Ascent Media's creative services group revenue is primarily generated from fees for video and audio post production, special effects and editorial services for the television, feature film and advertising industries. Generally, these services pertain to the completion of feature films, television programs and advertisements. These projects normally span from a few days to three months or more in length, and fees for these projects typically range from \$10,000 to \$1,000,000 per project.

The media management services group provides owners of film libraries a broad range of restoration, preservation, archiving, professional mastering and duplication services. The scope of media management



**Table of Contents**

services vary in duration from one day to several months depending on the nature of the service, and fees typically range from less than \$1,000 to \$100,000 per project. Additionally, the media management services group includes Ascent Media's digital media center which is developing new products and businesses in areas such as digital imaging, digital media and interactive media.

The network services group's revenue consists of fees relating to facilities and services necessary to assemble and transport programming for cable and broadcast networks across the world via fiber, satellite and the Internet. The group's revenues are also driven by systems integration and field support services, technology consulting services, design and implementation of advanced video systems, engineering project management, technical help desk and field service. Approximately 55% of network services group's revenue relates to broadcast services, satellite operations and fiber services that are earned monthly under long-term contracts ranging generally from one to seven years. Additionally, approximately 45% of revenue relates to systems integration and engineering services that are provided on a project basis over terms generally ranging from three to twelve months.

Corporate related items and expenses are reflected in Corporate and Other, below. Cost of services and operating expenses consists primarily of production wages, facility costs and other direct costs and selling, general and administrative expenses.

Each of Cinetech, LPC and SIC are included in Ascent Media's consolidated results of operations for the full year in 2005, and Ascent Media's consolidated results of operations for the year ended December 31, 2004, include twelve months of results for SIC, approximately nine months of results of LPC and approximately two months of results of Cinetech.

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>Amounts in thousands</b>		
<b><i>Segment Revenue</i></b>			
Creative services group	\$ 304,393	\$ 295,841	\$ 270,830
Media management services group	118,489	109,982	107,070
Network services group	271,627	225,392	128,203
Corporate and other			
	\$ 694,509	\$ 631,215	\$ 506,103
<b><i>Segment Operating Cash Flow</i></b>			
Creative services group	\$ 57,323	\$ 55,847	\$ 43,786
Media management services group	13,481	17,430	22,074
Network services group	55,781	62,163	43,221
Corporate and other	(47,960)	(37,645)	(32,901)
	\$ 78,625	\$ 97,795	\$ 76,180

*Revenue.* Ascent Media's total revenue increased 10.0% and 24.7% for the years ended December 31, 2005 and 2004, respectively, as compared to the corresponding prior year. In 2005, the creative services group revenue increased \$8,552,000 as a result of higher commercial revenue and strong features and television in the U.S. partially offset by declining revenue at sound services, and continued weakness in commercial and feature film activity in the U.K. The media management services group revenue increased \$8,507,000 in 2005 as a result of higher lab revenue of \$9,906,000 primarily driven by the acquisition of Cinetech and an increase in new digital services, partially offset by declines in the U.S. due to lower studio volumes from traditional business and lower subtitling business and DVD

volumes in the U.K. The network services group's 2005 revenue increased \$46,235,000 due to \$9,423,000 of revenue related to the LPC acquisition, higher number of large engineering and systems integration projects and higher origination business and other new initiatives, partially offset by lower renewal rates on certain ongoing broadcast services contracts.

**Table of Contents**

In 2004, the creative services group revenue increased \$25,011,000 as a result of higher feature film related revenue driven by the expansion in digital intermediate services in the U.S. and UK, expansion of creative sound services in the UK, growth in television post production activity and changes in foreign currency exchange rates of \$6,382,000. The media management services group revenue increased \$2,912,000 in 2004 as a result of higher lab revenue of \$2,229,000 due to the acquisition of Cinetech, higher demand for DVD mastering services and changes in foreign currency exchange rates of \$3,684,000, offset by the commoditization of traditional media services leading to a decline in rates and difficult market conditions primarily in the United Kingdom. The network services group's 2004 revenue increased \$97,189,000, reflecting the full year impact of the SIC acquisition (\$27,100,000), the nine month impact of the LPC acquisition (\$39,619,000) and changes in foreign currency exchange rates (\$1,979,000). The remaining increase is driven by the timing of various large systems integration projects and higher network origination and installation projects.

*Cost of Services.* Ascent Media's costs of services increased 17.2% and 26.3% for the years ended December 31, 2005 and 2004, respectively, as compared to the corresponding prior year. The 2005 increase is partially attributable to the 2004 acquisitions discussed above, which contributed \$12,109,000 in cost of services. In addition, cost of services increased in 2005 due to a change in revenue mix driven by higher systems engineering and integration projects in the network services group which have higher production and engineering labor and production material and equipment costs. Media management services group cost of services has increased at a faster rate than revenue. The group has increased spending on development of digital technologies and new services. Additionally, media management's projects have become increasingly more integrated, with complex work flows requiring higher levels of production labor and project management. This increase in labor costs, combined with investment in new technologies, has resulted in higher cost of services and decreasing operating cash flow margin.

The 2004 increase is attributed to the 2004 acquisitions discussed above, which contributed \$48,331,000 of the increase in cost of services, higher costs across all of its groups primarily in production material, production personnel and equipment expenses as a result of the increased revenue and production activity noted above and changes in foreign currency exchange rates, which resulted in an increase of \$6,321,000.

*Selling, General and Administrative.* Ascent Media's selling, general and administrative expenses increased 6.8% and 18.8% for the years ended December 31, 2005 and 2004, respectively, as compared to the corresponding prior year. The 2005 increase is primarily attributable to the impact of the 2004 acquisitions of \$5,270,000 and the growth in revenue driving higher labor, facility and selling expenses. The 2004 increase is primarily attributable to growth in the business driving higher personnel, facility and selling costs, the impact of the 2004 acquisitions of \$5,528,000 and changes in foreign currency exchange rates of \$4,222,000.

Corporate and Other operating cash flow (which includes DHC corporate general and administrative expenses of \$6,467,000 in 2005) decreased \$10,315,000 and \$4,744,000 in 2005 and 2004, respectively, as compared to the corresponding prior year. The 2005 decrease is due to the DHC corporate expenses, which primarily relate to the Spin Off (\$5,072,000) and charges pursuant to the services agreement with Liberty subsequent to the Spin Off (\$876,000), and higher Ascent Media corporate expenses (\$3,848,000) as a result of higher labor, facility, and professional services costs related to reengineering activities and a legal settlement. The 2004 increase is due to higher corporate expenses in the U.K. from the continued development of corporate infrastructure and acquisition of LPC, higher management incentive plan costs and changes in foreign currency exchange rates of \$872,300, offset by lower severance and lease abandonment charges.

*Depreciation and Amortization.* Depreciation and amortization were comparable in 2005 and 2004. The increase in depreciation and amortization expense in 2004, as compared to 2003, is due to an increase in the depreciable asset base due to capital expenditures and acquisitions.

*Stock Compensation.* In 2001, Ascent Media granted to certain of its officers and employees stock options (the Ascent Media Options) with exercise prices that were less than the market price of Ascent Media common stock on the date of grant. The Ascent Media Options became exercisable for Liberty shares in connection with Liberty's acquisition in 2003 of the Ascent Media shares that it did not already own. Ascent



**Table of Contents**

Media is amortizing the in-the-money value of the Ascent Media Options over the 5-year vesting period. Certain Ascent Media employees also hold options and stock appreciation rights granted by companies acquired by Ascent Media prior to 2003 and exchanged for Liberty options and SARs. Ascent Media records compensation expense for the SARs based on the underlying stock price and vesting of such awards.

On May 24, 2005, Liberty commenced an offer to purchase certain stock options and SARs held by eligible employees of Ascent Media. The offer to purchase related to 1,173,028 options and SARs, and the aggregate offering price for such options and SARs was approximately \$2.15 million. The offer to purchase expired at 9:00 p.m., Pacific time, on June 21, 2005. Eligible employees tendered options with respect to 1,121,673 shares of Liberty Series A common stock, and Liberty purchased such options for aggregate cash payments of approximately \$2.14 million. In connection with these purchases, Ascent Media recorded year to date compensation expense of \$3,830,000, which included (1) the amount of the cash payments less any previously accrued compensation for the SARs, (2) the previously unamortized in-the-money value related to the Ascent Media Options and (3) ongoing amortization of the unexercised Ascent Media options.

*Restructuring Charges.* During the year ended December 31, 2005, Ascent Media recorded a restructuring charge of \$4,112,000 related to the consolidation of certain operating facilities resulting in excess leased space, consolidation expenses and severance from reductions in headcount. These restructuring activities were implemented to improve ongoing operating efficiencies and effectiveness primarily in the creative services group in the U.K. During the year ended December 31, 2003, Ascent Media recorded a restructuring charge of \$3,476,000 related to the closing of certain facilities and corresponding reductions in headcount. These restructuring activities were implemented to improve operating efficiencies and effectiveness primarily in its creative services group. There was no restructuring charge in 2004.

*Interest Expense.* Interest expense in 2003 related primarily to interest on Ascent Media's bank debt and subordinated notes payable due to Liberty. In December 2003, Ascent Media repaid all principal and interest under its bank credit facility with cash provided by Liberty. In addition, Liberty contributed all amounts due under the subordinated notes payable to the equity of Ascent Media. As a result of the cancellation of the bank credit facility and the subordinated notes payable, Ascent Media incurred no interest expense in 2005 or 2004.

*Share of Earnings of Discovery.* Our share of earnings of Discovery decreased \$4,201,000 or 5% in 2005 and increased over 100% in 2004. Discovery's net income decreased in 2005 as increases in revenue and operating income were more than offset by increases in interest expense and income tax expense. Discovery's net income improved in 2004 primarily due to higher revenue and improved operating margins. Prior to June 2003, John Hendricks, Discovery's Founder and Chairman, held shares of Discovery common stock that were redeemable on demand. Changes in the redemption value of such shares were recorded by Discovery as adjustments to equity similar to dividends on preferred stock. We included in our share of earnings (losses) of Discovery 50% of the equity adjustments related to the redeemable common stock as those adjustments represented an adjustment in earnings available to common shareholders. The redeemable common stock was redeemed in June 2003. Our share of earnings (losses) of Discovery included gains of \$5,700,000 for the year ended December 31, 2003 related to changes in the redemption value of the redeemable common stock and other equity transactions.

For a more detailed discussion of Discovery's results of operations, see Management's Discussion and Analysis of Financial Condition and Results of Operations of Discovery.

*Income Taxes.* Our effective tax rate was 59.5% and 34.6% for the years ended December 31, 2005 and 2004, respectively. While we were a subsidiary of Liberty, we calculated our deferred tax liabilities using Liberty's blended weighted average state tax rate. Subsequent to our spin off, we assessed such rate in light of the fact that we are located primarily in California, which has a higher state income tax rate than many of the other states in which Liberty does business, and we determined that our effective tax rate should be increased from 39% to 39.55%. This increase resulted in additional deferred tax expense in 2005 of \$15,263,000. In addition, our income tax rate was higher than the federal income tax rate of 35% due to state and foreign tax expense. Although we incurred a pre-tax loss of \$32,238,000 in 2003, we recognized tax expense of



**Table of Contents**

\$20,156,000 due to an increase in our valuation allowance, interest expense that is not deductible for tax purposes and state tax expense.

**Liquidity and Capital Resources**

Prior to our spin off, our primary sources of funds were cash from operating activities and advances or contributions from Liberty. During the year ended December 31, 2005, our primary use of cash was capital expenditures (\$90,526,000), which we funded with our available cash and cash generated by operating activities (\$85,291,000). Of the foregoing 2005 capital expenditures, \$41,192,000 relates to the buildout of Ascent Media's existing facilities for specific customer contracts and the construction of Ascent Media's Digital Media Center in Burbank, California. The remainder of Ascent Media's capital expenditures relates to purchases of new equipment and the upgrade of existing facilities and equipment. For the year ended December, 31, 2004, our primary uses of cash were acquisitions (\$44,238,000) and capital expenditures (\$49,292,000). We funded these investing activities with cash from operating activities of \$84,322,000 and capital contributions from Liberty of \$30,999,000. In connection with the spin off, Liberty transferred to one of our subsidiaries \$200 million in cash. Subsequent to the spin off, Liberty will no longer be a long-term source of liquidity for us. Subsequent to December 31, 2005, we acquired AccentHealth LLC for approximately \$45 million in cash. We funded such acquisition with a portion of our available cash on hand. In addition, we expect to provide \$20 million of funding to AccentHealth in 2006 for expansion of their network. For the foreseeable future, we expect to have sufficient available cash balances and net cash from operating activities to meet our working capital needs and capital expenditure requirements. We intend to seek external equity or debt financing in the event any new investment opportunities, additional capital expenditures or our operations require additional funds, but there can be no assurance that we will be able to obtain equity or debt financing on terms that are acceptable to us.

Our ability to seek additional sources of funding depends on our future financial position and results of operations, which, to a certain extent, are subject to general conditions in or affecting our industry and our customers and to general economic, political, financial, competitive, legislative and regulatory factors beyond our control.

We do not have access to the cash Discovery generates from its operations, unless Discovery pays a dividend on its capital stock or otherwise distributes cash to its stockholders. Historically, Discovery has not paid any dividends on its capital stock and we do not have sufficient voting control to cause Discovery to pay dividends or make other payments or advances to us.

**Off-Balance Sheet Arrangements and Contractual Obligations**

Information concerning the amount and timing of required payments under our contractual obligations at December 31, 2005 is summarized below:

**Payments Due by Period**

	<b>Less Than 1 Year</b>	<b>1-3 Years</b>	<b>4-5 Years</b>	<b>After 5 Years</b>	<b>Total</b>
<b>Amounts in thousands</b>					
Operating leases	\$ 30,563	\$ 54,677	\$ 43,159	\$ 47,033	\$ 175,432
Other		6,100			6,100
<b>Total Contractual Obligations</b>	<b>\$ 30,563</b>	<b>\$ 60,777</b>	<b>\$ 43,159</b>	<b>\$ 47,033</b>	<b>\$ 181,532</b>

We have contingent liabilities related to legal proceedings and other matters arising in the ordinary course of business. Although it is reasonably possible we may incur losses upon conclusion of such matters, an estimate of any loss or range of loss cannot be made. In the opinion of management, it is expected that amounts, if any, which may be required to satisfy such contingencies will not be material in relation to the accompanying consolidated financial

statements.

II-7

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**Table of Contents****Recent Accounting Pronouncements**

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payments (Statement 123R). Statement 123R, which is a revision of Statement 123 and supersedes APB Opinion No. 25, establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services, primarily focusing on transactions in which an entity obtains employee services. Statement 123R generally requires companies to measure the cost of employee services received in exchange for an award of equity instruments (such as stock options and restricted stock) based on the grant-date fair value of the award, and to recognize that cost over the period during which the employee is required to provide service (usually the vesting period of the award). Statement 123R also requires companies to measure the cost of employee services received in exchange for an award of liability instruments (such as stock appreciation rights) based on the current fair value of the award, and to remeasure the fair value of the award at each reporting date.

Public companies are required to adopt Statement 123R as of the beginning of the registrant's next fiscal year, or January 1, 2006 for calendar-year companies, such as us. Accordingly, the provisions of Statement 123R will affect the accounting for all awards granted, modified, repurchased or cancelled after January 1, 2006. The accounting for awards granted, but not vested, prior to January 1, 2006 will also be impacted. The provisions of Statement 123R allow companies to adopt the standard on a prospective basis or to restate all periods for which Statement 123 was effective. We expect to adopt Statement 123R on a prospective basis, and will provide pro forma information as though the standard had been adopted for all periods presented.

While we have not yet quantified the impact of adopting Statement 123R, we do not believe that such adoption will have a significant effect on our operating income and net earnings in the future.

**Critical Accounting Estimates**

*Valuation of Long-lived Assets and Amortizable Other Intangible Assets.* We perform impairment tests for our long-lived assets if an event or circumstance indicates that the carrying amount of our long-lived assets may not be recoverable. In response to changes in industry and market conditions, we may also strategically realign our resources and consider restructuring, disposing of, or otherwise exiting businesses. Such activities could result in impairment of our long-lived assets or other intangible assets. We are subject to the possibility of impairment of long-lived assets arising in the ordinary course of business. We regularly consider the likelihood of impairment and recognize impairment if the carrying amount of a long-lived asset or intangible asset is not recoverable from its undiscounted cash flows in accordance with SFAS No. 144, Accounting for Impairment or Disposal of Long-Lived Assets. Impairment is measured as the difference between the carrying amount and the fair value of the asset. We use both the income approach and market approach to estimate fair value. Our estimates of fair value are subject to a high degree of judgment. Accordingly, any value ultimately derived from our long-lived assets may differ from our estimate of fair value.

*Valuation of Goodwill and Non-amortizable Other Intangible Assets.* We assess the impairment of goodwill annually and whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Factors we consider important which could trigger an impairment review include significant underperformance to historical or projected future operating results, substantial changes in our strategy or the manner of use of our assets, and significant negative industry or economic trends. Fair value of each reporting unit is determined through the use of an outside independent valuation consultant. Both the income approach and market approach are used in determining fair value.

*Valuation of Trade Receivables.* We must make estimates of the collectibility of our trade receivables. Our management analyzes the collectibility based on historical bad debts, customer concentrations, customer credit-worthiness, current economic trends and changes in our customer payment terms. We record an allowance for doubtful accounts based upon specifically identified receivables that we believe are uncollectible. In addition, we also record an amount based upon a percentage of each aged category of our trade receivables. These percentages are estimated based upon our historical experience of bad debts. Our trade

**Table of Contents**

receivables balance was \$134,615,000, net of allowance for doubtful accounts of \$7,708,000, as of December 31, 2005.

*Valuation of Deferred Tax Assets.* In accordance with SFAS No. 109, Accounting for Income Taxes, we review the nature of each component of our deferred income taxes for reasonableness. We have determined that it is more likely than not that we will not realize a portion of our tax benefits associated with certain cumulative net operating loss carry forwards and impairment reserves, and as such, we have reserved for a portion of our deferred income tax assets. The valuation allowance as of December 31, 2005 and 2004 was \$91,235,000 and \$88,067,000, respectively.

**Discovery**

We hold a 50% ownership interest in Discovery and account for this investment using the equity method of accounting. Accordingly, in our financial statements we record our share of Discovery's net income or loss available to common shareholders and reflect this activity in one line item in the statement of operations as Share of earnings of Discovery. The following financial information of Discovery for the years ended December 31, 2005, 2004 and 2003 and related discussion is presented to provide the reader with additional analysis of the operating results and financial position of Discovery. Because we do not control the decision-making process or business management practices of Discovery, we rely on Discovery to provide us with financial information prepared in accordance with GAAP that we use in the application of the equity method. The information included in this section should be read in conjunction with the audited financial statements of Discovery for the year ended December 31, 2005 included elsewhere herein. The following discussion and analysis of Discovery's operations and financial position has been prepared based on information that we receive from Discovery and represents our views and understanding of their operating performance and financial position based on such information. Discovery is not a separately traded public company, and we do not have the ability to cause Discovery's management to prepare their own management's discussion and analysis for our purposes. Accordingly, we note that the material presented in this section might be different if Discovery's management had prepared it.

The following discussion of Discovery's results of operations is presented on a consolidated basis. In order to provide a better understanding of Discovery's operations, we have also included a summarized presentation of revenue and operating cash flow of Discovery's three operating groups: Discovery networks U.S., or U.S. networks, Discovery networks international, or international networks, and Discovery commerce, education & other.

The U.S. networks is Discovery's largest division. It owns and operates 12 cable and satellite channels and provides distribution and advertising sales services for BBC America. International networks manages a portfolio of channels, led by the Discovery Channel and Animal Planet brands, that is distributed in virtually every pay-television market in the world via an infrastructure that includes major operational centers in London, Singapore, New Delhi and Miami. Discovery commerce, education & other includes Discovery's retail chain store operations and other direct consumer marketing activities as well as Discovery education which was recently formed to manage Discovery's distribution of education content.

**Table of Contents****Consolidated Results of Discovery**

	Years Ended December 31,		
	2005	2004	2003
Amounts in thousands			
<b>Revenue</b>			
Advertising	\$ 1,187,823	\$ 1,133,807	\$ 1,010,585
Distribution	1,198,686	976,362	747,927
Other	285,245	255,177	236,535
<b>Total revenue</b>	<b>2,671,754</b>	<b>2,365,346</b>	<b>1,995,047</b>
<b>Expenses</b>			
Cost of revenue	(979,765)	(846,316)	(751,578)
SG&A expense	(1,005,351)	(856,340)	(735,017)
<b>Operating cash flow</b>	<b>686,638</b>	<b>662,690</b>	<b>508,452</b>
Expenses arising from long-term incentive plans	(49,465)	(71,515)	(74,119)
Depreciation & amortization	(123,209)	(129,011)	(120,172)
Gain on sale of patents		22,007	
<b>Operating income</b>	<b>513,964</b>	<b>484,171</b>	<b>314,161</b>
<b>Other Income (Expense)</b>			
Interest expense, net	(184,575)	(167,420)	(159,409)
Realized and unrealized gains from derivative instruments, net	22,499	45,540	21,405
Minority interests in consolidated subsidiaries	(43,696)	(54,940)	(35,965)
Other	13,771	2,470	(2,170)
<b>Income before income taxes</b>	<b>321,963</b>	<b>309,821</b>	<b>138,022</b>
Income tax expense	(162,343)	(141,799)	(74,785)
<b>Net income</b>	<b>\$ 159,620</b>	<b>\$ 168,022</b>	<b>\$ 63,237</b>

**Business Segment Results of Discovery**

	Years Ended December 31,		
	2005	2004	2003
Amounts in thousands			
<b>Revenue</b>			
U.S. networks	\$ 1,743,358	\$ 1,599,678	\$ 1,345,097
International networks	731,352	588,416	480,129

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Discovery commerce, education & other	197,044	177,252	169,821
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<b>Total revenue</b>	<b>\$ 2,671,754</b>	<b>\$ 2,365,346</b>	<b>\$ 1,995,047</b>
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**Operating Cash Flow**

U.S. networks	\$ 643,366	\$ 597,922	\$ 482,747
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International networks	108,543	99,105	72,272
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Discovery commerce, education & other	(65,271)	(34,337)	(46,567)
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<b>Total operating cash flow</b>	<b>\$ 686,638</b>	<b>\$ 662,690</b>	<b>\$ 508,452</b>
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*Note:* Discovery commerce, education & other includes intercompany eliminations. Certain prior period amounts have been reclassified to conform to the current period presentation.

*Revenue.* Discovery's consolidated revenue increased 13% and 19% for the years ended December 31, 2005 and 2004, respectively, as compared to the corresponding prior year. Increased revenue was primarily due

II-10

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**Table of Contents**

to increases of 23% and 31% in distribution revenue for 2005 and 2004, respectively, as well as increases of 5% and 12% in advertising revenue for the same periods. Other revenue increased 12% and 8% for 2005 and 2004.

Distribution revenue increased \$130,609,000 or 22% and \$167,390,000 or 38% at the U.S. networks during the years ended December 31, 2005 and 2004, respectively. These increases are due to a 10% and 14% increase in paying subscription units for the years ended December 31, 2005 and 2004, respectively, combined with contractual rate increases. U.S. networks distribution benefited from contractual arrangements whereby certain subscribers that were previously covered under free carriage periods with distributors were converted to paying subscribers. U.S. networks distribution revenue increases were also helped by reduced launch fee amortization, a contra-revenue item, as a result of extensions of certain affiliation agreements. Launch amortization at the U.S. networks has declined during the most recent two years from \$118,888,000 during 2003 to \$93,763,000 in 2004 and \$67,750,000 in 2005, primarily due to these extensions. At the international networks, distribution revenue increased 25% and 20% during 2005 and 2004, respectively. Such increases were principally comprised of combined revenue growth in Europe and Asia of \$79,767,000 during 2005 and \$56,832,000 during 2004 resulting from increases in paying subscription units combined with contractual rate increases in certain markets.

The increase in advertising revenue during 2005, which includes revenue from paid programming, was primarily due to a 28% increase at the international networks. Over two-thirds of the international networks advertising revenue is generated by its operations in the United Kingdom and Europe. The increase in international networks advertising revenue was comprised of a \$36,926,000 increase resulting from higher viewership in the U.K. combined with an increased subscriber base in the U.K. and Europe. Advertising revenue at the U.S. networks was essentially flat, increasing \$1,316,000, as higher rates at certain of the larger networks, combined with growth at other newer networks, was offset by decreases resulting from lower audience delivery at certain of the larger networks. Paid programming, where Discovery sells blocks of time primarily for infomercials that are aired during the overnight hours on certain networks, represented 6% of total advertising revenue for each of the years ended December 31, 2005, 2004, and 2003.

Discovery is a leader in offering solutions to advertisers that allow them to reach a broad range of audience demographics in the face of increasing fragmentation of audience share. The overall industry is facing several issues with regard to its advertising revenue, including (1) audience fragmentation caused by the proliferation of other television networks, video-on-demand offerings from cable and satellite companies and broadband content offerings; (2) the deployment of digital video recording devices, allowing consumers to time shift programming and skip or fast-forward through advertisements; and (3) consolidation within the advertising industry, shifting more leverage to the bigger agencies and buying groups.

During 2004, the increase in advertising was primarily due to a 9% increase at the U.S. networks and a 31% increase at the international networks. The increase at the U.S. networks was primarily attributable to higher advertising sell-out and rates at most of the networks. The increase in advertising revenue at the international networks was due to a \$33,769,000 increase resulting from higher advertising rates and higher viewership ratings in the Europe region, combined with a \$6,033,000 increase as a result of increased distribution in Asia.

The increase in other revenue during 2005 was primarily due to a \$10,959,000 increase in education revenue due to acquisitions and organic growth in the business combined with a 5% or \$9,163,000 increase in commerce revenue, which resulted primarily from an increase in direct to consumer sales. The increase in other revenue during the year ended December 31, 2004 was primarily due to a \$9,409,000 increase in education revenue due to acquisitions, offset by a 5% or \$6,695,000 decrease in store revenue. The decrease in store revenue was due to the closure of certain unprofitable stores, which resulted in a 15% reduction in the average number of stores. Discovery began an initiative in 2003 to close stores that were not profitable. Lower revenue as a result of fewer stores was partially offset by a 4% improvement in same store sales.

*Cost of Revenue.* Cost of revenue increased 16% and 13% for the years ended December 31, 2005 and 2004, respectively. As a percent of revenue, cost of revenue was 37%, 36% and 38% for the years ended December 31, 2005, 2004 and 2003, respectively. The increase in 2005 primarily resulted from a \$106,901,000 increase in content amortization expense due to continued investment across all U.S. networks in original



**Table of Contents**

productions and high profile specials and continued investment in the lifestyles category internationally, particularly in Europe. These increases were offset partially by a net aggregate benefit of approximately \$11 million related to changes in estimates for music rights accruals.

The 2004 increase in cost of revenue was also primarily related to increased programming costs, particularly at the U.S. networks. Discovery also began investing in an initiative during the fourth quarter of 2004 to highlight and strengthen its lifestyles category, particularly in Europe, which contributed to the increase in cost of revenue during 2004. The decrease in cost of revenue as a percent of revenue in 2004 was due to a 15% reduction in the average number of stores as the company continued its efforts to close unprofitable stores.

*SG&A Expenses.* SG&A expenses increased 17% during each of the years ended December 31, 2005 and 2004, respectively. As a percent of revenue, SG&A expense was 38%, 36% and 37% for the years ended December 31, 2005, 2004 and 2003, respectively. Within the different business segments, SG&A expense decreased 2% at the U.S. networks and increased 34% and 65% at the international networks and Discovery commerce, education and other, respectively, during 2005. The increase at the international networks was caused by a \$26,326,000 increase in personnel expense resulting from adding headcount as the business expands, particularly in the U.K. and Europe combined with a \$27,275,000 increase in marketing expense associated with branding and awareness efforts related to the lifestyles category initiative. The increase at Discovery commerce, education and other is comprised of a \$34,329,000 increase primarily resulting from acquisitions and organic growth in Discovery's education business.

During 2004, SG&A expense increased 13%, 35%, and 3% at the U.S. networks, the international networks and Discovery commerce, education and other, respectively. The increase at the U.S. networks was due to a \$58,467,000 increase in marketing expenses and other variable costs. Marketing expense increased as the company continued to invest in brand promotion and gaining audience share in a highly competitive market. Other variable expenses increased as a result of the increase in revenue. The increase at Discovery's international networks of \$59,777,000 was due to a 20% increase in personnel costs and a 40% increase in marketing expenses. Increases in personnel expense are the result of adding headcount as the business expands particularly in the U.K. and Europe. Higher marketing expenses were experienced across all of the regions as the division began implementing the lifestyles category initiative during the fourth quarter of 2004.

*Expenses Arising from Long-term Incentive Plans.* Expenses arising from long-term incentive plans are related to Discovery's unit-based, long-term incentive plans, or LTIP, for its employees who meet certain eligibility criteria. Units are awarded to eligible employees and generally vest at a rate of 25% per year. Upon exercise, participants receive a cash payment for the increase in value of the units from the unit value on the date of issuance. The appreciation in unit value of LTIP awards outstanding is recorded as compensation expense over the period outstanding. In August 2005, Discovery discontinued one of its plans and settled all amounts with cash. Discovery established a new long-term incentive plan in October 2005 (the 2005 LTIP Plan) where participants in Discovery's remaining plan could elect to (1) continue in such plan or (2) exercise vested units and receive units in the 2005 LTIP Plan. The cash-out value of the units exercised was based on the plan valuation at the end of 2004, resulting in lower expense for 2005, as compared to 2004. The 31% or \$22,050,000 decrease in LTIP expense in 2005 is the result of this effect, offset by additional expenses related to the termination of one of Discovery's long-term incentive plans as well as current year vesting and appreciation under the 2005 LTIP Plan. Discovery made aggregate cash payments of \$325,756,000 to participants who exercised units during 2005. The aggregate number of units that are currently authorized to be granted under the 2005 LTIP Plan approximates a 6% sharing in the change in Discovery's equity value.

*Depreciation and Amortization.* The decrease in depreciation and amortization for the year ended December 31, 2005 is due to intangibles becoming fully amortized and a decrease in the depreciable asset base resulting from a reduction in the number of retail stores, offset by new assets placed in service during 2005. The increase in depreciation and amortization in 2004 is due to an increase in intangible assets resulting from acquisitions combined with increases in Discovery's depreciable asset base resulting from capital expenditures.

**Table of Contents**

*Gain on Sale of Patents.* In 2004, Discovery recorded a gain on the sale of certain of its television technology patents. The \$22 million gain represents the sale price less the costs incurred to sell the patents. The cost of developing the technology had been expensed in prior years to SG&A expense. Discovery does not expect a significant amount of income from patent sales in the future.

***Other Income and Expense***

*Interest Expense.* The increase in interest expense during the years ended December 31, 2005 and 2004 is primarily due to higher levels of outstanding debt in both years combined with increases in interest rates during those periods.

*Unrealized Gains from Derivative Instruments, net.* Unrealized gains from derivative transactions relate, primarily, to Discovery's use of derivative instruments to modify its exposure to interest rate fluctuations on its debt. These instruments include a combination of swaps, caps, collars and other structured instruments. As a result of unrealized mark to market adjustments, Discovery recognized \$29,109,000, \$44,060,000 and \$21,548,000 in gains on these instruments during the years ended December 31, 2005, 2004 and 2003, respectively. The foreign exchange hedging instruments used by Discovery are spot, forward and option contracts. Additionally, Discovery enters into forward contracts to hedge non-dollar denominated cash flows and foreign currency balances.

*Minority Interests in Consolidated Subsidiaries.* Minority interest represents increases and decreases in the estimated redemption value of mandatorily redeemable interests in subsidiaries which are initially recorded at fair value.

*Income Taxes.* Discovery's effective tax rate was 50%, 46% and 54% for 2005, 2004 and 2003, respectively. Discovery's effective tax rate differed from the federal income tax rate of 35% primarily due to foreign and state taxes.

***Liquidity & Capital Resources***

Discovery generated \$68,893,000, \$124,704,000 and \$154,296,000 of cash from operations during the years ended December 31, 2005, 2004 and 2003, respectively. The decrease in cash from operations in 2005 is primarily due to an increase in payments of LTIP obligations in the amount of \$325,756,000, offset partially by favorable working capital changes. In 2004, the decrease in cash provided by operations was due to payments of LTIP obligations partially offset by improved net income. As part of his long-term incentive plan with Discovery, John Hendricks, Discovery's Founder and Chairman, had a ten-year incentive agreement that granted him a cash award equal to 1.6% of the difference between Discovery's value at December 31, 1993 and December 31, 2003 for his services as Chairman and Chief Executive Officer during the period. This cash award was paid out to Mr. Hendricks in two installments, one in December 2003 and one in February 2004. The portion of the cash award that was paid out in February 2004 along with payments to other members of the Discovery management team during 2004 totaled \$240,752,000 in connection with the redemption of units pursuant to the terms of the LTIP. For a further discussion of Discovery's LTIP, please see Note 15 to the Discovery consolidated financial statements.

In addition to previous long-term incentive plans that have expired and have been paid out as described herein, Mr. Hendricks is a participant in the 2005 LTIP Plan and has been awarded long-term compensation units, which provide Mr. Hendricks with a total 1.3% participation in Discovery's increase in valuation in accordance with Discovery's LTIP.

During the years ended December 31, 2005 and 2004, Discovery paid \$92,874,000 and \$148,880,000, respectively, to acquire mandatorily redeemable securities related to minority interests in certain consolidated subsidiaries. Discovery also spent \$99,684,000 on capital expenditures during 2005.

In addition to cash provided by operations, Discovery funds its activities with proceeds borrowed under various debt facilities, including a term loan, a revolving loan facility and various senior notes payable. During the year ended December 31, 2005, net incremental borrowings under debt facilities aggregated approximately \$95,000,000. Total commitments of these facilities were \$4,025,000,000 at December 31, 2005. Debt



**Table of Contents**

outstanding on these facilities aggregated \$2,573,000,000 at December 31, 2005, providing excess debt availability of \$1,452,000,000. Discovery's ability to borrow the unused capacity is dependent on its continuing compliance with its covenants at the time of, and after giving effect to, a requested borrowing.

All term and revolving loans and senior notes are unsecured. They contain covenants that require Discovery to meet certain financial ratios and place restrictions on the payment of dividends, sale of assets, additional borrowings, mergers, and purchases of capital stock, assets and investments. Discovery has indicated they are in compliance with all debt covenants at December 31, 2005.

In 2006, Discovery expects to spend approximately \$115,000,000 for capital expenditures and \$190,000,000 for interest expense. Payments to satisfy LTIP obligations are not expected to be significant in 2006. Discovery believes that its cash flow from operations and borrowings available under its credit facilities will be sufficient to fund its working capital requirements.

*Contractual Obligations.* Discovery has agreements covering leases of satellite transponders, facilities and equipment. These agreements expire at various dates through 2020. Discovery is obligated to license programming under agreements with content suppliers that expire over various dates. Discovery also has other contractual commitments arising in the ordinary course of business.

A summary of all of the expected payments for these commitments as well as future principal payments under the current debt arrangements and minimum payments under capital leases at December 31, 2005 is as follows:

**Payments Due by Period(2)**

	<b>Total</b>	<b>Less Than 1 Year</b>	<b>1-3 Years</b>	<b>4-5 Years</b>	<b>After 5 Years</b>
<b>Amounts in thousands</b>					
Long-term debt	\$ 2,573,000	\$ 320,000	\$ 242,500	\$ 1,075,500	\$ 935,000
Capital leases	28,167	6,488	9,478	5,316	6,885
Operating leases	435,414	63,403	125,634	76,992	169,385
Program license fees	620,403	357,728	121,101	97,632	43,942
Launch incentives	71,520	36,156	33,219	2,145	
Other(1)	253,890	73,401	127,087	41,541	11,861
<b>Total</b>	<b>\$ 3,982,394</b>	<b>\$ 857,176</b>	<b>\$ 659,019</b>	<b>\$ 1,299,126</b>	<b>\$ 1,167,073</b>

- (1) Represents Discovery's obligations to purchase goods and services whereby the underlying agreements are enforceable, legally binding and specify all significant terms. The more significant purchase obligations include: agreements related to audience ratings, market research, contracts for entertainment talent and other education and service project agreements.
- (2) The table above does not include certain long-term obligations reflected in the Discovery consolidated balance sheet as the timing of the payments cannot be predicted or the amounts will not be settled in cash. The most significant of these obligations is the \$46.1 million accrued under Discovery's LTIP plans. In addition, amounts accrued in the Discovery consolidated balance sheet related to derivative financial instruments are not included in the table as such amounts may not be settled in cash or the timing of the payments cannot be predicted.

Discovery is subject to certain contractual agreements that may require Discovery to acquire the ownership interests of minority partners. At the end of 2005, Discovery estimates its aggregate obligations thereunder at approximately \$272,502,000. The put rights are exercisable at various dates, certain of which have already been

exercised at December 31, 2005. The amounts due associated with the put rights that have already been exercised is \$80,000,000.

In connection with the execution of long-term distribution agreements for certain of its European cable networks, Discovery is committed to pay a distributor a percentage increase in the value of these networks, if any, on June 30, 2006, six months prior to the termination of the contract on December 31, 2006. Discovery

II-14

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**Table of Contents**

adjusts its recorded liability for changes in the value of these networks each period. However, Discovery is currently unable to predict the likelihood or the terms and conditions of any renewal of the distribution agreements. Discovery will record the effect of a renewed distribution agreement when such terms are in place. The effect of a renewed agreement could result in a payment for an amount significantly greater than the amount currently accrued.

**Item 7A. Quantitative and Qualitative Disclosures about Market Risk.**

**Foreign Currency Risk**

We continually monitor our economic exposure to changes in foreign exchange rates and may enter into foreign exchange agreements where and when appropriate. Substantially all of our foreign transactions are denominated in foreign currencies, including the liabilities of our foreign subsidiaries. Although our foreign transactions are not generally subject to significant foreign exchange transaction gains or losses, the financial statements of our foreign subsidiaries are translated into United States dollars as part of our consolidated financial reporting. As a result, fluctuations in exchange rates affect our financial position and results of operations.

**Item 8. Financial Statements and Supplementary Data.**

Our consolidated financial statements are filed under this Item, beginning on Page II-16. The financial statement schedules required by Regulation S-X are filed under Item 15 of this Annual Report on Form 10-K.

**Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.**

None.

**Item 9A. Controls and Procedures.**

In accordance with Exchange Act Rules 13a-15 and 15d-15, the Company carried out an evaluation, under the supervision and with the participation of management, including its chief executive officer, principal accounting officer and principal financial officer (the Executives), of the effectiveness of its disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Executives concluded that the Company's disclosure controls and procedures were effective as of December 31, 2005 to provide reasonable assurance that information required to be disclosed in its reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

There has been no change in the Company's internal controls over financial reporting that occurred during the three months ended December 31, 2005 that has materially affected, or is reasonably likely to materially affect, its internal controls over financial reporting.

**Item 9B. Other Information.**

None.

**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

The Stockholders and Board of Directors

Discovery Holding Company:

We have audited the accompanying balance sheets of Discovery Holding Company and subsidiaries as of December 31, 2005 and 2004, and the related consolidated statements of operations and comprehensive earnings (loss), stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2005. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of Discovery Communications, Inc., (a 50 percent owned investee company). The Company's investment in Discovery Communications, Inc. at December 31, 2005 and 2004, was \$3,018,622,000 and \$2,945,782,000, respectively, and its equity in earnings of Discovery Communications, Inc. was \$79,810,000, \$84,011,000 and \$37,271,000 for the years 2005, 2004 and 2003, respectively. The financial statements of Discovery Communications, Inc. were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Discovery Communications, Inc., is based solely on the report of the other auditors.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and the report of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Discovery Holding Company and subsidiaries as of December 31, 2005 and 2004, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

KPMG LLP

Denver, Colorado  
March 23, 2006

II-16

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**Table of Contents**

**DISCOVERY HOLDING COMPANY**  
**Consolidated Balance Sheets**  
**December 31, 2005 and 2004**

	2005	2004
<b>Amounts in thousands</b>		
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 250,352	\$ 21,641
Trade receivables, net	134,615	151,120
Prepaid expenses	10,986	17,399
Other current assets	4,433	8,809
<b>Total current assets</b>	<b>400,386</b>	<b>198,969</b>
Investment in Discovery Communications, Inc. ( Discovery ) (note 5)	3,018,622	2,945,782
Property, plant, and equipment, net (note 6)	256,245	258,741
Goodwill (note 7)	2,133,518	2,135,446
Other assets, net	10,465	25,890
<b>Total assets</b>	<b>\$ 5,819,236</b>	<b>\$ 5,564,828</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 26,854	\$ 33,327
Accrued payroll and related liabilities	21,651	23,632
Other accrued liabilities	23,949	29,606
Deferred revenue	17,491	20,858
Due to Liberty Media Corporation ( Liberty )		1,104
<b>Total current liabilities</b>	<b>89,945</b>	<b>108,527</b>
Deferred income tax liabilities (note 11)	1,131,505	1,083,964
Other liabilities	22,361	25,058
<b>Total liabilities</b>	<b>1,243,811</b>	<b>1,217,549</b>
Commitments and contingencies (note 16)		
Stockholders' equity (note 12):		
Preferred stock, \$.01 par value. Authorized 50,000,000 shares; no shares issued		
Series A common stock, \$.01 par value Authorized 600,000,000 shares; issued and outstanding 268,097,442 shares at December 31, 2005	2,681	
Series B common stock, \$.01 par value. Authorized 50,000,000 shares; issued and outstanding 12,106,093 shares at December 31, 2005	121	

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Series C common stock, \$.01 par value. Authorized  
600,000,000 shares; no shares issued

Additional paid-in capital	5,712,304	
Parent's investment		5,506,066
Accumulated deficit	(1,137,821)	(1,171,097)
Accumulated other comprehensive earnings (loss)	(1,860)	12,310
Total stockholders' equity	4,575,425	4,347,279
Total liabilities and stockholders' equity	\$ 5,819,236	\$ 5,564,828

See accompanying notes to consolidated financial statements.

II-17

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**Table of Contents**

**DISCOVERY HOLDING COMPANY**  
**Consolidated Statements of Operations and Comprehensive Earnings (Loss)**  
**Years ended December 31, 2005, 2004 and 2003**

	2005	2004	2003
	Amounts in thousands		
Net revenue	\$ 694,509	\$ 631,215	\$ 506,103
Operating expenses:			
Cost of services	445,839	380,290	301,005
Selling, general, and administrative ( SG&A )	170,045	153,130	128,918
Depreciation and amortization	76,377	77,605	70,526
Stock compensation SG&A	4,383	2,775	2,602
Restructuring and other charges	4,112		3,476
Loss (gain) on sale of operating assets	(4,845)	429	1,418
Impairment of goodwill		51	562
	250,072	233,990	207,502
Operating income (loss)	(1,402)	16,935	(2,404)
Other income (expense):			
Share of earnings of Discovery	79,810	84,011	37,271
Interest expense third party			(47,489)
Interest to parent			(24,689)
Other, net	3,704	132	2,821
	83,514	84,143	(32,086)
Earnings (loss) before income taxes and minority interest	82,112	101,078	(34,490)
Income tax expense	(48,836)	(34,970)	(20,156)
Minority interests in losses of subsidiaries			2,252
Net earnings (loss)	\$ 33,276	\$ 66,108	\$ (52,394)
Other comprehensive earnings (loss), net of taxes (note 14):			
Unrealized holding gains (losses) arising during the period	651	(1,162)	1,770
Foreign currency translation adjustments	(14,821)	6,797	7,528
Other comprehensive earnings (loss)	(14,170)	5,635	9,298
Comprehensive earnings (loss)	\$ 19,106	\$ 71,743	\$ (43,096)
Basic and diluted earnings (loss) per common share (note 3)	\$ 0.12	\$ 0.24	\$ (0.19)

See accompanying notes to consolidated financial statements.





**Table of Contents**

**DISCOVERY HOLDING COMPANY**  
**Consolidated Statements of Cash Flows**  
**Years ended December 31, 2005, 2004 and 2003**

	2005	2004	2003
	Amounts in thousands (see note 4)		
<b>Cash flows from operating activities:</b>			
Net earnings (loss)	\$ 33,276	\$ 66,108	\$ (52,394)
Adjustments to reconcile net earnings (loss) to net cash provided by operating activities:			
Depreciation and amortization	76,377	77,605	70,526
Stock compensation	4,383	2,775	2,602
Payments for stock compensation	(2,139)		
Impairment of goodwill		51	562
Noncash interest expense			26,218
Amortization of debt discount			19,044
Share of earnings of Discovery	(79,810)	(84,011)	(37,271)
Deferred income tax expense	50,363	31,692	17,653
Other non-cash charges (credits), net	(4,684)	706	(3,149)
Changes in assets and liabilities (net of acquisitions):			
Trade receivables	16,237	(36,405)	(4,040)
Prepaid expenses and other current assets	10,804	(6,631)	(3,069)
Payables and other liabilities	(19,516)	32,432	(7,000)
<b>Net cash provided by operating activities</b>	<b>85,291</b>	<b>84,322</b>	<b>29,682</b>
<b>Cash flows from investing activities:</b>			
Capital expenditures	(90,526)	(49,292)	(25,863)
Cash paid for acquisitions		(44,238)	
Net sales (purchases) of marketable securities	12,800	(12,800)	
Cash proceeds from dispositions	15,374	3,978	5,453
Other investing activities, net	(394)	73	177
<b>Net cash used in investing activities</b>	<b>(62,746)</b>	<b>(102,279)</b>	<b>(20,233)</b>
<b>Cash flows from financing activities:</b>			
Net cash transfers from Liberty	206,044	30,999	
Borrowings of long-term debt			2,945
Payments of long-term debt and capital lease obligations	(12)		(406,820)
Borrowings under convertible subordinated notes with Liberty			391,027
Other financing activities	134		
<b>Net cash provided by (used in) financing activities</b>	<b>206,166</b>	<b>30,999</b>	<b>(12,848)</b>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>228,711</b>	<b>13,042</b>	<b>(3,399)</b>
<b>Cash and cash equivalents at beginning of year</b>	<b>21,641</b>	<b>8,599</b>	<b>11,998</b>

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Cash and cash equivalents at end of year	\$ 250,352	\$ 21,641	\$ 8,599
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See accompanying notes to consolidated financial statements.

II-19

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**Table of Contents**

**DISCOVERY HOLDING COMPANY**  
**Consolidated Statements of Stockholders' Equity**  
**Years ended December 31, 2005, 2004 and 2003**

	Preferred Stock	Common Stock Series A Series B Series C	Additional Paid-In Capital	Parent's Investment	Accumulated Deficit	Accumulated Other Comprehensive Earnings (Loss)	Total Stockholders' Equity	
<b>Amounts in thousands</b>								
Balance at January 1, 2003	\$	\$	\$	\$	\$ 4,804,212	\$ (1,184,811)	\$ (1,984)	\$ 3,617,417
Net loss					(52,394)		(52,394)	
Other comprehensive earnings						9,298	9,298	
Issuance of stock for interest on convertible subordinated notes				11,129			11,129	
Conversion of debt to equity				654,330			654,330	
Reallocation of enterprise level goodwill from Liberty				15,000			15,000	
Acquisition of Ascent Media's minority interest				5,811			5,811	
Other				317		(639)	(322)	
Balance at December 31, 2003				5,490,799	(1,237,205)	6,675	4,260,269	
Net earnings					66,108		66,108	
Other comprehensive earnings						5,635	5,635	
Stock compensation				2,268			2,268	
Reallocation of enterprise level goodwill from Liberty				(18,000)			(18,000)	
				30,999			30,999	

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Net cash  
transfers from  
Liberty

Balance at December 31, 2004				5,506,066	(1,171,097)	12,310	4,347,279				
Net earnings					33,276		33,276				
Other comprehensive loss						(14,170)	(14,170)				
Stock compensation		640		2,222			2,862				
Net cash transfers from Liberty				206,044			206,044				
Change in capitalization in connection with Spin Off (note 2)	2,681	121	5,711,530	(5,714,332)							
Stock option exercises			134				134				
Balance at December 31, 2005	\$	\$ 2,681	\$ 121	\$	\$ 5,712,304	\$	\$ (1,137,821)	\$	(1,860)	\$	4,575,425

See accompanying notes to consolidated financial statements.

II-20

**Table of Contents**

**DISCOVERY HOLDING COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**December 31, 2005, 2004 and 2003**

**(1) Basis of Presentation**

The accompanying consolidated financial statements of Discovery Holding Company ( DHC or the Company ) represent a combination of the historical financial information of (1) Ascent Media Group, LLC (f/k/a Ascent Media Group, Inc., Ascent Media ), a wholly-owned subsidiary of Liberty, and Liberty 's 50% ownership interest in Discovery for periods prior to the July 21, 2005 consummation of the spin off transaction ( the Spin Off ) described in note 2 and (2) DHC and its consolidated subsidiaries for the period following such date. The Spin Off has been accounted for at historical cost due to the pro rata nature of the distribution. Accordingly, DHC 's historical financial statements are presented in a manner similar to a pooling of interests.

Ascent Media is comprised of three operating divisions or groups. Ascent Media 's Creative Services group provides services necessary to complete the creation of original content, including feature films, mini-series, television shows, television commercials, music videos, promotional and identity campaigns, and corporate communications programming. The group manipulates or enhances original visual images or audio captured in principal photography or creates new three dimensional images, animation sequences, or sound effects. The Media Management Services group provides owners of content libraries with an entire complement of facilities and services necessary to optimize, archive, manage, and repurpose media assets for global distribution via freight, satellite, fiber, and the Internet. The Networks Services group provides the facilities and services necessary to assemble and distribute programming content for cable and broadcast networks via fiber, satellite, and the Internet to viewers in North America, Europe, and Asia. Additionally, the Networks Services group provides systems integration, design, consulting, engineering and project management services.

Discovery is a global media and entertainment company that provides original and purchased cable and satellite television programming in the United States and over 160 other countries. Discovery also develops and sells branded commerce and educational product lines in the United States.

**(2) Spin Off Transaction**

During the first quarter of 2005, the Board of Directors of Liberty (the Board ) approved a resolution to spin off the capital stock of DHC to the holders of Liberty Series A and Series B common stock. The Spin Off was effected as a dividend by Liberty to holders of its Series A and Series B common stock of shares of DHC Series A and Series B common stock, respectively. Holders of Liberty common stock on July 15, 2005 (the Record Date ) received 0.10 of a share of DHC Series A common stock for each share of Liberty Series A common stock owned and 0.10 of a share of DHC Series B common stock for each share of Liberty Series B common stock owned. Approximately 268.1 million shares of DHC Series A common stock and 12.1 million shares of DHC Series B common stock were issued in the Spin Off. The Spin Off did not involve the payment of any consideration by the holders of Liberty common stock and is intended to qualify as a tax-free transaction.

In addition to Ascent Media and its investment in Discovery, Liberty transferred \$200 million in cash to a subsidiary of DHC prior to the Spin Off.

Following the Spin Off, the Company and Liberty operate independently, and neither has any stock ownership, beneficial or otherwise, in the other. In connection with the Spin Off, the Company and Liberty entered into certain agreements in order to govern certain of the ongoing relationships between the Company and Liberty after the Spin Off and to provide for an orderly transition. These agreements include a Reorganization Agreement, a Services Agreement and a Tax Sharing Agreement.

The Reorganization Agreement provides for, among other things, the principal corporate transactions required to effect the Spin Off and cross indemnities. Pursuant to the Services Agreement, Liberty provides

**Table of Contents****DISCOVERY HOLDING COMPANY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the Company with office space and certain general and administrative services including legal, tax, accounting, treasury and investor relations support. The Company reimburses Liberty for direct, out-of-pocket expenses incurred by Liberty in providing these services and for the Company's allocable portion of costs associated with any shared services or personnel. Liberty and DHC have agreed that they will review cost allocations every six months and adjust such charges, if appropriate.

Under the Tax Sharing Agreement, Liberty will generally be responsible for U.S. federal, state, local and foreign income taxes reported on a consolidated, combined or unitary return that includes the Company or one of its subsidiaries and Liberty or one of its subsidiaries. The Company will be responsible for all other taxes that are attributable to the Company or one of its subsidiaries, whether accruing before, on or after the Spin Off. The Tax Sharing Agreement requires that the Company will not take, or fail to take, any action where such action, or failure to act, would be inconsistent with or prohibit the Spin Off from qualifying as a tax-free transaction. Moreover, the Company has indemnified Liberty for any loss resulting from (i) such action or failure to act or (ii) any agreement, understanding, arrangement or substantial negotiations entered into by DHC prior to the day after the first anniversary of the Spin Off, with respect to any transaction pursuant to which any of the other shareholders of Discovery would acquire shares of, or other interests in DHC's capital stock, in each case relating to the qualification of the Spin Off.

**(3) Summary of Significant Accounting Policies*****Cash and Cash Equivalents***

The Company considers investments with original purchased maturities of three months or less to be cash equivalents.

***Trade Receivables***

Trade receivables are shown net of an allowance based on historical collection trends and management's judgment regarding the collectibility of these accounts. These collection trends, as well as prevailing and anticipated economic conditions, are routinely monitored by management, and any adjustments required are reflected in current operations. The allowance for doubtful accounts as of December 31, 2005 and 2004 was \$7,708,000 and \$12,104,000, respectively.

A summary of activity in the allowance for doubtful accounts is as follows:

	<b>Balance Beginning of Year</b>	<b>Charged (Credited) to Expense</b>	<b>Acquired or Charged to Other Accounts</b>	<b>Write-Offs and Other</b>	<b>Balance End of Year</b>
	<b>Amounts in thousands</b>				
2005	\$ 12,104	\$ (619)	\$ (768)	\$ (3,009)	\$ 7,708
2004	\$ 11,580	\$ 555	\$ (403)	\$ 372	\$ 12,104
2003	\$ 9,013	\$ (5)	\$ 2,004	\$ 568	\$ 11,580

***Concentration of Credit Risk and Significant Customers***

For the years ended December 31, 2005, 2004 and 2003, no single customer accounted for more than 10% of consolidated revenue.

***Investment in Discovery***

DHC accounts for its 50% ownership interest in Discovery using the equity method of accounting. Under this method, the investment, originally recorded at cost, is adjusted to recognize the Company's share of the



**Table of Contents****DISCOVERY HOLDING COMPANY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

net earnings or losses of Discovery as they occur, rather than as dividends or other distributions are received. The excess of the Company's carrying value over its proportionate share of Discovery's equity is accounted for as equity method goodwill, and accordingly, is not amortized, but periodically reviewed for impairment.

Changes in the Company's proportionate share of the underlying equity of Discovery which result from the issuance of additional equity securities by Discovery are recognized as increases or decreases in stockholders' equity. No such adjustments were recorded during the three years ended December 31, 2005.

The Company periodically compares the carrying value of its investment in Discovery to its estimated fair value to determine if there are any other-than-temporary declines in value, which would require an adjustment in the statement of operations. The estimated fair value of the investment in Discovery exceeds its carrying value for all periods presented.

***Property and Equipment***

Property and equipment are carried at cost and depreciated using the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized over the shorter of their estimated useful lives or the term of the underlying lease. Estimated useful lives by class of asset are as follows:

Buildings	20 years
Leasehold improvements	15 years or lease term, if shorter
Furniture and fixtures	7 years
Computers	3 years
Machinery and equipment	5 to 7 years

Depreciation expense for property and equipment was \$74,805,000, \$74,986,000 and \$68,032,000 for the years ended December 31, 2005, 2004 and 2003, respectively.

***Goodwill***

The Company accounts for its goodwill pursuant to the provisions of SFAS No. 142, *Goodwill and Other Intangible Assets* ( SFAS No. 142 ). In accordance with SFAS No. 142, the Company reviews the impairment of goodwill annually and whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

***Other Intangible Assets***

Amortizable other intangible assets are amortized on a straight-line basis over their estimated useful lives of four to five years, and are reviewed for impairment in accordance with SFAS No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets* ( SFAS No. 144 ).

***Long-Lived Assets***

In accordance with SFAS No. 144, management reviews the realizability of its long-lived assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In evaluating the value and future benefits of long-term assets, their carrying value is compared to management's best estimate of undiscounted future cash flows over the remaining amortization period. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying value of the assets exceeds the estimated fair value of the assets.



**Table of Contents**

**DISCOVERY HOLDING COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Foreign Currency Translation***

The functional currencies of the Company's foreign subsidiaries are their respective local currencies. Assets and liabilities of foreign operations are translated into U.S. dollars using exchange rates on the balance sheet date, and revenues and expenses are translated into U.S. dollars using average exchange rates for the period. The effects of the foreign currency translation adjustments are deferred and are included in stockholder equity as a component of accumulated other comprehensive loss.

***Revenue Recognition***

Revenue from post-production and certain distribution related services is recognized when services are provided. Revenue on other long-term contracts is recorded on the basis of the estimated percentage of completion of individual contracts. Estimated losses on long-term contracts are recognized in the period in which a loss becomes evident.

Prepayments received for services to be performed at a later date are reflected in the consolidated balance sheets as deferred revenue until such services are provided.

***Income Taxes***

The Company accounts for income taxes under Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes* ( SFAS No. 109 ). SFAS No. 109 is an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's consolidated financial statements or tax returns. In estimating future tax consequences, SFAS No. 109 generally considers all expected future events other than proposed changes in the tax law or rates.

***Advertising Costs***

Advertising costs generally are expensed as incurred. Advertising expense aggregated \$3,465,000, \$3,303,000 and \$3,089,000 for the years ended December 31, 2005, 2004 and 2003, respectively.

***Stock-Based Compensation***

Employees of the Company hold stock options and stock appreciation rights ( SARs ) with respect to shares of Liberty Series A common stock. In addition, executive officers of the Company hold stock options with respect to shares of DHC common stock. The Company applies the intrinsic-value-based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations including FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation, an interpretation of APB Opinion No. 25*, to account for its fixed-plan stock options. Under this method, compensation expense is recorded on the date of grant only if the current market price of the underlying stock exceeds the exercise price and is recognized on a straight-line basis over the vesting period. SFAS No. 123, *Accounting for Stock-Based Compensation*, established accounting and disclosure requirements using a fair-value-based method of accounting for stock-based employee compensation plans. As allowed by SFAS No. 123, the Company has elected to continue to apply the intrinsic-value-based method of accounting described above and has adopted only the disclosure requirements of SFAS No. 123.

The following table illustrates the effect on net earnings (loss) if the fair-value-based method had been applied to all outstanding and unvested awards in each period. Compensation expense for SARs is the same

**Table of Contents****DISCOVERY HOLDING COMPANY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

under APB Opinion No. 25 and SFAS No. 123. Accordingly, no pro forma adjustment for such awards is included in the following table.

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>Amounts in thousands, except per share amounts</b>		
Net earnings (loss), as reported	\$ 33,276	\$ 66,108	\$ (52,394)
Add:			
Stock-based employee compensation expense included in reported net earnings (loss)	2,309	2,268	2,452
Deduct:			
Stock-based employee compensation expense determined under fair value based method for all awards	(8,247)	(6,247)	(4,817)
Pro forma net earnings (loss)	\$ 27,338	\$ 62,129	\$ (54,759)
Basic and diluted earnings (loss) per common share:			
As reported	\$ .12	\$ .24	\$ (.19)
Pro forma	\$ .10	\$ .22	\$ (.20)

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

Basic earnings (loss) per common share ( EPS ) is computed by dividing net earnings (loss) by the weighted average number of common shares outstanding for the period. EPS in the accompanying consolidated statements of operations is based on (1) 280,199,000 shares, which is the number of shares issued in the Spin Off, for all periods prior to the Spin Off and (2) the actual number of shares outstanding for all periods subsequent to the Spin Off. The weighted average outstanding shares for the year ended December 31, 2005 was 279,557,000. Dilutive EPS presents the dilutive effect on a per shares basis of potential common shares as if they had been converted at the beginning of the periods presented. Due to the relative insignificance of the dilutive securities in 2005 and 2004, their inclusion does not impact the EPS amount as reported in the accompanying consolidated statements of operations.

***Estimates***

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ( GAAP ) requires management to make estimates and assumptions that affect the reported amounts of revenue and expenses for each reporting period. The significant estimates made in preparation of the Company's consolidated financial statements primarily relate to valuation of goodwill, other intangible assets, long-lived assets, deferred tax assets, and the amount of the allowance for doubtful accounts. Actual results could differ from the estimates upon which the carrying values were based.

***Recent Accounting Pronouncements***

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payments* ( Statement 123R ). Statement 123R, which is a revision of Statement 123 and supersedes APB Opinion No. 25, establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services, primarily focusing on transactions in which an entity obtains employee services. Statement 123R generally requires companies to measure the cost of employee services received in exchange for an award of equity instruments (such as stock options and restricted stock) based on the grant-date fair value of the award, and to recognize that cost over



**Table of Contents****DISCOVERY HOLDING COMPANY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the period during which the employee is required to provide service (usually the vesting period of the award). Statement 123R also requires companies to measure the cost of employee services received in exchange for an award of liability instruments (such as stock appreciation rights) based on the current fair value of the award, and to remeasure the fair value of the award at each reporting date.

Public companies are required to adopt Statement 123R as of the beginning of the registrant's next fiscal year, or January 1, 2006 for calendar-year companies such as DHC. The provisions of Statement 123R will affect the accounting for all awards granted, modified, repurchased or cancelled after December 31, 2005. The accounting for awards granted, but not vested, prior to January 1, 2006 will also be impacted. The provisions of Statement 123R allow companies to adopt the standard on a prospective basis or to restate all periods for which Statement 123 was effective. The Company expects to adopt Statement 123R on a prospective basis, and will include in its financial statements for periods that begin after December 31, 2005 pro forma information as though the standard had been adopted for all periods presented.

While the Company has not yet quantified the impact of adopting Statement 123R, it does not believe that such adoption will have a significant impact on its operating income and net earnings in the future.

**(4) Supplemental Disclosure of Cash Flow Information**

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>Amounts in thousands</b>			
<b>Cash paid for acquisitions:</b>			
Fair value of assets acquired	\$	\$ 60,950	\$ 11,811
Net liabilities assumed		(17,073)	(6,000)
Deferred tax liability		361	
Issuance of Liberty common stock			(5,811)
Cash paid for acquisitions, net of cash acquired	\$	\$ 44,238	\$
<b>Cash paid during the year for:</b>			
Interest	\$	\$	\$ 25,206
Income taxes	\$ 1,190	\$ 1,916	\$ 731
<b>Noncash investing and financing activities:</b>			
Stock issued for payment of interest on convertible subordinated notes	\$	\$	\$ 11,129
Conversion of subordinated notes to parent's investment	\$	\$	\$ 654,330

**(5) Investment in Discovery**

The Company has a 50% ownership interest in Discovery and accounts for its investment using the equity method of accounting. Discovery is a global media and entertainment company, that provides original and purchased video programming in the United States and over 160 other countries.

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DHC's carrying value for Discovery was \$3,018,622,000 at December 31, 2005. In addition, as described in note 3, \$1,771,000,000 of enterprise-level goodwill has been allocated to the investment in Discovery.

Prior to the Spin Off, it was necessary for Liberty to periodically reallocate its enterprise level goodwill due to changes in reporting units caused by transactions or by internal reorganizations. These reallocation adjustments were made based on the relative fair values of the remaining reporting units in accordance with

II-26

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**Table of Contents****DISCOVERY HOLDING COMPANY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

SFAS No. 142. As a result, there were adjustments to the enterprise level goodwill allocated to DHC in 2003 and 2004. Such adjustments are reflected in DHC's consolidated statement of stockholder's equity.

Included in the Company's share of earnings of Discovery in 2003 is the Company's 50% share of adjustments to the redemption value of redeemable common stock held by an officer of Discovery. Such adjustments were recorded as reductions to equity by Discovery. These shares were redeemed in June 2003.

Summarized financial information for Discovery is as follows:

**Consolidated Balance Sheets**

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
	<b>Amounts in thousands</b>	
Current assets	\$ 831,369	\$ 835,450
Property and equipment	397,578	380,290
Goodwill and intangible assets	397,927	445,221
Programming rights, long term	1,175,988	1,027,379
Other assets	371,758	547,346
 Total assets	 \$ 3,174,620	 \$ 3,235,686
Current liabilities	\$ 692,465	\$ 880,561
Long-term debt	2,590,440	2,498,287
Other liabilities	101,571	165,197
Mandatorily redeemable equity in subsidiaries	272,502	319,567
Stockholders' deficit	(482,358)	(627,926)
 Total liabilities and stockholders' deficit	 \$ 3,174,620	 \$ 3,235,686

**Consolidated Statements of Operations**

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>Amounts in thousands</b>		
Revenue	\$ 2,671,754	\$ 2,365,346	\$ 1,995,047
Operating expenses	(979,765)	(846,316)	(751,578)
Selling, general and administrative	(1,005,351)	(856,340)	(735,017)
Equity-based compensation	(49,465)	(71,515)	(74,119)
Depreciation and amortization	(123,209)	(129,011)	(120,172)
Gain on sale of patent		22,007	
 Operating income	 513,964	 484,171	 314,161
Interest expense	(184,575)	(167,420)	(159,409)
Other expense	(7,426)	(6,930)	(16,730)

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Income tax expense	(162,343)	(141,799)	(74,785)
Net income	\$ 159,620	\$ 168,022	\$ 63,237

II-27

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**Table of Contents**

**DISCOVERY HOLDING COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(6) Property and Equipment**

During the year ended December 31, 2005, the Company retired approximated \$83 million of fully depreciated property and equipment. Property and equipment at December 31, 2005 and 2004 consist of the following:

	<b>2005</b>	<b>2004</b>
<b>Amounts in thousands</b>		
Property and equipment, net:		
Land	\$ 48,365	\$ 58,048
Buildings	186,389	183,985
Equipment	215,595	226,188
Accumulated depreciation	(194,104)	(209,480)
	\$ 256,245	\$ 258,741

**(7) Goodwill and Other Intangible Assets**

SFAS No. 142 prescribes the financial accounting and reporting for acquired goodwill and other intangible assets. Under SFAS No. 142, goodwill is not amortized, but is tested annually for impairment. SFAS No. 142 also requires that intangible assets with estimable useful lives be amortized over their respective estimated useful lives to their estimated residual values, and be reviewed for impairment in accordance with SFAS No. 144.

In fiscal 2004 and 2003, the Company recorded impairment charges of \$51,000 and \$562,000, respectively, as a result of the annual impairment test of goodwill in accordance with SFAS No. 142. The fair value of each reporting unit was determined through the use of an outside independent valuation consultant. The consultant used both the income approach and market approach in determining fair value.

SFAS No. 142 requires the Company to consider equity method affiliates as separate reporting units. As a result, a portion of DHC's enterprise-level goodwill balance has been allocated to a separate reporting unit which includes only its investment in Discovery. This allocation is performed for goodwill impairment testing purposes only and does not change the reported carrying value of the investment. However, to the extent that all or a portion of an equity method investment which is part of a reporting unit containing allocated goodwill is disposed of in the future, the allocated portion of goodwill will be relieved and included in the calculation of the gain or loss on disposal.

The following table provides the activity and balances of goodwill:

	<b>Creative Services Group</b>	<b>Media Management Services Group</b>	<b>Network Services Group</b>	<b>Discovery</b>	<b>Total</b>
<b>Amounts in thousands</b>					
Net balance at January 1, 2004	\$ 107,428	\$ 88,025	\$ 146,444	\$ 1,789,000	\$ 2,130,897
Acquisitions		5,325	17,379		22,704
Foreign exchange and other			(104)	(18,000)	(18,104)
2004 Impairment	(51)				(51)
	107,377	93,350	163,719	1,771,000	2,135,446



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Net balance at December 31, 2004					
Foreign exchange and other	(778)	52	(1,202)		(1,928)
Net balance at December 31, 2005	\$ 106,599	\$ 93,402	\$ 162,517	\$ 1,771,000	\$ 2,133,518

II-28

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**Table of Contents**

**DISCOVERY HOLDING COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Included in other assets at December 31, 2005 are amortizable intangibles with a net book value of \$1,442,000 and a tradename intangible (which is not subject to amortization) of \$2,440,000.

For the years ended December 31, 2005, 2004 and 2003, the Company recorded \$1,572,000, \$2,619,000 and \$2,494,000, respectively, of amortization expense for other intangible assets.

**(8) Restructuring Charges**

During 2005 and 2003, the Company completed certain restructuring activities designed to improve operating efficiencies and to strengthen its competitive position in the marketplace primarily through cost and expense reductions. In connection with these integration and consolidation initiatives, the Company recorded charges of \$4,112,000 and \$3,476,000, respectively. The 2005 restructuring charge relates primarily to the closure and consolidation of facilities in the United Kingdom. The 2003 restructuring charge is related to the consolidation of facilities and closure-related costs in the Creative Services group both domestically and in the United Kingdom.

The following table provides the activity and balances of the restructuring reserve.

	<b>Opening Balance</b>	<b>Additions</b>	<b>Deductions</b>	<b>Ending Balance</b>
<b>Amounts in thousands</b>				
Excess facility costs	\$ 2,227	\$ 2,130	\$ (980)	\$ 3,377
Employee separations		1,170	(1,170)	
Contract exit costs		176	(176)	
December 31, 2003	\$ 2,227	\$ 3,476	\$ (2,326)	\$ 3,377
Excess facility costs				
December 31, 2004	\$ 3,377	\$	\$ (788)	\$ 2,589
Excess facility costs				
December 31, 2005	\$ 2,589	\$ 4,112	\$ (2,718)	\$ 3,983

**(9) Acquisitions*****London Playout Centre.***

On March 12, 2004, pursuant to an Agreement for the Sale and Purchase, Ascent Media acquired all of the issued share capital of London Playout Centre Limited ( LPC ) from an independent third party for a purchase price of \$36,573,000 paid at closing. LPC is a UK-based television channel origination facility. The purchase was funded, in part, by proceeds from Liberty. The financial position and results of operations of LPC have been consolidated since the date of acquisition.

The following unaudited pro forma information for the years ended December 31, 2004 and 2003 was prepared assuming the acquisition of LPC occurred on January 1, 2003. However, those pro forma amounts are not necessarily indicative of operating results that would have occurred if the LPC acquisition had occurred on January 1, 2003 (amounts in thousands, except per share amounts):

	<b>2004</b>	<b>2003</b>
Revenue	\$ 639,718	\$ 547,912
Net earnings (loss)	\$ 65,317	\$ (53,194)

Basic and diluted net earnings (loss) per common share	\$	0.23	\$	(0.19)
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II-29

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**Table of Contents**

**DISCOVERY HOLDING COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(10) Long-Term Debt*****Liberty Subordinated Credit Agreement***

In December 2000, when Ascent Media was a publicly traded company and had a senior bank credit facility, Liberty and Ascent Media entered into a subordinated credit agreement pursuant to which Liberty agreed to make subordinated convertible loans to Ascent Media. From December 2000 through December 2003, Ascent Media borrowed funds under the subordinated credit agreement as needed, and as agreed to by its senior lenders, for acquisitions, capital expenditures, working capital and payments under its senior bank credit facility. From December 2000 through June 2003, at which time Liberty acquired the minority interest in Ascent Media held by the public, Ascent Media paid interest at the rate of 10% per annum on the subordinated debt primarily with shares of its common stock. From June 2003 through December 2003, accrued interest was added to the principal amount of debt. In December 2003, Liberty contributed the total amount of debt and accrued interest of \$654,330,000 to equity and the subordinated credit agreement was cancelled.

**(11) Income Taxes**

Deferred income tax assets and liabilities are computed annually for differences between the financial statement and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future. Such deferred income tax asset and liability computations are based on enacted tax laws and rates applicable to periods in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Income tax expense is the tax payable or refundable for the period plus or minus the change during the period in deferred tax assets and liabilities. Income tax benefit (expense) is as follows:

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>Amounts in thousands</b>		
Current			
Federal	\$	\$	\$
State	(637)	502	(1,100)
Foreign	2,164	(3,780)	(1,403)
Current	1,527	(3,278)	(2,503)
Deferred			
Federal	(26,402)	(25,221)	(15,628)
State	(20,743)	(7,774)	(3,494)
Foreign	(3,218)	1,303	1,469
Deferred	(50,363)	(31,692)	(17,653)
Total tax expense	\$ (48,836)	\$ (34,970)	\$ (20,156)

Components of pretax income (loss) are as follows:

**Years Ended December 31,**

	2005	2004	2003
	<b>Amounts in thousands</b>		
Domestic	\$ 76,907	\$ 96,470	\$ (28,772)
Foreign	5,205	4,608	(3,466)
	\$ 82,112	\$ 101,078	\$ (32,238)

II-30

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**Table of Contents**

**DISCOVERY HOLDING COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Income tax benefit (expense) differs from the amounts computed by applying the U.S. federal income tax rate of 35% as a result of the following:

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>Amounts in thousands</b>		
Computed expected tax benefit (expense)	\$ (28,739)	\$ (35,377)	\$ 11,283
State and local income taxes, net of federal income taxes	(3,976)	(5,311)	(2,986)
Change in valuation allowance affecting tax expense	1,630	3,575	(14,719)
Change in estimated state tax rate	(15,263)		
Disallowed interest expense			(13,963)
Other, net	(2,488)	2,143	229
<b>Income tax expense</b>	<b>\$ (48,836)</b>	<b>\$ (34,970)</b>	<b>\$ (20,156)</b>

Components of deferred tax assets and liabilities as of December 31 are as follows:

	<b>2005</b>	<b>2004</b>
	<b>Amounts in thousands</b>	
<b>Current assets:</b>		
Accounts receivable reserves	\$ 2,350	\$ 2,423
Accrued liabilities	14,676	11,987
	17,026	14,410
<b>Noncurrent assets:</b>		
Net operating loss carryforwards	59,064	59,819
Property and equipment	4,771	
Intangible assets	8,249	13,310
Other	5,506	10,280
	77,590	83,409
<b>Total deferred tax assets, gross</b>	<b>94,616</b>	<b>97,819</b>
Valuation allowance	(91,235)	(88,067)
<b>Total deferred tax assets, net</b>	<b>3,381</b>	<b>9,752</b>
<b>Current liabilities:</b>		
Prepaid expenses	(818)	(1,204)
Other	(3,010)	(2,802)
	(3,828)	(4,006)

Noncurrent liabilities:

Property and equipment		(2,760)
Investments	(1,131,058)	(1,086,950)
	(1,131,058)	(1,089,950)
Total deferred tax liabilities	(1,134,886)	(1,093,716)
Net deferred tax liability	\$ (1,131,505)	\$ (1,083,964)

II-31

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**Table of Contents****DISCOVERY HOLDING COMPANY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

At December 31, 2005, the Company has \$86,860,000 and \$463,311,000 in net operating loss carryforwards for federal and state tax purposes, respectively. These net operating losses expire, for federal purposes, as follows: \$24,216,000 in 2021; \$60,711,000 in 2022 and \$1,933,000 in 2025. The state net operating losses expire at various times through 2025. In addition, the Company has \$636,000 of federal income tax credits, which may be carried forward indefinitely. The Company has \$2,584,000 of state income tax credits, of which \$2,342,000 will expire in the year 2012.

During the current year, management has determined that it is more likely than not that the Company will not realize the tax benefits associated with certain cumulative net operating loss carryforwards and other deferred tax assets. As such, the Company continues to maintain a valuation allowance of \$91,235,000. The total valuation allowance increased \$3,168,000 during the year ended December 31, 2005 as a result of deferred tax assets related to acquisitions of \$4,798,000 and a decrease of \$1,630,000 which affected tax expense.

During 2004, the Company provided \$1,636,000 of U.S. tax expense for future repatriation of cash from its Asia operations pursuant to APB 23. This charge represents all undistributed earnings from Asia not previously taxed in the United States.

**(12) Stockholders Equity*****Preferred Stock***

DHC's preferred stock is issuable, from time to time, with such designations, preferences and relative participating, optional or other rights, qualifications, limitations or restrictions thereof, as shall be stated and expressed in a resolution or resolutions providing for the issue of such preferred stock adopted by DHC's Board of Directors. As of December 31, 2005, no shares of preferred stock were issued.

***Common Stock***

Holders of DHC Series A common stock are entitled to one vote for each share held, and holders of DHC Series B common stock are entitled to 10 votes for each share held. Holders of DHC Series C common stock are not entitled to any voting powers, except as required by Delaware law. As of December 31, 2005, no shares of DHC Series C common stock were issued. Each share of the Series B common stock is convertible, at the option of the holder, into one share of Series A common stock.

As of December 31, 2005, there were 1,937,616 shares of DHC Series A common stock and 2,996,525 shares of DHC Series B common stock reserved for issuance under exercise privileges of outstanding stock options and warrants.

**(13) Stock Options**

In connection with the Spin Off, employees of DHC, directors of Liberty and employees of Liberty who held Liberty stock options or Liberty stock appreciation rights ( pre-Spin Off Awards ) and who were expected to provide services to DHC pursuant to the Services Agreement received an option ( DHC Option ) to purchase common stock of DHC equal to 0.10 times the number of shares of Liberty common stock subject to the pre-Spin Off Awards held by the option holder. The exercise price of the DHC Options was based on an allocation of the exercise price of the pre-Spin Off Award. Approximately 2.0 million options to purchase DHC Series A common stock and 3.0 million options to purchase DHC Series B common stock were issued in the Spin Off, and no options have been issued by DHC subsequent to the Spin Off.

Pursuant to the terms of the Reorganization Agreement, DHC is responsible for settlement of all DHC Options. Liberty accounted for its pre-Spin Off Awards as variable awards under APB 25. Accordingly, DHC also accounts for the DHC Options as variable awards. DHC records stock compensation for the DHC



**Table of Contents**

**DISCOVERY HOLDING COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Options held by its executive officers. Liberty records stock compensation for all DHC Options held by Liberty employees and directors.

In addition, certain employees of Ascent Media who held Liberty pre-Spin Off Awards, continue to hold such awards. Ascent Media records stock compensation related to such awards.

The following table presents the number and weighted average exercise price ( WAEP ) of options to purchase DHC Series A and Series B common stock.

	<b>DHC Series A Common Stock</b>	<b>WAEP</b>	<b>DHC Series B Common Stock</b>	<b>WAEP</b>
Options issued in Spin Off	1,954,275	\$ 15.43	2,996,525	\$ 18.87
Exercises	(11,381)	\$ 11.77		
Cancellations	(5,278)	\$ 15.05		
Outstanding at December 31, 2005	1,937,616	\$ 15.43	2,996,525	\$ 18.87
Exercisable at December 31, 2005	1,116,354	\$ 16.44	2,323,633	\$ 19.06

**(14) Other Comprehensive Earnings (Loss)**

Accumulated other comprehensive earnings (loss) included in DHC's consolidated balance sheets and consolidated statements of stockholders' equity reflect the aggregate of foreign currency translation adjustments and unrealized holding gains and losses on available-for-sale securities.

The change in the components of accumulated other comprehensive earnings (loss), net of taxes, is summarized as follows:

	<b>Foreign Currency Translation Adjustments</b>	<b>Unrealized Holding Gains (Losses) on Securities</b>	<b>Accumulated Other Comprehensive Earnings (Loss), Net of Taxes</b>
<b>Amounts in thousands</b>			
Balance at January 1, 2003	\$ (2,034)	\$ 50	\$ (1,984)
Other comprehensive earnings	7,528	1,770	9,298
Other activity	(258)	(381)	(639)
Balance at December 31, 2003	5,236	1,439	6,675
Other comprehensive earnings	6,797	(1,162)	5,635
Balance at December 31, 2004	12,033	277	12,310
Other comprehensive loss	(14,821)	651	(14,170)

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Balance at December 31, 2005	\$	(2,788)	\$	928	\$	(1,860)
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II-33

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**Table of Contents**

**DISCOVERY HOLDING COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The components of other comprehensive earnings (loss) are reflected in DHC's consolidated statements of comprehensive earnings (loss) net of taxes. The following table summarizes the tax effects related to each component of other comprehensive earnings (loss).

	Before-Tax Amount	Tax (Expense) Benefit	Net-of-Tax Amount
<b>Amounts in thousands</b>			
<b>Year ended December 31, 2005:</b>			
Foreign currency translation adjustments	\$ (24,518)	\$ 9,697	\$ (14,821)
Unrealized holding gains on securities arising during period	\$ 1,077	\$ (426)	\$ 651
Other comprehensive loss	\$ (23,441)	\$ 9,271	\$ (14,170)
<b>Year ended December 31, 2004:</b>			
Foreign currency translation adjustments	\$ 11,143	\$ (4,346)	\$ 6,797
Unrealized holding losses on securities arising during period	\$ (1,905)	\$ 743	\$ (1,162)
Other comprehensive earnings	\$ 9,238	\$ (3,603)	\$ 5,635
<b>Year ended December 31, 2003:</b>			
Foreign currency translation adjustments	\$ 12,341	\$ (4,813)	\$ 7,528
Unrealized holding gains on securities arising during period	\$ 2,902	\$ (1,132)	\$ 1,770
Other comprehensive earnings	\$ 15,243	\$ (5,945)	\$ 9,298

**(15) Employee Benefit Plans**

Ascent Media offers a 401(k) defined contribution plan covering most of its full-time domestic employees not eligible to participate in the Motion Picture Industry Pension and Health Plan (MPIPHP), a multi-employer defined benefit pension plan. Contributions to the MPIPHP are determined in accordance with the provisions of negotiated labor contracts and generally are based on the number of hours worked. Ascent Media also sponsors a pension plan for eligible employees of its foreign subsidiaries. Employer contributions are determined by Ascent Media's board of directors. The plans are funded by employee and employer contributions. Total pension plan expenses for the years ended December 31, 2005, 2004 and 2003 were \$7,109,000, \$6,485,000 and \$6,380,000, respectively.

**(16) Commitments and Contingencies**

Future minimum lease payments under scheduled operating leases that have initial or remaining noncancelable terms in excess of one year are as follows (in thousands):

<b>Year ended December 31:</b>	
2006	\$ 30,563
2007	\$ 28,791
2008	\$ 25,886

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2009	\$	23,894
2010	\$	19,265
Thereafter	\$	47,033

Rent expense for noncancelable operating leases for real property and equipment was \$31,643,000, \$26,487,000 and \$21,909,000 for the years ended December 31, 2005, 2004 and 2003, respectively. Various lease arrangements contain options to extend terms and are subject to escalation clauses.

II-34

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**Table of Contents**

**DISCOVERY HOLDING COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

At December 31, 2005, the Company is committed to compensation under long-term employment agreements with its certain executive officers of Ascent Media as follows: 2006, \$2,442,000; 2007, \$1,354,000; and 2008, \$579,000.

The Company is involved in litigation and similar claims incidental to the conduct of its business. In management's opinion, none of the pending actions is likely to have a material adverse impact on the Company's financial position or results of operations.

**(17) Related Party Transactions**

Certain third-party general and administrative and spin off related costs were paid by Liberty on behalf of the Company prior to the Spin Off and reflected as expenses in the accompanying consolidated statements of operations. In addition, certain general and administrative expenses are charged by Liberty to DHC pursuant to the Services Agreement. Such expenses aggregated \$5,948,000 for the year ended December 31, 2005.

Ascent Media provides services, such as satellite uplink, systems integration, origination, and post-production, to Discovery. Revenue recorded by Ascent Media for these services for the years ended December 31, 2005, 2004 and 2003 aggregated \$34,189,000, \$41,785,000 and \$13,355,000, respectively.

**(18) Information About Operating Segments**

The Company's chief operating decision maker, or his designee (the CODM), has identified the Company's reportable segments based on (i) financial information reviewed by the CODM and (ii) those operating segments that represent more than 10% of the Company's combined revenue or earnings before taxes. In addition, those equity investments whose share of earnings represent more than 10% of the Company's earnings before taxes are considered reportable segments.

Based on the foregoing criteria, the Company's business units have been aggregated into four reportable segments: the Creative Services Group, the Media Management Services Group, and the Network Services Group, which are all operating segments of Ascent Media, and Discovery, which is an equity affiliate. Corporate related items and unallocated income and expenses are reflected in the Corporate and Other column listed below.

The Creative Services Group provides post-production services, which are comprised of services necessary to complete the creation of original content including feature films, television shows, movies of the week/mini series, television commercials, music videos, promotional and identity campaigns and corporate communications programming. The Media Management Services Group provides (i) content storage services, which are comprised of facilities and services necessary to optimize, archive, manage and repurpose media assets for global distribution via freight, satellite, fiber and the Internet, (ii) access to all forms of content, duplication and formatting services, (iii) language conversions and laybacks, (iv) restoration and preservation of old or damaged content, (v) mastering from motion picture film to high resolution or data formats, (vi) digital audio and video encoding services and (vii) digital media management services for global home video, broadcast, pay-per-view and emerging new media distribution channels. The Network Services Group provides broadcast services, which are comprised of services necessary to assemble and distribute programming for cable and broadcast networks via fiber and satellite to viewers in North America, Europe and Asia. Additionally, the Networks Services Group provides systems integration, design, consulting, engineering and project management services.

The accounting policies of the segments that are consolidated entities are the same as those described in the summary of significant accounting policies and are consistent with GAAP.

The Company evaluates the performance of these operating segments based on financial measures such as revenue and operating cash flow. The Company defines operating cash flow as revenue less cost of services

**Table of Contents****DISCOVERY HOLDING COMPANY****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

and selling, general and administrative expenses (excluding stock and other equity-based compensation). The Company believes this is an important indicator of the operational strength and performance of its businesses, including the businesses' ability to service debt and capital expenditures. In addition, this measure allows management to view operating results and perform analytical comparisons and identify strategies to improve performance. This measure of performance excludes depreciation and amortization, stock and other equity-based compensation and restructuring and impairment charges that are included in the measurement of operating income pursuant to GAAP. Accordingly, operating cash flow should be considered in addition to, but not as a substitute for, operating income, cash flow provided by operating activities and other measures of financial performance prepared in accordance with GAAP.

The Company's reportable segments are strategic business units that offer different products and services. They are managed separately because each segment requires different technologies, distribution channels and marketing strategies.

Summarized financial information concerning the Company's reportable segments is presented in the following tables:

	<b>Creative Services Group</b>	<b>Media Management Services Group</b>	<b>Network Services Group(1)</b>	<b>Corporate and Other</b>	<b>Consolidated Total</b>	<b>Equity Affiliate- Discovery</b>
<b>Amounts in thousands</b>						
<b>Year ended December 31, 2005</b>						
Revenue from external customers	\$ 304,393	\$ 118,489	\$ 271,627	\$	\$ 694,509	\$ 2,671,754
Operating cash flow	\$ 57,323	\$ 13,481	\$ 55,781	\$ (47,960)	\$ 78,625	\$ 686,638
Capital expenditures	\$ 22,795	\$ 25,252	\$ 37,608	\$ 4,871	\$ 90,526	\$ 99,684
Depreciation and amortization	\$ 30,951	\$ 7,731	\$ 27,008	\$ 10,687	\$ 76,377	\$ 123,209
Total assets	\$ 297,664	\$ 173,637	\$ 322,470	\$ 5,025,465	\$ 5,819,236	\$ 3,174,620
<b>Year ended December 31, 2004</b>						
Revenue from external customers	\$ 295,841	\$ 109,982	\$ 225,392	\$	\$ 631,215	\$ 2,365,346
Operating cash flow	\$ 55,847	\$ 17,430	\$ 62,163	\$ (37,645)	\$ 97,795	\$ 662,690
Capital expenditures	\$ 18,677	\$ 4,142	\$ 23,114	\$ 3,359	\$ 49,292	\$ 88,100
Depreciation and amortization	\$ 31,026	\$ 7,750	\$ 27,074	\$ 11,755	\$ 77,605	\$ 129,011
Total assets	\$ 298,613	\$ 171,588	\$ 294,328	\$ 4,800,299	\$ 5,564,828	\$ 3,235,686
<b>Year ended December 31, 2003</b>						
Revenue from external customers	\$ 270,830	\$ 107,070	\$ 128,203	\$	\$ 506,103	\$ 1,995,047
Operating cash flow	\$ 43,786	\$ 22,074	\$ 43,221	\$ (32,901)	\$ 76,180	\$ 508,452
Capital expenditures	\$ 13,132	\$ 4,751	\$ 5,207	\$ 2,773	\$ 25,863	\$ 109,956
Depreciation and amortization	\$ 28,975	\$ 11,481	\$ 22,171	\$ 7,899	\$ 70,526	\$ 120,172

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Total assets	\$ 305,576	\$ 174,916	\$ 239,939	\$ 4,676,196	\$ 5,396,627	\$ 3,194,211
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(1) Included in Network Services Group revenue is broadcast services revenue of \$148,483,000, \$135,883,000 and \$89,065,000 and systems integration revenue of \$123,144,000, \$89,509,000 and \$39,138,000 in 2005, 2004 and 2003, respectively.

II-36

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**Table of Contents**

**DISCOVERY HOLDING COMPANY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table provides a reconciliation of segment operating cash flow to earnings (loss) before income taxes and minority interest.

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>Amounts in thousands</b>		
Segment operating cash flow	\$ 78,625	\$ 97,795	\$ 76,180
Stock compensation	(4,383)	(2,775)	(2,602)
Depreciation and amortization	(76,377)	(77,605)	(70,526)
Share of earnings of Discovery	79,810	84,011	37,271
Interest expense			(72,178)
Other, net	4,437	(348)	(2,635)
<b>Earnings (loss) before income taxes and minority interest</b>	<b>\$ 82,112</b>	<b>\$ 101,078</b>	<b>\$ (34,490)</b>

Information as to the Company's operations in different geographic areas is as follows:

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>Amounts in thousands</b>		
<b>Revenue</b>			
United States	\$ 525,288	\$ 460,070	\$ 390,220
United Kingdom	149,928	148,002	92,523
Other countries	19,293	23,143	23,360
	<b>\$ 694,509</b>	<b>\$ 631,215</b>	<b>\$ 506,103</b>

**(19) Quarterly Financial Information (Unaudited)**

	<b>1st Quarter</b>	<b>2nd Quarter</b>	<b>3rd Quarter</b>	<b>4th Quarter</b>
	<b>Amounts in thousands, except per share amounts</b>			
<b>2005:</b>				
Revenue	\$ 174,290	\$ 178,019	\$ 167,934	\$ 174,266
Operating income (loss)	\$ 2,877	\$ (4,982)	\$ (1,403)	\$ 2,106
Net earnings	\$ 16,825	\$ 4,027	\$ 1,189	\$ 11,235
Basic and diluted net earnings per common share	\$ .06	\$ .01	\$ .04	\$ .04



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2004:

Revenue	\$ 145,943	\$ 160,477	\$ 151,924	\$ 172,871
Operating income	\$ 5,914	\$ 5,663	\$ 3,464	\$ 1,894
Net earnings	\$ 11,920	\$ 22,257	\$ 16,186	\$ 15,745
Basic and diluted net earnings per common share	\$ .04	\$ .08	\$ .06	\$ .06

II-37

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**Table of Contents**

**PART III.**

The following required information is incorporated by reference to our definitive proxy statement for our 2006 Annual Meeting of Shareholders presently scheduled to be held in the second quarter of 2006:

**Item 10. Directors and Executive Officers of the Registrant**

**Item 11. Executive Compensation**

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

**Item 13. Certain Relationships and Related Transactions**

**Item 14. Principal Accounting Fees and Services**

We will file our definitive proxy statement for our 2006 Annual Meeting of shareholders with the Securities and Exchange Commission on or before April 30, 2006.

III-1

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**Table of Contents****PART IV.****Item 15. Exhibits and Financial Statement Schedules.**(a)(1) Financial Statements

Included in Part II of this Report:

	<b>Page No.</b>
Discovery Holding Company:	
<u>Report of Independent Registered Public Accounting Firm</u>	II-16
<u>Consolidated Balance Sheets, December 31, 2005 and 2004</u>	II-17
<u>Consolidated Statements of Operations and Comprehensive Earnings (Loss), Years ended December 31, 2005, 2004 and 2003</u>	II-18
<u>Consolidated Statements of Cash Flows, Years ended December 31, 2005, 2004 and 2003</u>	II-19
<u>Consolidated Statements of Stockholders' Equity, Years ended December 31, 2005, 2004 and 2003</u>	II-20
<u>Notes to Consolidated Financial Statements, December 31, 2005, 2004 and 2003</u>	II-21

(a)(2) Financial Statement Schedules

Included in Part IV of this Report:

(i) All schedules have been omitted because they are not applicable, not material or the required information is set forth in the financial statements or notes thereto.

(ii) Separate financial statements for Discovery Communications, Inc.:

<u>Report of Independent Registered Public Accounting Firm</u>	IV-4
<u>Consolidated Balance Sheets, December 31, 2005 and 2004</u>	IV-5
<u>Consolidated Statements of Operations, Years ended December 31, 2005, 2004 and 2003</u>	IV-6
<u>Consolidated Statements of Cash Flows, Years ended December 31, 2005, 2004 and 2003</u>	IV-7
<u>Consolidated Statements of Changes in Stockholders' Deficit, Years ended December 31, 2005, 2004 and 2003</u>	IV-8
<u>Notes to Consolidated Financial Statements</u>	IV-9

(a)(3) Exhibits

Listed below are the exhibits which are filed as a part of this Report (according to the number assigned to them in Item 601 of Regulation S-K):

## 2 Plan of Acquisition, Reorganization, Arrangement, Liquidation or Succession:

- 2.1 Reorganization Agreement among Liberty Media Corporation, Discovery Holding Company ( DHC ) and Ascent Media Group, Inc. (incorporated by reference to Exhibit 2.1 to DHC's Registration Statement on Form 10, dated July 15, 2005 (File No. 000-51205) (the Form 10)).

## 3 Articles of Incorporation and Bylaws:

- 3.1 Restated Certificate of Incorporation of DHC (incorporated by reference to Exhibit 3.1 to the Form 10).
- 3.2 Bylaws of DHC (incorporated by reference to Exhibit 3.2 to the Form 10).

4 Instruments Defining the Rights of Securities Holders, including Indentures:

- 4.1 Specimen Certificate for shares of the Series A common stock, par value \$.01 per share, of DHC (incorporated by reference to Exhibit 4.1 to the Form 10).

IV-1

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**Table of Contents**

- 4.2 Specimen Certificate for shares of the Series B common stock, par value \$.01 per share, of DHC (incorporated by reference to Exhibit 4.2 to the Form 10).
- 4.3 Rights Agreement between DHC and EquiServe Trust Company, N.A., as Rights Agent (incorporated by reference to Exhibit 4.3 to the Form 10).

10 Material Contracts:

- 10.1 The Shareholders Agreement, dated as of November 30, 1991 (the Stockholders Agreement ), by and among Discovery Communications, Inc. ( Discovery ), Cox Discovery, Inc. ( Cox ), NewsChannels TDC Investments, Inc. ( NewChannels ), TCI Cable Education, Inc. ( TCID ) and John S. Hendricks ( Hendricks ) (incorporated by reference to Exhibit 10.1 to the Form 10).
- 10.2 First Amendment to the Stockholders Agreement, dated as of December 20, 1996, by and among Discovery, Cox Communications Holdings, Inc. (the successor to Cox), Newhouse Broadcasting Corporation ( the successor to NewChannels), TCID, Hendricks and for the purposes stated therein only, LMC Animal Planet, Inc. ( LMC ) and Liberty Media Corporation, a Colorado corporation ( Liberty ) (incorporated by reference to Exhibit 10.2 to the Form 10).
- 10.3 Second Amendment to the Stockholders Agreement, dated as of September 7, 2000, by and among Discovery, Cox Communications Holdings, Inc. (the successor to Cox), Advance/Newhouse Programming Partnership (the successor to NewChannels), LMC Discovery, Inc. (formerly known as TCID) and Hendricks (incorporated by reference to Exhibit 10.3 to the Form 10).
- 10.4 Third Amendment to the Stockholders Agreement, dated as of September, 2001, by and among Discovery, Cox, NewChannels, TCID, Hendricks and Advance Programming Holdings Corp. (incorporated by reference to Exhibit 10.4 to the Form 10).
- 10.5 Fourth Amendment to the Stockholders Agreement, dated as of June 23, 2003, by and among Discovery, Cox NewChannels, TCID, Liberty Animal, Inc. (the successor in interest to LMC) for the purposes stated in the First Amendment to the Stockholders Agreement, and Hendricks (incorporated by reference to Exhibit 10.5 to the Form 10).
- 10.6 Form of Tax Sharing Agreement between Liberty Media Corporation and DHC (incorporated by reference to Exhibit 10.6 to the Form 10).
- 10.7 Discovery Holding Company 2005 Incentive Plan (incorporated by reference to Exhibit 10.7 to the Form 10).
- 10.8 Discovery Holding Company 2005 Non-Employee Director Plan (incorporated by reference to Exhibit 10.8 to the Form 10).
- 10.9 Discovery Holding Company Transitional Stock Adjustment Plan (incorporated by reference to Exhibit 10.9 to the Form 10).
- 10.10 Agreement between DHC and John C. Malone (incorporated by reference to Exhibit 10.10 to the Form 10).
- 10.11 Agreement, dated June 24, 2005, between Discovery and DHC (incorporated by reference to Exhibit 10.11 to the Form 10).
- 10.12 Indemnification Agreement, dated as of June 24, 2005, between Cox and DHC (incorporated by reference to Exhibit 10.12 to the Form 10).
- 10.13 Indemnification Agreement, dated as of June 24, 2005, between NewChannels and DHC (incorporated by reference to Exhibit 10.13 to the Form 10).
- 10.14 Form of Indemnification Agreement with Directors and Executive Officers (incorporated by reference to Exhibit 10.14 to the Form 10).



**Table of Contents**

21	Subsidiaries of Discovery Holding Company, filed herewith.
23.1	Consent of KPMG LLP, filed herewith.
23.2	Consent of PricewaterhouseCoopers LLP, filed herewith.
31.1	Rule 13a-14(a)/15d-14(a) Certification, filed herewith.
31.2	Rule 13a-14(a)/15d-14(a) Certification, filed herewith.
31.3	Rule 13a-14(a)/15d-14(a) Certification, filed herewith.
32	Section 1350 Certification, filed herewith.

**Table of Contents**

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders of  
Discovery Communications, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of changes in stockholders' deficit, and of cash flows present fairly, in all material respects, the financial position of Discovery Communications, Inc. and its subsidiaries at December 31, 2005 and December 31, 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2005 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 9 to the consolidated financial statements, the Company adopted Financial Accounting Standards Board Interpretation No. 46R, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 in 2005.

PricewaterhouseCoopers LLP  
McLean, VA  
March 3, 2006



**Table of Contents**

**Discovery Communications, Inc.**  
**Consolidated Balance Sheets**

	December 31,	
	2005	2004
	(In thousands, except share data)	
<b>ASSETS</b>		
Current assets		
Cash and cash equivalents	\$ 34,491	\$ 24,282
Accounts receivable, less allowances of \$35,079 and \$24,375	565,407	527,659
Inventories	30,714	32,567
Deferred income taxes	88,765	144,606
Content rights, net	55,125	50,578
Other current assets	56,867	55,758
<b>Total current assets</b>	<b>831,369</b>	<b>835,450</b>
Property and equipment, net	397,578	380,290
Content rights, net, less current portion	1,175,988	1,027,379
Deferred launch incentives	255,259	314,601
Goodwill	254,989	257,460
Intangibles, net	142,938	187,761
Investments in and advances to unconsolidated affiliates	11,528	74,450
Deferred income taxes	69,316	114,673
Other assets	35,655	43,622
<b>TOTAL ASSETS</b>	<b>\$ 3,174,620</b>	<b>\$ 3,235,686</b>
<b>LIABILITIES AND STOCKHOLDERS DEFICIT</b>		
Current liabilities		
Accounts payable and accrued liabilities	\$ 371,326	\$ 333,390
Launch incentives payable	22,655	33,509
Content rights payable	97,075	94,969
Current portion of long-term incentive plan liabilities	20,690	261,627
Current portion of long-term debt	6,470	9,736
Income taxes payable	51,226	21,123
Unearned revenue	89,803	95,585
Other current liabilities	33,220	30,622
<b>Total current liabilities</b>	<b>692,465</b>	<b>880,561</b>
Long-term debt, less current portion	2,590,440	2,498,287
Derivative financial instruments, less current portion	18,592	46,541
Launch incentives payable, less current portion	21,910	34,328
Long-term incentive plan liabilities, less current portion	25,380	60,735

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Content rights payable, less current portion	4,380	8,027
Other liabilities	31,309	15,566
Total liabilities	3,384,476	3,544,045
Mandatorily redeemable interests in subsidiaries	272,502	319,567
Commitments and contingencies		
<b>Stockholders deficit</b>		
Class A common stock; \$.01 par value; 100,000 shares authorized; 51,119 shares issued, less 719 shares of treasury stock	1	1
Class B common stock; \$.01 par value; 60,000 shares authorized; 50,615 shares issued and held in treasury stock at December 31, 2005 and 2004		
Additional paid-in capital	21,093	21,093
Accumulated deficit	(513,311)	(672,931)
Accumulated other comprehensive income	9,859	23,911
Total stockholders deficit	(482,358)	(627,926)
<b>TOTAL LIABILITIES AND STOCKHOLDERS DEFICIT</b>	<b>\$ 3,174,620</b>	<b>\$ 3,235,686</b>

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





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Cash used by investing activities	(179,240)	(249,624)	(169,571)
<b>FINANCING ACTIVITIES</b>			
Proceeds from issuance of long-term debt	1,785,955	1,848,000	
Principal payments of long-term debt	(1,697,068)	(1,699,215)	(12,638)
Deferred financing fees	(4,810)	(8,499)	(56)
Contributions from minority shareholders	603	3,146	21,652
Increase in note receivable from stockholder			(5,238)
Collection of note receivable from stockholder			23,600
Repurchase of Class A common stock			(55,334)
Other financing	32,153	(30,840)	42,325
Cash provided by financing activities	116,833	112,592	14,311
Effect of exchange rate changes on cash	3,723	2,535	1,215
<b>CHANGE IN CASH AND CASH EQUIVALENTS</b>			
	10,209	(9,793)	251
Cash and cash equivalents, beginning of year	24,282	34,075	33,824
<b>CASH AND CASH EQUIVALENTS, END OF YEAR</b>	<b>\$ 34,491</b>	<b>\$ 24,282</b>	<b>\$ 34,075</b>

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

Table of Contents

**Discovery Communications, Inc.**  
**Consolidated Statements of Changes in Stockholders Deficit**

	Other Comprehensive Income (Loss)							Total
	Class A	Additional	Foreign	Unrealized	Unamortized			
	At Par	Paid-In Capital	Currency Translation	Gain (Loss) on Investments	Gain on Derivatives	Accumulated Deficit	Redeemable	
	(In thousands)							
<b>Balance, December 31, 2002</b>	\$ 1	\$ 50,696	\$ 21,093	\$ (915,590)	\$ 4,296	\$	\$	\$ (839,504)
Comprehensive income								
Net income			63,237					
Foreign currency translation, net of tax of \$5.7 million				10,027				
Unrealized gain on investments, net of tax of \$2.4 million					3,771			
Total comprehensive income								77,035
Decrease in loan to stockholder		18,362						18,362
Reduction of compensation from redeemable Class A common stock		(2,324)						(2,324)
Decrease of redeemable Class A common stock		(11,400)		11,400				
Repurchase of Class A common stock treasury shares		(55,334)						(55,334)
<b>Balance, December 31,</b>	\$ 1	\$	\$ 21,093	\$ (840,953)	\$ 14,323	\$ 3,771	\$	\$ (801,765)

**2003**Comprehensive  
income

Net income	168,022
Foreign currency translation, net of tax of \$5.2 million	8,409
Unrealized loss on investments, net of tax of \$1.7 million	(2,592)
Total comprehensive income	173,839

**Balance,  
December 31,  
2004**

\$ 1	\$	\$ 21,093	\$ (672,931)	\$ 22,732	\$ 1,179	\$	\$ (627,926)
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Comprehensive  
income

Net income	159,620
Foreign currency translation, net of tax of \$9.6 million	(16,017)
Unrealized loss on investments, net of tax of \$0.1 million	(101)
Unamortized gain on cash flow hedge, net of tax of \$1.3 million	2,066
Total comprehensive income	145,568

**Balance,  
December 31,  
2005**

\$ 1	\$	\$ 21,093	\$ (513,311)	\$ 6,715	\$ 1,078	\$ 2,066	\$ (482,358)
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The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents**

**Discovery Communications, Inc.**  
**Notes to Consolidated Financial Statements**

**1. Description of Business**

Discovery Communications, Inc. (the Company) is a privately held, globally diversified entertainment company whose operations are organized into four business units: U.S. Networks, International Networks, Commerce and Education. U.S. Networks operates cable and satellite television networks in the United States, including Discovery Channel, TLC, Animal Planet, The Travel Channel and Discovery Health Channel. International Networks operates cable and satellite television networks worldwide, including regional variants of Discovery Channel, Animal Planet, People & Arts, Travel & Living, and Discovery Real Time. Commerce operates approximately 120 Discovery Channel retail stores and manages consumer ventures in the United States. Education provides products and services to educational institutions and consumers.

**2. Summary of Significant Accounting Policies*****Principles of Consolidation***

The consolidated financial statements include the accounts of all majority-owned and controlled subsidiaries. In addition, the Company evaluates its relationships with other entities to identify whether they are variable interest entities as defined by Financial Accounting Standards Board (FASB) Interpretation No. (FIN) 46, Consolidation of Variable Interest Entities, an Interpretation of ARB No. 51 as revised in December 2003 (FIN 46R) and to assess whether it is the primary beneficiary of such entities. Variable Interest Entities (VIEs) are generally entities that lack sufficient equity to finance their activities without additional financial support from other parties or whose equity holders possess rights not proportionate to their ownership. The equity method of accounting is used for affiliates over which the Company exercises significant influence but does not control.

All significant intercompany accounts and transactions have been eliminated in consolidation.

***Use of Estimates***

The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results may differ from those estimates and could have a material impact on the consolidated financial statements.

The Company has issued redeemable interests in a number of its consolidated subsidiaries for which redemption events are outside of the Company's control. Estimating the redemption value of these interests requires complex contract interpretation and the use of fair value and future performance assumptions. Certain of our ventures with BBC are operated under interim or unfinalized agreements, which contributes to the complexity of associated estimates.

Other significant estimates include the amortization method and recoverability of content rights, the valuation and recoverability of intangible assets and other long-lived assets, the fair value of derivative financial instruments, and the adequacy of reserves associated with accounts receivable and retail inventory.

***Revenue Recognition***

The Company derives revenues from four primary sources: (1) advertising revenue for commercial spots aired on the Company's networks, (2) distribution revenue from cable system and satellite operators (distributors), (3) retail sales of consumer products, and (4) educational product and service sales.

Advertising revenue is recorded net of agency commissions and audience deficiency liabilities in the period advertising spots are broadcast. Distribution revenue is recognized over the service period, net of launch incentives and other vendor consideration. Retail revenues are recognized either at the point-of-sale or upon



**Table of Contents****Discovery Communications, Inc.****Notes to Consolidated Financial Statements (Continued)**

product shipment. Educational product and service sales are generally recognized ratably over the term of the agreement or as the product is delivered.

***Advertising Costs***

The Company expenses advertising costs as incurred. The Company incurred advertising costs of \$208.6 million, \$170.3 million and \$140.2 million in 2005, 2004 and 2003.

***Cash and Cash Equivalents***

Highly liquid investments with original maturities of ninety days or less are recorded as cash equivalents. The Company had \$3.9 million and \$4.3 million in restricted cash included in other assets as of December 31, 2005 and 2004. Book overdrafts representing outstanding checks in excess of funds on deposit are a component of accounts payable and total \$40.9 million, \$12.1 million in 2005 and 2004.

***Derivative Financial Instruments***

SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, requires every derivative instrument to be recorded on the balance sheet at fair value as either an asset or a liability. The statement also requires that changes in the fair value of derivatives be recognized currently in earnings unless specific hedge accounting criteria are met. From time to time, the Company uses financial instruments designated as a cash flow hedge of a forecasted transaction to hedge its exposures to interest rate risks. The effective changes in fair value of derivatives designated as cash flow hedges are recorded in accumulated other comprehensive income (loss). Amounts are reclassified from accumulated other comprehensive income (loss) as interest expense is recorded for debt. Substantially all of the Company's financial instruments were not designated as a hedge in 2005, and none were designated as a hedge in 2004 and 2003.

***Inventories***

Inventories are carried at the lower of cost or market and include inventory acquisition costs. Cost is determined using the weighted average cost method.

***Content Rights***

Costs incurred in the direct production, co-production or licensing of content rights are capitalized and stated at the lower of unamortized cost, fair value, or net realizable value. The Company evaluates the net realizable value of content by considering the fair value of the underlying produced and co-produced content and the net realizable values of the licensed content.

The costs of produced and co-produced content airing on the Company's networks are capitalized and amortized based on the expected realization of revenues, resulting in an accelerated basis over four years for developed networks (Discovery Channel, TLC, Animal Planet, and The Travel Channel) in the United States, and a straight-line basis over three to five years for developing networks in the United States and all International networks. The cost of licensed content is capitalized and amortized over the term of the license period based on the expected realization of revenues, resulting in an accelerated basis for developed networks in the United States, and a straight-line basis for all International networks, developing networks in the United States and educational ventures. The costs of content for educational ventures are amortized straight-line over a three to seven year period.

All produced and co-produced content is classified as long-term. The portion of the unamortized licensed content balance that will be amortized within one year is classified as a current asset.

**Table of Contents**

**Discovery Communications, Inc.**  
**Notes to Consolidated Financial Statements (Continued)**

***Property and Equipment***

Property and equipment are stated at cost less accumulated depreciation. Depreciation is recognized on a straight-line basis over the estimated useful lives of three to seven years for equipment, furniture and fixtures, five to forty years for building structure and construction, and six to thirteen years for satellite transponders. Leasehold improvements are amortized on a straight-line basis over the lesser of their estimated useful lives or the terms of the related leases, beginning on the date the asset is put into use. Equipment under capital lease represents the present value of the minimum lease payments at the inception of the lease, net of accumulated depreciation.

***Capitalized Software Costs***

All capitalized software costs are for internal use. Capitalization of software development costs occurs during the application development stage. Costs incurred during the pre and post implementation stages are expensed as incurred. Capitalized software is amortized on a straight-line basis over its estimated useful lives of one to five years. Unamortized capitalized software costs totaled \$59.1 million and \$55.2 million at December 31, 2005 and 2004. The Company capitalized software costs of \$23.2 million, \$28.6 million, and \$18.3 million in 2005, 2004 and 2003. Amortization of capitalized software costs totaled \$19.3 million, \$18.4 million, and \$15.5 million during 2005, 2004 and 2003. Write-offs of capitalized software totaled \$4.0 million in 2004; there were no write-offs for capitalized software costs during 2005 and 2003.

***Recoverability of Long-Lived Assets, Goodwill, and Intangible Assets***

The Company periodically reviews the carrying value of its acquired intangible assets, including goodwill, and its other long-lived assets, including deferred launch incentives, to determine whether an impairment may exist. Goodwill impairment is determined by comparing the fair value of the reporting unit to its carrying value. If the fair value of the reporting unit is less than its carrying value, an impairment loss is recorded to the extent that the fair value of the goodwill within the reporting unit is less than its carrying value. Intangible assets and other long-lived assets are grouped for purposes of evaluating recoverability at the lowest level for which independent cash flows are identifiable. If the carrying amount of an intangible asset, long-lived asset, or asset grouping exceeds its fair value, an impairment loss is recognized. Fair values for reporting units, goodwill and other intangible assets are determined based on discounted cash flows, market multiples, or comparable assets as appropriate. Generally, the Company's reporting units and asset groups consist of the individual networks or other operating units.

The determination of recoverability of goodwill and other intangible and long-lived assets requires significant judgment and estimates regarding future cash flows, fair values, and the appropriate grouping of assets. Such estimates are subject to change and could result in impairment losses being recognized in the future. If different reporting units, asset groupings, or different valuation methodologies had been used, the impairment test results could have differed.

***Deferred Launch Incentives***

Consideration issued to cable and satellite distributors in connection with the execution of long-term network distribution agreements is deferred and amortized on a straight-line basis as a reduction to revenue over the terms of the agreements. Obligations for fixed launch incentives are recorded at the inception of the agreement. Obligations for performance-based arrangements are recorded when performance thresholds have been achieved. Following the renewal of a distribution agreement, the remaining deferred consideration is amortized over the extended period. Amortization of deferred launch incentives and interest on unpaid deferred launch incentives was \$74.1 million, \$98.4 million and \$122.7 million in 2005, 2004 and 2003.

**Table of Contents**

**Discovery Communications, Inc.**  
**Notes to Consolidated Financial Statements (Continued)**

***Foreign Currency Translation***

The Company's foreign subsidiaries' assets and liabilities are translated at exchange rates in effect at the balance sheet date, while results of operations are translated at average exchange rates for the respective periods. The resulting translation adjustments are included as a separate component of stockholders' deficit in accumulated other comprehensive income.

***Long-term Compensation Programs***

Prior to October 2005, the Company maintained two unit-based, long-term incentive plans. Under these plans, unit awards, which vest over a period of years, were granted to eligible employees and increased or decreased in value based on a specified formula of Company business metrics. The Company accounted for these units similar to stock appreciation rights and applied the guidance in FASB Interpretation Number 28, Accounting for Stock Issued to Employees, (FIN 28). Accordingly, the Company adjusted compensation expense for changes in the accrued value of these awards over the period outstanding.

During August 2005, the Company discontinued one of its long-term incentive plans and settled all amounts with cash payments. In October 2005, the Company established a new long-term incentive plan for certain eligible employees. Substantially all participants in the remaining plan redeemed their vested units for cash payment and received units in the new plan.

Under the new plan, eligible employees receive unit awards indexed to the price of Class A Discovery Holding Company (DHC) stock. As the units are indexed to the equity of another entity, the Company treats the units similar to a derivative, marking to fair value each reporting period. The Company attributes compensation expense for the new awards on a straight-line basis; the Company attributes compensation expense for the partially vested units by continuing to apply the FIN 28 model that was utilized over the awards' original vesting periods. Once units are fully vested, the Company recognizes all mark-to-market adjustments in each period as compensation expense.

The Company classifies as a current liability 75% of the intrinsic value of the units that are vested or will become vested within one year. This amount corresponds to the value potentially payable should all participants separate from the Company. Upon voluntary termination of employment, the Company distributes 75% of unit benefits. The remainder is paid at the one-year anniversary of termination date.

***Mandatorily Redeemable Interests in Subsidiaries***

Mandatorily redeemable interests in subsidiaries are initially recorded at fair value. For those instruments with an estimated redemption value, the Company accretes or decretes to the estimated redemption value ratably over the period to the redemption date. Accretion and decreration are recorded as a component of minority interest expense. For instruments with a specified rate of return, the Company records interest expense as earned.

***Treasury Stock***

Treasury stock is accounted for using the cost method. The repurchased shares are held in treasury and are presented as if retired. Treasury stock activity for the three years ended December 31, 2005 is presented in the Consolidated Statements of Stockholders' Deficit.

***Income Taxes***

Income taxes are recorded using the asset and liability method of accounting for income taxes. Deferred income taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and

**Table of Contents****Discovery Communications, Inc.****Notes to Consolidated Financial Statements (Continued)**

liabilities for financial reporting purposes and the amounts used for income tax purposes. A valuation allowance is provided for deferred tax assets if it is more likely than not such assets will not be realized.

**Revisions**

The 2004 and 2003 Statements of Cash Flows have been revised for foreign currency effects on changes in cash, which had previously been included as a component of other non-cash items, minority interest contributions, which had previously been included as a component of investing cash flows, and dividends from equity investments, which had previously been included as a component of investing cash flows, to conform to the 2005 presentation. The 2004 Balance Sheet has been revised to include deferred rent, which had previously been included as a component of accounts payable and accrued liabilities, as a component of other long-term liabilities.

**3. Supplemental Disclosures to Consolidated Statements of Cash Flows**

	<b>Year Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>(In thousands)</b>		
Cash paid for acquisitions:			
Fair value of assets acquired	\$ 400	\$ 21,414	\$ 50,509
Net liabilities assumed		(4,196)	(3,968)
Cash paid for acquisitions, net of cash acquired	400	17,218	46,541
Cash paid for interest	171,151	166,584	162,904
Cash paid for income taxes	27,678	28,999	32,395

**4. Business Combinations**

During 2004, the Company completed two acquisitions in its Education division, in which the Company acquired customer lists valued at \$14.6 million and covenants not to compete valued at \$0.6 million, which are being amortized over their useful lives of three years.

During 2003, the Company completed two acquisitions, one in its Education division and one in its International Networks division. In connection with these acquisitions, the Company acquired customer lists valued at \$27.7 million, which are being amortized over their useful lives of three years. The Company also acquired deferred launch incentives valued at \$16.7 million. Of these, \$13.2 million are being amortized over the five-year term of the agreements, and \$3.5 million relate to a penalty for non-renewal in 2008. If no renewal is effectuated in 2008, the acquiree will refund the Company. If renewed, the Company will amortize this amount over the renewal period.

During 2005, changes in goodwill result solely from fluctuations in foreign currency. Purchase price in excess of the fair value of the assets and liabilities acquired of \$1.1 million and \$6.0 million was recorded to goodwill in 2004 and 2003.

**Table of Contents**

**Discovery Communications, Inc.**  
**Notes to Consolidated Financial Statements (Continued)**

**5. Content Rights**

	<b>December 31,</b>	
<b>Content Rights,</b>	<b>2005</b>	<b>2004</b>
<b>(In thousands)</b>		
Produced content rights		
Completed	\$ 1,339,705	\$ 1,099,483
In process	122,366	100,086
Co-produced content rights		
Completed	792,184	698,758
In process	53,704	38,575
Licensed content rights		
Acquired	225,769	189,662
Prepaid	3,371	4,232
Content rights, at cost	2,537,099	2,130,796
Accumulated amortization	(1,305,986)	(1,052,839)
Content rights, net	1,231,113	1,077,957
Current portion, licensed content rights	(55,125)	(50,578)
Non-current portion	\$ 1,175,988	\$ 1,027,379

Amortization of content rights was \$601.1 million, \$494.2 million and \$413.9 million in 2005, 2004 and 2003, and is recorded as a component of cost of revenue.

The Company estimates that approximately 91% of unamortized costs of content rights at December 31, 2005 will be amortized within the next three years. The Company expects to amortize \$471.7 million of unamortized content rights, not including in-process and prepaid productions, during the next twelve months.

**6. Property and Equipment**

	<b>December 31,</b>	
<b>Property and Equipment,</b>	<b>2005</b>	<b>2004</b>
<b>(In thousands)</b>		
Equipment and software	\$ 347,667	\$ 344,525
Land	28,781	28,781
Buildings	157,896	136,088
Furniture, fixtures, leasehold improvements and other	187,589	160,418
Assets in progress	16,824	60,806
Property and equipment, at cost	738,757	730,618
Accumulated depreciation and amortization	(341,179)	(350,328)

Property and equipment, net	\$	397,578	\$	380,290
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The cost and accumulated depreciation of satellite transponders under capital leases were \$23.5 million and \$7.0 million at December 31, 2005, and \$23.5 million and \$4.1 million at December 31, 2004. Depreciation and amortization of property and equipment, including equipment under capital lease, was \$85.0 million, \$85.4 million and \$86.4 million in 2005, 2004 and 2003.

IV-14

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**Table of Contents**

**Discovery Communications, Inc.**  
**Notes to Consolidated Financial Statements (Continued)**

During 2005, the Company completed construction of a media uplink facility and transferred the final asset balances for building and furniture costs of \$24.0 million and equipment costs of \$24.0 million from assets in progress.

**7. Sale of Equity Investments and Long-lived Assets**

In January 2005, the Company recorded a gain of \$12.8 million as a component of other non-operating expenses for the sale of certain equity investments, previously accounted for under the cost method. The gain represents the difference between the proceeds received and the net book value of the investments.

In 2004, the Company recorded a net gain of \$22.0 million on the sale of certain television technology patents. The transaction closed in August 2004, and the gain represents the sale price less costs to sell. The Company expensed all of the costs to develop this technology in prior years.

**8. Goodwill and Intangible Assets**

	<b>December 31,</b>	
<b>Goodwill and Intangible Assets,</b>	<b>2005</b>	<b>2004</b>
	<b>(In thousands)</b>	
Goodwill	\$ 254,989	\$ 257,460
Trademarks	12,327	13,383
Customer lists, net of amortization of \$111,954 and \$86,406	38,561	64,109
Non-compete and other, net of amortization of \$41,107 and \$43,021	24,207	33,068
Representation rights, net of amortization of \$69,886 and \$60,528	67,843	77,201
Goodwill and intangible assets, net	\$ 397,927	\$ 445,221

Goodwill and trademarks are not amortized. Customer lists are amortized on a straight-line basis over the estimated useful lives of three to seven years. Non-compete assets are amortized on a straight-line basis over the contractual term of three to seven years. Other intangibles are amortized on a straight-line basis over the estimated useful lives of three to ten years. Representation rights are amortized on a straight-line basis over the contractual term of fifteen years.

During 2004, the Company reduced its estimate of certain pre-acquisition contingencies associated with certain contractual distribution arrangements acquired as part of the acquisition of FitTV (f.k.a. The Health Network). These revisions resulted in a reduction of goodwill of \$8.0 million at December 31, 2004.

The Company has the exclusive right to represent BBC America ( BBCA ), a cable network, in sales, marketing, distribution and other operational activities through 2013. As a part of this agreement, the Company will receive a percentage of revenues earned and collected by BBCA during the representation term. The cost of acquiring the representation rights is being amortized on a straight-line basis over the fifteen-year term of the agreement, and is reported as a reduction of other revenue.

Amortization of intangible assets, including the BBC Representation rights, totaled \$45.0 million, \$41.8 million and \$33.8 million in 2005, 2004 and 2003.

The Company estimates that unamortized costs of intangible assets at December 31, 2005 will be amortized over the next five years as follows: \$41.2 million in 2006, \$28.7 million in 2007, \$20.1 million in 2008, \$9.7 million in 2009, and \$9.7 million in 2010.

**Table of Contents**

**Discovery Communications, Inc.**  
**Notes to Consolidated Financial Statements (Continued)**

**9. Investments**

The following table outlines the Company's joint ventures and the method of accounting during 2005:

Affiliates:	Accounting Method
<b><i>Joint Ventures with the British Broadcasting Corporation ( BBC ):</i></b>	
JV Programs LLC ( JVP )	Consolidated
Joint Venture Network LLC ( JVN )	Consolidated
Animal Planet United States (see Note 11)	Consolidated
Animal Planet Europe	Consolidated
Animal Planet Latin America	Consolidated
People & Arts Latin America	Consolidated
Animal Planet Asia	Consolidated
Animal Planet Japan ( APJ )	Consolidated
Animal Planet Canada	Equity
<b><i>Other Ventures:</i></b>	
Discovery Times Channel (see Note 11)	Consolidated
Discovery Canada	Equity
Discovery Japan	Equity
Discovery Health Canada	Equity
Discovery Kids Canada	Equity
Discovery Civilization Canada	Equity
Meteor Studios	Equity

***Joint Ventures with the BBC***

The Company and the BBC have formed several cable and satellite television network joint ventures, JVP, a venture to produce and acquire factual based content, and JVN, a venture to provide debt funding to these joint ventures.

In addition to its own funding requirements, the Company has assumed the BBC funding requirements, giving the Company preferential cash distribution with these ventures. The Company controls substantially all of the ventures and consolidates them accordingly. However, as the BBC does not have risk of loss, no losses were allocated to minority interest for consolidated joint ventures with the BBC, and the Company recognizes both its own and the BBC's share of earnings in the equity method venture with the BBC.

In connection with the adoption of FIN 46R, the Company concluded that JVP and APJ are VIEs and the Company is the primary beneficiary. Therefore, on January 1, 2005, the Company began consolidating these entities, which had fair value net asset balances of \$58.0 million, combined. There is no minority interest for JVP; minority interest for APJ is a benefit of \$1.4 million and is reported as a component of minority interest expense. Previously, the Company has accounted for JVP and APJ under the equity method of accounting. Other equity investments do not require consolidation as either they are not VIEs, or in the event that they are VIEs, the Company is not the primary beneficiary.

***Variable Interest Entities***

The Company is a partner in other international joint venture cable and satellite television networks in which the Company has a variable interest. The Company's funding to these joint ventures totaled



**Table of Contents****Discovery Communications, Inc.****Notes to Consolidated Financial Statements (Continued)**

\$0.2 million, \$3.3 million and \$7.5 million during 2005, 2004 and 2003. At December 31, 2005, the Company's maximum exposure to loss as a result of its involvement with these joint ventures is the \$11.5 million investment book value and future operating losses, should they occur, of these joint ventures that the Company is obligated to fund. These joint ventures have no third party debt.

Combined financial information of the Company's unconsolidated ventures (amounts do not reflect eliminations of activity with the Company):

<b>Operating Results,</b>	<b>Year Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>(In thousands)</b>		
Net Revenue	\$ 111,872	\$ 163,630	\$ 145,786
Income from operations	41,934	26,201	13,278
Net income	24,634	8,688	1,155

<b>Balance Sheets,</b>	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
	<b>(In thousands)</b>	
Current assets	\$ 68,529	\$ 68,554
Total assets	80,365	136,703
Current liabilities	24,204	21,817
Total liabilities	33,578	46,683
Total shareholders' equity or partners' capital	46,787	90,020

**10. Long-Term Debt**

<b>Long-Term Debt,</b>	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
	<b>(In thousands)</b>	
\$1,000.0 Term Loan, due quarterly December 2008 to October 2010	\$ 1,000,000	\$
\$1,555.0 Revolving Loan, due October 2010	103,000	
\$2,500.0 Term Loan and Revolving Loans, paid 2005		1,488,000
7.81% Senior Notes, semi annual interest, due March 2006	300,000	300,000
8.06% Senior Notes, semi annual interest, due March 2008	180,000	180,000
7.45% Senior Notes, semi annual interest, due September 2009	55,000	55,000
8.37% Senior Notes, semi annual interest, due March 2011	220,000	220,000
8.13% Senior Notes, semi annual interest, due September 2012	235,000	235,000
Senior Notes, semi annual interest, due December 2012	90,000	
6.01% Senior Notes, semi annual interest, due December 2015	390,000	
Obligations under capital leases	23,910	25,125
Other notes payable		4,898

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Total long-term debt	2,596,910	2,508,023
Current portion	(6,470)	(9,736)
Non-current portion	\$ 2,590,440	\$ 2,498,287

In October 2005, the Company refinanced its syndicated bank credit agreement, replacing the existing Term Loan and the Revolving Loans, with principal payments beginning in 2007 and final maturity in 2009, with a new Term Loan and Revolving Facility, with principal payments beginning in 2008 and final maturity

IV-17

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**Table of Contents****Discovery Communications, Inc.****Notes to Consolidated Financial Statements (Continued)**

in 2010. In November 2005, the Company modified the outstanding unsecured Senior Notes. In December 2005, the Company issued two series of unsecured Senior Notes, \$90.0 million of floating rate Senior Notes due December 2012 and \$390.0 million of 6.01% Senior Notes due December 2015. The Company capitalized \$4.8 million in deferred financing costs as a result of these transactions. The Company expensed \$4.2 million in capitalized costs as a component of interest expense associated with the refinancing of the previous credit arrangement. The Company intends to borrow additional funds available under the expanded Revolving Facility to refinance the \$300.0 million 7.81% Senior Notes due March 2006; as a result, the Company has classified the outstanding amount as long-term debt.

In June 2004, the Company refinanced the Term Loan and the Revolving Facility, maturing in 2004 and 2005, with a new Term Loan and Revolving Facility. The Company capitalized \$8.5 million in deferred financing costs as part of the new Term Loan and Revolving Facility and expensed \$6.3 million in capitalized costs associated with the previous Term Loan and Revolving Facility.

All Term and Revolving Loans are unsecured. Interest, which is payable quarterly at a minimum, is based on the London Interbank Offered Rate ( LIBOR ) or prime rate plus a margin based on the Company's leverage ratios. The weighted average interest rate on these facilities was 5.3% and 3.7% at December 31, 2005 and 2004, and the interest rate averaged 4.41% and 2.8% during 2005 and 2004. The cost of the Revolving Facility includes a fee on the revolving commitment (ranging from 0.1% to 0.3%) based on the Company's leverage ratios. The interest rate on the floating rate Senior Notes was 5.33% through the period and at December 31, 2005. The Company uses derivative instruments to modify its exposure to interest rate fluctuations on its debt.

The Term Loans, Revolving Facility, and Senior Notes contain covenants that require the Company to meet certain financial ratios and place restrictions on the payment of dividends, sale of assets, borrowing level, mergers, and purchases of capital stock, assets, and investments. The Company was in compliance with all debt covenants at December 31, 2005.

Future principal payments under the current debt arrangements, excluding obligations under capital leases and other notes payable, are as follows: \$320 million in 2006, none in 2007, \$242.5 million in 2008, \$430 million in 2009 and \$645.5 million in 2010, and \$935.0 million from 2011 to 2015. Future minimum payments under capital leases are as follows: \$6.5 million in 2006, \$5.7 million in 2007, \$3.8 million in 2008, \$3.8 million in 2009, \$1.5 million in 2010 and \$6.9 million thereafter.

**11. Mandatorily Redeemable Interests in Subsidiaries**

	<b>December 31,</b>	
<b>Mandatorily Redeemable Interests in Subsidiaries,</b>	<b>2005</b>	<b>2004</b>
	<b>(In thousands)</b>	
Discovery Times	\$ 106,862	\$ 125,763
FitTV (f.k.a. The Health Network)		92,874
Animal Planet LLC	80,000	50,000
Animal Planet LP	48,840	48,730
People & Arts Latin America and Animal Planet Channel Group	36,800	2,200
Mandatorily redeemable interests in subsidiaries	\$ 272,502	\$ 319,567

***Discovery Times***

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In April 2002, the Company sold a 50% interest in Discovery Times Channel to the New York Times ( NYT ) for \$100 million. Due to the NYT 's redemption rights, this transaction resulted in no gain or loss to the Company. The NYT has the right in April 2006, to put its interest back to the Company for a value

IV-18

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**Table of Contents****Discovery Communications, Inc.****Notes to Consolidated Financial Statements (Continued)**

determined by a specified formula, with a floor of \$80 million and a ceiling of \$135 million. The Company accretes or decretes the mandatorily redeemable interest in a subsidiary through the redemption date to its estimated redemption value, never decreasing below the NYT's estimated minority interest. The Company updates its estimate of the redemption value and estimated minority interest each period and based on its most recent calculations, the Company will ratably adjust to an amount representing the NYT's calculated minority interest of \$103.1 million. The Company recorded a decrease of \$19.5 million in 2005 and accretion of \$1.3 million and \$7.0 million to minority interest expense in 2004 and 2003.

After 2006, the NYT has certain other protective rights that, if triggered and not cured, could require the Company to repurchase the NYT's interest for a value determined by a specified formula.

***FitTV (f.k.a. The Health Network)***

Fox Entertainment Group (FEG) had the right, from December 2003 to February 2004, to put its FitTV interests back to the Company. In December 2003, FEG notified the Company of its intention to put its interest in FitTV back to the Company. The Company acquired this interest for approximately \$92.9 million in 2005. The Company recorded a decrease of \$1.1 million in 2004 and recorded accretion of \$8.5 million in 2003 to minority interest expense.

***Animal Planet LLC***

In April 2004, the BBC notified the Company of its intention to put its interest in Animal Planet LLC back to the Company. The estimated redemption value of this interest is \$80.0 million based on current negotiated terms. The Company has recorded accretion of \$30.0 million and \$50.0 million in 2005 and 2004 to minority interest expense.

***Animal Planet LP***

One of the Company's stockholders holds 44,000 senior preferred partnership units of Animal Planet LP ( APLP ) that have a redemption value of \$44.0 million and carry a rate of return ranging from 8.75% to 13%. Payments are made quarterly and totaled \$4.6 million, \$4.6 million and \$5.8 million during 2005, 2004 and 2003. APLP's senior preferred partnership units may be called by APLP during the period January 2007 through December 2011 for \$44.0 million, and may be put to the Company by the holder beginning in January 2012 for \$44.0 million. At December 31, 2005, and 2004, the Company has recorded this security at the redemption value of \$44.0 million plus accrued returns of \$4.8 million and \$4.7 million. Preferred returns are recorded as a component of interest expense and aggregated \$4.7 million in 2005, 2004 and 2003.

***People & Arts Latin America and Animal Planet Channel Group***

The BBC has the right, upon a failure of the People & Arts Latin America or the Animal Planet Channel Group (comprised of Animal Planet Europe, Animal Planet Asia, and Animal Planet Latin America), the Channel Groups, to achieve certain financial performance benchmarks to put its interests back to the Company for a value determined by a specified formula. The Company accretes or decretes the mandatorily redeemable equity in a subsidiary to its estimated redemption value through the 2005 redemption date. The redemption value estimate is based on a contractual formula utilizing projected results of each network within the channel group. Based on calculated performance benchmarks, the BBC has the right to put. Although this right has not been exercised, the BBC has 90 days following the valuation of the Channel Groups by an independent appraiser to exercise this right. The Company has estimated a redemption value of \$36.8 million at December 31, 2005. Accretion to the redemption value has been recorded as a component of minority interest expense of \$34.6 million and \$2.2 million in 2005 and 2004.

**Table of Contents**

**Discovery Communications, Inc.**  
**Notes to Consolidated Financial Statements (Continued)**

**Discovery Health Channel (DHC)**

During the second quarter of 2004, Comcast put its DHC interests back to the Company for \$148.9 million. The Company recorded accretion of \$5.1 million to minority interest expense in 2004.

**12. Stockholder Put Right**

In June 2003, the Company's founder, John Hendricks, put 215 outstanding shares of Class A Common Stock to the Company in exchange for \$55.3 million. Concurrent with this transaction, outstanding loans, secured by Mr. Hendricks' shares and vested compensation units, of \$23.6 million to Mr. Hendricks were repaid to the Company with interest. Prior to this purchase, the value of these shares had been recorded as redeemable common stock and changes in value had been recorded to stockholders' deficit.

The Company received a third party valuation in connection with the transactions. The valuation reflected a lower value for the Company than had been previously estimated and, as a result, the Company decreased the carrying value of the stock by \$13.7 million and reduced compensation expense recorded in prior years associated with the loans by \$2.3 million in connection with the settlement.

**13. Commitments and Contingencies****Year Ending December 31,**

<b>Future Minimum Payments,</b>	<b>Leases</b>	<b>Content</b>	<b>Other</b>	<b>Total</b>
	<b>(In thousands)</b>			
2006	\$ 63,403	\$ 260,653	\$ 73,401	\$ 397,457
2007	64,818	59,762	74,308	198,888
2008	60,816	56,959	52,779	170,554
2009	42,610	52,488	22,711	117,809
2010	34,382	45,144	18,830	98,356
Thereafter	169,385	43,942	11,861	225,188
<b>Total</b>	<b>\$ 435,414</b>	<b>\$ 518,948</b>	<b>\$ 253,890</b>	<b>\$ 1,208,252</b>

Expenses recorded in connection with operating leases, including rent expense, were \$142.1 million, \$127.8 million and \$128.7 million for the years ended December 31, 2005, 2004 and 2003. The Company receives contributions from certain landlords to fund leasehold improvements. Such contributions are recorded as deferred rent and amortized as reductions to lease expense over the lease term. Certain of the Company's leases provide for rental rates that increase or decrease over time. The Company recognizes operating lease minimum rentals on a straight-line basis over the lease term. The Company's deferred rent balance was \$29.8 million and \$15.6 million at December 31, 2005 and 2004. The lease term begins on the date the Company has access to the leased property.

In August 2005, the Company subleased rented property and guaranteed third party performance under the lease. The guarantee for the \$7.6 million value of the lease is full and unconditional.

In connection with the long-term distribution agreements for certain of its European cable networks, the Company is committed to pay a satellite system operator 25% to 49% of the increase in value of these networks, if any, prior to the termination of the contract on December 31, 2006. The value of the networks, and the Company's liability thereon, are materially impacted by the terms of future renewed distribution agreements with the satellite system operator. The Commitment was designed as an incentive to enter into a renewed agreement. However, the Company is currently unable to predict the terms and conditions of any renewal of the distribution agreements. The Company has recorded a liability associated with this arrangement based on the estimated value of the networks at the termination of the

agreement if no renewal is in

IV-20

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**Table of Contents****Discovery Communications, Inc.****Notes to Consolidated Financial Statements (Continued)**

place and adjusts such liability each period for changes in value. However, if the current distribution agreement is renewed before the expiration of the existing agreement, amounts to be paid in 2007 to this system operator could be significantly higher than amounts currently accrued. The Company will record the effect of a renewed distribution agreement when such terms are in place.

The Company is solely responsible for providing financial, operational and administrative support to the JVP, JVN, Animal Planet United States, Animal Planet Latin America, People & Arts Latin America, Animal Planet Asia, and Animal Planet Europe ventures and has committed to do so through at least fiscal 2006.

The Company is involved in litigation incidental to the conduct of its business. In addition, the Company is involved in negotiations with organizations holding the rights to music used in the Company's content. As global music rights societies evolve, the Company uses all information available to estimate appropriate obligations. During 2005, DCI analyzed its music rights reserves and recorded a net reduction to cost of revenue of approximately \$11.0 million. The Company believes the reserves related to these music rights are adequate and does not expect the outcome of such litigation and negotiations to have a material adverse effect on the Company's results of operations, cash flows, or financial position.

**14. Employee Savings Plans**

The Company maintains employee savings plans, defined contribution savings plans and a Supplemental Deferred Compensation Plan for certain management employees, together the Savings Plans. The Company contributions to the Savings Plans were \$8.2 million, \$6.8 million and \$5.5 million during 2005, 2004 and 2003.

**15. Long-term Incentive Plans**

Prior to October 2005, the Company maintained two unit-based, long-term incentive plans with substantially similar terms. Units were awarded to eligible employees following their one-year anniversary of hire and vested 25% per year thereafter. Upon exercise, participants received the increase in value from the date of issuance. The value of the units was based on changes in the Company's value as estimated by an external investment-banking firm utilizing a specified formula of Company business metrics. The average assumptions used in the valuation model included adjusted projected operating cash flows segregated by business group. The valuation also included a business group specific discount rate and terminal value based on business risk. The intrinsic value for unit appreciation had been recorded as compensation expense over the period the units were outstanding.

In August 2005, the Company discontinued one of its plans, which resulted in the full vesting and cash redemption of units at the December 31, 2004 valuation, including a 25% premium on appreciated value. In October 2005, the Company established a new long-term incentive plan. At inception of the plan, eligible participants in the remaining plan chose to either continue in that plan or to redeem their vested units at the December 31, 2004 valuation and receive partially vested units in the new plan. Substantially all participants in the prior plan redeemed their vested units and received partially vested units in the new plan. Certain eligible employees were granted new units in the new plan.

Units partially vested in the new plan have vesting and appreciation similar to units in the old plan. New units awarded vest 25% per year. The units in the new plan are indexed to the market price of Class A DHC stock. Every two years, one quarter of the units awarded will expire and the employee will receive a cash payment for the increase in value throughout an eight-year period after the grant date. The Company has authorized the issuance of up to 31.9 million units under this plan.



**Table of Contents**

**Discovery Communications, Inc.**  
**Notes to Consolidated Financial Statements (Continued)**

Upon voluntary termination of employment, the Company distributes 75% of the intrinsic value of the participant's vested units, as participants are required to comply with post-employment obligations for one year in order to receive remaining benefits. There were no payments during 2005 related to the new plan.

Compensation expense under the prior plans was \$20.4 million, \$68.8 million, and \$101.7 million in 2005, 2004 and 2003. The Company's cash disbursements under the prior plans aggregated \$325.8 million, \$45.9 million and \$27.9 million during 2005, 2004 and 2003. The accrued value of units based on the Company's vesting schedule was \$322.4 million at December 31, 2004.

The following table summarizes information about unit transactions (units in millions) for prior plans:

	2005		2004		2003	
	Units	Weighted Average Exercise Price	Units	Weighted Average Exercise Price	Units	Weighted Average Exercise Price
Outstanding at January 1	25.6	\$ 24.10	19.1	\$ 18.18	17.2	\$ 15.12
Units exchanged	(7.8)	34.31				
Units granted	0.5	37.35	8.7	34.22	4.1	29.02
Units redeemed/cancelled	(18.3)	20.53	(2.2)	13.49	(2.2)	14.18
Outstanding at December 31			25.6	24.10	19.1	18.18
Vested at December 31		\$	17.5	\$ 19.76	16.5	\$ 16.65

The fair value of the units issued under the new plan has been determined using the Black-Scholes option-pricing model. The weighted average assumptions used in the Black-Scholes model are a risk-free interest rate of 4.36%, a contractual term of 4.75 years, an expected volatility of 30.36%, and a dividend yield of zero. The expected volatility represents the calculated volatility of the DHC stock price over each of the various contractual terms. As a result of the limited trading history of the DHC stock, this amount was determined based on an analysis of DHC's industry peer group over the corresponding periods.

All units under the new plan were granted on October 1, 2005 with a weighted average grant date fair value of \$5.83. The weighted average fair value of units outstanding is \$6.63 at December 31, 2005. Compensation expense in connection with the new plan was \$29.1 million in 2005, including \$12.8 million related to the exchange of partially vested units from the prior plan. This charge reflects the difference between the fair value of the award and the intrinsic value of the award attributable to prior vesting. The accrued fair value of units outstanding under the new plan was \$45.5 million at December 31, 2005.

The Company has classified as a current liability \$20.7 million for the intrinsic value of units that are or will become fully vested and potentially payable in the next twelve months. The aggregate intrinsic value of units outstanding at December 31, 2005 is \$50.1 million. At December 31, 2005, there was \$115.0 million of unrecognized compensation cost related to unvested units, which the Company expects to recognize over a weighted average period of 2.9 years.

During 2005, 7.8 million units, with a weighted average grant price of \$12.77, were granted to replace units exchanged from the prior plan, and the Company granted 16.4 million new units, with a weighted average grant price of \$15.81. No units from the new plan were redeemed or cancelled.



**Table of Contents**

**Discovery Communications, Inc.**  
**Notes to Consolidated Financial Statements (Continued)**

The following table summarizes information about unit awards outstanding at December 31, 2005 (units in millions):

Unit Price	Outstanding		Vested	
	Number of Units	Weighted Average Remaining Years of Contractual Life	Number of Units	Weighted Average Remaining Years of Contractual Life
\$3.48	0.1	4.75	0.1	4.75
\$7.06	0.6	4.75	0.3	2.75
\$12.52	5.2	4.75	1.6	3.75
\$15.81	18.3	4.74		
<b>Total</b>	<b>24.2</b>	<b>4.74</b>	<b>2.0</b>	<b>3.60</b>

**Unit Appreciation and Incentive Agreement**

As part of his long-term incentive plan with the Company, the Company's Founder, John Hendricks, had a 10-year incentive agreement with the Company that granted him a cash award equal to 1.6% of the difference between the Company's value at December 31, 1993 and December 31, 2003 for his services as Chairman and Chief Executive Officer during the period. This cash award was paid out to Mr. Hendricks in two installments, one in December 2003 and one in February 2004. The final determination of value was based on an appraisal from an investment banking firm using a consistent valuation methodology both at the beginning and the end of the 10-year term. The estimated change in value of this incentive was recorded as a component of compensation expense during the term of the agreement.

**16. Income Taxes**

Income Tax Expense,	Year Ended December 31,		
	2005	2004	2003
	(In thousands)		
<b>Current</b>			
Federal	\$ (1,479)	\$ (231)	\$ 2,813
State	(3,205)	3,952	6,722
Foreign	57,644	32,556	22,970
<b>Total current income tax provision</b>	<b>52,960</b>	<b>36,277</b>	<b>32,505</b>
<b>Deferred</b>			
Federal	95,098	95,761	33,963
State	16,298	7,723	5,175
Foreign	(3,851)		

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Total deferred income tax expense	107,545	103,484	39,138
Change in valuation allowance	1,838	2,038	3,142
Total income tax expense	\$ 162,343	\$ 141,799	\$ 74,785

IV-23

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**Table of Contents**

**Discovery Communications, Inc.**  
**Notes to Consolidated Financial Statements (Continued)**

**December 31,**

**2005**

**2004**

**Deferred Income Tax Assets and Liabilities**

**Current**

**Non-Current**

**Current**

**Non-Current**

**(In thousands)**

(In thousands)				
Assets				
Loss carryforwards	\$ 43,470	\$ 61,974	\$ 1,148	\$ 20,090
Compensation	15,185	12,432	102,595	22,745
Accrued expenses	17,769		26,474	
Reserves and allowances	10,392	463	8,720	10,132
Tax credits		3,823	4,330	
Derivative financial instruments		7,052		16,979
Investments		86,039		69,729
Intangibles		41,401		31,627
Other	3,689	11,732	3,066	8,342
	90,505	224,916	146,333	179,644
Valuation allowance		(21,392)		(19,554)
<b>Total deferred income tax assets</b>	<b>90,505</b>	<b>203,524</b>	<b>146,333</b>	<b>160,090</b>
Liabilities				
Accelerated depreciation		(11,948)		(20,908)
Programming costs		(109,009)		
Foreign currency translation		(4,103)		(13,687)
Unrealized gains on investments		(1,920)		(720)
Other	(1,740)	(7,228)	(1,727)	(10,102)
<b>Total deferred income tax liabilities</b>	<b>(1,740)</b>	<b>(134,208)</b>	<b>(1,727)</b>	<b>(45,417)</b>
<b>Deferred income tax assets, net</b>	<b>\$ 88,765</b>	<b>\$ 69,316</b>	<b>\$ 144,606</b>	<b>\$ 114,673</b>

**Year Ended December 31,**

**Reconciliation of Effective Tax Rate,**

**2005**

**2004**

**2003**

Federal statutory rate	35.0%	35.0%	35.0%
Increase (decrease) in tax rate arising from:			
State income taxes, net of Federal benefit	3.0	2.4	7.9
Foreign income taxes, net of Federal benefit	9.3	6.4	12.2
Other	3.1	2.0	(0.9)

Effective income tax rate	50.4%	45.8%	54.2%
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The Company has Federal operating loss carryforwards of \$231.1 million that begin to expire in 2021 and state operating loss carryforwards of \$682.9 million in various state jurisdictions available to offset future taxable income that expire in various amounts through 2025. The Company also has \$3.8 million of alternative minimum tax credits that do not have an expiration date.

Deferred tax assets are reduced by a valuation allowance relating to the state tax benefits attributable to net operating losses in certain jurisdictions where realizability is not more likely than not.

**Table of Contents**

**Discovery Communications, Inc.**  
**Notes to Consolidated Financial Statements (Continued)**

**17. Financial Instruments***Derivative Financial Instruments*

The Company uses derivative financial instruments to modify its exposure to market risks from changes in interest rates and foreign exchange rates. The Company does not hold or enter into financial instruments for speculative trading purposes.

The Company's interest expense is exposed to movements in short-term interest rates. Derivative instruments, including both fixed to variable and variable to fixed interest rate instruments, are used to modify this exposure. These instrument contracts include a combination of swaps, caps, collars, and other structured instruments to modify interest rate exposure. At December 31, 2005, the variable to fixed interest rate instruments have a notional principal amount of \$1,200 million and have a weighted average interest rate of 5.82%. At December 31, 2005, the fixed to variable interest rate agreements have a notional principal amount of \$225 million and have a weighted average interest rate of 8.39%. At December 31, 2005, the Company held an unexercised option to extend an interest rate swap contract with a notional amount of \$375 million at a fixed rate of 5.28% and an unexercised interest rate swap put right held by a bank had a notional amount of \$25.0 million at a fixed rate of 5.44%. As a result of unrealized mark to market adjustments, the Company recorded \$29.1 million, \$44.1 million and \$21.6 million in gains on these instruments during 2005, 2004 and 2003. The fair value of these derivative instruments is recorded as a component of long-term liabilities and other current liabilities in the consolidated balance sheets. These derivative instruments did not receive hedge accounting treatment.

The foreign exchange instruments used are spot, forward, and option contracts. Additionally, the Company enters into non-designated forward contracts to hedge non-dollar denominated cash flows and foreign currency balances. At December 31, 2005, the notional amount of foreign exchange derivative contracts was \$91.4 million. As a result of unrealized mark to market adjustments, the Company recognized \$2.3 million, \$0.4 million and \$0.1 million in losses on these instruments during 2005, 2004 and 2003. The fair value of these derivative instruments is recorded as a component of long-term liabilities and other current liabilities in the consolidated balance sheets. These derivative instruments did not receive hedge accounting treatment.

During 2005 the Company entered into several treasury locks to hedge a forecasted debt financing transaction. The value of the hedges at closing was \$3.3 million. These derivatives received hedge accounting treatment and the balance has been recorded as a component of Other Comprehensive Income (Loss), net of taxes and amortization to interest expense.

*Fair Value of Financial Instruments*

The fair values of cash and cash equivalents, receivables, and accounts payable approximate their carrying values. Investments are carried at fair value and fluctuations in fair value are recorded through other comprehensive income. Losses on investments that are other than temporary declines in value are recorded in the statement of operations.

The carrying amount of the Company's borrowings was \$2,597 million and the fair value was \$2,674 million at December 31, 2005. The carrying amount of the Company's borrowings was \$2,508 million and the fair value was \$2,616 million at December 31, 2004.

The carrying amount of all derivative instruments represents their fair value. The net fair value of the Company's short and long-term derivative instruments is \$(19.8) million at December 31, 2005; 6.5%, 38.6%, 35.2%, 2.4%, 6.7% and 10.6% of these derivative instrument contracts will expire in 2006, 2007, 2008, 2009, 2010 and thereafter. The fair value of the Company's derivative instruments totaled \$(44.8) million at December 31, 2004.

**Table of Contents**

**Discovery Communications, Inc.**  
**Notes to Consolidated Financial Statements (Continued)**

The fair value of derivative contracts was estimated by obtaining interest rate and volatility market data from brokers. As of December 31, 2005, an estimated 100 basis point parallel shift in the interest rate yield curve would change the fair value of the Company's portfolio by approximately \$7.7 million.

***Credit Concentrations***

The Company continually monitors its positions with, and the credit quality of, the financial institutions that are counterparties to its financial instruments and does not anticipate nonperformance by the counterparties. In addition, the Company limits the amount of investment credit exposure with any one institution.

The Company's trade receivables and investments do not represent a significant concentration of credit risk at December 31, 2005 due to the wide variety of customers and markets in which the Company operates and their dispersion across many geographic areas.

**18. Related Party Transactions**

The Company identifies related parties as investors and their consolidated businesses, equity investment companies, and executive management. The most significant transactions with related parties result from companies that distribute networks, produce content, or provide media uplink services. Gross revenue earned from related parties was \$73.7 million, \$71.8 million and \$209.2 million in 2005, 2004 and 2003. Accounts receivable from these entities were \$17.0 million and \$10.9 million at December 31, 2005 and 2004. Purchases from related parties totaled \$71.4 million, \$133.2 million, and \$164.7 million in 2005, 2004, and 2003; of these \$23.1 million, \$91.0 million and \$101.1 million relate to capitalized assets. Amounts payable to these parties totaled \$2.3 million and \$4.3 million at December 31, 2005 and 2004.

**19. Subsequent event**

In December 2005, the Company signed an agreement to acquire 98% of a free-to-air channel in Germany. The purchase has several significant contingencies for completion. However, the Company expects to complete the purchase during the 1st Quarter of 2006. The estimated purchase price of the acquisition is \$50.0 million, approximately \$60.0 million, including distribution arrangements and other assets.



**Table of Contents****SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) 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.

## DISCOVERY HOLDING COMPANY

By: /s/ Charles Y. Tanabe

Charles Y. Tanabe  
Senior Vice President and  
General Counsel

Dated: March 23, 2006

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the date indicated.

Signature	Title	Date
<u>/s/ John C. Malone</u> John C. Malone	Chairman of the Board, Director and Chief Executive Officer	March 23, 2006
<u>/s/ Robert R. Bennett</u> Robert R. Bennett	Director and President	March 23, 2006
<u>/s/ Paul A. Gould</u> Paul A. Gould	Director	March 23, 2006
<u>/s/ M. LaVoy Robison</u> M. LaVoy Robison	Director	March 23, 2006
<u>/s/ J. David Wargo</u> J. David Wargo	Director	March 23, 2006
<u>/s/ David J.A. Flowers</u> David J.A. Flowers	Senior Vice President and Treasurer (Principal Financial Officer)	March 23, 2006
<u>/s/ Christopher W. Shean</u> Christopher W. Shean	Senior Vice President and Controller (Principal Accounting Officer)	March 23, 2006

**Table of Contents**

**INDEX TO EXHIBITS**

- 2 Plan of Acquisition, Reorganization, Arrangement, Liquidation or Succession:
- 2.1 Reorganization Agreement among Liberty Media Corporation, Discovery Holding Company ( DHC ) and Ascent Media Group, Inc. (incorporated by reference to Exhibit 2.1 to DHC's Registration Statement on Form 10, dated July 15, 2005 (File No. 000-51205) (the Form 10 )).
- 3 Articles of Incorporation and Bylaws:
- 3.1 Restated Certificate of Incorporation of DHC (incorporated by reference to Exhibit 3.1 to the Form 10).
- 3.2 Bylaws of DHC (incorporated by reference to Exhibit 3.2 to the Form 10).
- 4 Instruments Defining the Rights of Securities Holders, including Indentures:
- 4.1 Specimen Certificate for shares of the Series A common stock, par value \$.01 per share, of DHC (incorporated by reference to Exhibit 4.1 to the Form 10).
- 4.2 Specimen Certificate for shares of the Series B common stock, par value \$.01 per share, of DHC (incorporated by reference to Exhibit 4.2 to the Form 10).
- 4.3 Rights Agreement between DHC and EquiServe Trust Company, N.A., as Rights Agent (incorporated by reference to Exhibit 4.3 to the Form 10).
- 10 Material Contracts:
- 10.1 The Shareholders Agreement, dated as of November 30, 1991 (the Stockholders Agreement ), by and among Discovery Communications, Inc. ( Discovery ), Cox Discovery, Inc. ( Cox ), NewsChannels TDC Investments, Inc. ( NewChannels ), TCI Cable Education, Inc. ( TCID ) and John S. Hendricks ( Hendricks ) (incorporated by reference to Exhibit 10.1 to the Form 10).
- 10.2 First Amendment to the Stockholders Agreement, dated as of December 20, 1996, by and among Discovery, Cox Communications Holdings, Inc. (the successor to Cox), Newhouse Broadcasting Corporation ( the successor to NewChannels), TCID, Hendricks and for the purposes stated therein only, LMC Animal Planet, Inc. ( LMC ) and Liberty Media Corporation, a Colorado corporation ( Liberty ) (incorporated by reference to Exhibit 10.2 to the Form 10).
- 10.3 Second Amendment to the Stockholders Agreement, dated as of September 7, 2000, by and among Discovery, Cox Communications Holdings, Inc. (the successor to Cox), Advance/Newhouse Programming Partnership (the successor to NewChannels), LMC Discovery, Inc. (formerly known as TCID) and Hendricks (incorporated by reference to Exhibit 10.3 to the Form 10).
- 10.4 Third Amendment to the Stockholders Agreement, dated as of September, 2001, by and among Discovery, Cox, NewChannels, TCID, Hendricks and Advance Programming Holdings Corp. (incorporated by reference to Exhibit 10.4 to the Form 10).
- 10.5 Fourth Amendment to the Stockholders Agreement, dated as of June 23, 2003, by and among Discovery, Cox NewChannels, TCID, Liberty Animal, Inc. (the successor in interest to LMC) for the purposes stated in the First Amendment to the Stockholders Agreement, and Hendricks (incorporated by reference to Exhibit 10.5 to the Form 10).

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- 10.6 Form of Tax Sharing Agreement between Liberty Media Corporation and DHC (incorporated by reference to Exhibit 10.6 to the Form 10).
  - 10.7 Discovery Holding Company 2005 Incentive Plan (incorporated by reference to Exhibit 10.7 to the Form 10).
  - 10.8 Discovery Holding Company 2005 Non-Employee Director Plan (incorporated by reference to Exhibit 10.8 to the Form 10).
  - 10.9 Discovery Holding Company Transitional Stock Adjustment Plan (incorporated by reference to Exhibit 10.9 to the Form 10).
  - 10.10 Agreement between DHC and John C. Malone (incorporated by reference to Exhibit 10.10 to the Form 10).
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**Table of Contents**

10.11	Agreement, dated June 24, 2005, between Discovery and DHC (incorporated by reference to Exhibit 10.11 to the Form 10).
10.12	Indemnification Agreement, dated as of June 24, 2005, between Cox and DHC (incorporated by reference to Exhibit 10.12 to the Form 10).
10.13	Indemnification Agreement, dated as of June 24, 2005, between NewChannels and DHC (incorporated by reference to Exhibit 10.13 to the Form 10).
10.14	Form of Indemnification Agreement with Directors and Executive Officers (incorporated by reference to Exhibit 10.14 to the Form 10).
21	Subsidiaries of Discovery Holding Company, filed herewith.
23.1	Consent of KPMG LLP, filed herewith.
23.2	Consent of PricewaterhouseCoopers LLP, filed herewith.
31.1	Rule 13a-14(a)/15d-14(a) Certification, filed herewith.
31.2	Rule 13a-14(a)/15d-14(a) Certification, filed herewith.
31.3	Rule 13a-14(a)/15d-14(a) Certification, filed herewith.
32	Section 1350 Certification, filed herewith.

anPerry PC

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Roanoke, Virginia 24016

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**8.6 Counterparts.**

This Agreement may be executed in any number of counterparts, each of which shall be an original, but such counterparts together shall constitute one and the same agreement.

**8.7 Waiver of Jury Trial.**

Each party hereto acknowledges and agrees that any controversy which may arise under this Agreement is likely to involve complicated and difficult issues, and therefore each party hereby irrevocably and unconditionally waives any right such party may have to a trial by jury in respect of any litigation, directly or indirectly, arising out of or relating to this Agreement or the transactions contemplated by this Agreement. Each party certifies and acknowledges that (i) it understands and has considered the implications of this waiver and (ii) it makes this waiver voluntarily.

**8.8 Severability.**

In the event that any provision of this Agreement shall be held invalid or unenforceable by any court of competent jurisdiction, such holding shall not invalidate or render unenforceable any other provisions hereof. Any provision of this Agreement held invalid or unenforceable only in part or degree shall remain in full force and effect to the extent not held invalid or unenforceable. Further, the parties agree that a court of competent jurisdiction may reform any

provision of this Agreement held invalid or unenforceable so as to reflect the intended agreement of the parties hereto.

[Signatures on following page]

A-44

**Table of Contents**

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed in counterparts by their duly authorized officers and their corporate seals to be affixed hereto, all as of the date first written above.

AMERICAN NATIONAL BANKSHARES  
INC.

By: /s/ Jeffrey V. Haley  
Jeffrey V. Haley  
President and Chief Executive Officer

MAINSTREET BANKSHARES, INC.

By: /s/ Brenda H. Smith  
Brenda H. Smith  
President and Chief Executive Officer

A-45

**Table of Contents**

**EXHIBIT 1.1**

To the Agreement and  
Plan of Reorganization

**PLAN OF MERGER**  
**BETWEEN**  
**AMERICAN NATIONAL BANKSHARES INC.**  
**AND**  
**MAINSTREET BANKSHARES, INC.**

Pursuant to this Plan of Merger ( **Plan of Merger** ), MainStreet BankShares, Inc., a Virginia corporation ( **MainStreet** ), shall merge with and into American National Bankshares Inc., a Virginia corporation ( **American** ).

**ARTICLE 1**

**Terms of the Merger**

Subject to the terms and conditions of the Agreement and Plan of Reorganization, dated as of August 24, 2014, between American and MainStreet (the **Agreement** ), at the Effective Date (as defined herein), MainStreet shall be merged with and into American (the **Merger** ) in accordance with the provisions of Virginia law, and with the effect set forth in Section 13.1-721 of the Virginia Stock Corporation Act (the **VSCA** ). The separate corporate existence of MainStreet thereupon shall cease, and American shall be the surviving corporation in the Merger. The Merger shall become effective on such date and time as may be determined in accordance with Section 1.2 of the Agreement (the **Effective Date** ).

**ARTICLE 2**

**Merger Consideration; Exchange Procedures**

**2.1 Conversion of Shares; Exchange of Shares.**

At the Effective Date, by virtue of the Merger and without any action on the part of the stockholders of MainStreet and American, as the case may be, such stockholders will be entitled to the following:

- (a) Each share of common stock, par value \$1.00 per share, of American ( **American Common Stock** ), that is issued and outstanding immediately before the Effective Date shall remain issued and outstanding and shall remain unchanged by the Merger.
- (b) Each share of common stock, no par value, of MainStreet ( **MainStreet Common Stock** ), that is issued and outstanding immediately before the Effective Date (other than the Dissenting Shares as defined in Section 2.8) will be converted into and exchanged for the right to receive (i) 0.482 shares (the **Exchange Ratio** ) of American Common

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Stock (the Stock Consideration ) and (ii) a cash sum of \$3.46 (the Cash Consideration and, together with the Stock Consideration, the Merger Consideration ).

(c) All shares of MainStreet Common Stock converted pursuant to this Section 2.1 shall no longer be outstanding and shall automatically be cancelled and retired and shall cease to exist as of the Effective Date.

A-46



**Table of Contents**

(d) Each certificate previously representing shares of MainStreet Common Stock (a MainStreet Common Certificate ) shall cease to represent any rights except the right to receive with respect to each underlying share of MainStreet Common Stock (i) the Merger Consideration upon the surrender of such MainStreet Common Certificate in accordance with Section 2.2, and (ii) any dividends or distributions or cash in lieu of financial shares which the holder thereof has the right to receive pursuant to Sections 2.4 and 2.6.

(e) Each share of MainStreet Common Stock held by either party and each share of American Common Stock held by MainStreet or any of the MainStreet Subsidiaries (as defined in the Agreement) prior to the Effective Date (in each case other than in a fiduciary or agency capacity or on behalf of third parties as a result of debts previously contracted) shall be cancelled and retired and shall cease to exist at the Effective Date and no consideration shall be issued in exchange therefor; provided, that such shares of American Common Stock shall resume the status of authorized and unissued shares of American Common Stock.

**2.2 Exchange Procedures.**

(a) On or before the Closing Date, American shall deposit, or shall cause to be deposited, with its transfer agent or such other transfer agent or depository or trust institution of recognized standing approved by American (in such capacity, the Exchange Agent ), for the benefit of the holders of the MainStreet Common Certificates, (i) certificates representing the shares of American Common Stock issuable pursuant to this Article 2, and (ii) cash equal to the aggregate amount of the Cash Consideration issuable pursuant to this Article 2, together with any dividends or distributions with respect thereto and any cash to be paid in lieu of fractional shares without any interest thereon (the Exchange Fund ), in exchange for certificates representing outstanding shares of MainStreet Common Stock.

(b) As promptly as practicable after the Effective Date, American shall cause the Exchange Agent to send to each former stockholder of record of MainStreet immediately before the Effective Date transmittal materials for use in exchanging such stockholder's MainStreet Common Certificates for the Merger Consideration, as provided for herein.

(c) American shall cause the Merger Consideration into which shares of MainStreet Common Stock are converted at the Effective Date or dividends or distributions which such stockholder shall be entitled to receive and any cash to be paid in lieu of fractional shares to be issued and paid to such stockholder upon delivery to the Exchange Agent of MainStreet Common Certificates representing such shares of MainStreet Common Stock, together with the transmittal materials duly executed and completed in accordance with the instructions thereto. No interest will accrue or be paid on any such cash to be paid pursuant to Sections 2.4 or 2.6.

(d) Any MainStreet stockholder whose MainStreet Common Certificates have been lost, destroyed, stolen or are otherwise missing shall be entitled to the Merger Consideration, dividends or distributions, and cash in lieu of fractional shares to which such stockholder shall be entitled upon compliance with reasonable conditions imposed by American pursuant to applicable law and as required in accordance with American's standard policy (including the requirement that the shareholder furnish a surety bond or other customary indemnity).

(e) Any portion of the Exchange Fund that remains unclaimed by the stockholders of MainStreet for six (6) months after the Effective Date shall be returned to American (together with any earnings in respect thereof). Any stockholders of MainStreet who have not complied with this Article 2 shall thereafter be entitled to look only to American, and only as a general creditor



## **Table of Contents**

thereof, for payment of the consideration deliverable in respect of each share of MainStreet Common Stock such stockholder holds as determined pursuant to this Agreement, without any interest thereon.

(f) None of the Exchange Agent, American, MainStreet or any of the American Subsidiaries or the MainStreet Subsidiaries (as such terms are defined in the Agreement) shall be liable to any stockholder of MainStreet for any amount of property delivered to a public official pursuant to applicable abandoned property, escheat or similar laws.

### **2.3 MainStreet Stock Options.**

(a) At the Effective Date, each option to purchase shares of MainStreet Common Stock (a MainStreet Stock Option ) granted under an equity or equity-based compensation plan of MainStreet (a MainStreet Stock Plan ) shall vest and shall be converted into an option (each, a Replacement Option ) to acquire, on the same terms and conditions as were applicable under such MainStreet Stock Option (except as provided otherwise in this Section 2.3(a)), the number of shares of American Common Stock equal to the product of (i) the number of shares of MainStreet Common Stock subject to the MainStreet Stock Option multiplied by (ii) 0.643 (the Option Exchange Ratio ). Such product shall be rounded down to the nearest whole number. The exercise price per share (rounded up to the next whole cent) of each Replacement Option shall equal (y) the exercise price per share of shares of MainStreet Common Stock that were purchasable pursuant to such MainStreet Stock Option divided by (z) the Option Exchange Ratio. Notwithstanding the foregoing, each MainStreet Stock Option that is intended to be an incentive stock option (as defined in Section 422 of the Internal Revenue Code of 1986, as amended (the Code )) shall be adjusted in accordance with the requirements of Section 424 of the Code and all other options shall be adjusted in a manner that maintains the options exemption from Section 409A of the Code. At the Effective Date, American shall assume the MainStreet Stock Plans; provided that such assumption shall only be with respect to the Replacement Options and American shall have no obligation to make any additional grants or awards under the MainStreet Stock Plans.

(b) As soon as practicable after the Effective Date, American will deliver to the holders of Replacement Options any required notices setting forth such holders' rights pursuant to the respective MainStreet Stock Plan and award documents and stating that such Replacement Options have been issued by American and shall continue in effect on the same terms and conditions (subject to the adjustments required by this Section 2.3 after giving effect to the Merger and the terms of the MainStreet Stock Plan).

### **2.4 No Fractional Shares.**

Each holder of shares of MainStreet Common Stock exchanged pursuant to the Merger which would otherwise have been entitled to receive a fraction of a share of American Common Stock shall receive, in lieu thereof, cash (without interest and rounded to the nearest cent) in an amount equal to such fractional part of a share of American Common Stock multiplied by the closing sale price of American Common Stock on the NASDAQ Global Select Market for the trading day immediately preceding (but not including) the Effective Date.

### **2.5 Anti-Dilution.**

In the event American changes (or establishes a record date for changing) the number of shares of American Common Stock issued and outstanding before the Effective Date as a result of a stock split, stock dividend, recapitalization, reclassification, reorganization or similar transaction, appropriate and proportional adjustments will be made to the Exchange Ratio.



**Table of Contents**

**2.6 Dividends.**

No dividend or other distribution payable to the holders of record of MainStreet Common Stock at, or as of, any time after the Effective Date will be paid to the holder of any MainStreet Common Certificate until such holder physically surrenders such certificate (or furnishes a surety bond or a customary indemnity that such certificate is lost, destroyed, stolen or otherwise missing as provided in Section 2.2(d)) for exchange as provided in Section 2.2 of this Plan of Merger, promptly after which time all such dividends or distributions will be paid (without interest).

**2.7 Withholding Rights.**

The Exchange Agent will be entitled to deduct and withhold from the Merger Consideration otherwise payable pursuant to this Agreement to any person such amounts, if any, as it is required to deduct and withhold with respect to the making of such payment under the Code (as defined in the Agreement) or any provision of state, local or foreign Tax (as defined in the Agreement) law. To the extent that amounts are so withheld and remitted to the appropriate Governmental Authority (as defined in the Agreement) by the Exchange Agent, such amounts withheld will be treated for all purposes of this Agreement as having been paid to such person in respect of which such deduction and withholding was made by the Exchange Agent.

**2.8 Dissenting Shares.**

Any holder of shares of MainStreet Common Stock who perfects such holder's appraisal rights in accordance with and as contemplated by Sections 13.1-729 through 13.1-741.1 of the VSCA shall be entitled to receive from American, in lieu of the Merger Consideration, the value of such shares as to which appraisal rights have been perfected in cash as determined pursuant to the VSCA; provided, that no such payment shall be made to any dissenting stockholder unless and until such dissenting stockholder has complied with all applicable provisions of the VSCA, and surrendered to MainStreet the certificate or certificates representing the shares for which payment is being made. In the event that after the Effective Date a dissenting stockholder of MainStreet fails to perfect, or effectively withdraws or loses, such holder's right to appraisal of and payment for such holder's shares, American shall issue and deliver the consideration to which such holder of shares of MainStreet Common Stock is entitled under this Article 2 (without interest) upon surrender by such holder of the MainStreet Common Certificate representing such shares.

**ARTICLE 3**

**Articles of Incorporation and Bylaws of American**

The Articles of Incorporation of American as in effect immediately prior to the Effective Date shall be the Articles of Incorporation of American at and after the Effective Date until thereafter amended in accordance with applicable law. The Bylaws of American as in effect immediately prior to the Effective Date shall be the Bylaws of American at and after the Effective Date until thereafter amended in accordance with applicable law.

**Table of Contents**

**ARTICLE 4**

**Conditions Precedent**

The obligations of American and MainStreet to effect the Merger as herein provided shall be subject to satisfaction, unless duly waived, of the conditions set forth in the Agreement.

A-50

**Table of Contents**

**APPENDIX B**

**OPINION OF BB&T CAPITAL MARKETS**

**Table of Contents**

Member  
NYSE/SIPC  
August 22, 2014

901 East Byrd Street, Suite 410  
Richmond, Virginia 23219

Tel (804) 780-3230  
FAX (804) 649-0990

Board of Directors

MainStreet Bankshares, Inc.

1075 Spruce Street

Martinsville, Virginia 24112

Members of the Board:

The Board of Directors (the Board) of MainStreet Bankshares, Inc., a Virginia corporation (the Company), has requested that BB&T Capital Markets, a division of BB&T Securities, LLC (BB&T Capital Markets or we), provide to the Board our opinion as to the fairness, from a financial point of view, to the Company's shareholders of the Merger Consideration to be provided to the Company's shareholders as set forth in that certain Agreement and Plan of Reorganization, dated August 22, 2014 (the Agreement), by and between the Company and American National Bankshares Inc., a Virginia corporation (AMNB), pursuant to which the Company will merge with and into AMNB (the Merger). Under the terms of the Agreement, upon consummation of the Merger, each outstanding share of Company common stock, no par value, issued and outstanding immediately prior to the Merger, will be converted into and exchanged for the right to receive the Merger Consideration. Capitalized terms used herein without definition have the meanings assigned to them in the Agreement. The terms and conditions of the Merger are more fully set forth in the Agreement.

BB&T Capital Markets has acted as financial advisor to the Board in connection with the Merger. As a customary part of our investment banking business, we regularly engage in the valuation of financial institutions and their securities in connection with mergers and acquisitions and other corporate transactions. In the ordinary course of our business as a broker-dealer, we may, from time to time purchase securities from, and sell securities to, the Company and AMNB, and as a market maker in securities, we may from time to time have a long or short position in, and buy, sell or hold equity securities of the Company and AMNB for our own account and for the accounts of our customers. Further, BB&T Capital Markets initiated equity research coverage of AMNB in September 1998 and expects to publish research notes on AMNB from time to time in the future.

Over the past two years, excluding in connection with the Merger, BB&T Capital Markets has not received compensation for investment banking services from either the Company or AMNB. As of the date hereof, there are no material relationships mutually understood to be contemplated in which any compensation is intended to be received by us as a result of the relationship between us and any of the parties to the Agreement.

In connection with the Merger and the preparation and delivery of this opinion, we have reviewed, analyzed, and relied upon, among other things:



- i. The Agreement and meetings and discussions with members of senior management of the Company regarding the material terms of the Agreement;

B-1

**Table of Contents**

Board of Directors

MainStreet Bankshares, Inc.

August 22, 2014

Page 2 of 5

- ii. Certain publicly available financial statements and other historical financial information of AMNB that we deemed relevant and meetings and discussions regarding the same with members of senior management of AMNB;
- iii. Certain publicly and non-publicly available financial statements and other historical financial information of the Company that we deemed relevant and meetings and discussions regarding the same with members of senior management of the Company;
- iv. Internal financial forecasts for the Company related to the business, earnings, cash flows, assets and prospects of the Company for the years ending December 31, 2014 through 2018 prepared by BB&T Capital Markets and reviewed with senior management of the Company (the Forecasts );
- v. The estimated pro forma financial impact of the Merger on AMNB, based on assumptions relating to, without limitation, transaction expenses, purchase accounting adjustments, cost savings, and certain synergies determined by and reviewed with the senior management of the Company and discussed summarily with the senior management of AMNB;
- vi. The historical market prices and trading activity for AMNB common stock and a comparison of certain financial and stock market information for AMNB and the Company with similar publicly-traded companies which we deemed to be relevant;
- vii. The proposed financial terms of the Merger and a comparison of such terms with the financial terms, to the extent publicly available, of certain recent business combinations in the banking industry which we deemed to be relevant;
- viii. The relative contribution of the Company and AMNB with regard to certain assets, liabilities, earnings, and capital;
- ix. The current market environment generally and the banking environment in particular;

- x. A discounted dividend scenario of the Company based upon the Forecasts and an illustrative dividend payout; and
  
- xi. Such other information, financial studies, analyses and investigations, and financial, economic, and market criteria as we deemed appropriate.

We also held discussions with members of senior management of the Company and AMNB regarding the reasons and basis for the Merger and the historical and current business operations, financial condition, results of operations, regulatory relationships and future prospects (including, with respect to senior management of the Company and AMNB, synergies anticipated to result from the Merger) of their respective companies and such other matters as we have deemed relevant to our inquiry.

B-2

**Table of Contents**

Board of Directors

MainStreet Bankshares, Inc.

August 22, 2014

Page 3 of 5

In conducting our review and arriving at our opinion, we have relied upon and assumed the accuracy and completeness of all of the financial and other information that was available to us from public sources, that was provided to us by the Company and AMNB or their respective representatives, or that was otherwise reviewed by us and Company management (including the Forecasts), and we assumed such accuracy and completeness in rendering this opinion. We have further relied on the assurances of management of the Company and AMNB that they are not aware of any facts or circumstances that would make any of such information inaccurate or misleading. We have not been asked nor have we attempted independently to verify such information, and we assume no responsibility or liability for independently verifying the accuracy and completeness of such information. We did not make an independent evaluation or appraisal of any specific assets, any collateral securing assets or the liabilities, including any contingent, off-balance sheet assets or liabilities, of the Company or AMNB or any of their subsidiaries. We did not make an independent evaluation of the adequacy of the allowance for loan losses of the Company or AMNB nor have we reviewed any individual credit files relating to the Company or AMNB. We assumed, with your consent, the respective allowances for loan losses for both the Company and AMNB are adequate to cover such losses and will be adequate for the combined entity on a pro forma basis after all accounting adjustments for the Merger. We also assumed that all governmental, regulatory or other consents and approvals necessary for the consummation of the Merger will be obtained without any adverse effect on the Company and AMNB or on the expected benefits of the Merger.

With respect to the financial projections (including the Forecasts) and earnings estimates for the Company and AMNB and all projections of transaction costs, purchase and other accounting adjustments and expected cost savings or other synergies prepared by and/or reviewed with the management of the Company and AMNB and used by BB&T Capital Markets in its analyses, the Company's and AMNB's senior management confirmed to us that they reflect the best currently available estimates and judgments of the respective management of the Company and AMNB as to the future financial performance of AMNB as the surviving entity in the Merger, and we assumed that such financial performance would be achieved. We express no opinion as to such financial projections (including the Forecasts) or the assumptions or judgments on which they are based. We have assumed that there has been no material change in the assets, financial conditions, results of operations, business or prospects of the Company and AMNB since the date of the most recent financial statements made available to us. We have further assumed, with your consent, that the synergies referenced above will be realized substantially in accordance with the expectations of the Company and AMNB as expressed in collaborative discussion between us and them. Moreover, we have assumed that the Merger will be consummated upon the terms set forth in the Agreement without material alteration or waiver thereof, qualify as a reorganization within the meaning of Section 368(a) of the Internal Revenue Code of 1986, as amended, and that the representations and warranties of each party in the Agreement and in all related documents and instruments referred to in the Agreement are true and correct. Finally, with your consent, we have relied upon the advice the Company has received from its legal, accounting and tax advisors as to all legal, accounting and tax matters related to the Merger and other transactions contemplated by the Agreement.

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Our opinion is necessarily based on, and we have necessarily taken into account, the financial, economic, market and other conditions as in effect on, and the information made available to us as of, the date hereof. We are not legal, tax, regulatory, or bankruptcy advisors. We have not considered any legislative or regulatory changes recently adopted or currently being considered by the United States Congress, the various federal banking agencies, the Securities and Exchange Commission (the SEC), or any other regulatory bodies, or any changes in accounting methods or generally accepted accounting principles that may be adopted by the SEC or the Financial Accounting Standards Board, or any changes in regulatory accounting principles that may be adopted by any or all of the federal banking agencies. Our opinion is not a solvency opinion and does not in any way address the solvency or financial condition

B-3

**Table of Contents**

Board of Directors

MainStreet Bankshares, Inc.

August 22, 2014

Page 4 of 5

of AMNB, the Company or the combined entity after consummation of the Merger. Events occurring after the date hereof could materially affect this opinion. We have no obligation to update, revise, reaffirm or withdraw this opinion or otherwise comment upon events occurring after the date hereof. We are expressing no opinion herein as to what the value of shares of AMNB common stock will be when issued to the Company shareholders at the closing of the Merger pursuant to the Agreement or the prices at which shares of AMNB common stock may trade at any time.

The terms of the fee arrangement with BB&T Capital Markets, which BB&T Capital Markets and the Company believe are customary in transactions of this nature, were negotiated at arm's length between the Company and BB&T Capital Markets, and the Board was aware of such arrangement, including the fact that the majority of the fee payable to BB&T Capital Markets is contingent upon consummation of the merger. The Company also has agreed to reimburse BB&T Capital Markets for reasonable out-of-pocket expenses incurred in connection with its engagement and has agreed to indemnify BB&T Capital Markets and certain related persons against certain liabilities, including liabilities under the federal securities laws, in connection with our engagement for the delivery of this opinion.

Our opinion is directed to the Board in connection with its consideration of the Merger and our opinion does not constitute a recommendation to any holder of the Company shares as to how such holder should vote at any meeting of shareholders called to consider and vote upon the Agreement. This opinion is not intended to, and does not, (i) create any rights or remedies for any person or entity, other than the Board, or (ii) create any fiduciary duty on the part of BB&T Capital Markets to any party. BB&T Capital Markets was not retained as an advisor or agent to the Company's shareholders or any other person, and it is acting only as a financial advisor to the Company's Board of Directors. This opinion has been reviewed and approved by our Investment Banking Valuation Committee in conformity with our policies and procedures established under the requirements of FINRA Rule 5150 of the Financial Industry Regulatory Authority, Inc. Our opinion is limited and directed only to the fairness, from a financial point of view, to the Company's shareholders of the Merger Consideration to be received by such shareholders in connection with the Merger and pursuant to the terms of the Agreement and does not address the underlying business decision by the Company to engage in the Merger, the relative merits of the Merger as compared to any other alternative business strategies or other strategic alternatives that might exist for the Company, the fairness of the amount or nature of any compensation to any of the officers, directors or employees of the Company, or class of such persons, relative to the compensation to the holders of the Company's common shares or the effect of any other transaction in which the Company might engage or the fairness of the Merger to the holders of any securities of AMNB or any creditor or other constituencies of the Company or AMNB. Our opinion is not to be quoted or referred to, in whole or part, in a registration statement, prospectus, proxy statement, or in any other document, nor shall this opinion be used for any other purposes, without BB&T Capital Markets' prior written consent. Notwithstanding the foregoing, BB&T Capital Markets hereby consents to the inclusion of this opinion as an exhibit to the proxy statement to be distributed to the Company's shareholders to solicit their approval of the Merger, provided that this opinion is quoted in full in such proxy statement. BB&T Capital Markets further consents to the inclusion of a summary of this opinion in such proxy statement.

B-4

**Table of Contents**

Board of Directors

MainStreet Bankshares, Inc.

August 22, 2014

Page 5 of 5

Based upon and subject to the foregoing, it is our opinion, as of the date hereof, that the Merger Consideration to be received by the shareholders of the Company in the Merger is fair, from a financial point of view, to such shareholders.

Very truly yours,

G. Jacob Savage III  
Senior Managing Director  
BB&T Capital Markets, a division of BB&T  
Securities, LLC

B-5



**Table of Contents**

**APPENDIX C**

**MAINSTREET BANKSHARES, INC. S**  
**ANNUAL REPORT ON FORM 10-K**  
**FOR THE YEAR ENDED DECEMBER 31, 2013**

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-K**

(Mark One)

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

**For the fiscal year ended December 31, 2013**

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

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

**Commission file number 333-86993**

**MainStreet BankShares, Inc.**

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

**Virginia**  
**(State or other jurisdiction of**  
**incorporation or organization)**

**54-1956616**  
**(I.R.S. Employer**  
**Identification No.)**

**1075 Spruce Street, Martinsville, Virginia**  
**(Address of principal executive offices)**

**24112**  
**(Zip Code)**

**Registrant's telephone number, including area code (276) 632-8054**

**Securities registered pursuant to Section 12(b) of the Act:**

<b>Title of each class</b>	<b>Name of each exchange on which registered</b>
----------------------------	--

**None**

**None**

**Securities registered pursuant to Section 12(g) of the Act:**

**Common Stock, No Par Value**

**(Title of class)**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

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Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of June 30, 2013. \$8,872,899 based on \$7.07 per share.

**(Applicable only to corporate registrants)** Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date 1,713,375 shares outstanding as of March 17, 2014.

**Documents incorporated by reference.** Portions of the Corporation's 2014 Proxy Statement have been incorporated by reference into Part III.

C-1

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**Table of Contents**

MainStreet BankShares, Inc.

Form 10-K

Index

**PART I**

Item 1	<u>Business</u>	C-3
Item 1A	<u>Risk Factors</u>	C-8
Item 1B	<u>Unresolved Staff Comments</u>	C-8
Item 2	<u>Properties</u>	C-8
Item 3	<u>Legal Proceedings</u>	C-8
Item 4	<u>Mine Safety Disclosures</u>	C-8

**PART II**

Item 5	<u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	C-9
Item 6	<u>Selected Financial Data</u>	C-10
Item 7	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	C-10
Item 7A	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	C-31
Item 8	<u>Financial Statements and Supplementary Data</u>	C-32
Item 9	<u>Changes In and Disagreements with Accountants on Accounting and Financial Disclosure</u>	C-74
Item 9A	<u>Controls and Procedures</u>	C-74
Item 9B	<u>Other Information</u>	C-74

**PART III**

Item 10	<u>Directors, Executive Officers and Corporate Governance</u>	C-75
Item 11	<u>Executive Compensation</u>	C-78
Item 12	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	C-78
Item 13	<u>Certain Relationships and Related Transactions, and Director Independence</u>	C-78
Item 14	<u>Principal Accounting Fees and Services</u>	C-79

**PART IV**

Item 15	<u>Exhibits and Financial Statement Schedules</u>	C-79
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**Table of Contents**

**PART I**

**Item 1. Business**

**General**

MainStreet BankShares, Inc., (the Corporation, MainStreet, or BankShares), was incorporated in the Commonwealth of Virginia on January 14, 1999. MainStreet was primarily formed to serve as a bank holding company. Its first wholly-owned subsidiary was located in Martinsville, Virginia and was sold on March 23, 2005. In 2002, MainStreet organized a second bank subsidiary, Franklin Community Bank, National Association (Franklin Bank). On February 8, 2007, MainStreet formed a wholly-owned real estate company, MainStreet RealEstate, Inc., for the sole purpose of owning the real estate of the Corporation.

MainStreet is authorized to engage in any lawful activity for a bank holding company. The holding company structure provides greater flexibility than a bank standing alone because it allows expansion and diversification of business activities through newly formed subsidiaries or through acquisitions. MainStreet's business is conducted through its subsidiary bank.

**Franklin Community Bank, N.A.**

Franklin Bank is a nationally chartered commercial bank and member of the Federal Reserve whose deposits are insured by the FDIC. Franklin Bank opened for business on September 16, 2002. Franklin Bank accepts deposits from the general public and makes commercial, consumer, and real estate loans. Franklin Bank operates as a locally-owned and operated commercial bank emphasizing personal customer service and other advantages incident to banking with a locally owned community bank. It relies on local advertising and the personal contacts of its directors, employees, and shareholders to attract customers and business to the Bank. Franklin Bank emphasizes a high degree of personalized client service in order to be able to serve each customer. Franklin Bank's marketing approach emphasizes the advantages of dealing with an independent, locally managed commercial bank to meet the particular needs of individuals, professionals and small to medium-sized businesses. The main office of Franklin Bank is located at 400 Old Franklin Turnpike, Suite 100, Rocky Mount, Virginia. Franklin Bank has banking offices located at 12930 Booker T. Washington Highway, Hardy, Virginia and 25 Southlake Drive, Union Hall, Virginia. Franklin Bank's primary service area is Franklin County, Town of Rocky Mount and surrounding areas. For the most part, Franklin Bank's business activity is with customers located in its primary market area. Accordingly, operating results are closely correlated with the economic trends within the region and influenced by the significant industries in the region including pre-built housing, real estate development, agriculture, and resort and leisure services. Much of the market area is considered rural; however, the resort surrounding Smith Mountain Lake attracts many tourists to the area.

**MainStreet RealEstate, Inc.**

MainStreet RealEstate, Inc. was formed for the sole purpose of owning the real estate of the Corporation. It now owns the facility in which Franklin Bank's Southlake office operates.

**Competition**

Franklin Bank experiences competition in attracting and retaining business and personal checking and savings accounts, making commercial, consumer, and real estate loans and providing other services in their primary service area. The principal methods of competition in the banking industry for deposits are service, rates offered, convenience

of location, and flexible office hours. The principal methods of competition in the banking industry for loans are interest rates, loan origination fees, and the range of lending services offered. Competition in the service area comes from other commercial banks, savings institutions, brokerage firms, credit unions, and mortgage banking firms. Competition for deposits is particularly intense in Franklin Bank's market which increases the cost and reduces the availability of local deposits. Because of the nature of Franklin Bank's market, a substantial portion of the loan opportunities for which banks compete are real estate related. During the present economic downturn, which has been focused on real estate, the number of loan opportunities has been reduced and the risk of those loans has been increased. Franklin Bank has been able to take advantage of the consolidation in the banking industry in our market area by providing personalized banking services that are desirable to large segments of customers, which has enabled the bank to compete satisfactorily. We intend to continue to provide a high level of service with local decision-making focused solely on our local market. We process daily by branch capture, a method by which checks are processed by tellers rather than item processing, which allows for better efficiencies along with all day banking. We also receive and send our cash letters electronically. In addition, a new online business module will be implemented in 2014, which will allow our business banking clients to have more control over their accounts. We believe these factors more than offset the advantages that larger banks in our markets may have in offering a larger number of banking locations and broader range of services.

C-3

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**Table of Contents****Regulation, Supervision and Government Policy**

BankShares and Franklin Bank are subject to state and federal banking laws and regulations that provide for general regulatory oversight of all aspects of their operations. As a result of substantial regulatory burdens on banking, financial institutions like MainStreet and Franklin Bank are at a disadvantage to other competitors who are not as highly regulated, and MainStreet and Franklin Bank's costs of doing business are accordingly higher. A brief summary follows of certain laws, rules and regulations which affect MainStreet and Franklin Bank. Recent and expected changes in the laws and regulations governing banking and financial services could have an adverse effect on the business prospects of MainStreet and Franklin Bank. The current economic environment has created uncertainty in this area, as legislators and regulators attempt to address rapidly changing problems which are likely to lead to new laws and regulations affecting financial institutions.

**MainStreet BankShares, Inc.**

MainStreet is a bank holding company organized under the Federal Bank Holding Company Act ( BHCA ), which is administered by the Board of Governors of the Federal Reserve System ( Federal Reserve ). MainStreet is required to file an annual report with the Federal Reserve and may be required to furnish additional information pursuant to the BHCA. The Federal Reserve is authorized to examine MainStreet and its subsidiaries. With some limited exceptions, the BHCA requires a bank holding company to obtain prior approval from the Federal Reserve before acquiring or merging with a bank or before acquiring more than 5% of the voting shares of a bank unless it already controls a majority of shares. On June 17, 2009, MainStreet entered into a Memorandum of Understanding ( MOU ) with the Federal Reserve which was amended effective January 26, 2011. The MOU was terminated in September 2013 and there are no longer restrictions or stipulations attributable to the MOU. Refer to Item 7, Management's Discussion and Analysis for a detailed discussion.

*The Bank Holding Company Act.* Under the BHCA, a bank holding company is generally prohibited from engaging in nonbanking activities unless the Federal Reserve has found those activities to be incidental to banking. Bank holding companies also may not acquire more than 5% of the voting shares of any company engaged in nonbanking activities.

*The Virginia Banking Act.* The Virginia Banking Act requires all Virginia bank holding companies to register with the Virginia State Corporation Commission ( Commission ). MainStreet is required to report to the Commission with respect to financial condition, operations and management. The Commission may also make examinations of any bank holding company and its subsidiaries.

*The Gramm-Leach-Bliley Act.* The Gramm-Leach-Bliley Act ( GLBA ) permits significant combinations among different sectors of the financial services industry, allows for expansion of financial service activities by bank holding companies and offers financial privacy protections to consumers. GLBA preempts most state laws that prohibit financial holding companies from engaging in insurance activities. GLBA permits affiliations between banks and securities firms in the same holding company structure, and it permits financial holding companies to directly engage in a broad range of securities and merchant banking activities. MainStreet is not a financial holding company.

*The Sarbanes-Oxley Act.* The Sarbanes-Oxley Act ( SOX ) enacted sweeping reforms of the federal securities laws intended to protect investors by improving the accuracy and reliability of corporate disclosures. It impacts all companies with securities registered under the Securities Exchange Act of 1934, including MainStreet. SOX creates increased responsibilities for chief executive officers and chief financial officers with respect to the content of filings with the Securities and Exchange Commission. Section 404 of SOX and related Securities and Exchange Commission rules focused increased scrutiny by internal and external auditors on MainStreet's systems of internal controls over financial reporting, which is designed to insure that those internal controls are effective in both design and operation.



SOX sets out enhanced requirements for audit committees, including independence and expertise, and it includes stronger requirements for auditor independence and limits the types of non-audit services that auditors can provide. Finally, SOX contains additional and increased civil and criminal penalties for violations of securities laws.

*Emergency Economic Stabilization Act of 2008.* On October 14, 2008, the U. S. Treasury announced the Troubled Asset Relief Program ( TARP ) under the Emergency Economic Stabilization Act of 2008. In the program, the Treasury was authorized to purchase up to \$250 million of senior preferred shares in qualifying U. S. banks, savings and loan associations, and bank and savings and loan holding companies. The amount of TARP funds was later increased up to \$350 million. The minimum subscription amount was 1% of risk-weighted assets and the maximum amount was the lesser of \$25 billion or 3% of risk-weighted assets. MainStreet did not participate in TARP.

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**Table of Contents**

*American Recovery and Reinvestment Act of 2009 (ARRA)*. The ARRA was enacted in 2009 and includes a wide range of programs to stimulate economic recovery. In addition, it also imposed new executive compensation and corporate governance obligations on TARP Capital Purchase Program recipients. Because MainStreet did not participate in TARP, it is not affected by these requirements.

*Dodd-Frank Wall Street Reform and Consumer Protection Act*. The Dodd-Frank Act was signed into law on July 21, 2010. Its wide ranging provisions affect all federal financial regulatory agencies and nearly every aspect of the American financial services industry. Among the provisions of the Dodd-Frank Act that directly impact the Corporation is the creation of an independent Consumer Financial Protection Bureau, (CFPB), which has the ability to write rules for consumer protections governing all financial institutions. All consumer protection responsibility formerly handled by other banking regulators is consolidated in the CFPB. It will also oversee the enforcement of all federal laws intended to ensure fair access to credit. The CFPB has begun implementing mortgage lending regulations to carry out its mandate. Even though Franklin Bank did not participate in the activities which precipitated the crisis these new rules have the effect of increasing the processing time and cost for making residential mortgage loans and from a practical standpoint limiting the residential mortgage loans Franklin Bank will make. In addition, the Federal Reserve issues new rules, effective October 1, 2011, which had the effect of limiting the fees charged to merchants by credit card companies for debit card transactions. The Dodd-Frank Act also contains provisions that affect corporate governance and executive compensation.

Although the Dodd-Frank Act provisions themselves are extensive, the full impact on the Corporation of this massive legislation continues to be unknown. The Act provides that several federal agencies, including the Federal Reserve, the CFPB and the Securities and Exchange Commission, shall issue regulations implementing major portions of the legislation, and this process is ongoing.

*Jumpstart Our Business Startups (JOBS ACT)*. On April 5, 2012, the President signed the Jumpstart our Business Startups (JOBS) Act into law. The objective of the legislation, as the name implies, is to stimulate the growth of small to midsized companies through facilitated access to capital and reduced regulatory reporting requirements. This, in turn, is expected to create jobs as businesses use this newly infused capital to expand operations.

**Franklin Community Bank, N.A.**

Franklin Bank is a national banking association incorporated under the laws of the United States, and the bank is subject to regulation and examination by the Office of the Comptroller of the Currency (OCC). Franklin Bank's deposits are insured by the Federal Deposit Insurance Corporation (FDIC) up to the limits of applicable law. The OCC, as the primary regulator, and the FDIC regulate and monitor all areas of Franklin Bank's operation. These areas include adequacy of capitalization and loss reserves, loans, deposits, business practices related to the charging and payment of interest, investments, borrowings, payment of dividends, security devices and procedures, establishment of branches, corporate reorganizations and maintenance of books and records. Franklin Bank is required to maintain certain capital ratios. It must also prepare quarterly reports on its financial condition for the OCC and conduct an annual audit of its financial affairs. The OCC requires Franklin Bank to adopt internal control structures and procedures designed to safeguard assets and monitor and reduce risk exposure. While appropriate for the safety and soundness of banks, these requirements add to overhead expense for Franklin Bank and other banks. On April 16, 2009, Franklin Bank entered into a formal agreement (Agreement) with the OCC. Franklin Bank has achieved full compliance with the agreement, which was terminated in August of 2013. Refer to Item 7, Management's Discussion and Analysis for a detailed discussion.

*The Community Reinvestment Act*. Franklin Bank is subject to the provisions of the Community Reinvestment Act (CRA), which imposes an affirmative obligation on financial institutions to meet the credit needs of the communities

they serve, including low and moderate income neighborhoods. The OCC monitors Franklin Bank's compliance with the CRA and assigns public ratings based upon the bank's performance in meeting stated assessment goals. Unsatisfactory CRA ratings can result in restrictions on bank operations or expansion. Franklin Bank received a satisfactory rating in its last CRA examination by the OCC.

*The Gramm-Leach-Bliley Act.* In addition to other consumer privacy provisions, the Gramm-Leach-Bliley Act (GLBA) restricts the use by financial institutions of customers' nonpublic personal information. At the inception of the customer relationship and annually thereafter, Franklin Bank is required to provide its customers with information regarding its policies and procedures with respect to handling of customers' nonpublic personal information. GLBA generally prohibits a financial institution from providing a customer's nonpublic personal information to unaffiliated third parties without prior notice and approval by the customer.

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**Table of Contents**

*The USA Patriot Act.* The USA Patriot Act ( Patriot Act ) facilitates the sharing of information among government entities and financial institutions to combat terrorism and money laundering. The Patriot Act imposes an obligation on Franklin Bank to establish and maintain anti-money laundering policies and procedures, including a customer identification program. Franklin Bank is also required to screen all customers against government lists of known or suspected terrorists. There is additional regulatory oversight to insure compliance with the Patriot Act.

*Consumer Laws and Regulations.* There are a number of laws and regulations that regulate banks' consumer loan and deposit transactions. Among these are the Truth in Lending Act, the Truth in Savings Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Fair Credit Reporting Act, and the Fair Debt Collections Practices Act. Franklin Bank is required to comply with these laws and regulations in its dealing with customers. In addition, the CFPB has begun adopting rules regulating consumer mortgage lending pursuant to the Dodd-Frank Act. There are numerous disclosure and other compliance requirements associated with the consumer laws and regulations.

*Deposit Insurance.* Franklin Bank has deposits that are insured by the Federal Deposit Insurance Corporation ( FDIC ). FDIC maintains a Bank Insurance Fund ( BIF ) that is funded by risk-based insurance premium assessments on insured depository institutions. Assessments are determined based upon several factors, including the level of regulatory capital and the results of regulatory examinations. FDIC may adjust assessments if the insured institution's risk profile changes or if the size of the BIF declines in relation to the total amount of insured deposits. In 2013 and 2012, Franklin Bank paid \$196,501 and \$253,874, respectively, in FDIC assessments. It is anticipated that assessments may increase in the future to offset demands on the BIF from banks that fail in the troubled economy. Such increases could adversely affect the Bank's profitability.

On October 3, 2008, the FDIC announced that deposits at FDIC-insured institutions would be insured up to at least \$250,000. It was extended to December 31, 2013, and then permanently.

FDIC announced its Transaction Account Guarantee Program on October 14, 2008. The Transaction Account Guarantee Program, which is a part of the Temporary Liquidity Guarantee Program, provides full coverage for non-interest bearing deposit accounts of FDIC-insured institutions that elected to participate. Franklin Bank elected to participate in this program and opted to continue in the program. There were increased BIF assessments for program participants. This program has terminated.

After giving primary regulators an opportunity to first take action, FDIC may initiate an enforcement action against any depository institution it determines is engaging in unsafe or unsound actions or which is in an unsound condition, and the FDIC may terminate that institution's deposit insurance.

*Capital Requirements.* The Federal Reserve has adopted risk-based capital guidelines that are applicable to MainStreet. The guidelines provide that the Corporation must maintain a minimum ratio of 8% of qualified total capital to risk-weighted assets (including certain off-balance sheet items, such as standby letters of credit). At least half of total capital must be comprised of Tier 1 capital, for a minimum ratio of Tier 1 capital to risk-weighted assets of 4%. In addition, the Federal Reserve has established minimum leverage ratio guidelines of 4% for banks that meet certain specified criteria. The leverage ratio is the ratio of Tier 1 capital to total average assets, less intangibles. MainStreet is expected to be a source of capital strength for its subsidiary bank, and regulators can undertake a number of enforcement actions against MainStreet if its subsidiary bank becomes undercapitalized. MainStreet's bank subsidiary is well capitalized and fully in compliance with capital guidelines. However, regulatory capital requirements relate to earnings and asset quality, among other factors. Bank regulators could choose to raise capital requirements for banking organizations beyond current levels. As discussed in Item 7, Management's Discussion and Analysis, MainStreet's subsidiary bank entered into a formal agreement with the Office of the Comptroller of the

Currency which contained requirements relative to Franklin Bank's capital levels. Franklin Bank has achieved full compliance with the agreement, which was terminated in August 2013.

On July 2, 2013, the Federal Reserve voted to adopt final Basel III capital rules for U. S. banking organizations. The final rules establish an integrated regulatory capital framework and will implement in the United States the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the Dodd-Frank Act. Under the final rule, minimum requirements will increase for both the quantity and quality of capital held by banking organizations. Consistent with the international Basel framework, the final rule includes a new minimum ratio of common equity tier I capital (Tier 1 Common) to risk-weighted assets and a common equity tier I capital conservation buffer of 2.5% of risk-weighted assets that will apply to all supervised financial institutions. The rule also raises the minimum ratio of tier I capital to risk-weighted

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## Table of Contents

assets and includes a minimum leverage ratio of 4% for all banking organizations. These new minimum capital ratios will become effective for MainStreet on January 1, 2015 and will be fully phased in on January 1, 2019. The final rule emphasizes common equity tier I capital, the most loss-absorbing form of capital, and implements strict eligibility criteria for regulatory capital instruments. The final rule also improves the methodology for calculating risk-weighted assets to enhance risk sensitivity. Banks and regulators use risk weighting to assign different levels of risk to different classes of assets. Failure to meet statutorily mandated capital guidelines or more restrictive ratios separately established for a financial institution could subject the Bank or MainStreet to a variety of enforcement remedies, including issuance of a capital directive, the termination of deposit insurance by the FDIC, a prohibition on accepting or renewing brokered deposits, limitations on the rates of interest that the institution may pay on its deposits and other restrictions on its business. As described above, significant additional restrictions can be imposed on Franklin Bank if it would fail to meet applicable capital requirements.

*Limits on Dividend Payments.* As a national bank, Franklin Bank may not pay dividends from its capital, and it may not pay dividends if the bank would become undercapitalized, as defined by regulation, after paying the dividend. Without prior OCC approval, Franklin Bank's dividend payments in any calendar year are restricted to the bank's retained net income for that year, as that term is defined by the laws and regulations, combined with retained net income from the preceding two years, less any required transfer to surplus. Under the Agreement, Franklin Bank was restricted from paying dividends. Franklin Bank has achieved full compliance with the Agreement, which was terminated in August 2013.

The OCC and FDIC have authority to limit dividends paid by Franklin Bank, if the payment were determined to be an unsafe and unsound banking practice. Any payment of dividends that depletes the Bank's capital base could be deemed to be an unsafe and unsound banking practice. Under the MOU with the Federal Reserve, MainStreet could not pay any dividends without approval. The MOU was terminated in September 2013 and there are no longer any restrictions or stipulations attributable to the MOU.

*Branching.* As a national bank, Franklin Bank is required to comply with the state branch banking laws of Virginia, the state in which the Bank is located. Franklin Bank must also have the prior approval of OCC to establish a branch or acquire an existing banking operation. Under Virginia law, Franklin Bank may open branch offices or acquire existing banks or bank branches anywhere in the state. Virginia law also permits banks domiciled in the state to establish a branch or to acquire an existing bank or branch in another state. The Dodd-Frank Act permits the OCC to approve national bank branches in any state in which a bank located in that state is permitted to establish a branch.

## Monetary Policy

The monetary and interest rate policies of the Federal Reserve, as well as general economic conditions, affect the business and earnings of MainStreet. Franklin Bank and other banks are particularly sensitive to interest rate fluctuations. The spread between the interest paid on deposits and that which is charged on loans is the most important component of Franklin Bank's profits. In addition, interest earned on investments held by MainStreet and Franklin Bank has a significant effect on earnings. As conditions change in the national and international economy and in the money markets, the Federal Reserve's actions, particularly with regard to interest rates, can impact loan demand, deposit levels and earnings at Franklin Bank. It is not possible to accurately predict the effects on MainStreet of economic and interest rate changes.

## Other Legislative and Regulatory Concerns

Particularly because of current uncertain and volatile economic conditions as well as recent credit market turmoil and related financial institution concerns, federal and state laws and regulations are likely to be enacted that will affect the

regulation of financial institutions. The Dodd-Frank Reform Act has been adopted and additional regulations affecting the financial sector have been enacted and additional regulations can be expected, although many of these are not directly applicable to small community financial institutions like MainStreet. The net effect of these changes in this law as well as others will add to the regulatory burden on banks and increase the costs of compliance, or they could change the products that can be offered and the manner in which banks do business. We cannot foresee how the additional regulation of financial institutions may change in the future and how those changes might affect MainStreet.

Company Website

MainStreet maintains a website at [www.msbsinc.com](http://www.msbsinc.com) and for Franklin Bank at [www.fcbva.com](http://www.fcbva.com). The Corporation's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports are made available on its website through a link to the Securities and Exchange Commission for filings. The Corporation's proxy materials for the 2014 Annual Meeting of Shareholders are also posted on a separate website at [www.cfpproxy.com/6043](http://www.cfpproxy.com/6043).

## Table of Contents

### Employees

The total number of full-time equivalent persons employed by MainStreet and its wholly owned bank subsidiary as of December 31, 2013 was 52. MainStreet believes its relationship with its employees is good and no employees are represented by a labor union.

### **Item 1A. Risk Factors**

Not required.

### **Item 1B. Unresolved Staff Comments**

Not required.

### **Item 2. Properties**

The Corporation leases its executive office and operations facility in Martinsville, Virginia. The lease commenced on November 19, 2010 for space located at 1075 Spruce Street in Martinsville, Virginia. The lease will expire November 30, 2015. The lease has an option to renew for one additional five year term.

Franklin Bank's main office is located at 400 Old Franklin Turnpike, Suite 100, Rocky Mount, Virginia, in a section of town known as the Rocky Mount Marketplace. The bank leases a two-story facility with approximately 8,200 square feet of which the Bank provides permanent financing to the owners of which one is a director. The lease is for a 15-year period and the expiration date of the lease is June 30, 2018. The lease payment mirrors the loan payment plus an 8% return on investment to the owner. Subject to certain compliance issues, Franklin Bank has the option to extend the lease for one additional term of five years. If the right to extend this lease for the first renewal term is exercised, Franklin Bank has the right to extend this lease for five additional terms of five years each. One of the owners is a director of Franklin Bank and both owners are shareholders of BankShares. Franklin Bank owns a lot adjacent to their Rocky Mount Office which is utilized for employee parking. Franklin Bank leases its branch which opened on April 9, 2004 at 12930 Booker T. Washington Highway, Hardy, Virginia. Franklin Bank provides permanent financing to the owner of this facility. A director of Franklin Bank is a partner in the ownership of this facility. The lease commenced on April 7, 2004 and will expire April 6, 2019. The lease payment mirrors the loan payment plus an 8% return on investment to the owner. Subject to certain compliance issues, Franklin Bank has the option to extend the lease for one additional term of five years. If the right to extend this lease for the first renewal term is exercised, Franklin Bank has the right, or option, to extend or renew this lease for five additional terms of five years each. Franklin Bank leased its 220 North branch located at 35 Shepherd Drive, Rocky Mount, Virginia. A director of Franklin Bank was a partner in the ownership of the facility. The lease commenced June 1, 2007 and expired June 1, 2012. Franklin Bank closed this banking office effective November 13, 2010; however, the lease remained in effect until its maturity. Franklin Bank purchased the building at the maturity of the lease and assigned the purchase to another buyer which was a director of both the Corporation and Franklin Bank. The main office and all branches have a drive-up ATM.

MainStreet RealEstate, Inc. owns the Southlake branch located in the Union Hall area of Franklin County and leases it to Franklin Bank. The branch opened in August 2007. The total cost of the land and building were \$425,286 and \$881,123, respectively. MainStreet believes its banking facilities are well located to serve their intended banking



markets and are attractively furnished and well equipped for banking purposes. All facilities are adequately insured in management's opinion.

**Item 3. Legal Proceedings**

MainStreet currently is not involved in any legal proceedings outside the normal operations associated with problem credits.

**Item 4. Mine Safety Disclosures**

Not applicable.

C-8

**Table of Contents****PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

MainStreet has 10,000,000 authorized shares of common stock, no par value, and had 1,713,375 shares of its common stock outstanding at January 31, 2014. In addition, the initial organizers of MainStreet received 96,250 warrants in connection with the initial public offering. Each warrant provided the holder with the right to buy one share of common stock at a price of \$9.09 per share of which 27,500 were exercised and the remainder were either forfeited or expired unexercised in 2010.

Options in the amount of 33,000 were granted at the then fair market value of \$9.55 to a former employee and expired in June 2013.

In addition, the shareholders of MainStreet BankShares, Inc. approved the 2004 Key Employee Stock Option Plan (the Plan) at its Annual Meeting on April 15, 2004. The Plan permitted the grant of Non-qualified Stock Options and Incentive Stock Options to persons designated as Key Employees of BankShares and its subsidiaries. The Plan terminated on January 21, 2009. Awards made under the Plan prior to and outstanding on that date remain outstanding in accordance with their terms. Option awards were generally granted with an exercise price equal to the market value of MainStreet's stock at the date of grant. The options issued in 2007 and 2006 had a vesting period of 3 years and have a ten year exercise term. The options issued in 2005 vested immediately upon grant and have a ten year exercise term. As of December 31, 2013, there were 136,527 options granted under this plan of which 822 options have been exercised, 61,249 options have expired, and 7,433 stock options have been forfeited. The rest remain unexercised.

As of December 31, 2013, 67,023 stock options are outstanding, of which all are vested and exercisable.

MainStreet enrolled its stock with the OTC Bulletin Board (OTCBB) quotation service effective February 12, 2007.

In order to continue on the OTCBB, MainStreet must maintain at least one market maker and continue to submit its periodic reports to the Securities and Exchange Commission (SEC) in a timely manner. MainStreet has been current on all periodic filings with the SEC and currently has three market makers. MainStreet is quoted under the symbol MREE.

According to information obtained by Corporation management and believed to be reliable, the quarterly range of closing prices per share for the common stock during the last two fiscal years was as follows:

Quarter Ended	2013		2012	
	High Close	Low Close	High Close	Low Close
March 31	\$ 7.20	\$ 6.00	\$ 4.25	\$ 3.75
June 30	\$ 8.24	\$ 6.40	\$ 6.39	\$ 4.25
September 30	\$ 7.80	\$ 7.07	\$ 4.90	\$ 4.50
December 31	\$ 8.50	\$ 7.01	\$ 6.00	\$ 4.55

There are approximately 1,565 shareholders of common stock as of December 31, 2013.

Given the injection of \$1.3 million into the loan loss reserve by Franklin Bank during the fourth quarter of 2008, MainStreet's Board of Directors deemed it prudent to suspend the cash dividend at that time. The only source of funds for dividends is dividends paid to MainStreet by Franklin Bank. Franklin Bank is limited in the amount of dividend payments by the Office of the Comptroller of the Currency, ( OCC ), its primary regulator. The OCC limits annual dividends to a maximum of retained profits of the current year plus the two prior years, without prior OCC approval. On April 16, 2009, Franklin Bank entered into a formal Agreement ( Agreement ) with the OCC. Among other things, the Agreement required the Bank to adopt a three year capital program and prohibited the payment of a dividend until the Bank achieved compliance with the program and satisfied certain other conditions. Franklin Bank has achieved full compliance with the Agreement, which was terminated in August 2013. On June 17, 2009, MainStreet entered into a Memorandum of Understanding ( MOU ) with the Federal Reserve Bank of Richmond, which was amended January 26, 2011. Under the MOU, MainStreet was prohibited from paying any dividends. The MOU was terminated in September 2013 and there are no longer any restrictions or stipulations attributable to the MOU. However, the payment of future dividends by MainStreet may depend on a return by Franklin Bank to more historical levels of profitability. Refer to Item 7, Management's Discussion and Analysis for a detailed discussion.

**Table of Contents**

Information in the format relating to MainStreet securities authorized for issuance under the Company's Equity Compensation plans is as follows:

Plan Category	Number of Securities To be Issued Upon Exercise of Outstanding Options, Warrants and Rights (a)	Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights (b)	Number of Securities Remaining Available For Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) (c)
Equity compensation plans approved by security holders	67,023	\$ 12.87	
Equity compensation plans not approved by security holders			
<b>Total</b>	<b>67,023</b>	<b>\$ 12.87</b>	

The Plan terminated January 21, 2009, except with respect to awards granted prior to that date.

Refer to Part II, Item 8, Note 14 for a detailed discussion of the stock options and warrants that are outstanding.

**Item 6. Selected Financial Data**

Not required

**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion is intended to assist in understanding and evaluating the financial condition and results of operations of MainStreet BankShares, Inc. ( MainStreet , BankShares , or Corporation ) on a consolidated basis. This discussion and analysis should be read in conjunction with BankShares' consolidated financial statements and related notes included in Item 8 of this report on Form 10-K.

**Forward-Looking Statements**

This report contains forward-looking statements that are subject to risks and uncertainties that could cause actual results to differ materially from those reflected in such forward-looking statements which are representative only on the date hereof. Readers of this report should not rely solely on the forward-looking statements and should consider all uncertainties and risks discussed throughout this report. MainStreet takes no obligation to update any forward-looking statements contained herein. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements include, among others, the following possibilities: (1) competitive pressures among

depository and other financial institutions may increase significantly; (2) changes in the interest rate environment may reduce margins; (3) general economic conditions, either nationally or regionally, may be less favorable than expected that could result in a deterioration of credit quality or a reduced demand for credit; and (4) legislative or regulatory changes including changes in accounting standards, may adversely affect the business.

### General

MainStreet was incorporated on January 14, 1999 in the Commonwealth of Virginia and is the bank holding company for Franklin Bank which serves the Franklin County area of Virginia. MainStreet provides a wide variety of banking services through Franklin Bank, which emphasizes personal customer service and other advantages incident to banking with a locally owned community bank. It relies on local advertising and the personal contacts of its directors, employees, and shareholders to attract customers and business to the Bank. Franklin Bank has three banking offices in Rocky Mount and Franklin County. On February 8, 2007, MainStreet formed a wholly-owned real estate company, MainStreet RealEstate, Inc. for the sole purpose of owning the real estate of the Corporation. MainStreet RealEstate, Inc. owns the Union Hall (Southlake) office of Franklin Bank.

On April 16, 2009, Franklin Bank entered into a formal agreement ( Agreement ) with The Comptroller of the Currency ( OCC ). The Agreement required Franklin Bank to perform certain actions within designated time frames. The Agreement

## Table of Contents

was intended to demonstrate the Bank's commitment to review/enhance certain aspects of various policies and practices related to credit administration and liquidity. Franklin Bank achieved full compliance with the Agreement. The Agreement was terminated in August 2013.

On June 17, 2009, MainStreet BankShares, Inc. entered into a Memorandum of Understanding ( MOU ) with the Federal Reserve Bank of Richmond ( Federal Reserve ). The MOU required the bank holding company to utilize its financial and managerial resources to assist Franklin Bank in functioning in a safe and sound manner and restricted MainStreet from conducting various activities. On January 26, 2011, we entered into a new MOU with the Federal Reserve which contained the same terms of the previous MOU (which was terminated) but added provisions regarding compliance with certain laws and regulations. This MOU was terminated in September 2013. There are no longer any restrictions or stipulations attributable to the MOU.

## Critical Accounting Policies

MainStreet's financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP). The financial information contained within our statements is, to a significant extent, based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability.

### Allowance for Loan Losses

We use historical loss factors, peer comparisons, regulatory factors, concentrations of credit, past dues, and the trend in the economy as factors in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from the historical factors that we use in estimating risk. The allowance for loan losses reflects our best estimate of the losses inherent in our loan portfolio. The allowance is based on two basic principles of accounting: (i) losses are accrued when they are probable of occurring and are capable of estimation and (ii) losses are accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance. The allowance for loan losses is maintained at a level, which, reflects management's best estimate of probable credit losses inherent in the loan portfolio and is, therefore, believed to be appropriate.

The amount of the allowance is based on management's evaluation of the collectability of the loan portfolio, including the nature of the portfolio, credit concentrations, trends in historical loss experience, specific impaired loans, economic conditions and other risks inherent in the portfolio. Management reviews the past due reports and risk-rated loans and discusses individually the loans on these reports with the responsible loan officers. Management uses these tools and provides a quarterly analysis of the allowance based on our historical loan loss experience, risk-rated loans, past dues, concentrations of credit, unsecured loans, loan exceptions, and the economic trend. These are generally grouped by homogeneous loan pools. Impaired loans are reviewed individually to determine possible impairment based on one of three recognized methods which are fair value of collateral, present value of expected cash flows, or observable market price. A specific reserve is then allocated for the amount of the impairment. Although management uses available information to recognize losses on loans, the substantial uncertainties associated with local economic conditions, collateral values, and future cash flows on impaired loans, make it possible that a material change in the allowance for loan losses in the near term may be appropriate. However, the amount of the change cannot be estimated. The allowance is increased by a provision for loan losses, which is charged to expense, and reduced by charge-offs, net of recoveries. Changes in the allowance relating to impaired loans are charged or credited to the provision for loan losses. Past due status is determined based on contractual terms.

Deferred Tax Assets

The Corporation uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. If current available information raises doubt as to the realization of the deferred tax assets, a valuation allowance may be established.

Management considers the determination of this valuation allowance to be a critical accounting policy due to the need to exercise significant judgment in evaluating the amount and timing of recognition of deferred tax liabilities and assets, including projections of future taxable income.

C-11

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**Table of Contents**

These judgments and estimates are reviewed on a continual basis as regulatory and business factors change. A valuation allowance for deferred tax assets may be required if the amounts of taxes recoverable through loss carry backs decline, or if we project lower levels of future taxable income. If such a valuation allowance is deemed necessary in the future, it would be established through a charge to income tax expense that would adversely affect our operating results.

**Overview**

We finished 2013 with a low interest rate environment and near flat loan demand in our market, which has negatively impacted our net interest margin. Despite these continued challenges and an increase in our nonaccrual loans, we are pleased to report a dramatic improvement in our other real estate properties on our balance sheet. Our aggressive approach has moved large dollars in foreclosed assets off our balance sheet. We will continue to maintain an aggressive posture in resolving problem assets as we move into 2014. We believe this strategy will strengthen the Corporation's position and prepare us for future growth.

Total assets at December 31, 2013 and 2012 were \$169,031,017 and \$183,110,988, respectively, a decline of \$14,079,971, or 7.69%. The composition of the balance sheet has also changed. The largest components of change were in cash and cash equivalents and loans, net of unearned deferred fees and costs. Total cash and cash equivalents declined \$6.1 million from year-end 2012 while loans, net of unearned deferred fees and costs declined \$10.8 million. Loan demand has remained soft during 2013 and we have aggressively continued to work through our problem loans, which has resulted in additional payouts and foreclosures. Please refer to Footnote #4 for a discussion of our criticized assets. We continue to monitor our asset quality closely and we have had substantial improvement in the level of our criticized assets, which include loans rated special mention, substandard, doubtful, and loss. Securities available for sale increased to \$21.8 million at year-end 2013 from \$18.8 million at year-end 2012 primarily due to purchases in excess of pay downs on mortgage backed securities. This increase was further reduced by calls and sales of securities. Our total deposits declined \$7.8 million from year-end 2012 to year-end 2013. With the continued focus on lowering our overall deposit costs and soft loan demand, this was an anticipated and expected result. Our loan to deposit ratio was 86.63% and 89.32% at December 31, 2013 and 2012, respectively. Overall costs of our interest bearing deposits declined 16 basis points in 2013 compared to 2012. We maintained our relationships as can be evidenced by the increase in demand deposits which are our non-interest bearing funds. We also had \$6.0 million in repurchase agreements mature in January 2013 for which certain securities available for sale were utilized as collateral. At maturity, we paid off the \$6.0 million and now have additional securities that can be utilized and pledged for other purposes, as needed.

Total shareholders' equity at December 31, 2013 and 2012 was \$23,987,541 and \$24,250,373, respectively. MainStreet and Franklin Bank were considered well capitalized at December 31, 2013 and 2012 under the standards of regulatory capital classifications. The book value of shareholders' equity at December 31, 2013 and 2012 was \$14.00 and \$14.15 per share, respectively.

MainStreet had net income of \$205,034 for the year ending December 31, 2013 compared to net income of \$1,970,776 for the year ending December 31, 2012. Net income for 2013 was impacted substantially by increased provision expense and reduced income from bank owned life insurance as discussed below, all offset by a decrease in supplemental executive retirement plan (SERP) expense. Basic and diluted net income per common share was \$0.12 and \$1.15 for 2013 and 2012, respectively. Return on average assets in 2013 and 2012 was 0.12% and 1.02%, respectively while return on average shareholders' equity was 0.85% and 8.69% for 2013 and 2012, respectively. The return on average assets and average equity for 2011 was (0.07%) and (0.66%), respectively. Year 2013 continued to be impacted by our level of criticized assets. As we worked through these assets and they moved through the cycle, we experienced losses on the sales of other real estate, write downs associated with lower appraisals and selling prices,



and had expenses associated with holding these assets. However, these expenses declined by \$1,257,198 over 2012 levels. Provision expense in 2013 was higher than 2012 as we worked through our problem loans and experienced an increase in our net charge offs in the amount of \$730,729. Provision expense for the periods ending December 31, 2013 and 2012 was \$1,664,880 and \$486,257, respectively.

Franklin Bank has two bank owned life insurance policies on the life of its covered current President and Chief Executive Officer. Upon the tragic death of former CEO Larry A. Heaton in 2012, Franklin Bank collected a death benefit on the bank owned life insurance of approximately \$2.4 million. Also under the Supplemental Executive Retirement Plan ( SERP ) upon Mr. Heaton s death, the present value of the payout of this benefit was accrued and expensed totaling approximately \$1 million in 2012.

C-12

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**Table of Contents****Results of Operations****Net Interest Income**

The low interest rate environment continued during 2013 with the Federal Reserve leaving the short-term interest rates within a range of 0% - .25% which has been effective since 2008. At the most recent meeting of the FOMC, the Federal Reserve indicated a slowdown in the purchase of securities due to an improving employment rate. This change will slowly reverse the QE 3 strategy gradually raising rates over time. The Federal Reserve also indicated they will continue to monitor the economy given its tenuous nature and threat of inflation. By employing the QE 3 strategy the Federal Reserve plans to continue purchasing mortgage backed assets at a slower pace. This should slow the effects of the previous Federal Reserve decision to twist the yield curve by driving up short term rates and lowering long term rates. The net effect is to keep mortgage rates low for an extended period of time to help spur the housing industry and economic growth. It is also designed to maintain inflation at low levels.

As interest rates have remained low, our borrowers have extended pressure to move to more fixed rate interest products; however, interest rates on variable rate loans make up approximately 25% of Franklin Bank's loan portfolio. In a rising interest rate environment, this initially would have a positive impact on the net interest margin because deposit rates are slower to reprice at the higher rates. In a declining interest rate environment such as we have been in, asset sensitivity initially has had a negative impact on the net interest margin until deposit rates reach an opportunity to reprice. The addition of floors to segments of our variable rate loan portfolio has helped to control the impact to our net interest margin. Due to the large amount of repricing deposit liabilities in the near term, the Bank will have a positive impact to the net interest margin in this low interest rate environment. Throughout our history, our overall deposit maturity has been short which has benefited us by allowing us to reprice our deposits downward as they have matured in the lower interest rate environment. On the other hand, in an environment of increasing interest rates, short deposit maturity would reduce the benefit of rising interest rates on loans. Furthermore, even though lower interest rates have been beneficial for our cost of deposits, with prime at 3.25% which is the interest rate basis for many of our loans, MainStreet's net interest margin has been adversely affected by the prolonged, recessionary low interest rate environment. In addition, competition for deposits remains fierce in our market; however, our goal is to continue to lower our cost of deposits during 2014. The maturity of our repurchase agreement in September 2012 had a positive impact on our net interest margin for the last quarter of 2012 and continued in 2013. In addition, the remaining \$6 million in repurchase agreements matured in January 2013, which also had a positive impact on our net interest margin.

Net interest income is the difference between total interest income and total interest expense. The amount of net interest income is determined by the volume of interest-earning assets, the level of interest rates earned on those assets and the cost of supporting funds. The difference between rates earned on interest-earning assets and the cost of supporting funds is measured as the net interest margin. MainStreet's principal source of income is from the net interest margin. The distribution of assets, liabilities, and equity along with the related interest income and interest expense is presented in the following table. The statistical information in the table is based on daily average balances.

**Table of Contents**

Distribution of Assets, Liabilities, and Shareholders Equity: Interest Rates and Interest Differentials

	2013			2012			2011		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
Assets, net of unearned	\$ 128,428,764	\$ 6,726,039	5.24%	\$ 138,184,714	\$ 7,782,200	5.63%	\$ 153,201,363	\$ 8,608,985	5.63%
Assets held for sale	254,394	8,048	3.16	244,544	7,613	3.11	8,016	270	3.33
Assets									
Assets-for-sale-taxable	14,566,168	324,736	2.23	18,863,608	468,374	2.48	24,103,456	753,407	3.12
Assets									
Assets-for-sale-non-taxable (2)	4,814,962	70,181	2.14	3,717,392	56,838	2.25	96,835	2,029	3.33
Assets									
Assets-expected equity	673,537	32,473	4.82	778,190	32,098	4.12	927,000	30,280	3.26
Assets									
Assets-bearing deposits									
Assets									
Assets	15,601,834	34,175	.22	13,450,334	29,526	.22	11,857,846	25,757	.22
Assets									
Assets	4,696,754	7,997	.17	7,074,748	12,634	.18	6,820,273	11,497	.17
Assets									
Interest Earning Assets									
Assets	169,036,413	7,203,649	4.28%	182,313,530	8,389,283	4.62%	197,014,789	9,432,225	4.79%
Assets									
Assets	3,031,847			2,877,211			2,746,269		
Assets									
Assets	5,719,827			10,182,472			12,119,036		
Assets									
Assets	(2,673,876)			(2,755,936)			(3,280,304)		
Assets									
Assets	\$ 175,114,211			\$ 192,617,277			\$ 208,599,790		
Assets									
Assets	\$ 8,701,907	\$ 1,962	.02%	\$ 7,475,890	\$ 3,687	.05%	\$ 6,928,098	\$ 6,720	.10%
Assets									
Assets	22,186,133	44,398	.20	23,419,522	48,219	.21	24,678,500	105,840	.43
Assets									
Assets	15,493,135	7,708	.05	13,324,572	7,318	.05	12,231,895	26,004	.21
Assets									
Assets	34,219,163	488,265	1.43	38,988,324	627,801	1.61	46,314,130	853,058	1.82
Assets									
Assets	42,246,584	514,212	1.22	51,597,511	685,542	1.33	61,126,990	1,000,582	1.64
Assets									
Assets	274	3	1.09	164	2	1.22	603	2	.33
Assets									
Assets	16,438	595	3.62	11,348,361	447,233	3.94	13,500,000	538,071	3.95
Assets									
Assets	85			55			712	3	.43
Assets									
Interest-bearing Assets									
Assets	122,863,719	1,057,143	.86%	146,154,399	1,819,802	1.25%	164,780,928	2,530,280	1.54%
Assets									
Assets	26,065,529			22,899,719			20,680,934		
Assets									
Liabilities	1,933,643			878,634			870,010		
Liabilities									
Liabilities	150,862,891			169,932,752			186,331,872		
Liabilities									
Liabilities	24,251,320			22,684,525			22,267,918		

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Liabilities and holders Equity	\$ 175,114,211		\$ 192,617,277		\$ 208,599,790
Interest Earnings	\$ 6,146,506	3.42%	\$ 6,569,481	3.37%	\$ 6,901,945
Yield on Interest Earning Assets (3)		3.66%		3.62%	

- (1) Loan fees, net of costs, are included in total interest income. Gross loan fee income totaled \$183,294, \$279,789 and \$269,618 for the years ended December 31, 2013, 2012, and 2011, respectively. The average balance of nonaccrual assets is included in the calculation of asset yields.
- (2) The yield is calculated based on the tax equivalent yield for tax exempt interest on municipal securities using a 34% marginal tax rate.
- (3) The net yield on earning assets includes the tax adjustment for tax exempt interest on municipal securities using a 34% marginal tax rate.

C-14

**Table of Contents**

MainStreet's net interest margin for the years ending December 31, 2013 and 2012 was 3.66% and 3.62%, respectively, an increase of 4 basis points. Both interest income and interest expense declined in comparison to last year, primarily due to the interest rate environment. The yield on earning assets dropped 34 basis points to 4.28%. The funding side dropped 39 basis points. In addition to the low interest rate environment and lower average balances, the effect of lost interest on nonaccrual loans impacted the net interest margin. Lost interest for 2013 was \$217,248 compared to \$221,579 in 2012. Competition for good loans is great and declining rates reduced loan profitability as loans repriced and new loans were made at lower rates. The ability of nonfinancial entities to provide financial services also increases competition, particularly during periods of reduced loan demand, like the present one. These factors also negatively impact the margin. Finally, Franklin Bank's growth has been quite dependent on consumer and real estate based lending and in the current economic environment sound growth opportunities in these areas are dramatically reduced.

The following table sets forth, for the period indicated, a summary of the change in interest income and interest expense resulting from changes in volume and rates. The change in interest attributable to both rate and volume changes has been allocated to rate and volume changes in proportion to the relationship of the absolute dollar amounts of the change in each.

	2013 Compared to 2012 Increase (Decrease) Due to Change In			2012 Compared to 2011 Increase (Decrease) Due to Change In		
	Average Volume	Average Rate	Total Increase (Decrease)	Average Volume	Average Rate	Total Increase (Decrease)
<b>Interest Income:</b>						
Loans, net of unearned	\$ (530,109)	\$ (526,052)	\$ (1,056,161)	\$ (845,658)	\$ 18,873	\$ (826,785)
Loans held for sale	310	125	435	7,365	(22)	7,343
Securities						
available-for-sale-taxable	(99,179)	(44,459)	(143,638)	(146,475)	(138,558)	(285,033)
Securities available for sale-nontaxable	16,105	(2,762)	13,343	55,505	(696)	54,809
Restricted equity securities	(4,640)	5,015	375	(5,345)	7,163	1,818
Interest-bearing deposits in banks	4,713	(64)	4,649	3,493	276	3,769
Federal funds sold	(4,073)	(564)	(4,637)	782	355	1,137
<b>Total Interest Income</b>	<b>\$ (616,873)</b>	<b>\$ (568,761)</b>	<b>\$ (1,185,634)</b>	<b>\$ (930,333)</b>	<b>\$ (112,609)</b>	<b>\$ (1,042,942)</b>
<b>Interest Expense:</b>						
Interest checking deposits	\$ 528	\$ (2,253)	\$ (1,725)	\$ 495	\$ (3,528)	\$ (3,033)
Money market deposits	(2,493)	(1,328)	(3,821)	(5,149)	(51,559)	(56,708)
Savings deposits	1,120	(730)	390	2,138	(20,824)	(18,686)
Certificates of deposit \$100,000 and over	(72,266)	(67,270)	(139,536)	(125,480)	(99,777)	(225,257)
Other time deposits	(117,115)	(54,215)	(171,330)	(142,648)	(173,305)	(315,953)
Federal funds purchased	1		1	(2)	2	
Repurchase agreements	(412,925)	(33,713)	(446,638)	(84,858)	(5,980)	(90,838)
Short-term borrowings				(1)	(2)	(3)

Total Interest Expense	\$ (603,150)	\$ (159,509)	\$ (762,659)	\$ (355,505)	\$ (354,973)	\$ (710,478)
Net Interest Income	\$ (13,723)	\$ (409,252)	\$ (422,975)	\$ (574,828)	\$ 242,364	\$ (332,464)

For 2013 and 2012, net interest income totaled \$6,146,506 and \$6,569,481, respectively, a decline of \$422,975, or 6.44%. The total average interest-earning assets were \$169,036,413 and \$182,313,530 for the years ending December 31, 2013 and 2012, respectively, a decrease of \$13,277,117, or 7.28%. The largest category of decline was in loans, net of unearned deferred fees and costs which decreased by \$9.8 million. Higher yielding loan volume declines far exceeded other lower yielding earning assets, hence decreasing total interest income. Interest income was also affected by lost interest on nonaccrual loans as discussed above. The total average interest-bearing liabilities were \$122,863,719 and \$146,154,399 for the years ending December 31, 2013 and 2012, respectively, a decrease of \$23.3 million. Interest-bearing deposit liabilities declined due to our strategy to lower our overall deposit costs. This decline can be seen primarily in time deposits including, certificates of deposit \$100,000 and over. While implementing this strategy, loan demand remained soft, which complemented our strategy. Repurchase agreements also declined due to the maturities in January 2013 and September 2012.

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**Table of Contents****Provision for Loan Losses**

A provision for loan losses is charged to earnings for the purpose of establishing an allowance for loan losses that is maintained at a level which reflects management's best estimate of probable credit losses inherent in the loan portfolio and is, therefore, believed to be appropriate. The amount of the allowance is based on management's evaluation of the collectability of the loan portfolio, including the nature of the portfolio, credit concentrations, trends in historical loss experience, specific impaired loans, economic conditions, and other risks inherent in the portfolio. As part of this process, management reviews the past due reports and risk ratings and discusses individually the loans on these reports with the responsible loan officers. Management provides a detailed quarterly analysis of the allowance based on homogenous loan pools, identifying impairment, historical losses, credit concentrations, economic conditions, and other risks. As the allowance is maintained losses are, in turn, charged to this allowance rather than being reported as a direct expense.

Our methodology for determining the allowance is based on two basic principles of accounting: (i) losses are accrued when they are probable of occurring and are capable of estimation and (ii) losses are accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance. Our analysis is based on an individual review of all credits rated Pass/Watch and lower in our risk rating system by account officers in addition to a review of management information system reports on numerous portfolio segments. The analysis of the allowance is solely based on historical and qualitative factors with historical losses adjusted to higher factors for our criticized and classified loans compared to similar banks with comparable real estate concentrations nationally. Our process allows loan groups to be identified and properly categorized. Our impaired loans are individually reviewed to determine possible impairment based on one of three recognized methods which are fair value of collateral, present value of expected cash flows, or observable market price. A specific reserve is then allocated for the amount of the impairment. Impairment is defined as a loan in which we feel it is probable (meaning likely, not virtually certain) that we will be unable to collect all amounts due under the contractual terms of the loan agreement. Possible loss for loans risk rated special mention or lower are then allocated based on a historical loss migration and adjusted for qualitative factors. Remaining loans are pooled based on homogenous loan groups and allocated based on Franklin Bank's historical net loss experience. These pools are as follows: 1) commercial and industrial loans not secured by real estate; 2) construction and land development loans; 3) residential 1-4 family loans; 4) residential 1-4 family junior liens; 5) home equity lines; 6) commercial real estate; and 7) consumer or loans to individuals. Historical loss is calculated based on a twelve-quarter average history. Historical net loss data is adjusted and applied to pooled loans based on qualitative factors. We utilize the following qualitative factors: 1) changes in the value of underlying collateral such as loans not conforming to supervisory loan to value limits; 2) national and local economic conditions; 3) changes in portfolio volume and nature such as borrower's living outside our primary trade area; 4) changes in past dues, nonaccruals; and 5) quality and impact and effects of defined credit concentrations. The methodology has continued to evolve as our company has grown and our loan portfolio has grown and become more diverse.

The provision for loan losses was \$1,664,880 and \$486,257 for the years ending December 31, 2013 and 2012, respectively, an increase of \$1,178,623, or 242.39%. The allowance for loan losses was \$2,379,145 at December 31, 2013 which equated to 1.92% of loans, net of unearned deferred fees and costs. At December 31, 2012, the allowance was \$2,602,098, or 1.93% of loans, net of unearned deferred fees and costs. Net charge-offs of \$1,887,833 and \$1,157,104 for the years ending December 31, 2013 and 2012, respectively equated to 1.47% and .84%, respectively, of average loans outstanding net of unearned income and deferred fees. The amount of charge-offs can fluctuate substantially based on the financial condition of the borrowers, business conditions in the borrower's market, collateral values and other factors which are not capable of precise projection at any point in time. The allowance for loan losses was not replenished by the full \$1,967,911 of gross charge offs because \$268,850 of that total gross charge off amount was provided for in our allowance for loan losses at year end 2012 as a specific reserve. Nonaccrual loans were \$4.0

million and \$1.5 million at December 31, 2013 and 2012, respectively, a negative impact of \$2.5 million. These loans were 3.24% and 1.13% of loans, net of unearned deferred fees and costs at December 31, 2013 and 2012, respectively. In addition, troubled debt restructurings, not included in nonaccrual loans, were \$1,929,999 and \$1,305,180 at December 31, 2013 and 2012, respectively. Specific reserves allocated to the nonaccrual loans and troubled debt restructurings at year end 2013 and 2012 were \$575,926 and \$292,003, respectively, an increase of \$283,923. Our criticized and classified loans, not included in the individually evaluated loans, decreased in the year-to-year comparison approximately \$7.7 million which caused a decline in the year-to-year comparison of the allowance by approximately \$407,000. The remainder of the loans, collectively evaluated, declined in volume \$5.1 million. Once the qualitative factors were adjusted, the allowance allocated to this group decreased approximately \$50,000. The change in the unallocated amount decreased \$50,000 in the year to year comparison.

C-16



**Table of Contents**

Following is a breakdown of our nonperforming loans by balance sheet type which includes nonaccrual loans, loans past due 90 days and still accruing, other impaired loans, and troubled debt restructurings (not on nonaccrual).

	December 31, 2013	December 31, 2012	December 31, 2011	December 31, 2010	December 31, 2009
Commercial	\$ 725,863	\$ 212,738	\$ 136,680	\$ 354,125	\$ 167,267
Real Estate:					
Construction and land development	576,552	1,100,585	1,624,238	3,835,729	1,863,772
Residential 1-4 families:					
First liens	1,130,961	938,555	4,852,061	4,055,568	1,615,027
Junior Liens	182,170	225,669	424,795	196,970	302,781
Home equity lines	71,338		131,439	147,978	
Commercial real estate	3,308,733	346,807	1,533,473	530,432	494,249
Consumer			50,694	18,312	
<b>Total Nonperforming Loans</b>	<b>\$ 5,995,617</b>	<b>\$ 2,824,354</b>	<b>\$ 8,753,380</b>	<b>\$ 9,139,114</b>	<b>\$ 4,443,096</b>

As can be seen by the chart above, the commercial real estate segment had the largest nonperforming loans at December 31, 2013 followed by the residential 1-4 family first lien loan segment. The construction and land development and residential 1-4 family first lien loan segments have the largest categories of nonperforming loans in the remaining years shown above. The remainder of the loans in these loan segments were performing credits at December 31, 2013 and December 31, 2012. Loans 90 days or more past due and still accruing at December 31, 2013 were \$0. There were \$3,485 in loans 90 days or more past due and still accruing included in the nonperforming loans at December 31, 2012. Troubled debt restructurings included in nonperforming loans that were not on nonaccrual at December 31, 2013 and 2012 were \$1,929,999 and \$1,305,180, respectively. Many of the asset quality issues are the result of our borrowers having to sell various real estate properties to repay the loan. In order to sell the properties and repay the loan, there must be buyers in the marketplace to acquire the properties. Our market, mainly real estate, continues to produce few buyers. In addition, borrowers' incomes have been reduced which increases the debt to income ratio. Please refer to Item 8, Financial Statements, Note 4, for further disclosures of past due loans, nonaccrual loans, troubled debt restructurings, impaired loans, and the allowance.

The overall economy in Franklin County has shown little improvement over the last year. We continue to struggle with high unemployment, a continued slowing of building activity, and a slowing of transportation and warehousing. Unemployment was 4.6% at December 31, 2013. Although this rate has declined since 2012, this rate is not reflective of those persons who have left the workforce or are under-employed in their current positions. Absorption analysis in our market place shows elevated turnover rates for various inventories over historical levels. With the sale of our other real estate properties, we have seen the decline in real estate values. Smith Mountain Lake is a core area for development in Franklin County and is largely real estate based. It is a resort area and largely follows the national trend rather than the local trend. Until unemployment declines and consumer confidence increases, these trends may continue. There is continued economic pressure on consumers and business enterprises. No assurance can be given that continuing adverse economic conditions or other circumstances will not result in increased provisions in the future. Our level of nonperforming loans increased to 2009 levels since last year-end; therefore, we remain cautious and prudent with our allowance. Economists believe that small businesses will continue to be challenged during 2014. As a community bank, small businesses are core for our loan portfolio.

C-17

**Table of Contents**

The following table shows MainStreet's average loan balance for each period, changes in the allowance for loan losses by loan category, and additions to the allowance which have been charged to operating expense.

	December 31, 2013	December 31, 2012	December 31, 2011	December 31, 2010	December 31, 2009
Average amount of loans, net of unearned, outstanding during the year	\$ 128,428,764	\$ 138,184,714	\$ 153,201,363	\$ 162,931,745	\$ 182,502,689
Balance of allowance for loan losses at beginning of year	2,602,098	3,272,945	3,584,180	3,277,559	3,502,029
Loans charged off:					
Commercial	(450,100)	(186)	(482,651)	(142,335)	(488,436)
Construction and land development	(592,292)	(257,796)	(922,440)	(597,206)	(585,219)
Residential 1-4 families	(307,856)	(1,055,384)	(476,172)	(377,957)	(704,347)
Home equity lines	(9,052)		(34,745)	(21,766)	
Commercial real estate	(534,150)		(205,824)		(325,646)
Consumer	(74,461)	(16,785)	(21,670)	(15,971)	(30,318)
Total loans charged off:	(1,967,911)	(1,330,151)	(2,143,502)	(1,155,235)	(2,133,966)
Recoveries of loans previously charged off:					
Commercial	12,278	1,842	32,312	1,740	128,901
Construction and land development	9,090	8,377	62,883	117,595	11,571
Residential 1-4 families	27,945	145,830	63,987	46,247	41
Home equity lines		3,374			
Commercial real estate	1,429				
Consumer	29,336	13,624	12,302	4,174	2,683
Total recoveries:	80,078	173,047	171,484	169,756	143,196
Net loans charged off:	(1,887,833)	(1,157,104)	(1,972,018)	(985,479)	(1,990,770)
Additions to the allowance for loan losses	1,664,880	486,257	1,660,783	1,292,100	1,766,300

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Balance of allowance for loan losses at end of year	\$ 2,379,145	\$ 2,602,098	\$ 3,272,945	\$ 3,584,180	\$ 3,277,559
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Ratio of net charge offs during the period to average loans outstanding during period	1.47%	.84%	1.29%	.60%	1.09%
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The amount of the loan loss reserve by category and the percentage of each category to total loans is as follows:

	December 2013		December 2012		December 2011		December 2010		December 2009	
Commercial	\$ 151,289	7.63%	\$ 108,336	7.77%	\$ 154,991	7.73%	\$ 138,449	6.85%	\$ 236,610	7.1
Estate:										
Construction &										
Development	353,391	13.26	767,018	15.82	902,644	18.24	1,086,183	19.78	1,053,136	20.7
Residential 1-4										
Equity lines	601,276	27.33	701,668	26.40	1,100,139	26.36	1,065,683	24.89	817,387	22.7
Commercial	100,906	5.12	134,847	5.68	174,809	5.93	243,526	6.01	184,617	5.3
Commercial	100,351	4.66	88,411	4.54	98,582	5.34	217,063	6.71	349,041	8.9
Commercial	1,061,037	40.91	740,073	38.58	824,759	35.12	793,308	34.30	613,786	33.2
Commercial	10,895	1.09	11,745	1.21	11,911	1.28	39,968	1.46	22,982	1.7
Commercial			50,000		5,110					
Total	\$ 2,379,145	100.00%	\$ 2,602,098	100.00%	\$ 3,272,945	100.00%	\$ 3,584,180	100.00%	\$ 3,277,559	100.0

**Table of Contents****Noninterest Income**

Noninterest income for the years ending December 31, 2013 and December 31, 2012 was \$1,063,425 and \$3,480,767, respectively, a decrease of \$2,417,342 or 69.45%. The following chart demonstrates the categories of change:

Noninterest Income	YTD 12/31/13	YTD 12/31/12	Dollar Change	Percentage Change
Service charges on deposit accounts	\$ 251,958	\$ 261,487	\$ (9,529)	(3.64)%
Mortgage commission	244,390	239,565	4,825	2.01
Electronic card fees	191,092	179,443	11,649	6.49
Investment fee income	177,034	185,780	(8,746)	(4.71)
Income on bank owned life insurance	37,296	2,494,285	(2,456,989)	(98.50)
Gain on sale of securities available for sale	47,194	1,848	45,346	2,453.79
Other fee income & miscellaneous	114,461	118,359	(3,898)	(3.29)

As can be seen by the above chart, the largest dollar change in noninterest income was in income received from our bank owned life insurance. Franklin Bank has two life insurance policies on the current covered executive participating in the supplemental executive retirement plan ( SERP ). Franklin Bank is the owner and beneficiary of these policies. Our former CEO, Larry Heaton, was tragically killed in a car accident in December 2012. Franklin Bank recorded approximately \$2.4 million in income from the death benefit of the bank owned life insurance in 2012. Securities gains were \$47,194 in 2013 compared to \$1,848 in 2012. Mortgage commission increased \$4,825, or 2.01% in 2013 over the 2012 income. However, volumes have decreased in part by the economic environment and additional regulatory requirements which reduce the loans we can make from a practical standpoint. Franklin Bank partners with several organizations in which we originate residential mortgage loans that are sold to other companies. Franklin Bank receives the mortgage commission income on the sales. Within our partnerships, we close some mortgage loans in our name and then sell them to our partners within a very short period of days. Our partners provide the underwriting of the loans. This process allows us to change our commission levels and has increased our income. Franklin Bank has an investment advisor which partners with Infinex Financial Group to advise and manage investment portfolios for our clients. Franklin Bank receives fee income from this partnership based upon volume. Fee income received on investment income in 2013 was \$177,034 as compared to \$185,780 in 2012, a decrease of \$8,746 or 4.71%. Electronic card fees experienced an increase in the year to year comparison of \$11,649. Other fee income and miscellaneous income decreased \$3,898. Franklin Bank has elected to present assets and liabilities related to derivatives on its mortgage loans held for sale on a gross basis. Derivatives in a gain position are recorded as other assets and those in a loss position are recorded as other liabilities, with the offset being miscellaneous income and miscellaneous expense, respectively. This quarterly entry can cause fluctuations in these accounts, as an increase of \$1,797 has been recorded to noninterest income in 2013. Service charges on deposit accounts decreased \$9,529, or 3.64%, primarily due to a decline in overall NSF fee income. Customers are more aware of these charges in this difficult economic time and monitor their accounts more closely to protect against these fees.

**Table of Contents****Noninterest Expense**

Total noninterest expense for the years ending December 31, 2013 and December 31, 2012 was \$5,292,709 and \$7,898,161, respectively, a decrease of \$2,605,452, or 32.99%. Nonrecurring other real estate and repossession expenses were \$172,056 and \$1,429,254 for the years ending December 31, 2013 and 2012, respectively. Excluding these expenses, total noninterest expense would have been \$5,120,653 and \$6,468,907, respectively, for 2013 and 2012, a decrease of \$1,348,254. This decrease is primarily due to the \$980,278 decrease in the Supplemental Executive Retirement Plan ( SERP ) expense. Our former President and CEO, Larry Heaton, was tragically killed in a car accident in December 2012. This caused the present value of the death benefit and expense required to be recorded in 2012. The following chart shows the noninterest expense by category for the years ending December 31, 2013 and 2012, the dollar change and the percentage change.

Noninterest Expense	YTD 12/31/13	YTD 12/31/12	Dollar Change	Percentage Change
Salaries and employee benefits	\$ 2,625,465	\$ 2,727,946	\$ (102,481)	(3.76)%
Supplemental executive retirement plan	116,949	1,097,227	(980,278)	(89.34)
Occupancy and equipment	764,245	791,736	(27,491)	(3.47)
Professional fees	217,858	262,633	(44,775)	(17.05)
Outside processing	388,826	494,235	(105,409)	(21.33)
FDIC Assessment	196,501	253,874	(57,373)	(22.60)
Franchise tax	221,504	199,587	21,917	10.98
Regulatory examination fees	87,267	109,559	(22,292)	(20.35)
Other real estate and repossessions	172,056	1,429,254	(1,257,198)	(87.96)
Other expenses	502,038	532,110	(30,072)	(5.65)

As can be seen by the table, the largest component of noninterest expense is salaries and employee benefits. Total salaries and benefit expense comprised 51.81% and 48.43% of total noninterest expense for the years ending December 31, 2013 and December 31, 2012, respectively. MainStreet's employees continue to be its most valuable resource and asset. Salaries and employee benefits, exclusive of supplemental executive retirement plan, decreased in 2013 compared to 2012 by \$102,481, or 3.76%. During 2012 salaries were frozen for all employees with the exception of certain budgeted promotions. Commissions were only paid to mortgage and investment personnel. Referral fees were also paid to employees for mortgage and investment referrals. Under FAS ASC 310 certain costs associated with originating loans are amortized over the life of the loan. These costs begin as credits to salary expense and are amortized into the net interest margin over the life of the loan as a reduction. These credits to salary expense were \$16,254 more in 2013 than 2012 causing an overall decrease in salary expense. This was due to a modest increase in loan volumes. Personnel taxes were \$175,040 and \$194,525 in 2013 and 2012, respectively, a decrease of \$19,485. Employee insurance costs increased by \$9,967 and 401-K expense decreased by \$6,064 in the year to year comparison.

The supplemental executive retirement plan expense was \$116,949 and \$1,097,227 for the years ending 2013 and 2012, a decrease of \$980,278. As discussed above, there was an acceleration of the recording of the retirement funds due to the tragic death of our former President and CEO, Larry A. Heaton in 2012.

Other real estate and repossessions are nonrecurring expenses in the category of noninterest expense. The losses, write downs and expenses associated with our other real estate properties experienced a significant decrease of \$1,257,198 or 87.96%, compared to the same period in 2012. The Company has taken a more aggressive approach to disposing of its other real estate properties to rid its balance sheet of nonperforming assets. A substantial amount of properties were

either sold or written down in 2012. These expenses are driven by factors such as updated appraisals reflecting depressed values, write-downs due to length of time being held in other real estate, and normal expenses associated with owning and maintaining these properties. Expenses on these properties are influenced by the volume of these properties and the duration of time properties remain on our balance sheet.

Occupancy and equipment costs include rent, utilities, janitorial service, repairs and maintenance, real estate taxes, equipment rent, service maintenance contracts and depreciation expense. This expense decreased \$27,491 or 3.47% for the year 2013 as compared to 2012 primarily due to a decline in depreciation expense, repairs and maintenance, and rent, all offset by increases in utilities and service maintenance contracts. Rent expense declined due to the termination of the lease on the 220 North building, which was closed in 2010.

Professional fees include fees for audit, legal, and other and experienced a decrease of \$44,775 or 17.05% in the year to year comparison. Of this amount, legal fees decreased \$31,850 primarily due to reduced fees associated with work outs of our criticized assets. Other professional fees declined by \$10,130 in the year to year comparison. Our outside processing expenses decreased \$105,409, or 21.33%, primarily due to a decrease in data processing fees and checkbook charges. Our FDIC premium expense decreased \$57,373, or 22.60% due to the decline in assets and the new method adopted by the FDIC for its calculation using assets as its base; however, the overall premium is still burdensome. The turmoil in the financial services industry resulted in the need to increase prepaid FDIC premiums several years ago to sustain the insurance fund. Depending on the length and depth of the recessionary environment, there could be additional increased prepaid assessments depending on the health of the financial services sector. This could place a great financial burden on our financial institution. Franchise tax expense increased \$21,917 due to a decreased deduction associated with our other real estate properties at year end 2013 over 2012. Regulatory fees from examinations decreased \$22,292 in the year-to-year comparison. With the termination of the

## **Table of Contents**

formal agreement with the OCC, the surcharge on our regulatory assessment fee is no longer applicable. The other expenses category includes supplies, advertising and promotion, shareholder communications, telephone, postage, director fees, travel expense, meals and entertainment, subscriptions and dues, seminars and education, and contributions. This category decreased \$30,072, or 5.65%, in the year over year comparison. Miscellaneous expense decreased \$25,528 in 2013 as compared to 2012. This was primarily due to the recordation, and subsequent adjustments, of a reserve for undrawn lines and letters of credit in 2012 in the amount of \$22,725. This reserve was adjusted in 2013, decreasing miscellaneous expense by \$4,558. The quarterly adjustment of the mortgage loan held for sale derivative during 2013 decreased miscellaneous expense by \$2,303.

## **Income Taxes**

MainStreet is subject to both federal and state income taxes. Franklin Bank is not subject to state income taxes. A bank in Virginia is required to pay a franchise tax that is based on the capital of the entity. The liability (or balance sheet) approach is used in financial accounting and reporting for income taxes. Deferred income tax assets and liabilities are computed quarterly for differences between the financial statement and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. No valuation allowances were deemed necessary at December 31, 2013 and December 31, 2012. Income tax expense is the tax payable or refundable for the period plus or minus the change during the period in deferred tax assets and liabilities. MainStreet recorded income tax expense in the amount of \$47,308 for the year ended December 31, 2013 and an income tax benefit in the amount of \$304,946 for the year ended December 31, 2012.

## **BALANCE SHEET**

### **Investment Portfolio**

MainStreet's investment portfolio is used for the following purposes:

- 1) To maintain sufficient liquidity to cover deposit fluctuations and loan demand.
- 2) To fulfill pledging collateral requirements.
- 3) To help balance the overall interest rate risk position of the balance sheet.
- 4) To make a reasonable return on investments.



**Table of Contents**

Funds not utilized for capital expenditures or lending are invested in overnight federal funds, securities of the U.S. Government and its agencies, mortgage-backed securities, municipal bonds, corporate debt securities, and certain equity securities. Currently, the Corporation has invested in U.S. agencies, mortgage backed securities, municipal bonds, corporate debt securities, Federal Reserve Bank stock and Federal Home Loan Bank stock. The value of our investment portfolio is susceptible to the impact of monetary and fiscal policies of the United States, particularly whether and how the current debate over fiscal issues are resolved. Our mortgage backed securities are either guaranteed by U.S. government agencies or issued by U.S. government sponsored agencies. MainStreet's policy is not to invest in derivatives or other high-risk instruments at this time. The entire securities portfolio was categorized as available-for-sale at December 31, 2013 and December 31, 2012 and is carried at estimated fair value. Unrealized market valuation gains and losses, net of deferred taxes, on securities classified as available-for-sale are recorded as a separate component of shareholders' equity. The amortized cost and approximate market values and gross unrealized gains and losses of securities available for sale for years ending December 31, 2013 and 2012 appear in Part II, Item 8, Note 2 of this report. The amortized cost and approximate market values and gross unrealized gains and losses of securities available for sale for the year ending December 31, 2011 is shown in the table below:

	2011			Approximate
	Amortized	Gross Unrealized	Gross Unrealized	Market
	Cost	Gains	Losses	Value
U.S. government sponsored agencies	\$ 2,804,763	\$ 7,497	\$ (1,478)	\$ 2,810,782
Mortgage backed securities	16,758,613	496,577		17,255,190
States and political subdivisions	1,111,363	22,549		1,133,912
Total securities available-for-sale	\$ 20,674,739	\$ 526,623	\$ (1,478)	\$ 21,199,884

Proceeds from the sale of these securities are included in the cash flow statement. Gross gains and losses along with pledged information appear in Part II, Item 8, Note 2 of this report. The following table shows the maturities of securities available-for-sale as of December 31, 2013 and the weighted average yields of such securities. The weighted average yields are calculated on the basis of the cost and effective yields weighted for the scheduled maturity of each security. The maturities of the mortgage backed securities are based on stated final maturity. Cash flows from prepayments can cause actual maturities to differ significantly.

	Due in One		Due After		Due After		Due After		Total	
	Year or Less	Amount	1 5 Years	Yield	5 10 Years	Yield	10 Years	Yield		
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield		
U.S. government sponsored agencies	\$	%	%	\$ 2,623,000	1.41%	\$	%	\$ 2,623,000		
				1,638,433	2.44			11,516,722	2.54	13,155,155

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Mortgage backed securities

States and political subdivisions		469,762	1.05	5,087,615	2.16	5,557,377
Corporates		496,900	1.35			496,900
<b>Total</b>	<b>\$</b>	<b>\$ 966,662</b>		<b>\$ 9,349,048</b>		<b>\$ 11,516,722</b>
						<b>\$ 21,832,432</b>

C-22

**Table of Contents****Loan Portfolio**

MainStreet has established a credit policy detailing the credit process and collateral in loan originations. Loans to purchase real estate and personal property are generally collateralized by the related property with loan amounts established based on certain percentage limitations of the property's total stated or appraised value. Credit approval is primarily a function of the credit worthiness of the individual borrower or project based on pertinent financial information, the amount to be financed, and collateral. At December 31, 2013, 2012, 2011, 2010 and 2009 the breakdown of gross loans in the loan portfolio was as follows:

	2013		2012		2011		2010		2009
l	\$ 9,426,188	7.63%	\$ 10,439,173	7.77%	\$ 11,061,471	7.73%	\$ 10,874,581	6.85%	\$ 11,882,830
n &									
nt	16,394,964	13.26	21,268,316	15.82	26,102,914	18.24	31,397,922	19.78	34,744,468
1-4									
	33,787,645	27.33	35,490,285	26.41	37,735,618	26.36	39,509,829	24.89	38,082,662
	6,331,233	5.12	7,633,851	5.68	8,486,594	5.93	9,537,112	6.01	9,011,349
y	5,764,941	4.66	6,093,783	4.53	7,639,785	5.34	10,650,365	6.71	14,974,066
l	50,579,103	40.91	51,861,252	38.58	50,272,002	35.12	54,455,674	34.30	55,537,593
	1,353,312	1.09	1,627,706	1.21	1,836,110	1.28	2,320,162	1.46	2,978,950
s	123,637,386	100.00%	134,414,366	100.00%	143,134,494	100.00%	158,745,645	100.00%	167,211,918
es	86,600		78,300		89,510		79,176		105,524
of									
es	123,723,986		134,492,666		143,224,004		158,824,821		167,317,442
for	(2,379,145)		(2,602,098)		(3,272,945)		(3,584,180)		(3,277,559)
	\$ 121,344,841		\$ 131,890,568		\$ 139,951,059		\$ 155,240,641		\$ 164,039,883

As can be seen by the loan portfolio volume, our loan volume has been on a decline over the last five years. Loans, net of unearned income and deferred fees, decreased \$10.8 million, or 8.01%, at December 31, 2013 compared to December 31, 2012. The real estate market continues to be soft and the credit markets have tightened substantially. In addition, we have been aggressively working through our troubled assets which has resulted in charge-offs and foreclosures, thus lowering outstanding loans. These and other factors have resulted in diminished economic activity

and lower loan demand and levels, particularly in real estate related loans. Moreover, Franklin Bank's current concentration in real estate related loans reduces the Bank's participation in these loan markets. Our loan to deposit ratio for 2013 and 2012 was 86.63% and 89.32%, respectively. In prior years, we maintained a larger loan to deposit ratio and leverage of the balance sheet. We deemed it prudent to decrease the ratio by reducing the loan portfolio thereby increasing liquidity and preserving the institution's history of safety and soundness during these difficult economic times. As can be seen by the chart above, loans secured by real estate represent 91.28% and 91.02% of gross loans at December 31, 2013 and December 31, 2012, respectively. Franklin Bank's loan portfolio has a large composition of real estate related loans primarily due to the markets we serve. Accordingly, the Bank took steps to reduce certain concentrations including participating loans. The loan committee of the board of directors reviews all new loans and renewals of loans within our target concentrations for approval.

MainStreet's loan portfolio is its primary source of profitability; therefore, our underwriting approach is critical and is designed throughout our policies to have an acceptable level of risk. Cash flow adequacy has always been a necessary condition of creditworthiness. If the debt cannot be serviced by the borrower's cash flow, there must be an additional secondary source of repayment. As we have discussed, many of our loans are real estate based so they are also secured by the underlying collateral. We strive to build relationships with our borrowers, so it is very important to continually understand and assess our borrowers' financial strength and condition.

The credit policy requires that new loans originated must have a maximum loan-to-value of 80% while certain loans have lower limits as follows: raw land (65%); improved land (75%); non-obsolete inventory (60% of value); used automobiles (75% of purchase price; and stock (75%). We do not require mortgage insurance; however, loans exceeding supervisory loan to value limits are one of our qualitative factors in the analysis of the allowance for loan loss methodology.

Our credit policy requires updated appraisals to be obtained on existing loans upon which collateral value is critical to the repayment of the loan and market value may have declined by 15% or more. In regard to development projects our policy requires a new appraisal when the project sale out rate is less than 25% of the original assumptions documented by the existing appraisal in the file. Development loans must be reviewed at least annually or sooner in a declining real estate cycle. Once an appraisal exceeds 18 months, it must be updated and reviewed before additional funding may occur. An appraisal in file may not be used for additional funding under any circumstances after 36 months. Loan account officers prepare criticized loan workout sheets for the Problem Loan Committee on all loans risk rated special mention or lower and any loan delinquent 60 days or more. Account officers who indicate a loan is impaired are required to determine collateral value by one of three recognized methods which are 1) fair value of collateral; 2) present value of expected cash flows; or 3) observable market value. The difference in the collateral value, less estimated

**Table of Contents**

selling expense, compared to the recorded loan balance is allocated as a specific reserve in the loan loss analysis. Any collateral declines dropping loans below supervisory loan to value limits are included in the qualitative factors based on loan pools in the loan loss analysis.

We continue to review and enhance our credit policies. We monitor our concentration limits and have targets that reflect the current environment. Our concentrations levels are within the established limits. All new credits that are deemed to be in concentration buckets are reviewed by loan committee. We have floors in our home equity lines and certain commercial loan products. Our maximum debt to income ratio is 40% for all retail loans. Construction loans and bridge loans can be underwritten within retail products with the use of interest only payments. Also, we have the interest only feature available to unsecured retail lines with a one-year term which are underwritten on strict guidelines on retail products. New loans originated must have a maximum loan-to-value of 80%; certain loans have lower limits as follows: raw land (65%); improved land (75%); non-obsolete inventory (60% of value); used automobiles (75% of purchase price); and stock (75%). We have an outside service to perform environmental risk assessments prior to funding. Our home equity line products previously had a maturity of 20 years with a three or five year review feature. The loan policy was modified for these loans to mature in five years and be renewed only upon proper underwriting.

In addition, we have an experienced in-house credit analyst and purchased software to assist lenders with cash flow and certain ratio analysis. We also have software to assist with the credit ratings of loans upon origination, renewal, and the receipt of new financials.

Please refer to Item 8, Financial Statements, Notes #3 and #4 for further discussion of underwriting and risk ratings of loans.

MainStreet's variable rate loans comprise approximately 25% of our loan portfolio. Variable commercial loans are underwritten to the current fully indexed rate at origination with cash flow analysis in underwriting at fully drawn lines. In most cases account officers stress borrowers at 2% over the fully indexed rate. Home equity lines are underwritten and qualified at 1.5% of the full equity line commitment.

For the most part, MainStreet's business activity is with customers located in its primary market area. Accordingly, operating results are closely correlated with the economic trends within the region and influenced by the significant industries in the region including pre-built housing, real estate development, agriculture, and resort and leisure services.

Please refer to Item 8, Note 18, Concentrations of Credit Risk, for a detailed discussion of our concentrations of credit.

The following table shows the amount of commercial loans outstanding at December 31, 2013 and their maturity distribution.

	Within One Year	After One But Within Five Years	After Five Years	Total
Commercial	\$ 2,525,922	\$ 6,101,670	\$ 798,596	\$ 9,426,188
Interest rates are floating or adjustable	1,978,878	1,857,664	91,343	3,927,885
Interest rates are fixed or predetermined	547,044	4,244,006	707,253	5,498,303

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The following table shows the amount of real estate construction loans outstanding at December 31, 2013 and their maturity distribution.

	Within One Year	After One But Within Five Years	After Five Years	Total
Real estate construction	\$ 3,233,194	\$ 9,521,474	\$ 3,640,296	\$ 16,394,964
Interest rates are floating or adjustable	421,815	1,633,115	176,145	2,231,075
Interest rates are fixed or predetermined	2,811,379	7,888,359	3,464,151	14,163,889

Nonaccrual loans, loans past due 90 days or more, other impaired loans, and troubled debt restructurings (not on nonaccrual) are considered by MainStreet to be nonperforming loans. MainStreet's policy is to discontinue the accrual of interest on loans once they become 90 days past due and are not well-collateralized, or earlier when it becomes doubtful that the full principal and interest will be collected. Once a loan is placed on nonaccrual status, any interest that is collected will generally be recorded on a cash basis until the loan is satisfied in full or circumstances have changed to such an extent that the collection of both principal and interest is probable.

C-24

**Table of Contents**

To ensure timely identification of nonaccrual loans, loan account officers review monthly their individual portfolios along with past due reports to determine the proper accrual status. Account officers also prepare quarterly criticized loan workout sheets for all loans risk rated special mention or lower and all loans 60-days or more delinquent to the Franklin Bank's Problem Loan Committee made up of senior management. The accrual status of these loans is reviewed and approved by the Problem Loan Committee. Account officers must attest to the accrual status and risk rating of all loans in their portfolio on a monthly basis. Attestations are presented to and reviewed by the Problem Loan Committee. The criticized loan worksheets are presented to the Problem Loan Committee quarterly. The Committee meets monthly to review updates on these loans along with the attestation sheets completed by the account officers. The criticized loan worksheets have been expanded to include a summary of the most recent financial analysis; most recent collateral valuation factoring possible liquidation and timing discount; and enhanced action plans with target dates. Primary and secondary repayment sources are detailed. An officer has been assigned to manage our problem assets as a full-time position. A credit analyst performs required financial analysis on all loans \$100,000 and over at origination or renewal and at the receipt of new financial statements. In addition, new software was purchased to assist with this process. Software has been purchased to assist the credit analyst and lender in the risk rating of each loan. We have an internal loan review function that has an annual loan review plan approved by the loan committee and the President. Enhanced reporting includes the overall quality of the loan portfolio; the identification, type, rating, and amount of problem loans; the identification and amount of delinquent loans; credit and collateral documentation exceptions; the identification and status of credit-related violations of law; the loan officer who originated each loan reported; concentrations of credit; and loans to executive officers and directors.

In summary, we have enhanced our processes, personnel and software to address nonaccrual and criticized loans. Also, more detailed and frequent reporting regarding asset quality helps insure timely and greater oversight of asset quality. We believe these enhancements are assisting us in working through the asset quality issues resulting from the severe recession.

Net charge offs of \$1,887,833 and \$1,157,104 for 2013 and 2012, respectively, equated to 1.47% and .84%, respectively, of average loans outstanding, net of unearned deferred fees and costs. Gross charge offs were \$1,967,911 for 2013 which was \$303,031 more than the provision expense for 2013. This was due to a specific reserve of \$292,003 at year end 2012. The loan loss reserve at December 31, 2013 and 2012 represented 1.92% and 1.93%, respectively, of loans, net of unearned deferred fees and costs. Refer to the provision for loan losses section of this discussion and analysis for a breakdown by loan type of nonperforming loans at December 31, 2013 and 2012, respectively. Following is a breakdown of our nonperforming assets.

	For the Periods Ended	
	December 31, 2013	December 31, 2012
Nonaccrual loans and leases	\$ 4,005,618	\$ 1,515,689
Loans 90 days or more past due and still accruing		3,485
Troubled debt restructurings (not on nonaccrual)	1,929,999	1,305,180
Other impaired loans	60,000	
<b>Total nonperforming loans</b>	<b>5,995,617</b>	<b>2,824,354</b>
Foreclosed real estate	728,163	1,441,722
Other foreclosed property		111,149

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Total foreclosed property	728,163	1,552,871
Total nonperforming assets	\$ 6,723,780	\$ 4,377,225

At December 31, 2011, 2010, and 2009, nonaccrual loans were \$7,067,722, \$7,702,343, and \$3,890,152, respectively. Lost interest related to impaired loans as of December 31, 2013, 2012, 2011, 2010, and 2009 was \$217,248, \$221,579, \$521,729, \$282,181, and \$334,620, respectively. Interest income reflected in the 2013, 2012, 2011, 2010, and 2009 income statements related to impaired loans was \$152,004, \$73,697, \$272,445, \$240,882, and \$203,755, respectively. Loans that were past due more than 90 days and still accruing at December 31, 2011, 2010, and 2009 were \$0, \$1,062,174, and \$552,944, respectively. Nonaccrual loans, troubled debt restructurings (not on nonaccrual), other impaired loans, and loans 90 days or more past due are considered to be our impaired loans. A specific reserve allowance was maintained against these loans at December 31, 2013 and 2012 in the amount of \$575,926 and \$292,003, respectively. Overall, Franklin Bank continues to work with troubled borrowers when appropriate and to move quickly to identify and resolve any problem loans. Please refer to Item 8, Financial Statements, Note #4 for further discussions and break downs of our past due loans, nonaccrual loans, and troubled debt restructurings.

At December 31, 2013, 2012, and 2011, MainStreet had \$728,163, \$1,441,722, and \$3,572,518, respectively, in other real estate, which is property acquired through foreclosure. Other real estate is carried at fair market value, less selling costs, based on appraised value. Because of the regulatory environment, we worked aggressively in 2013 to sell our other real estate properties. We also have approximately \$0.6 million of our other real estate under contract as this report is prepared. Other foreclosed assets were \$0, \$111,149 and \$103,649 at December 31, 2013, 2012, and 2011, respectively.



**Table of Contents****Deposits**

Deposits are the largest source of funds used to support the liquidity of MainStreet and to fund our loan portfolio. The ratio of loans, net of unearned deferred costs and fees, to deposits was 86.63% and 89.32% as of December 31, 2013 and 2012, respectively. The ratio of total time deposits, including \$100,000 and over, to total deposits declined to 46.78% at year end 2013, from 55.97% at December 31, 2012. Total deposits at December 31, 2013 and 2012 were \$142,821,438 and \$150,579,368, respectively, a decrease of \$7,757,930, or 5.15%. The deposit mix was as follows:

	2013		2012	
Demand deposits	\$ 26,856,990	18.80%	\$ 22,819,544	15.15%
Interest checking deposits	9,248,249	6.48	8,882,374	5.90
Money market deposits	23,660,000	16.57	19,929,905	13.24
Savings deposits	16,240,448	11.37	14,672,674	9.74
Time deposits \$100,000 and over	29,977,151	20.99	36,757,507	24.41
Other time deposits	36,838,600	25.79	47,517,364	31.56
<b>Total</b>	<b>\$ 142,821,438</b>	<b>100.00%</b>	<b>\$ 150,579,368</b>	<b>100.00%</b>

The chart reflects that the largest component of deposits continues to be in time deposits including \$100,000 and over; however these categories have declined as a whole. As a percentage of total deposits, the mix has changed somewhat over the past year. Demand deposits rose \$4.0 million, or 17.69%, in 2013 compared to the prior year volume. Demand deposits are essentially considered low cost funds. As a percentage of total deposits, demand deposits also increased. This certainly had a positive impact on our overall cost of funds. Interest checking, money market deposits, and savings deposits have all increased in dollars in comparison to the prior year and as a percentage of total deposits. As discussed above, total deposits declined \$7.8 million in comparison to the prior year of which time deposits including \$100,000 and over experienced a \$17.5 million decline. All other deposit categories increased a total of \$9.7 million in the year to year comparison. Our strategy for deposits in 2013 continued to be to lower our deposit costs while maintaining ample liquidity to fill our needs and for contingency planning. The levels and mix of deposits are influenced by such factors as customer service, interest rates paid, service charges, and the convenience of banking locations. Competition for deposits is great in our market. This affects the availability and ultimately the pricing of deposits. Management attempts to identify and implement the pricing and marketing strategies that will help control the overall cost of deposits and to maintain a stable deposit mix. Our goal has been to strive to gather the whole relationship and not just certificates of deposit. We have been successful in lowering our deposit costs and maintaining liquidity. Loan demand has been soft, therefore, paralleling our strategy. The overall rate on interest bearing deposits was 0.86% and 1.02% for 2013 and 2012, respectively, a decline of 16 basis points. Our strategic plan in 2014 also includes continued lowering of our deposit costs to benefit net income. Franklin Bank attracted brokered deposits for the first time during 2009. Total brokered deposits were \$4.0 million and \$5.3 million, respectively, at December 31, 2013 and 2012. Deposits gathered through the CDARS program and included in total brokered deposits were \$0 and \$1.0 million at December 31, 2013 and 2012, respectively. The average amount and rate of deposits can be found in the Net Interest Income section of this Management's Discussion and Analysis in the Distribution of Assets, Liabilities, and Shareholders' Equity: Interest Rate and Interest Differentials table. The maturities of time deposits \$100,000 and over and other time deposits are shown in Part II, Item 8, Footnote #7. Demand deposits were 18.80% and 15.15% of total deposits at year end 2013 and 2012, respectively. A further increase in demand deposits would improve the net interest margin and the total rate paid on interest bearing deposits. Increasing demand deposits is a continued focus in 2014.

Borrowings

MainStreet has several sources for borrowings generally to assist with liquidity. At December 31, 2013, MainStreet had no balances outstanding with Federal Home Loan Bank of Atlanta ( FHLB ), overnight federal funds purchased, or corporate cash management accounts. The FHLB holds a blanket lien on loans secured by commercial real estate and loans secured by 1-4 family first liens, second liens, and equity lines, which provide a source of liquidity to the Corporation. Loans included in these portfolios at December 31, 2013 and 2012 were \$96,223,160 and \$100,810,587, respectively.

C-26

**Table of Contents**

The Corporation entered into a repurchase agreement with Barclays Capital on January 2, 2008 in the amount of \$6,000,000. The repurchase date was January 2, 2013. The interest rate was fixed at 3.57% until maturity or until it was called. Beginning January 2, 2009 the repurchase agreement became callable and could have been called quarterly with two business days prior notice. Interest was payable quarterly. The repurchase agreement was collateralized by federal agency and agency mortgage backed securities.

The following table presents information on each category of MainStreet's borrowings.

	December 31, 2013	December 31, 2012	December 31, 2011
<b>Short-term Federal Home Loan Bank advances</b>			
Amount outstanding at period end	\$	\$	\$
Weighted average interest rate at period end		%	%
Maximum amount outstanding at any month-end during the period	\$	\$	\$
Average amount outstanding during the period	\$ 85	\$ 55	\$ 712
Weighted average interest rate during period	.00%	.00%	.42%
<b>Federal funds purchased</b>			
Amount outstanding at period end	\$	\$	\$
Weighted average interest rate at period end		%	%
Maximum amount outstanding at any month-end during the period	\$	\$	\$
Average amount outstanding during the period	\$ 274	\$ 164	\$ 603
Weighted average interest rate during period	1.09%	1.22%	.33%
<b>Repurchase agreements</b>			
Amount outstanding at period end	\$	\$ 6,000,000	\$ 13,500,000
Weighted average interest rate at period end		3.57%	3.93%
Maximum amount outstanding at any month-end during the period	\$	\$ 13,500,000	\$ 13,500,000
Average amount outstanding during the period	\$ 16,438	\$ 11,348,361	\$ 13,500,000
Weighted average interest rate during the period	3.62%	3.94%	3.99%

**Shareholders' Equity**

Total shareholders' equity was \$23,987,541, \$24,250,373, and \$22,240,789 at December 31, 2013, 2012 and 2011, respectively. Average shareholders' equity to average assets was 13.85%, 11.78%, and 10.67% for 2013, 2012, and 2011, respectively. Book value per share was \$14.00, \$14.15, and \$12.98 at December 31, 2013, 2012, and 2011,

respectively.

In September 2007, the Board of Directors approved a plan to repurchase up to 100,000 shares of the Company's common stock. By year end 2008, a total of 78,800 shares had been repurchased with total costs of \$1,176,170. The plan has been terminated. The Corporation was prohibited from repurchasing any of its own stock by the terms of the MOU with the Federal Reserve Bank of Richmond. The MOU was terminated in September 2013 and there are no longer any restrictions or stipulations attributable to the MOU.

Also, in September 2007, MainStreet's Board of Directors approved a cash dividend of \$.05 per share which was MainStreet's first cash dividend paid. Since that date, MainStreet paid a quarterly dividend until the fourth quarter of 2008. The dividend payout ratio for 2008 was 43.99%. Under the MOU with the Federal Reserve Bank of Richmond, MainStreet was restricted from declaring or paying any dividends without the prior written approval of the Federal Reserve Bank of Richmond. Accordingly, MainStreet has not paid any dividends. Also while under the MOU, MainStreet could not incur or guarantee any debt or redeem or purchase any shares of its common stock without the prior written consent of the Federal Reserve Bank of Richmond. The MOU was terminated in September 2013 and there are no longer any restrictions or stipulations attributable to the MOU.

The maintenance of appropriate levels of capital is a priority and is continually monitored. MainStreet and Franklin Bank are subject to various regulatory capital requirements administered by the federal and state banking agencies as discussed above. Quantitative measures established by regulations to ensure capital adequacy require MainStreet and Franklin Bank to maintain certain capital ratios. Failure to meet capital ratios can initiate certain mandatory and possibly additional discretionary actions

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**Table of Contents**

by regulators that, if undertaken, could have a material effect on the consolidated financial statements. Also, declining capital can impact the ability of the bank to grow other assets. The required level of capital can also be affected by earnings, asset quality and other issues. Franklin Bank was required under the Agreement with the OCC to implement a three-year capital program which, among other things, required Franklin Bank to plan for adequate capital to meet its current and future needs. Accordingly, Franklin Bank developed a capital plan while under the Agreement. The Agreement with the OCC was terminated in August 2013. MainStreet and Franklin Bank were considered well-capitalized under established regulatory classifications at December 31, 2013 and 2012; however, in the current economic circumstances, capital resources continue to be a focus for the Corporation. Tier I capital to average assets, Tier I risk based and Tier II risk based for the Corporation were 13.59%, 18.98%, and 20.24%, respectively. See Note 15 to the financial statements for capital ratios. Should it be necessary or appropriate to obtain additional capital, then current shareholders could suffer dilution.

**Liquidity and Asset Liability Management**

Asset liability management functions to maximize profitability within established guidelines for liquidity, capital adequacy, and interest rate risk. It also helps to ensure that there is adequate liquidity to meet loan demand or deposit outflows and interest rate fluctuations. Liquidity is the ability to meet maturing obligations and commitments, withstand deposit fluctuations, fund operations, and provide for loan requests. In this economic environment liquidity remains a concern. MainStreet's material off-balance sheet obligations are loan commitments that were \$17,681,657 and \$15,726,309, respectively at December 31, 2013 and 2012. MainStreet has a liquidity contingency plan that gives guidance on the maintenance of appropriate liquidity and what action is required under various liquidity scenarios. MainStreet's liquidity is provided by cash and due from banks, interest-bearing deposits, overnight federal funds sold, securities available-for-sale, and loan repayments. MainStreet also has overnight borrowing lines available with their correspondent banks, the ability to borrow from the Federal Reserve Bank's discount window, and the ability to borrow long-term and short-term from the Federal Home Loan Bank (FHLB). At December 31, 2013 and December 31, 2012, we had available credit from borrowings in the amount of \$43,687,459 and \$47,521,700, respectively. MainStreet's ratio of liquid assets to total liabilities at December 31, 2013, December 31, 2012 and December 31, 2011 was 26.88%, 22.28%, and 19.17%, respectively. As can be seen from the ratios, liquidity has continued to be strong and has increased over the last three years due to strategies implemented. Deposits provide the basic core for our liquidity. As discussed previously, our deposits declined \$7.8 million at December 31, 2013 compared to December 31, 2012. Total time deposits have decreased from year end 2012; however, demand deposits, interest checking accounts, money market deposits and savings deposits all increased over 2012 levels. The shrinkage of the balance sheet has had a positive impact on our capital. We monitor the deposits and our liquidity daily to ensure we have ample liquidity. Pricing in our market continues to be competitive as customers seek higher interest rates especially during this low interest rate environment. Lines of credit are essential to our business while other funding sources may be utilized. As a company, one of our strategies for 2013 was to lower deposit costs. In doing this, we have lost some deposits. Loan demand in 2013 was soft which worked well with our strategy to lower deposits. We have accomplished this and have increased our liquidity percentages at the same time. We have managed these levels and continue to do so as we work towards lowering our deposits costs in 2014.

In addition to the borrowing facilities, MainStreet has continuing relationships with several entities allowing for the gathering of brokered deposits. We are also a member of the Certificate of Deposit Account Registry Service (CDARS). This allows us to provide our depositors with up to \$50 million dollars in FDIC insurance. We receive the deposits and forward them to CDARS and we receive deposits back if wanted. The send and receive transaction is called a reciprocal transaction. We can also bid on deposits in a one-way buy transaction which would allow for new depositors. CDARS deposits are also considered brokered deposits. Franklin Bank has accepted brokered deposits in the amount of \$4.0 million as of December 31, 2013 which was 2.37% of total bank assets. Franklin Bank's Liquidity Contingency Funding Plan limits brokered deposits to 25% of total assets. We are well within this margin. At

December 31, 2013, this would allow us to gather an additional \$38.1 million in brokered deposits. Franklin Bank continues to be a member of QwickRate in order to bid for internet certificates of deposit as another source of liquidity. At December 31, 2013, Franklin Bank had \$2.3 million in internet certificates of deposit. We have set policy limits on the amount of internet certificates of deposit that we can gather. According to our policy, we would be able to accept an additional \$23.0 million at December 31, 2013.

Interest rate sensitivity is measured by the difference, or gap, between interest sensitive earning assets and interest sensitive interest bearing liabilities and the resultant change in net interest income due to market rate fluctuations, and the effect of interest rate movements on the market. MainStreet utilizes these techniques for management of interest rate risk in order to minimize change in net interest income with interest rate changes. MainStreet BankShares, Inc. has partnered with Compass Bank using the Sendero model to help measure interest rate risk. The asset liability management process requires a number of key assumptions. Management determines the most likely outlook for the economy and interest rates measuring the effect on net interest income in a rising and declining 100, 200, 300 and 400 basis point interest rate environment, as applicable. With the change from level shock, net interest income is modeled assuming that interest rates move the full rate change in the first

**Table of Contents**

month. With the change from level ramp, net interest income is modeled assuming rates move one quarter of the full rate change in each quarter. With this approach, management also reviews the economic value of equity that is the net present value of the balance sheet's cash flows or the residual value of future cash flows ultimately due to shareholders. The following table demonstrates the percentage change in net interest income from the then current level prime rate of 3.25% at December 31, 2013 in a rising and declining 100, 200, 300 and 400, basis point interest rate environment, as applicable:

**Net Interest Income Percentage Change From Level Rates**

Rate Shift	Prime Rate	Change From Level Ramp	Change from Level Shock
+400 bp	7.25%	4.00%	6.00%
+300 bp	6.25	4.00	4.00
+200 bp	5.25	3.00	3.00
+100 bp	4.25	1.00	1.00
100 bp	2.25	1.00	1.00
200 bp	1.25	1.00	3.00
300 bp	0.25	2.00	5.00

MainStreet is sensitive to change in the interest rate environment particularly due to the level of variable rate loans in our loan portfolio, the short-term of fixed rate loans, and the assumed repricing of our interest bearing liabilities. Management seeks to lower the impact on the net interest margin. The addition of floors to segments of our variable rate loan portfolio has contributed significantly to management of the interest income component of our net interest margin. Historically, Franklin Bank has been asset sensitive. However, due to the large amount of repricing deposit liabilities in the near term, the Bank has shifted to a liability sensitive position.

**Contractual Obligations, Commitments, Contingent Liabilities, Off-Balance Sheet Arrangements, and Related Party Transactions**

MainStreet provides certain services for its subsidiary bank and real estate company. These services include accounting, investments, treasury management, compliance, audit, deposit and loan operations, and data processing. In exchange for these services, the Bank and the real estate company pay an affiliate fee to the holding company.

The affiliate fee paid to MainStreet helps support MainStreet's cash requirements since most of the expenses are directly related to the companies it owns. Dividends from Franklin Bank are also a source of cash for MainStreet. Under the applicable federal laws, the Comptroller of the Currency restricts the total dividend payments of any calendar year, without prior approval, to the net profits of that year as defined, combined with retained net profits for the two preceding years. The Agreement required Franklin Bank to adopt a three year capital program and prohibited the payment of a dividend until the Bank achieved compliance with the Agreement, which was terminated in August 2013. However, the payment of future dividends by MainStreet will depend on a return by Franklin Bank to more historical levels of profitability.

MainStreet RealEstate owns the facility in which the Southlake office of Franklin Bank operates. The land cost was \$425,286 and the cost of the building was \$881,123. The construction of the facility was completed and operations began in August 2007. The Corporation has only a modest amount of fixed assets.

A summary of MainStreet's significant contractual obligations and commitments is presented in the following table, with a reference to the footnote disclosure in Item 8 detailing the dollar amount by maturity.

Footnote Disclosure in Item 8  
Notes to Consolidated Financial Statements

Contractual Cash Obligations	
Operating Leases	Footnote #13
Other Commitments	
Commitments to extend credit	Footnote #17
Related Person Loans	Footnote #5
Borrowings	Footnote #8



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## Table of Contents

### Impact of Inflation

Most of MainStreet's assets are monetary in nature and therefore are sensitive to interest rate fluctuations. MainStreet does not have significant fixed assets or inventories. Fluctuations in interest rates and actions of the Board of Governors of the Federal Reserve System (FRB), including quantitative easing during the Great Recession, as well as whether and how the fiscal issues confronting the United States are resolved can have a great effect on MainStreet's profitability. Management continually strives to manage the relationship between interest-sensitive assets and liabilities. As discussed above, MainStreet and Franklin Bank must comply with numerous federal and state laws and regulations. In light of the increasing government involvement in the financial services industry and to address the underlying causes of the recent credit crunch, it is likely that financial institutions like MainStreet and Franklin Bank will have to meet additional legal requirements, all of which add to the Corporation's cost of doing business. In addition, regulatory concerns over real estate related assets on the balance sheets of financial institutions and liquidity due to deposit fluctuations and other factors are likely to translate into higher regulatory scrutiny of financial institutions. This could impact MainStreet.

### Stock Compensation Plans

BankShares approved the 2004 Key Employee Stock Option Plan at its Annual Meeting of Shareholders on April 15, 2004. This Plan permitted the granting of Non-qualified Stock Options and Incentive Stock Options to persons designated as Key Employees of BankShares and its subsidiaries. The Plan terminated on January 21, 2009. Awards made under the Plan prior to and outstanding on that date remain valid in accordance with their terms.

### Recent Accounting Developments

In December 2011, the FASB issued ASU 2011-11, Balance Sheet (Topic 210) Disclosures about Offsetting Assets and Liabilities. This ASU requires entities to disclose both gross information and net information about both instruments and transactions eligible for offset in the balance sheet and instruments and transactions subject to an agreement similar to a master netting arrangement. An entity is required to apply the amendments for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by those amendments retrospectively for all comparative periods presented. The adoption of the new guidance did not have a material impact on the Corporation's consolidated financial statements.

In February 2013, the FASB issued ASU 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The amendments in this ASU require an entity to present (either on the face of the statement where net income is presented or in the notes) the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income. In addition, the amendments require a cross-reference to other disclosures currently required for other reclassification items to be reclassified directly to net income in their entirety in the same reporting period. Companies should apply these amendments for fiscal years, and interim periods within those years, beginning on or after December 15, 2012. The Corporation adopted this guidance effective 2013, and has elected to present amounts reclassified out of accumulated other comprehensive income in the footnotes to the consolidated financial statements.

In July 2013, the FASB issued ASU 2013-11, Income Taxes (Topic 740): Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. The amendments in this ASU provide guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, similar tax loss, or tax credit carryforward exists. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except as

follows. To the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date under the tax law of the applicable jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position or the tax law of the applicable jurisdiction does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, the unrecognized tax benefit should be presented in the financial statements as a liability and should not be combined with deferred tax assets. The amendments in this ASU are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. Early adoption is permitted. The amendments should be applied prospectively to all unrecognized tax benefits that exist at the effective date. Retrospective application is permitted. The adoption of the new guidance did not have a material impact on the Corporation's consolidated financial statements.

In January 2014, the FASB issued ASU 2014-04, *Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure* (a consensus of the FASB Emerging Issues Task Force). The amendments in this ASU clarify that an in substance repossession or foreclosure

**Table of Contents**

occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Corporation is currently assessing the impact that the new guidance will have on its consolidated financial statements.

**Item 7A. Quantitative and Qualitative Disclosures about Market Risk**

Not required.

**Table of Contents**

**Item 8. Financial Statements and Supplementary Data**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders

MainStreet BankShares, Inc.

Martinsville, Virginia

We have audited the accompanying consolidated balance sheets of MainStreet BankShares, Inc. and Subsidiaries as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income (loss), changes in shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Corporation is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of MainStreet BankShares, Inc. and Subsidiaries as of December 31, 2013 and 2012, and the results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

Winchester, Virginia

March 25, 2014

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Balance Sheets**

	December 31, 2013	December 31, 2012
<b>ASSETS</b>		
Cash and due from banks	\$ 2,929,591	\$ 3,076,535
Interest-bearing deposits in banks	10,343,469	11,546,938
Federal funds sold	4,691,091	9,414,880
<b>Total Cash and Cash Equivalents</b>	<b>17,964,151</b>	<b>24,038,353</b>
Securities available-for-sale, at fair value	21,832,432	18,836,561
Restricted equity securities	654,600	741,000
Loans held for sale	306,250	432,000
<b>Loans:</b>		
Total Gross Loans	123,637,386	134,414,366
Unearned deferred fees and costs, net	86,600	78,300
<b>Loans, net of unearned deferred fees and costs</b>	<b>123,723,986</b>	<b>134,492,666</b>
Less: Allowance for loan losses	(2,379,145)	(2,602,098)
<b>Net Loans</b>	<b>121,344,841</b>	<b>131,890,568</b>
Bank premises and equipment, net	1,509,562	1,566,987
Accrued interest receivable	462,081	552,402
Bank owned life insurance	1,898,736	1,061,440
Other real estate, net of valuation allowance	728,163	1,441,722
Other assets	2,330,201	2,549,955
<b>Total Assets</b>	<b>\$ 169,031,017</b>	<b>\$ 183,110,988</b>

**LIABILITIES AND SHAREHOLDERS' EQUITY**

<b>Deposits:</b>		
Non-interest bearing demand deposits	\$ 26,856,990	\$ 22,819,544
Interest bearing deposits	115,964,448	127,759,824
<b>Total Deposits</b>	<b>142,821,438</b>	<b>150,579,368</b>
Repurchase agreements		6,000,000
Accrued interest payable and other liabilities	2,222,038	2,281,247
<b>Total Liabilities</b>	<b>145,043,476</b>	<b>158,860,615</b>

Commitments and contingencies

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Shareholders' Equity:

Preferred stock, no par value, authorized 10,000,000 shares; none issued		
Common stock, no par value, authorized 10,000,000 shares; issued and outstanding 1,713,375 shares in 2013 and 2012, respectively	17,866,890	17,866,890
Retained earnings	6,161,960	5,956,926
Accumulated other comprehensive income (loss)	(41,309)	426,557
<b>Total Shareholders' Equity</b>	<b>23,987,541</b>	<b>24,250,373</b>
<b>Total Liabilities and Shareholders' Equity</b>	<b>\$ 169,031,017</b>	<b>\$ 183,110,988</b>

See accompanying notes to consolidated financial statements.

C-33

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Income**

	Year Ended December 31, 2013	Year Ended December 31, 2012
<b>Interest and Dividend Income:</b>		
Interest and fees on loans	\$ 6,734,087	\$ 7,789,813
Interest on interest-bearing deposits	34,175	29,526
Interest on federal funds sold	7,997	12,634
<b>Interest on securities available-for-sale:</b>		
Taxable	324,736	468,374
Nontaxable	70,181	56,838
Dividends on restricted equity securities	32,473	32,098
<b>Total Interest and Dividend Income</b>	<b>7,203,649</b>	<b>8,389,283</b>
<b>Interest Expense:</b>		
Interest on deposits	1,056,545	1,372,567
Interest on short-term borrowings	3	2
Interest on repurchase agreements	595	447,233
<b>Total Interest Expense</b>	<b>1,057,143</b>	<b>1,819,802</b>
<b>Net Interest Income</b>	<b>6,146,506</b>	<b>6,569,481</b>
Provision for loan losses	1,664,880	486,257
<b>Net Interest Income After Provision for Loan Losses</b>	<b>4,481,626</b>	<b>6,083,224</b>
<b>Noninterest Income:</b>		
Service charges on deposit accounts	251,958	261,487
Mortgage commission	244,390	239,565
Electronic card fees	191,092	179,443
Investment fee income	177,034	185,780
Income on bank owned life insurance	37,296	2,494,285
Gain on sale of securities available-for-sale	47,194	1,848
Other fee income and miscellaneous income	114,461	118,359
<b>Total Noninterest Income</b>	<b>1,063,425</b>	<b>3,480,767</b>
<b>Noninterest Expense:</b>		
Salaries and employee benefits	2,625,465	2,727,946

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Supplemental executive retirement plan	116,949	1,097,227
Occupancy and equipment expense	764,245	791,736
Professional fees	217,858	262,633
Outside processing	388,826	494,235
FDIC assessment	196,501	253,874
Franchise tax	221,504	199,587
Regulatory examination fees	87,267	109,559
Other real estate and repossessions	172,056	1,429,254
Other expenses	502,038	532,110
 Total Noninterest Expense	 5,292,709	 7,898,161
 Net Income Before Tax	 \$ 252,342	 \$ 1,665,830
Income Tax Expense (Benefit)	47,308	(304,946)
 Net Income	 \$ 205,034	 \$ 1,970,776
 Basic Net Income Per Common Share	 \$ .12	 \$ 1.15
 Diluted Net Income Per Common Share	 \$ .12	 \$ 1.15

See accompanying notes to consolidated financial statements.



**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Income (Loss)**

	Year Ended December 31, 2013	Year Ended December 31, 2012
Net Income	\$ 205,034	\$ 1,970,776
Other Comprehensive Income (Loss):		
Net unrealized holding gains (losses) on securities available for sale during the period	(564,402)	37,218
Deferred income tax (expense) benefit on unrealized holding gains on securities available for sale	191,897	(12,653)
Less reclassification adjustments for gains included in net Income	(47,194)	(1,848)
Tax related to realized gain on securities sold	16,046	628
Change in actuarial gain (loss) on benefit plan	(97,292)	23,429
Deferred income tax (expense) benefit on actuarial gain (loss)	33,079	(7,966)
Other Comprehensive Income (Loss)	(467,866)	38,808
Total Comprehensive Income (Loss)	\$ (262,832)	\$ 2,009,584

See accompanying notes to consolidated financial statements.

C-35

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Changes in Shareholders' Equity**

	Number Of Common Shares	Common Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance at December 31, 2011	1,713,375	\$ 17,866,890	\$ 3,986,150	\$ 387,749	\$ 22,240,789
Net income			1,970,776		1,970,776
Other comprehensive income, net of taxes				38,808	38,808
Balance at December 31, 2012	1,713,375	\$ 17,866,890	\$ 5,956,926	\$ 426,557	\$ 24,250,373
Net income			205,034		205,034
Other comprehensive loss, net of taxes				(467,866)	(467,866)
Balance at December 31, 2013	1,713,375	\$ 17,866,890	\$ 6,161,960	\$ (41,309)	\$ 23,987,541

See accompanying notes to consolidated financial statements.

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows**

	Year Ended December 31, 2013	Year Ended December 31, 2012
<b>Cash Flows From Operating Activities:</b>		
Net income	\$ 205,034	\$ 1,970,776
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,664,880	486,257
Depreciation and amortization	153,532	179,512
Amortization of discounts and premiums, net	190,116	201,223
Gain on sale of securities	(47,194)	(1,848)
Loss and impairment on other real estate owned and repossessions	118,860	1,314,015
Loss on disposal of fixed assets	4,215	5,767
Deferred tax expense (benefit)	36,399	(438,135)
Change in loans held for sale	125,750	(432,000)
(Increase) decrease in accrued interest receivable	90,321	(4,497)
Decrease in other assets	313,228	453,929
Increase in value of BOLI	(37,296)	(2,494,285)
Change in reserve for unfunded lending commitments	(4,558)	22,725
Increase in executive retirement plan accrual	116,949	1,089,065
Payments on executive retirement plan	(140,628)	
Increase (decrease) in accrued interest payable and other liabilities	(128,264)	161,206
<b>Net cash provided by operating activities</b>	<b>2,661,344</b>	<b>2,513,710</b>
<b>Cash Flows From Investing Activities:</b>		
Purchases of furniture, fixtures, and equipment	(100,322)	(97,770)
Purchases of securities available-for-sale	(9,505,740)	(9,862,042)
Purchases of restricted equity securities		(500)
Redemption of restricted equity securities	86,400	89,500
Calls/maturities/repayments of securities available-for-sale	4,669,068	12,061,360
Proceeds from sale of securities	1,086,283	
Proceeds from sale of other real estate owned and repossessions	1,511,391	4,165,523
Purchase of bank owned life insurance	(800,000)	
Proceeds from life insurance		4,482,541
Loan originations and principal collections, net	8,075,304	4,217,992
<b>Net cash provided by investing activities</b>	<b>5,022,384</b>	<b>15,056,604</b>
<b>Cash Flows From Financing Activities:</b>		
Increase in non-interest bearing deposits	4,037,446	1,843,884
Decrease in interest bearing deposits	(11,795,376)	(18,347,358)

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Repayment of repurchase agreement	(6,000,000)	(7,500,000)
Net cash used in financing activities	(13,757,930)	(24,003,474)
Net decrease in cash and cash equivalents	(6,074,202)	(6,433,160)
Cash and cash equivalents at beginning of year	24,038,353	30,471,513
Cash and cash equivalents at end of year	\$ 17,964,151	\$ 24,038,353
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest	\$ 1,146,704	\$ 1,869,277
Cash paid during the period for taxes	\$ 250,000	\$ 45,000
Unrealized gain (loss) on securities available for sale	\$ (611,596)	\$ 35,370
Change in actuarial gain (loss) on benefit plan	\$ (97,292)	\$ 23,429
Transfer of loans to other real estate and other assets	\$ 805,543	\$ 3,356,242

See accompanying notes to consolidated financial statements.

C-37

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**December 31, 2013 and 2012**

**Note 1 Summary of Accounting Policies**

(a) General

MainStreet BankShares, Inc. (the Corporation, MainStreet, or BankShares), was incorporated in Virginia on January 14, 1999. The Corporation was primarily organized to serve as a bank holding company. Its first wholly-owned subsidiary was located in Martinsville, Virginia and was sold on March 23, 2005. In 2002, MainStreet organized a second bank subsidiary, Franklin Community Bank, National Association (Franklin Bank). On February 8, 2007, MainStreet formed a wholly-owned real estate company, MainStreet RealEstate, Inc., for the sole purpose of owning the real estate of the Corporation.

Franklin Bank was organized as a nationally chartered commercial bank and member of the Federal Reserve Bank of Richmond. Franklin Bank opened for business on September 16, 2002. Franklin Bank operates as a locally owned and operated commercial bank emphasizing personal customer service and other advantages incident to banking with a locally owned community bank. Franklin Bank's primary service area is Franklin County, Town of Rocky Mount and surrounding areas. It currently has three banking offices including its main office.

The Corporation reports its activities as a single business segment. In determining the appropriateness of segment definition, the Corporation considered components of the business about which financial information is available and will evaluate it regularly relative to resource allocation and performance assessment.

(b) Principles of Consolidation

The consolidated financial statements include the accounts of MainStreet and its wholly-owned subsidiaries, Franklin Bank and MainStreet RealEstate, Inc. All significant intercompany accounts and transactions associated with MainStreet's subsidiaries have been eliminated.

(c) Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash, due from banks, interest-bearing deposits in banks, and federal funds sold.

(d) Securities

Certain debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Trading securities are recorded at fair value with changes in fair value included in earnings. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as available for sale and recorded at fair value, with unrealized gains and losses

excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) whether the Corporation intends to sell the security, whether it is more likely than not that the Corporation will be required to sell the security before recovery of its amortized cost basis, and whether the Corporation expects to recover the security's entire amortized cost basis.

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**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**December 31, 2013 and 2012**

**(e) Loans**

The recorded investment in loans represents the customers unpaid principal balances, net of partial charge-offs and unearned deferred fees and costs. Interest on loans is computed by methods which generally result in level rates of return on principal amounts outstanding. Past due status on all loans is recognized and determined based on contractual terms. It is the Corporation's policy to discontinue the accrual of interest on all loans once they become 90 days past due and are not well-collateralized or earlier when it becomes doubtful that the full principal and interest will be collected. Generally, all payments for all loans on nonaccrual status are applied as a principal reduction until the principal is satisfied. As a general rule, a nonaccrual loan may be restored to accrual status when none of its principal and interest is due and unpaid, and the Company expects repayment of the remaining contractual principal and interest. If any interest payments received while the loan was in nonaccrual status were applied to reduce the recorded investment in the loan, the application of these payments to the loan's recorded investment is not reversed (and interest income is not credited) when the loan is returned to accrual status. The Company must have received repayment of the past due principal and interest unless the asset has been formally restructured and qualifies for accrual status or the borrower has resumed paying the full amount of the scheduled contractual interest and principal payments on a loan that is past due and in nonaccrual status, even though the loan has not been brought fully current, and the following two criteria are met: (1) all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within a reasonable period and, (2) there is a sustained period of repayment performance (generally a minimum of six months) by the borrower in accordance with the contractual terms involving payments of cash or cash equivalents. A loan that meets these two criteria may be restored to accrual status but must continue to be disclosed as past due if all arrearages have not been paid.

BankShares collectively reviews for impairment all consumer loans and smaller homogeneous loans. BankShares considers a loan to be impaired when, based upon current information and events, it is probable that BankShares will be unable to collect all amounts due according to the contractual terms of the loan agreement. Included in our analysis of impaired loans are loans 90 days or more past due and still accruing, other impaired loans, nonaccrual loans and troubled debt restructurings (not on nonaccrual). BankShares evaluates its impaired loans and troubled debt restructurings on an individual basis. For collateral dependent loans, BankShares bases the measurement of these impaired loans on the fair value of the loan's collateral properties. For all other loans, BankShares uses the measurement of these impaired loans on the more readily determinable of the present value of expected future cash flows discounted at the loan's effective interest rate or the observable market price. Impairment losses are recognized through an increase in the allowance for loan losses and a corresponding charge to the provision for loan losses. Adjustments to impairment losses due to changes in the fair value of impaired loans are included in the provision for loan losses.

**(f) Troubled Debt Restructurings**

In situations where, for economic or legal reasons related to a borrower's financial condition, management may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a troubled debt restructuring ( TDR ). Management strives to identify borrowers in financial difficulty early and work with them to

modify their loan to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of either interest or principal, management measures any impairment on the restructuring as noted above for impaired loans. Total troubled debt restructurings at December 31, 2013 and 2012 were \$3.9 million and \$2.2 million, respectively.

(g) Loan Fees and Costs

Using a method that approximates the interest method, loan origination and commitment fees and certain costs are deferred over the contractual life of the related loan as an adjustment to the net interest margin.



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**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**December 31, 2013 and 2012**

**(h) Allowance for Loan Losses**

The allowance for loan losses is an estimate of the losses that may be sustained in our loan portfolio. The allowance is based on two basic principles of accounting: (1) losses are accrued when they are probable of occurring and are capable of estimation and (2) losses are accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance. The allowance for loan losses is maintained at a level, which, in management's judgment, is adequate to absorb credit losses inherent in the loan portfolio. The amount of the allowance is based on management's evaluation of the collectibility of the loan portfolio, including the nature of the portfolio, credit concentrations, trends in historical loss experience, specific impaired loans, economic conditions, and other risks inherent in the portfolio. As part of this process management reviews the past due reports and risk-rated loans and discusses individually the loans on these reports with the responsible loan officers. Management provides a detailed quarterly analysis of the allowance based on our historical loan loss experience, risk-rated loans, past dues, concentrations of credit, unsecured loans, loan exceptions and the economic trend. These are generally grouped by loan segments. Our impaired loans are individually reviewed to determine possible impairment based on one of three recognized methods, which are described above. A specific reserve is then allocated for the amount of the impairment. Possible loss for loans risk rated special mention or lower are then allocated based on a historical loss migration and adjusted for qualitative factors. Remaining loans are pooled based on homogenous loan groups and allocated based on Franklin Bank's historical net loss experience. These pools are as follows: (1) commercial and industrial loans not secured by real estate; (2) construction and land development loans; (3) residential 1-4 family first liens; (4) residential 1-4 family junior liens; (5) home equity lines; (6) commercial real estate; and (7) consumer or loans to individuals. Historical loss is calculated based on twelve-quarter average history. Historical net loss data is adjusted and applied to pooled loans based on qualitative factors. We utilize the following qualitative factors: (1) changes in the value of underlying collateral, such as loans not conforming to supervisory loan to value limits; (2) national and local economic conditions; (3) changes in portfolio volume and nature such as borrowers living outside our primary trade area; (4) changes in past dues, nonaccruals; and (5) quality, impact and effects of defined credit concentrations.

Our allowance methodology has continued to evolve as our Company has grown and our loan portfolio has grown and become more diverse. Although management uses available information to recognize losses on loans, because of uncertainties associated with local economic conditions, collateral values, and future cash flows on impaired loans, it is reasonably possible that a material change could occur in the allowance for loan losses in the near term; however, this amount cannot be reasonably estimated.

The allowance is increased by a provision for loan losses, which is charged to expense, and reduced by charge-offs, net of recoveries. Charge-offs on commercial loans are recorded when available information confirms the loan is not fully collectible and the loss is reasonably quantifiable. Consumer loans are generally charged off for closed end loans after 120 days past due and open end loans after 180 days past due, or earlier if there is information related to a loss. Loans secured by real estate are generally written down to appraised value less liquidation expenses, with the remainder charged-off when a loss is apparent. Refer to Note 4 of the consolidated financial statements for detailed information related to the allowance for loan losses.

(i) Other Real Estate

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the lower of the loan balance or the fair value less costs to sell at the date of foreclosure. Any losses at this point in time are charged against the allowance for loan losses. Subsequent to foreclosure, management periodically performs valuations of the foreclosed assets based on updated appraisals, general market conditions, recent sales of like properties, length of time the properties have been held, and our ability and intention with regard to continued ownership of the properties. The Corporation may incur additional write-downs of foreclosed assets to fair value less costs to sell if valuations indicate a further deterioration in market conditions. These write-downs are recorded in the consolidated statement of income as other real estate and repossessions expense.

C-40

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**December 31, 2013 and 2012**

**(j) Bank Premises and Equipment**

Land is carried at cost. Buildings, furniture, fixtures and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are charged to expense on a straight-line basis over the estimated useful lives ranging from three years to forty years. Maintenance, repairs and minor improvements are charged to expense as incurred. Significant improvements are capitalized.

**(k) Stock Options and Warrants**

MainStreet recognizes compensation cost relating to share-based payment transactions in accordance with generally accepted accounting principles. That cost is measured based on the fair value of the equity or liability instruments issued. The expense measures the cost of employee services received in exchange for the award based on the grant-date fair value of the award and recognizes the cost over the period the employee is required to provide services for the award. MainStreet recorded no compensation cost for share-based payment transactions for the years ended December 31, 2013 and December 31, 2012. Additional disclosures required are included in Note 14 to the consolidated financial statements herein.

**(l) Income Taxes**

The Corporation is subject to federal and state income taxes. The liability (or balance sheet) approach is used in financial accounting and reporting for income taxes. Deferred income tax assets and liabilities are computed quarterly for differences between the financial statement and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Income tax expense is the tax payable or refundable for the period plus or minus the change during the period in deferred tax assets and liabilities.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying consolidated balance sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination. Interest and penalties associated with unrecognized tax benefits are classified as additional income taxes in the consolidated statements of income.

(m) Net Income Per Common Share

ASC 260, Earnings Per Share, requires dual presentation of basic and diluted net income per common share on the face of the consolidated statements of income and requires a reconciliation of the numerators and denominators of the basic and diluted net income per common share calculation. Basic income per common share is calculated based on the weighted average number of shares of common stock outstanding during each period. Diluted net income per common share is computed using the weighted average number of shares of common stock outstanding during each period adjusted to reflect the dilutive effect of all potential common shares that were outstanding during the period. Please refer to Note 11 for detailed information on net income per common share for the years ending December 31, 2013 and 2012, respectively. Please refer to Note 14 for detailed information on stock options for the years ending December 31, 2013 and 2012, respectively.

(n) Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income.

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**December 31, 2013 and 2012**

Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities and pension liability adjustments, are reported as a separate component of the equity section of the consolidated balance sheet, such items, along with net income are components of comprehensive income (loss).

**(o) Fair Value Measurements**

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 19. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

**(p) Advertising Costs**

The Corporation follows the policy of charging the costs of advertising to expense as incurred. Advertising expense was \$72,175 and \$62,301 for 2013 and 2012, respectively.

**(q) Transfers of Financial Assets**

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Corporation – put presumptively beyond reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

**(r) Loans Held for Sale**

The Corporation accounts for new originations of prime residential mortgage loans held for sale at fair value. The Corporation accounts for the derivatives used to economically hedge the loans held for sale at fair value. Income from the sale of these mortgage loans is included in mortgage commissions.

**(s) Reclassifications**

Certain reclassifications have been made to prior period balances to conform to current year provisions. None were of a material nature.

(t) Use of Estimates

The presentation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of deferred tax assets, other-than-temporary impairments of securities, valuation of other real estate owned, and the fair value of financial instruments.

The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions. In connection with the determination of the estimated losses on loans, management periodically obtains independent appraisals for significant collateral.

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

The Corporation's loans are generally secured by specific items of collateral including real property, consumer assets, and business assets. Although the Corporation has a diversified loan portfolio, a substantial portion of its debtors ability to honor their contracts is dependent on local economic conditions.

While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Corporation to recognize additional losses based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

**Note 2 Securities**

The carrying values, unrealized gains and losses and approximate market values of investment securities at December 31, 2013 and 2012 are shown in the following tables. The entire investment portfolio is classified as available-for-sale to preserve maximum liquidity for funding needs.

	2013			Approximate
	Amortized	Gross Unrealized	Gross Unrealized	Market
	Cost	Gains	Losses	Value
U. S. government sponsored agencies	\$ 2,688,955	\$ 555	\$ (66,510)	\$ 2,623,000
Mortgage backed securities	13,012,376	202,523	(59,744)	13,155,155
States and political subdivisions	5,686,412	11,784	(140,819)	5,557,377
Corporates	495,770	2,488	(1,358)	496,900
<b>Total securities available-for-sale</b>	<b>\$ 21,883,513</b>	<b>\$ 217,350</b>	<b>\$ (268,431)</b>	<b>\$ 21,832,432</b>

	2012			Approximate
	Amortized	Gross Unrealized	Gross Unrealized	Market
	Cost	Gains	Losses	Value
	\$ 1,464,102	\$ 7,671	\$	\$ 1,471,773

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U.S. government sponsored agencies				
Mortgage backed securities	12,130,273	507,264		12,637,537
States and political subdivisions	4,681,671	53,683	(8,103)	4,727,251
Total securities available-for-sale	\$ 18,276,046	\$ 568,618	\$ (8,103)	\$ 18,836,561

All of our mortgage backed securities are either guaranteed by U. S. government agencies or issued by U. S. government sponsored agencies.

The amortized costs and market values of securities available-for-sale at December 31, 2013, by contractual maturity, are shown in the following table. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Approximate Market Value
Due in one year or less	\$	\$
Due after one year but within five years	966,796	966,662
Due after five years but within ten years	9,516,704	9,349,048
Due after ten years	11,400,013	11,516,722
	\$ 21,883,513	\$ 21,832,432

There were gross gains of \$47,194 and \$1,848 and no losses recorded on sales and calls of securities available for sale during the years ended December 31, 2013 and 2012, respectively.



Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

Securities available-for-sale with carrying values approximating \$25,041 and \$6,865,968 at December 31, 2013 and December 31, 2012, respectively, were pledged to secure public deposits and for other purposes as required or permitted by law.

Following demonstrates the unrealized loss position of securities available for sale at December 31, 2013 and 2012.

	December 31, 2013					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. government sponsored agencies	\$ 1,921,845	\$ (66,510)	\$	\$	\$ 1,921,845	\$ (66,510)
Mortgage backed securities	4,275,948	(59,744)			4,275,948	(59,744)
States and political subdivisions	3,856,363	(140,819)			3,856,363	(140,819)
Corporates	248,135	(1,358)			248,135	(1,358)
<b>Total temporarily impaired securities</b>	<b>\$ 10,302,291</b>	<b>\$ (268,431)</b>	<b>\$</b>	<b>\$</b>	<b>\$ 10,302,291</b>	<b>\$ (268,431)</b>

	December 31, 2012					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
States and political subdivisions	\$ 1,182,824	\$ (8,103)	\$	\$	\$ 1,182,824	\$ (8,103)
<b>Total temporarily impaired securities</b>	<b>\$ 1,182,824</b>	<b>\$ (8,103)</b>	<b>\$</b>	<b>\$</b>	<b>\$ 1,182,824</b>	<b>\$ (8,103)</b>

An impairment is considered other than temporary if any of the following conditions are met: the Corporation intends to sell the security, it is more likely than not that the Corporation will be required to sell the security before the recovery of its amortized cost basis, or the Corporation does not expect to recover the security's entire amortized cost basis (even if the Bank does not intend to sell). At December 31, 2013, \$10.3 million of securities had unrealized losses, comprised of twenty-three securities, based on market prices. At December 31, 2012, \$1.2 million of securities had unrealized losses, comprised of three securities, based on market prices. Declines in fair value are due to interest rate fluctuations and not due to credit deterioration of the issuers. The Corporation does not have any securities that are considered other than temporarily impaired at December 31, 2013 and December 31, 2012.

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Federal Reserve Bank stock is included in restricted equity securities and totaled \$435,100 at December 31, 2013 and December 31, 2012. Federal Home Loan Bank ( FHLB ) stock makes up the remainder of the balance in restricted equity securities and totaled \$219,500 and \$305,900 at December 31, 2013 and 2012, respectively. FHLB stock is generally viewed as a long term investment and as a restricted investment security which is carried at cost, because there is no market for the stock other than the FHLB or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on ultimate recoverability of the par value rather than by recognizing temporary declines in value.

C-44

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012****Note 3 Loans Receivable**

The major components of gross loans in the consolidated balance sheets at December 31, 2013 and 2012 are as follows:

	2013	2012
Commercial	\$ 9,426,188	\$ 10,439,173
Real Estate:		
Construction and land development	16,394,964	21,268,316
Residential 1-4 families		
First liens	33,787,645	35,490,285
Junior liens	6,331,233	7,633,851
Home Equity lines	5,764,941	6,093,783
Commercial real estate	50,579,103	51,861,252
Consumer	1,353,312	1,627,706
Total Gross Loans	123,637,386	134,414,366
Unearned fees and costs, net	86,600	78,300
Recorded Investment	\$ 123,723,986	\$ 134,492,666

Overdrafts reclassified to loans at December 31, 2013 and 2012 were \$6,196 and \$5,287, respectively.

**Loan Origination/Risk Management:** Franklin Bank's Board of Directors annually approves and reviews policies and procedures to be utilized as tools by account officers for the purpose of making sound and prudent credit decisions. Every loan transaction is closely evaluated from the perspective of profitability realizing that there is no profit in a loan that becomes a loss. Each credit decision is based on merit and no other factors. Account officers carry a heavy burden of accountability in being assigned the responsibility for the development of the Corporation's loan portfolio by meeting the legitimate credit needs of our customers while also exercising prudence and seasoned judgment. A comprehensive reporting system has been developed to provide senior management timely information related to portfolio performance including growth, delinquency, adversely risk rated, and credit concentrations. The portfolio is constantly reviewed based on segments of concern, past due status, extension of credits along with stress testing the portfolio's collateral values and debt service coverage for a significant portion of loans within defined loan concentrations. Annually, a loan review plan is developed to identify and mitigate potential weakness in the loan portfolio. Scope is determined based upon a risk assessment of various concentrations and loan product types in which higher risk may exist. The developed plan is presented to the Loan Committee of Franklin Bank's Board of Directors each year for approval. Overall, the goal for 2013 was to review 30% of the entire loan portfolio. Review segments vary from year to year to ensure a complete cycle of all significant loan product types. Results of each review segment

are communicated to the Loan Committee of the Board of Directors with a response from the Bank's Senior Lender or Head of Retail lending depending on the product type reviewed.

In general all loans exceeding \$100,000 are documented by three years of financial reports in conjunction with review and analysis by a credit analyst independent of the lending approval process. Generally all real estate loans are underwritten based on verified income, or cash flow, and margined at 80% or less depending upon the regulatory supervisory limit. All loans are underwritten based upon analysis of all identified primary and secondary repayment sources.

**Construction & Land Development**: Emphasis is placed on the estimated absorption period of the project based on the intimate knowledge of local demand and geographic concentrations by appraisers and account officers. Projects are monitored by Franklin Bank's in-house construction inspector to ensure adherence to project specifications and timely completion. Loan to values are manually tracked to ensure conforming collateral coverage is maintained throughout the development phase.

C-45

**Table of Contents**

Interest carry abilities are determined by analyzing global cash flow and available liquidity. Due to the complex nature of loans for speculative housing and speculative lots, requests are underwritten by Franklin Bank's business lending group. Terms at origination for speculative lot loans are based on collateral margins and on qualifying the borrower to policy requirements based on a ten year amortization period. Speculative housing terms generally are held to eighteen months with allowance made for substantial curtailments.

**Commercial Real Estate:** Loans are generally underwritten based on verified income or cash flow to ensure a global debt service coverage ratio of at least 1.25. In general, collateral margin is determined based on appraisal or evaluation of market value not to exceed 80 percent of appraised market value or cost, whichever is less. All properties receive proper environmental due diligence prior to funding of the credit. Account officers perform and document a market analysis which may include data on competing businesses and projects. When applicable, market analysis data may be obtained from independent sources. Cash flows and collateral margins are appropriately stress tested. Terms generally range from five to fifteen years, however, may be longer based on approval from Franklin Bank's President or Senior Lender.

**Commercial Loans:** Loans are generally underwritten based on verified income or cash flow to ensure global debt service coverage ratio of at least 1.25. Terms can range up to seven years based on loan purpose and collateral offered. Based on policy, credit lines have maturities of one year. Generally inventory loans are margined at 50% while equipment loans, depending on age of collateral, range from 90%, if new, to 80%, if used. Receivables are margined at 80% based on the aging of receivables outstanding sixty days or less.

**Consumer /Residential 1-4 Families and Equity Lines:** Loans are generally underwritten based on a maximum debt to income ratio of 40 percent gross. Incomes are verified for all secured loans exceeding \$35,000 and unsecured loans totaling \$10,000 or more. Policy requires income verification to be documented for all real estate loans. Collateral margins and terms for non-real estate collateral are determined and made available to retail lenders by Franklin Bank's Senior Lender. Cash flows for all self employed borrowers are determined by Franklin Bank's independent credit analyst. Policy defines unsecured loan terms at a maximum of thirty six months while individual unsecured lines are underwritten to maturities of less than one year with the line amount being based on a percentage of available liquidity and net worth. Construction loans for individuals are underwritten to policy based on cost overruns of at least fifteen percent. Debt to income ratios for equity lines are underwritten based on the borrower paying 1.5% of the total available line monthly. All equity lines are reviewed annually and filtered based on updated credit scores, average percentage drawn and delinquency. Watch accounts are identified based on filters and then individually reviewed by the responsible account officer.

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012****Note 4 Allowance for Loan Losses**

Changes in the allowance for loan losses for the years ended December 31, 2013 and 2012 are as follows:

	2013	2012
Balance at beginning of year	\$ 2,602,098	\$ 3,272,945
Provision for loan losses	1,664,880	486,257
Losses charged to allowance	(1,967,911)	(1,330,151)
Recoveries credited to allowance	80,078	173,047
Balance at end of year	\$ 2,379,145	\$ 2,602,098

A breakdown of the allowance for loan losses by loan segment for the year ended December 31, 2013 is as follows:

	Commercial	Construction and Land Development	Residential First Liens	Real Estate 1-4 Families Junior Liens	Home Equity Lines	Commercial Real Estate	Consumer	Unallocated	Total
Beginning									
Balance	\$ 108,336	\$ 767,018	\$ 701,668	\$ 134,847	\$ 88,411	\$ 740,073	\$ 11,745	\$ 50,000	\$ 2,602,098
Charge-offs	(450,100)	(592,292)	(151,295)	(156,561)	(9,052)	(534,150)	(74,461)		(1,967,911)
Recoveries	12,278	9,090	7,448	20,497		1,429	29,336		80,078
Provision	480,775	169,575	43,455	102,123	20,992	853,685	44,275	(50,000)	1,664,880
Ending									
Balance	\$ 151,289	\$ 353,391	\$ 601,276	\$ 100,906	\$ 100,351	\$ 1,061,037	\$ 10,895	\$	\$ 2,379,145

A breakdown of the allowance for loan losses by loan segment for the year ended December 31, 2012 is as follows:

	Commercial	Construction and Land Development	Residential First Liens	Real Estate 1-4 Families Junior Liens	Home Equity Lines	Commercial Real Estate	Consumer	Unallocated	Total
	\$ 154,991	\$ 902,644	\$ 1,100,139	\$ 174,809	\$ 98,582	\$ 824,759	\$ 11,911	\$ 5,110	\$ 3,272,945

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Beginning Balance									
Charge-offs	(186)	(257,796)	(911,535)	(143,849)			(16,785)		(1,330,151)
Recoveries	1,842	8,377	134,305	11,525	3,374		13,624		173,047
Provision	(48,311)	113,793	378,759	92,362	(13,545)	(84,686)	2,995	44,890	486,257
Ending Balance									
	\$ 108,336	\$ 767,018	\$ 701,668	\$ 134,847	\$ 88,411	\$ 740,073	\$ 11,745	\$ 50,000	\$ 2,602,098

C-47

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

A breakdown of the allowance for loan losses and the recorded investment in loans by individually and collectively evaluated for impairment at December 31, 2013 is shown below.

	Commercial	Construction and Land Development	Residential First Liens	Real Estate 1-4 Families Junior Liens	Home Equity Lines	Commercial Real Estate	Consumer	Unallocated	Total
Allowance for loan losses:									
Ending Balance: Individually evaluated for impairment	\$ 50,000	\$ 10	\$ 101,540	\$	\$	\$ 424,376	\$	\$	\$ 575,926
Ending Balance: Collectively evaluated for impairment	101,289	353,381	499,736	100,906	100,351	636,661	10,895		1,803,219
	\$ 151,289	\$ 353,391	\$ 601,276	\$ 100,906	\$ 100,351	\$ 1,061,037	\$ 10,895	\$	\$ 2,379,145

	Commercial	Construction and Land Development	Residential First Liens	Real Estate 1-4 Families Junior Liens	Home Equity Lines	Commercial Real Estate	Consumer	Gross Loans
Recorded investment in loans:								



Ending Balance: Individually evaluated for impairment	\$ 725,863	\$ 576,552	\$ 1,130,961	\$ 182,170	\$ 71,338	\$ 3,308,733	\$	\$ 5,995,617
Ending Balance: Collectively evaluated for impairment	8,700,325	15,818,412	32,656,684	6,149,063	5,693,603	47,270,370	1,353,312	117,641,769
	\$ 9,426,188	\$ 16,394,964	\$ 33,787,645	\$ 6,331,233	\$ 5,764,941	\$ 50,579,103	\$ 1,353,312	\$ 123,637,386

C-48

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

A breakdown of the allowance for loan losses and the recorded investment in loans by individually and collectively evaluated for impairment at December 31, 2012 is shown below.

	Commercial	Construction and Land Development	Real Estate Residential First Liens	Real Estate 1-4 Families Junior Liens	Home Equity Lines	Commercial Real Estate	Consumer	Unallocated	Total
Allowance for loan losses:									
Ending Balance: Individually evaluated for impairment	\$	\$ 268,850	\$ 23,122	\$ 31	\$	\$	\$	\$	\$ 292,003
Ending Balance: Collectively evaluated for impairment	108,336	498,168	678,546	134,816	88,411	740,073	11,745	50,000	2,310,095
	\$ 108,336	\$ 767,018	\$ 701,668	\$ 134,847	\$ 88,411	\$ 740,073	\$ 11,745	\$ 50,000	\$ 2,602,098

	Commercial	Construction and Land Development	Real Estate Residential First Liens	Real Estate 1-4 Families Junior Liens	Home Equity Lines	Commercial Real Estate	Consumer	Gross Loans
Recorded investment in loans:								

Ending Balance: Individually valuated or impairment	\$ 212,738	\$ 1,100,585	\$ 938,555	\$ 225,669	\$	\$ 346,807	\$	\$ 2,824,354
Ending Balance: Collectively valuated or impairment	10,226,435	20,167,731	34,551,730	7,408,182	6,093,783	51,514,445	1,627,706	131,590,012
	\$ 10,439,173	\$ 21,268,316	\$ 35,490,285	\$ 7,633,851	\$ 6,093,783	\$ 51,861,252	\$ 1,627,706	\$ 134,414,366

C-49

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

An age analysis of past due loans as of December 31, 2013 is as follows:

	Loans 30-59 Days Past Due	Loans 60-89 Days Past Due	Loans 90 Or More Days Past Due	Total Past Due Loans	Current Loans	Gross Loans	Accruing Loans 90 or More Days Past Due (Included in (Included in Past Dues & Current))	Nonaccrual Loans (Included in Past Dues & Current)
Commercial	\$	\$	\$	\$	\$ 9,426,188	\$ 9,426,188	\$	\$
Real Estate:								
Construction and land development	320,143		259,973	580,116	15,814,848	16,394,964		576,552
Residential 1-4 Families								
First Liens	893,473	33,154	802,830	1,729,457	32,058,188	33,787,645		1,125,187
Junior Liens	65,603		16,232	81,835	6,249,398	6,331,233		152,985
Home Equity lines					5,764,941	5,764,941		71,338
Commercial Real Estate	416,668			416,668	50,162,435	50,579,103		2,079,556
Consumer	50,244			50,244	1,303,068	1,353,312		
	\$ 1,746,131	\$ 33,154	\$ 1,079,035	\$ 2,858,320	\$ 120,779,066	\$ 123,637,386	\$	\$ 4,005,618

An age analysis of past due loans as of December 31, 2012 is as follows:

	Loans 30-59 Days Past Due	Loans 60-89 Days Past Due	Loans 90 Or More Days Past Due	Total Past Due Loans	Current Loans	Gross Loans	Accruing Loans 90 or More Days Past Due (Included in Past Dues & Current)	Nonaccrual Loans (Included in Past Dues & Current)
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Commercial	\$	1,612	\$	\$	\$	1,612	\$	10,437,561	\$	10,439,173	\$	\$				
Real Estate:																
Construction and land development		338,195		88,022		364,099		790,316		20,478,000		21,268,316		3,485		447,542
Residential 1-4 Families																
First Liens		751,946				291,682		1,043,628		34,446,657		35,490,285				938,556
Junior Liens		19,000				128,905		147,905		7,485,946		7,633,851				129,591
Home Equity lines										6,093,783		6,093,783				
Commercial Real Estate		329,921						329,921		51,531,331		51,861,252				
Consumer		4,262						4,262		1,623,444		1,627,706				
		\$ 1,444,936		\$ 88,022		\$ 784,686		\$ 2,317,644		\$ 132,096,722		\$ 134,414,366		\$ 3,485		\$ 1,515,689

C-50

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

Impaired loans at December 31, 2013 are as follows:

	Unpaid Contractual Principal Balance	Recorded Investment with Related Allowance	Recorded Investment with No Related Allowance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Commercial	\$ 778,980	\$ 60,000	\$ 665,863	\$ 50,000	\$ 287,405	\$ 34,511
Real Estate:						
Construction and land development	890,255	162,710	413,842	10	960,164	24,249
Residential 1-4 Families						
First Liens	1,154,822	541,539	589,422	101,540	1,460,986	37,253
Junior Liens	190,455		182,170		216,673	9,361
Home Equity lines	80,390		71,338		59,495	263
Commercial Real Estate	3,308,733	2,079,556	1,229,177	424,376	2,156,878	46,367
Consumer						
	\$ 6,403,635	\$ 2,843,805	\$ 3,151,812	\$ 575,926	\$ 5,141,601	\$ 152,004

Impaired loans at December 31, 2012 are as follows:

	Unpaid Contractual Principal Balance	Recorded Investment with Related Allowance	Recorded Investment with No Related Allowance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Commercial	\$ 212,738	\$	\$ 212,738	\$	\$ 170,618	\$ 14,359
Real Estate:						
Construction and land development	1,345,286	268,850	831,735	268,850	1,044,368	17,765
Residential 1-4 Families						
First Liens	943,996	238,722	699,833	23,122	2,700,973	17,067
Junior Liens	229,886	52,031	173,638	31	390,654	10,898
Home Equity lines					77,775	
Commercial Real Estate	346,807		346,807		1,259,284	13,608

Consumer	20,098
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\$ 3,078,713	\$ 559,603	\$ 2,264,751	\$ 292,003	\$ 5,663,770	\$ 73,697
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C-51

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

Impaired loans on nonaccrual were \$4,005,618 and \$1,515,689 at December 31, 2013 and December 31, 2012, respectively. The average balance for impaired loans was \$5,141,601 and \$5,663,770 for the years ending December 31, 2013 and December 31, 2012, respectively. Of the impaired loans at December 31, 2013, \$2,843,805 had specific reserves of \$575,926 included in the allowance for loan losses and \$787,586 had portions of the loan charged off. Of the impaired loans at December 31, 2012, \$559,603 had specific reserves of \$292,003 included in the allowance for loan losses and an additional \$188,220 had portions of the loan charged off. Following is a breakdown of the interest for impaired loans for the years ending December 31, 2013 and 2012, respectively.

	December 2013	December 2012
Interest that would have been earned	\$ 369,252	\$ 295,276
Interest reflected in income	152,004	73,697
Lost interest	\$ 217,248	\$ 221,579

All interest income on impaired loans had been received in 2013 and 2012. No additional interest was reflected in income for 2013 and 2012 on impaired loans.

At December 31, 2013 and December 31, 2012, the balance in loans under the terms of troubled debt restructurings not included in nonaccrual loans was \$1,929,999 and \$1,305,180, respectively. These loans did not have any additional commitments at December 31, 2013 and December 31, 2012, respectively. The Corporation assesses all loan modifications to determine whether they are considered troubled debt restructurings (TDRs). Loan restructurings generally occur when a borrower is experiencing, or is expected to experience, financial difficulties in the near-term. Consequently, a modification that would otherwise not be considered is granted to the borrower. These loans may continue to accrue interest as long as the borrower complies with the revised terms and conditions and has demonstrated repayment performance with the modified terms. The borrowers were complying with the modified terms of their contracts at December 31, 2013 and December 31, 2012, respectively. Troubled debt restructurings are included in the impaired loan disclosures.

For the period ended December 31, 2013, the following table presents information relating to loans modified as TDRs:

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial	3	\$ 807,414	\$ 754,297
Commercial Real Estate	2	3,541,847	3,147,854



5	\$	4,349,261	\$	3,902,151
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During the year ended December 31, 2013, the Corporation modified five loans that were considered to be TDRs, of which one is on nonaccrual. Two of the commercial loans were the renewals of credit designated as a TDR. The last commercial note was the restructure of a stale line of credit, of which part of the credit was restructured to a term note. This credit belongs to a former director who resigned in February 2014. The Corporation lowered the payment on one of the commercial real estate credits, which extended the amortization out of policy guidelines, in order to allow the borrower time to attract new tenants. The second commercial real estate credit was a result of charging off part of the original credit and positioning the credit and borrowers with the ability to go forward with a performing credit.

There were no troubled debt restructurings modified during the prior twelve months that defaulted during the year ended December 31, 2013. For this purpose, if a note defaults it means at some point it has been greater than 60 days past due or we have received some information that leads us to believe the full collection of the principal and interest is doubtful.

C-52

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

For the period ended December 31, 2012, the following table presents information relating to loans modified as TDRs:

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial	2	\$ 183,842	\$ 183,842
Construction and land development	3	683,410	689,954
Residential 1-4 families first liens	1	239,036	239,036
Commercial Real Estate	1	354,156	354,156
	7	\$ 1,460,444	\$ 1,466,988

One of the commercial loans restructured was a renewal of an existing loan for a short period of time to allow the borrower to come up with an action plan. The borrower's debt service ratio had declined moving the credit to a criticized asset. The second commercial loan was restructured to interest only to lower the payment to allow the borrower time to receive their inheritance. The first construction and land development loan was the renewal of a criticized credit for a short term to allow the borrower to sell assets. The second construction and land development loan was restructured to obtain additional collateral and reduce impairment. The third construction and land development loan was restructured to give the borrower additional time to have an auction in the spring to sell properties. The loan was modified to interest only. The residential 1-4 family loan was modified to gain additional collateral and allow the borrower to improve cash flow. The commercial real estate loan was the restructure of a stale line of credit into an amortizing loan of a criticized asset.

There were no troubled debt restructurings modified during the prior twelve months that defaulted during the year ended December 31, 2012. For this purpose, if a note defaults it means at some point it has been greater than 60 days past due or we have received some information that leads us to believe the full collection of the principal and interest is doubtful.

The Corporation's internally assigned grades for credit quality are as follows:

**Prime (1.00)**

Exceptional credits are of the highest quality. These loans are supported by large, well-established borrowers with excellent financial stability and strength, and may be secured by cash or cash equivalents. Where applicable, guarantors have substantial net worth and personal cash flow, and could easily fulfill their obligation should the need arise.

**Good (2.00)**

Superior credits are supported by well-established borrowers with excellent financial stability and strength. The borrower's cash flow, liquidity, and equity are more than ample. These credits may be secured by cash or cash equivalents. For loans with personal guarantees, the guarantors are high net worth individuals, and have the resources available to satisfy their obligation if necessary.

**Acceptable (3.00)**

Loans in this category are supported by borrowers and guarantors that are financially sound. Cash flow, liquidity and equity are sufficient to provide a comfortable margin in the event of short-term economic disturbances. Assets pledged as collateral would provide a dependable secondary source of repayment.

**Pass/Watch (4.00)**

Credits in this category present the maximum acceptable risk for new facilities. Borrowers generate enough cash for debt service needs, but may not have sufficient resources to weather short-term market fluctuations. Management may lack depth or experience, and industry volatility may be an issue. Where applicable, guarantors have sufficient resources to provide an additional margin of protection.

**Special Mention (5.00)**

Assets in this category demonstrate signs of potential weakness, which, if uncorrected, could result in default. The borrower's liquidity or equity may be marginal, trends in cash flow and profitability may point to a weakening financial condition, or the borrower's industry may be slightly unstable or showing early indications of decline. Collateral may be illiquid or provide only a relatively small margin. Migration analysis data is performed and updated quarterly on these loans. It is based on loans

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**December 31, 2013 and 2012**

downgraded originally into this category. Our loss factor is determined based on charge-offs during the quarter divided by the balance of special mention loans at the beginning of the quarter, which is then increased by qualitative factors resulting in an applied loss factor of 3%.

**Substandard (6.00)**

Loans in this category present an unacceptable credit risk. Borrowers and guarantors may be financially weak, and may lack the sufficient resources to adequately service debt. The abilities of management and industry stability may also be of concern. Collateral may be lacking in quality or liquidity, and offers little additional protection. Migration analysis data is performed and updated quarterly on these loans. It is based on loans downgraded originally into this category. For non-impaired substandard loans, our loss factor is determined based on charge-offs during the quarter divided by the balance of substandard loans at the beginning of the quarter. This is then increased by the substandard loans qualitative factors resulting in an applied loss factor of 8%.

**Doubtful (7.00)**

These loans have an extremely high probability of loss, though the timing and magnitude of the loss may remain unclear. Borrowers and guarantors exhibit major financial shortcomings, and clearly lack the sufficient resources to adequately service the debt or honor their commitments. Collateral is lacking in quality or liquidity, and offers little, if any, additional protection.

**Loss (8.00)**

The probability of collection on these credits is so low that they may be properly classified as uncollectible.

Generally, consumer loans, home equity lines, and residential 1-4 family loans are not risk rated and are considered a pass credit unless they are related to a risk rated commercial loan relationship or exhibit criticized asset characteristics.

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

The tables below represent the balances in the risk rating categories at December 31, 2013 and 2012.

December 31, 2013

Risk Rating Grades	Commercial	Construction And Land Development	Real Estate		Home Equity Lines	Commercial Real Estate	Consumer	Totals Internal Rating
			Residential 1-4 First Liens	Families Junior Liens				
	\$ 9,179,636	\$ 14,308,667	\$ 32,126,801	\$ 5,773,125	\$ 5,693,603	\$ 47,028,384	\$ 1,342,215	\$ 115,452
Special Mention		907,175	204,731			711,413	907	1,824
Standard	196,552	1,179,112	1,354,573	558,108	71,338	2,414,930	10,190	5,784
Substandard	50,000	10	101,540			424,376		575
	\$ 9,426,188	\$ 16,394,964	\$ 33,787,645	\$ 6,331,233	\$ 5,764,941	\$ 50,579,103	\$ 1,353,312	\$ 123,637

December 31, 2012

Risk Rating Grades	Commercial	Construction And Land Development	Real Estate		Home Equity Lines	Commercial Real Estate	Consumer	Totals Internal Rating
			Residential 1-4 First Liens	Families Junior Liens				
	\$ 10,077,178	\$ 18,038,151	\$ 32,046,560	\$ 6,719,907	\$ 5,984,847	\$ 45,339,487	\$ 1,624,080	\$ 119,830
Special Mention	169,616	658,199	943,993	228,364		4,014,141		6,014
Standard	192,379	2,571,966	2,261,010	685,580	108,936	2,507,624	3,626	8,331
Substandard			238,722					238
	\$ 10,439,173	\$ 21,268,316	\$ 35,490,285	\$ 7,633,851	\$ 6,093,783	\$ 51,861,252	\$ 1,627,706	\$ 134,414

**Note 5 Related Party Loans**

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Directors, executive officers and related interests provide the Corporation with business and many are among its significant depositors and borrowers. Total amounts outstanding at December 31, 2013 and 2012 for all such loans are summarized below:

	2013	2012
Balance at beginning of year	\$ 10,876,858	\$ 11,164,683
Additions	8,539,997	9,419,490
Payments	(9,029,939)	(9,707,315)
Charge-offs	(413,117)	
Balance at end of year	\$ 9,973,799	\$ 10,876,858

C-55

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

These loans, in the opinion of management, were made in the ordinary course of business on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans with persons not related to the lender and did not involve more than the normal risk of collectability or present other unfavorable features. Total unfunded commitments to related persons were \$3,860,698 and \$2,281,956 at December 31, 2013 and 2012, respectively.

A former Director's total relationship with Franklin Bank was approximately \$1.6 million prior to his resignation in February 2014. Franklin Bank was required to make certain allocations and charge-offs to the allowance for loan losses in the total amount of \$453,883. Restructured loans deemed to be troubled debt restructurings to this former director were \$640,141.

**Note 6 Bank premises and Equipment**

Bank premises and equipment at December 31, 2013 and 2012 are as follows:

	2013	2012
Buildings and land	\$ 1,306,410	\$ 1,306,410
Furniture and equipment	1,471,554	1,408,707
Computer software	275,676	256,741
Leasehold improvements	408,533	402,638
Automobiles	20,284	20,284
	3,482,457	3,394,780
Accumulated depreciation and amortization	(1,972,895)	(1,827,793)
Bank premises and equipment, net	\$ 1,509,562	\$ 1,566,987

Depreciation expense was \$153,532 and \$179,512 for 2013 and 2012, respectively.

**Note 7 Deposits**

The maturities of time deposits \$100,000 and over and other time deposits at December 31, 2013 are as follows:

	2013
	Time Deposits
	Other Time Deposits

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	\$100,000 and Over	
2014	\$ 21,099,317	\$ 24,954,551
2015	4,235,835	6,267,608
2016	2,445,037	2,329,664
2017	1,093,745	1,947,402
2018	1,103,217	1,339,375
Total	\$ 29,977,151	\$ 36,838,600

Total deposit dollars from executive officers, directors, and their related interests at December 31, 2013 and 2012 were \$8,058,395 and \$7,053,010, respectively. Brokered deposits totaled \$4.0 million and \$5.3 million at December 31, 2013 and 2012, respectively.

**Note 8 Borrowings**

The Corporation has the ability to borrow from the Federal Home Loan Bank of Atlanta ( FHLB ). Borrowing capacity is secured by a blanket lien on loans secured by commercial real estate and loans secured by 1-4 family first liens, second liens, and equity lines. The borrowing capacity at December 31, 2013, based upon lendable collateral value, was \$29,187,459. There were no FHLB advances outstanding at December 31, 2013 and December 31, 2012.



**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

There were no overnight federal funds purchased at December 31, 2013 and December 31, 2012. The Corporation has \$14,500,000 in overnight federal funds lines with its correspondents.

The Corporation has an internal Corporate Cash Management account for customers to sweep their excess demand deposit accounts on an overnight basis in order to earn interest. This account is not FDIC insured but the Corporation is required to pledge agency funds at 100% towards these balances. There were no Corporate Cash Management sweep accounts at December 31, 2013 and December 31, 2012.

**Note 9 Repurchase Agreements**

The Corporation entered into a repurchase agreement with Barclays Capital on January 2, 2008 in the amount of \$6,000,000. The repurchase date was January 2, 2013. The interest rate was fixed at 3.57% until maturity or until it was called. Beginning January 2, 2009 the repurchase agreement became callable and could have been called quarterly with two business days prior notice. Interest was payable quarterly. The repurchase agreement was collateralized by agency mortgage backed securities.

**Note 10 Income Taxes**

The Corporation files income tax returns in the U.S. federal jurisdiction and the state of Virginia. With few exceptions, the Corporation is no longer subject to U. S. federal, state and local income tax examinations by tax authorities for years prior to 2010.

Allocation of federal and state income taxes between current and deferred portions is as follows:

	2013	2012
Current expense	\$ 10,909	\$ 133,189
Deferred tax expense (benefit)	36,399	(438,135)
<b>Income tax expense (benefit)</b>	<b>\$ 47,308</b>	<b>\$ (304,946)</b>

The reasons for the differences between the statutory federal income tax rate and the effective tax rate are summarized as follows:

	2013	2012
Computed at the expected federal statutory rate	\$ 85,796	\$ 566,382
Nondeductible meals & entertainment	828	1,020

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Bank owned life insurance	(12,681)	(848,057)
Tax exempt loan interest	(4,804)	(7,396)
Tax exempt securities income	(21,831)	(16,895)
Income tax expense (benefit)	\$ 47,308	\$ (304,946)

C-57

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

The components of deferred tax assets and liabilities are as follows:

	2013	2012
Allowance for loan losses	\$ 418,959	\$ 565,904
SERP accrual	563,516	571,567
Alternative minimum tax carry forward	306,452	295,543
Net operating loss carry forward	219,483	
Interest on nonaccrual loans	79,134	82,557
Charitable contributions	25,445	17,856
Unrealized loss on securities available-for-sale	17,368	
Other	13,707	16,499
Unrealized losses on other real estate	19,511	140,065
 Deferred tax assets	 1,663,575	 1,689,991
Prepaid service contracts and insurance	(32,476)	(31,691)
Depreciation and amortization	(49,834)	(62,999)
Unrealized gain on securities available-for-sale		(190,575)
Other	(10,138)	(38,222)
 Deferred tax liabilities	 (92,448)	 (323,487)
 Net deferred tax assets	 \$ 1,571,127	 \$ 1,366,504

Under the provisions of the Internal Revenue Code, the Corporation has approximately \$645,538 of net operating loss carryforwards which can be offset against future taxable income. The carryforwards expire through December 31, 2033. The full realization of the tax benefits associated with the carryforwards depends predominately upon the recognition of ordinary income during the carryforward period.

**Note 11 Net Income Per Common Share**

The following table shows the weighted average number of common shares used in computing earnings per common share and the effect on weighted average number of common shares of diluted potential common stock. Potential dilutive common stock had no effect on income available to common stockholders.

2013

2012

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	Shares	Per Share Amount	Shares	Per Share Amount
Earnings per common share, basic	1,713,375	\$ .12	1,713,375	\$ 1.15
Effect of dilutive securities:				
Stock options and warrants				
Earnings per common share, diluted	1,713,375	\$ .12	1,713,375	\$ 1.15

In 2013 and 2012, stock options representing 121,210 and 161,272 average shares, respectively, were not included in the calculation of earnings per common share because they would have been antidilutive.

C-58

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012****Note 12 - Employee Benefit Plans**

MainStreet funds certain costs for medical benefits in amounts determined at the discretion of management. BankShares has a 401-K plan which provides for contributions by employees and a matching contribution by the Company. Total 401-K match expense was \$65,133 and \$71,197 for the years ended December 31, 2013 and 2012, respectively.

In addition, MainStreet has supplemental retirement benefits provided to one of its current executive officers and its former President and CEO under a supplemental executive retirement plan ( SERP ) executed in 2007. Although technically unfunded, a Rabbi Trust and two insurance policies on the life of the covered current executive are available to finance future benefits. The Bank is the owner and beneficiary of these policies. The expense for 2013 and 2012 was \$132,215 and \$1,097,227, respectively. Total expected expense for 2014 is \$142,628. The following were significant actuarial assumptions used to determine benefit obligations:

	December 31, 2013	December 31, 2012
<u>Actuarial Assumptions</u>		
Weighted average assumed discount rate	6.25%	6.25%
Assumed rate of annual compensation increases	3.50	3.50
	December 31, 2013	December 31, 2012
<u>Changes in Projected Benefit Obligation</u>		
Projected benefit obligation January 1,	\$ 1,595,297	\$ 506,232
Service cost	43,215	1,023,743
Interest cost	95,629	78,842
Prior gain amortized	(6,629)	(5,358)
Actuarial (gain) loss	82,026	(8,162)
Benefits paid	(140,628)	
Projected benefit obligation, December 31	\$ 1,668,910	\$ 1,595,297

The SERP liability, equal to the projected benefit obligation above, is included in other liabilities on the Corporation's consolidated balance sheet.

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Amounts Recognized in Accumulated Other Comprehensive Income (Loss)		
Actuarial gains (losses)	\$ (11,509)	\$ 70,517
Deferred income tax asset (liability)	3,913	(23,976)
	\$ (7,596)	\$ 46,541
Components of Net Periodic Benefit Cost		
Service cost	\$ 43,215	\$ 1,023,743
Interest cost	95,629	78,842
Actuarial gains	(6,629)	(5,358)
Net Periodic Benefit Cost	\$ 132,215	\$ 1,097,227
Other Pre-tax Changes in Benefit Obligations Recognized in Other Comprehensive Income (Loss)		
Actuarial (gains) losses	\$ 82,026	\$ (8,162)
Total Pre-tax Amounts Recognized in Net Periodic Cost and Other Comprehensive Income (Loss)	\$ 214,241	\$ 1,089,065

The SERP is designed to provide 65% of final average five years base salary less the social security contribution. The SERP has certain provisions for early retirement, death benefits and disability. Upon the death of Larry A. Heaton in December 2012, his beneficiary began receiving payments in 2013. These payments will be made over 15 years continuing through January 2027. Brenda H. Smith is scheduled to begin receiving benefit payments in 2025.

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**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**December 31, 2013 and 2012**

**Note 13 Leases and Commitments**

The Corporation has a lease agreement for its facility in Martinsville, Virginia. MainStreet's executive office and operations area lease, which commenced on November 19, 2010, is for 7,900 square feet of space located at 1075 Spruce Street in Martinsville, Virginia. The lease will expire November 30, 2015.

Franklin Bank's main office is located at 400 Old Franklin Turnpike, Suite 100, Rocky Mount, Virginia, in a section of town known as the Rocky Mount Marketplace. The bank leases a two-story facility with approximately 8,200 square feet of which the Bank provides permanent financing to the owners, of which one is a director. The lease is for a 15-year period and the expiration date of the lease is June 30, 2018. The lease payment mirrors the loan payment plus an 8% return on investment to the owner. One of the owners is also a director of Franklin Bank and both owners are shareholders of BankShares. A banking office, Westlake Branch, of Franklin Bank opened on April 9, 2004 at 12930 Booker T. Washington Highway, Hardy, Virginia. The bank also provides permanent financing to the owner of this facility, of which a director of the bank is a partner. The lease commenced on April 7, 2004 and will expire April 6, 2019. The lease payment mirrors the loan payment plus an 8% return on investment to the owner. Franklin Bank's 220 North banking office was located at 35 Shepherd Drive, Rocky Mount, Virginia. A director of Franklin Bank was a partner in the ownership of the facility. The lease commenced June 1, 2007 and expired June 1, 2012. This banking office was closed effective November 13, 2010; however, the lease remained in effect until its maturity and had a sublease until then. Franklin Bank purchased the building at the maturity of the lease and assigned the purchase to another buyer who was a director of both the Corporation and Franklin Bank.

In addition to the leases for office space, the Corporation also leases various pieces of office equipment under short and long-term leases.

Total rent expense approximated \$347,000 and \$356,000 for the years ended December 31, 2013 and 2012, respectively. Future rental payments under non-cancelable operating leases approximate \$347,000, \$343,000, \$307,000, \$307,000 and \$214,000 for the years ended December 31, 2014, 2015, 2016, 2017 and 2018, respectively. The total aggregate of lease payments after 2018 total approximately \$21,000.

The Corporation has an employment agreement with its President and Chief Executive Officer, Brenda H. Smith. This agreement has a three-year term and is automatically extended by one year if not terminated at least 90 days prior to each anniversary. The Corporation and Franklin Bank had an employment agreement with Larry A. Heaton, former President and Chief Executive Officer. This agreement is no longer in effect as a result of Mr. Heaton's death.

MainStreet and Franklin Bank have change in control agreements with its other executive officers. The agreements shall remain in effect until the termination of employment, other than a termination of employment which results in a payment obligation, at which time it will become null and void. Each executive officer is entitled, if there is a payment obligation, to one times salary. The control agreements for Ms. Correll and Ms. Sonya Smith do not include a non-compete clause. The agreement for Mr. Hammock includes a non competition obligation within a 50 mile radius of the principal bank office where the officer was located during the twelve months preceding termination.

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MainStreet and Franklin Bank entered into change in control agreements with its Vice Presidents effective November 14, 2007. The agreements shall remain in effect until the termination of the officers' employment, other than a termination of employment which results in a payment obligation, at which time it will become null and void. The Franklin Community Bank agreements provide for a non competition obligation within a 50 mile radius of the office where the officer was principally located during the twelve months preceding the officer's termination.

C-60



Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012****Note 14 - Stock Options and Warrants**

The shareholders of MainStreet approved the 2004 Key Employee Stock Option Plan, (the Plan), at its Annual Meeting on April 15, 2004. The Plan permitted the grant of Non-Qualified Stock Options and Incentive Stock Options to persons designated as Key Employees of BankShares or its subsidiaries. The Plan was approved by the Board of Directors on January 21, 2004 and terminated on January 21, 2009, except with respect to awards made prior to and outstanding on that date which remain valid in accordance with their terms. Option awards were granted with an exercise price equal to the market value of MainStreet's stock at the date of grant. The options issued in 2007 and 2006 had a vesting period of 3 years and have a ten year contractual term. The options issued in 2005 vested immediately upon grant and have a ten year contractual term. All share awards provide for accelerated vesting if there is a change in control (as defined in the Plan). The maximum number of shares that could have been issued under the Plan could not exceed 150,700. As of December 31, 2013, there were 136,527 options granted under this Plan of which 822 options have been exercised, 61,249 options have expired, and 7,433 stock options forfeited.

Options in the amount of 33,000 were granted at the then fair market value of \$9.55 to a former employee and expired in June 2013. Options in the total amount of 61,249 granted at various fair market values to our former President and CEO expired in December 2013. Mr. Heaton was tragically killed in a car accident in December 2012.

The Corporation has reserved 67,023 shares of authorized but unissued shares of common stock related to these option agreements as of December 31, 2013.

There were no stock option grants during 2013 and 2012. The Black-Scholes option-pricing model was utilized for grants using the assumptions of risk-free interest rate; expected life of options; expected volatility of the stock price and expected dividend yield. Expected volatilities were based on the historical volatility of MainStreet's stock. The risk-free rate for the period within the contractual life of the stock option was based upon the applicable Treasury rate at the date of the grant. Expected life was calculated using the simplified method based on the average of the vesting period and contractual life of the options.

MainStreet recorded no stock-based compensation during the years ended December 31, 2013 and 2012. MainStreet did not have anyone exercise warrants or stock options during the years ended December 31, 2013 and 2012.

Following is a status and summary of changes of stock options and warrants during the year ended December 31, 2013:

2013	Weighted Average Exercise Price	Weighted Average Remaining Contractual	Aggregate Intrinsic Value
------	--	---	---------------------------------

			Term	
Outstanding at beginning of year	161,272	\$ 12.17		
Granted				
Exercised				
Forfeited				
Expired	(94,249)	11.68		
Outstanding at year-end	67,023	\$ 12.87	2.25	\$
Exercisable at year-end	67,023	\$ 12.87	2.25	\$

The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on December 31, 2013. This amount changes based on changes in the market value of the Corporation's stock.

C-61

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

As of December 31, 2013 and 2012, there was no unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan.

As of December 31, 2013, stock options outstanding and exercisable are summarized as follows:

Range of Exercise Prices	Stock Options and Warrants Outstanding And Exercisable	Remaining Contractual Life
12.09	43,977	1.90
12.09	9,066	2.00
15.00	7,464	3.95
16.75	6,516	3.00
\$12.09 - \$16.75	67,023	

**Note 15 Regulatory Requirements and Restrictions**

The payment of dividends to the shareholders is significantly dependent on the ability of the subsidiary bank to pay dividends to the Corporation. Under the applicable federal laws, the Comptroller of the Currency restricts the total dividend payments of any calendar year, without prior approval, to the net profits of that year as defined, combined with retained net profits for the two preceding years. As of December 31, 2013, the aggregate amount of unrestricted funds according to the regulation that could be transferred from the Corporation's bank subsidiary to the Parent Corporation for payment of dividends to shareholders without prior regulatory approval, totaled \$1,879,805 or 1.11% of the total consolidated assets. On April 16, 2009, Franklin Bank entered into a formal agreement with the Office of the Comptroller of the Currency that restricted dividend payments to the holding company. Franklin Bank has achieved full compliance with the Agreement, which was terminated in August 2013.

Franklin Bank is a member of the Federal Reserve System; however, Franklin Bank processes daily through a correspondent bank, Community Bankers Bank. As of December 31, 2013, Franklin Bank was required to maintain a reserve balance of \$250,000 with Community Bankers Bank.

Franklin Bank is subject to various regulatory capital requirements administered by the federal and state banking agencies. Failure to meet minimum capital ratios can initiate certain mandatory, and possibly additional discretionary actions by regulators that, if undertaken, could have a material effect on the consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, Franklin Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance sheet

items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Quantitative measures established by regulations to ensure capital adequacy require Franklin Bank to maintain minimum capital ratios. Franklin Bank was well-capitalized at December 31, 2013 and 2012.

As of December 31, 2013, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following tables. There are no conditions or events since the notification that management believes have changed the Bank's category.

C-62

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

Actual capital amounts and ratios for Franklin Bank at December 31, 2013 and 2012 are presented in the following table:

As of December 31, 2013	Actual		Minimum Capital Requirement		Minimum to be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk weighted assets)	\$ 23,258,724	19.41%	\$ 9,585,000	8.00%	\$ 11,981,000	10.00%
Tier I capital (to risk weighted assets)	21,749,975	18.15	4,792,000	4.00	7,189,000	6.00
Tier I capital (to average assets)	21,749,975	12.98	6,703,000	4.00	8,378,000	5.00

  

As of December 31, 2012	Actual		Minimum Capital Requirement		Minimum to be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk weighted assets)	\$ 24,400,282	18.68%	\$ 10,452,000	8.00%	\$ 13,065,000	10.00%
Tier I capital (to risk weighted assets)	22,754,882	17.42	5,226,000	4.00	7,839,000	6.00
Tier I capital (to average assets)	22,754,882	12.47	7,298,000	4.00	9,122,000	5.00

**Note 16 Parent Company Financial Information****CONDENSED BALANCE SHEETS**

	December 31, 2013	December 31, 2012
<b>Assets</b>		
Cash and due from banks	\$ 163,744	\$ 176,652
Interest-bearing deposits in other banks	412,471	422,381
Furniture, fixtures and equipment, net	112,548	80,608
Other assets	70,321	94,296
Investment in subsidiaries	23,337,047	23,600,121

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Total Assets	\$ 24,096,131	\$ 24,374,058
<u>Liabilities and Shareholders' Equity</u>		
Accrued interest payable and other liabilities	\$ 108,590	\$ 123,685
<u>Shareholders' Equity</u>		
Common shareholders' equity	23,987,541	24,250,373
Total Liabilities and Shareholders' Equity	\$ 24,096,131	\$ 24,374,058

C-63

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012****CONDENSED STATEMENTS OF INCOME**

	Year Ended December 31, 2013	Year Ended December 31, 2012
<b><u>Income</u></b>		
Equity in undistributed income of subsidiaries	\$ 204,792	\$ 1,971,194
Interest income	619	913
Other income	1,522	561
Affiliate fee income	1,717,193	1,563,393
<b>Total Income</b>	<b>1,924,126</b>	<b>3,536,061</b>
<b><u>Expenses</u></b>		
Salaries and employee benefits	1,151,261	1,008,864
Occupancy and equipment expense	155,472	132,422
Professional fees	170,825	201,621
Outside processing	106,528	104,379
Other expenses	134,643	118,002
<b>Total Expenses</b>	<b>1,718,729</b>	<b>1,565,288</b>
<b>Net Income Before Tax</b>	<b>205,397</b>	<b>1,970,773</b>
<b>Income Tax Expense (Benefit)</b>	<b>363</b>	<b>(3)</b>
<b>Net Income</b>	<b>\$ 205,034</b>	<b>\$ 1,970,776</b>

**CONDENSED STATEMENTS OF CASH FLOWS**

	Year Ended December 31, 2013	Year Ended December 31, 2012
<b>Cash Flows From Operating Activities:</b>		
Net income	\$ 205,034	\$ 1,970,776
Adjustments to reconcile net income to net cash provided by operating activities:		

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Depreciation	39,202	32,301
Equity in undistributed income of subsidiaries	(204,792)	(1,971,194)
(Increase) decrease in other assets	23,975	(52,769)
Increase (decrease) in other liabilities	(15,095)	50,779
Net Cash Provided by Operating Activities	48,324	29,893
Cash Flows From Investing Activities:		
Decrease in interest-bearing deposits	9,910	6,122
Purchases of furniture and equipment	(71,142)	(17,468)
Net Cash used in Investing Activities	(61,232)	(11,346)
Net Increase (Decrease) in Cash	(12,908)	18,547
Cash at Beginning of Year	176,652	158,105
Cash at End of Year	\$ 163,744	\$ 176,652

**Note 17 Financial Instruments With Off-Balance-Sheet Risk**

In the normal course of business to meet the financing needs of its customers, BankShares is a party to financial instruments with off-balance-sheet risk. These financial instruments involve commitments to extend credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheets.

C-64



**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

The Corporation's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit is represented by the contractual amount of those instruments. The same credit policy is used in

making commitments as is used for on-balance-sheet risk. At December 31, 2013 and 2012, outstanding commitments to extend credit including letters of credit were \$17,681,657 and \$15,726,309 respectively.

	2013	2012
Commercial	\$ 4,258,081	\$ 3,507,973
Real Estate:		
Construction and land development	1,691,512	1,496,661
Residential 1-4 families		
First liens	918,377	1,046,761
Junior liens	359,672	209,253
Home Equity lines	7,790,927	7,979,295
Commercial real estate	2,271,121	1,062,715
Consumer	391,967	423,651
Total Outstanding Commitments	\$ 17,681,657	\$ 15,726,309

There are no commitments to extend credit on impaired loans. Commitments to extend credit are agreements to lend to a customer as long as there is no breach of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments may expire without ever being drawn upon, therefore, the total commitment amounts do not necessarily represent future cash outlays for the Corporation.

**Note 18 Concentrations of Credit Risk**

MainStreet monitors its loan portfolio by the segments found in Note 3 of these financial statements. In addition, we look at the trends of significant industries within the segments. Loan segments are categorized primarily based upon regulatory guidelines which follow the underlying collateral. For the most part, MainStreet's business activity is with customers located in our primary market area. Accordingly, operating results are closely correlated with the economic trends within the region and influenced by the significant regional industries within the region including pre-built housing, real estate development, agricultural, and resort and leisure services. In addition, the ultimate collectability of the loan portfolio is susceptible to changes in the market condition of the region. The real estate market in our area is also affected by the national economy because a portion of our real estate lending is dependent on buyers who move into our region. There are three industry concentrations that are broken out in the table below by our loan segments.

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	December 31, 2013			
	Loans for Construction of Buildings	Loans for Construction of Heavy & Civil Engineering Buildings	Loans for Real Estate Including Construction	Total
Commercial	\$ 296,178	\$ 687,341	\$ 221,608	\$ 1,205,127
Real Estate				
Construction and land development	2,366,758	4,138,105	2,014,334	8,519,197
Residential, 1-4 families				
First Liens	3,666,276	795,653	8,179,695	12,641,624
Junior Liens	529,732		472,819	1,002,551
Home Equity Lines	9,880	34,667	334,442	378,989
Commercial real estate	2,552,156		24,556,483	27,108,639
Consumer	2,735		13,209	15,944
Total	\$ 9,423,715	\$ 5,655,766	\$ 35,792,590	\$ 50,872,071

C-65

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

	December 31, 2012			
	Loans for Construction of Buildings	Loans for Construction of Heavy & Civil Engineering Buildings	Loans for Real Estate Including Construction	Total
Commercial	\$ 383,219	\$ 580,462	\$ 758,289	\$ 1,721,970
Real Estate				
Construction and land development	2,776,618	4,364,771	2,669,695	9,811,084
Residential, 1-4 families				
First Liens	4,292,479	1,324,124	6,739,075	12,355,678
Junior Liens	900,379		616,553	1,516,932
Home Equity Lines	19,881			19,881
Commercial real estate	3,971,666		22,907,145	26,878,811
Consumer	6,457		3,000	9,457
<b>Total</b>	<b>\$ 12,350,699</b>	<b>\$ 6,269,357</b>	<b>\$ 33,693,757</b>	<b>\$ 52,313,813</b>

Disclosed below are concentrations in acquisition and development loans, speculative lot loans, and speculative single-family housing construction. Some of these amounts are also included in the above concentrations.

	December 31, 2013		
	Total Concentration	Concentrations Included Above	Net Addition to Concentrations
Acquisition & development	\$ 455,405	\$	\$ 455,405
Speculative lot loans	4,007,894	3,138,066	869,828
Speculative single-family housing construction	1,971,059	1,399,864	571,195

	December 31, 2012		
	Total Concentration	Concentrations Included Above	Net Addition to Concentrations
Acquisition & development	\$ 124,964	\$ 124,964	\$
Speculative lot loans	4,912,535	3,086,490	1,826,045
Speculative single-family housing construction	4,275,965	1,802,221	2,473,744

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MainStreet has established policies related to the credit process and collateral in loan originations. Loans to purchase real and personal property are generally collateralized by the related property with loan amounts established based on certain percentage limitations of the property's total stated or appraised value. Credit approval is primarily a function of cash flow, collateral and the evaluation of the creditworthiness of the individual borrower or project based on pertinent financial information and the amount to be financed.

MainStreet has established policies for correspondent bank risk to include cash and due from accounts and overnight federal funds sold. Correspondents are monitored on a quarterly basis, and more frequently if warranted, on several financial and credit ratios. Total exposure is evaluated.

C-66

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**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**December 31, 2013 and 2012**

**Note 19 Fair Value Measurements**

Generally accepted accounting principles specify a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect MainStreet's market assumptions. The three levels of the fair value hierarchy based on these two types of inputs are as follows:

- Level 1 Valuation is based on quoted prices in active markets for identical assets and liabilities.
- Level 2 Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.
- Level 3 Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

The following describes the valuation techniques used by MainStreet to measure certain financial assets and liabilities recorded at fair value on a recurring basis in the consolidated financial statements:

Securities available for sale: Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). We only utilize third party vendors to provide fair value data for the purposes of recording amounts related to our fair value measurements of our securities available for sale portfolio. We obtain SSAE16 reports from our third party vendor on an annual basis. Our third party vendor also utilizes a reputable pricing company for security market data that utilizes a matrix pricing model. For government sponsored agencies, the model gathers information from market sources and integrates relative credit information, observed market movements and sector news. For agency mortgage backed securities, the model incorporates the current weighted average maturity and takes into account additional pool level information supplied directly by the agency or government sponsored enterprise. The third party vendor system has controls and edits in place for month-to-month market checks and zero pricing. We make no adjustments to the pricing service data received for our securities available for sale.

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2013:

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Description	Fair Value Measurements at December 31, 2013 Using Quoted Prices			
	Balance as of December 31, 2013	in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale securities:				
U. S. government sponsored agencies	\$ 2,623,000	\$	\$ 2,623,000	\$
Mortgage backed securities	13,155,155		13,155,155	
States and political Subdivisions	5,557,377		5,557,377	
Corporates	496,900		496,900	
Total available-for-sale securities	\$ 21,832,432	\$	\$ 21,832,432	\$

C-67

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

The following table presents the balances of financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2012:

Description	Balance as of December 31, 2012	Fair Value Measurements at December 31, 2012 Using Quoted Prices		
		in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Available-for-sale securities:</b>				
U. S. government sponsored agencies	\$ 1,471,773	\$	\$ 1,471,773	\$
Mortgage backed securities	12,637,537		12,637,537	
States and political subdivisions	4,727,251		4,727,251	
<b>Total available-for-sale securities</b>	<b>\$ 18,836,561</b>	<b>\$</b>	<b>\$ 18,836,561</b>	<b>\$</b>

Certain assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by MainStreet to measure certain assets recorded at fair value on a nonrecurring basis in the financial statements:

**Loans Held for Sale:** Loans held for sale are recorded at fair value on a nonrecurring basis which is the carrying value. Loans held for sale, generally, are closed and sold within two weeks.

**Impaired Loans:** Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans or the present value of future cash flows. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing recent appraisals conducted by an independent, licensed appraiser outside of MainStreet using observable market data (Level 2). However, if the appraisal of the real estate property is not current, or has been discounted, then the fair value is considered Level 3. It is also considered Level 3 if an evaluation is conducted by Franklin Bank, rather than by a third party. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the financial statements of the applicable business,

if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

Other Real Estate Owned (OREO): Foreclosed assets are adjusted to fair value upon transfer of the loans to OREO. Subsequently, OREO is carried at the lower of carrying value or fair market value less selling costs. 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 a recent appraisal conducted by an independent licensed appraiser using observable market data, the Corporation records the OREO as nonrecurring Level 2. When the appraisal of the real estate property is not current, or has been discounted, the Corporation records the OREO as nonrecurring Level 3. It is also considered Level 3 if an evaluation is conducted by Franklin Bank, rather than by a third party. Any fair value adjustments are recorded as other real estate and repossessions expense on the Consolidated Statements of Income.



Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

The following table summarizes MainStreet's financial assets that were measured at fair value on a nonrecurring basis during the period.

Description	Carrying value at December 31, 2013			
	Balance as of December 31, 2013	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Loans held for sale	\$ 306,250	\$	\$ 306,250	\$
Impaired loans, net	3,055,465		369,592	2,685,873
Other real estate owned, net	728,163		65,800	662,363

The following table summarizes MainStreet's financial assets that were measured at fair value on a nonrecurring basis during the period.

Description	Carrying value at December 31, 2012			
	Balance as of December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Loans held for sale	\$ 432,000	\$	\$ 432,000	\$
Impaired loans, net	455,820			455,820
Other real estate owned, net	1,441,722			1,441,722

The following table displays quantitative information about Level 3 Fair Value Measurements for December 31, 2013:

Quantitative information about Level 3 Fair Value Measurements for December 31, 2013					
	Fair Value	Valuation Technique(s)	Unobservable Input	Range	(Weighted Average)
<b>Assets</b>					
Impaired loans			Selling cost/ market discount	15%-49%	(22%)
	\$ 2,075,166	Appraisal			
	\$ 610,707	Internal evaluations	Internal evaluations	6%-83%	(18%)
Other real estate owned	\$ 260,000	Discounted appraised value		41%	(41%)

Selling cost /  
market discount

\$ 402,363	Internal evaluations	Internal evaluations	28%-56%	(33%)
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The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

(a) **Short-Term Financial Instruments**

The carrying values of short-term financial instruments including cash and cash equivalents, federal funds sold and interest-bearing deposits in domestic banks approximate the fair value of these instruments. These financial instruments generally expose the Corporation to limited credit risk and have no stated maturity or have an average maturity of 30-45 days and carry interest rates which approximate market value.

C-69

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**December 31, 2013 and 2012**

(b) **Securities Available-for-Sale**

The fair value of investments is estimated based on quoted market prices or dealer quotes.

(c) **Restricted Equity Securities**

The carrying value of restricted equity securities approximates fair value based on the redemption provisions of the appreciable entities.

(d) **Loans Held for Sale**

The carrying value of these loans approximates the fair value. These loans close in our name but are generally sold within a two-week period.

(e) **Loans**

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, real estate commercial, real estate construction, real estate mortgage and other consumer.

Each loan category is further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories. The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan as well as estimates for operating expenses and prepayments. The estimate of maturity is based on management's assumptions with repayment for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions.

(f) **Accrued Interest**

The carrying amounts of accrued interest approximate fair value.

(g) **Bank Owned Life Insurance**

The carrying amount is a reasonable estimate of fair value.

(h) **Deposits**

The fair value of demand, interest checking, savings and money market deposits is the amount payable on demand.

The fair value of fixed maturity time deposits and certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities and repayment characteristics.

(i) **Repurchase Agreements**

The fair value of repurchase agreements is estimated using a discounted cash flow calculation that applies contracted interest rates being paid on the debt to the current market interest rate of similar debt.

(j) **Commitments to Extend Credit and Standby Letters of Credit**

The only amounts recorded for commitments to extend credit and standby letters of credit are the fees arising from these unrecognized financial instruments. The fair value of these commitments has been determined to be immaterial.

C-70

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012**

The carrying values and estimated fair values of financial instruments at December 31, 2013 and 2012 are as follows:

	Carrying Value	Fair Value measurements at December 31, 2013 using			Fair Value
		Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	
<b>FINANCIAL ASSETS:</b>					
Cash and due from banks	\$ 2,929,591	\$ 2,929,591	\$	\$	\$ 2,929,591
Interest-bearing deposits in banks	10,343,469	10,343,469			10,343,469
Federal funds sold	4,691,091	4,691,091			4,691,091
Securities available-for-sale	21,832,432		21,832,432		21,832,432
Restricted equity securities	654,600		654,600		654,600
Loans held for sale	306,250		306,250		306,250
Loans, net	121,344,841		369,592	120,980,345	121,349,937
Accrued interest receivable	462,081		462,081		462,081
Bank owned life insurance	1,898,736		1,898,736		1,898,736
<b>FINANCIAL LIABILITIES:</b>					
Deposits:					
Non-interest bearing demand deposits	\$ 26,856,990	\$	\$ 26,856,990	\$	\$ 26,856,990
Interest bearing deposits	115,964,448		116,336,714		116,336,714
Accrued interest payable	86,575		86,575		86,575
<b>FINANCIAL ASSETS:</b>					
Fair Value measurements at December 31, 2012 using					
	Carrying Value	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Fair Value
Cash and due from banks	\$ 3,076,535	\$ 3,076,535	\$	\$	\$ 3,076,535
Interest-bearing deposits in banks	11,546,938	11,546,938			11,546,938

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Federal funds sold	9,414,880	9,414,880	9,414,880
Securities available-for-sale	18,836,561	18,836,561	18,836,561
Restricted equity securities	741,000	741,000	741,000
Loans held for sale	432,000	432,000	432,000
Loans, net	131,890,568	132,468,434	132,468,434
Accrued interest receivable	552,402	552,402	552,402
Bank owned life insurance	1,061,440	1,061,440	1,061,440

FINANCIAL  
LIABILITIES:

Deposits:

Non-interest bearing			
demand deposits	\$ 22,819,544	\$ 22,819,544	\$ 22,819,544
Interest bearing deposits	127,759,824	128,335,646	128,335,646
Repurchase agreements	6,000,000	6,001,070	6,001,070
Accrued interest payable	176,136	176,136	176,136

C-71

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**December 31, 2013 and 2012**

Fair value estimates are made at a specific point in time, based on relevant market information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Corporation's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates. Fair value estimates are based on existing on-and-off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments.

The Corporation assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Corporation's financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the Corporation. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the Corporation's overall interest rate risk.

**Note 20 Contingencies and Other Matters**

The Corporation currently is not involved in any litigation matters outside the normal operations associated with problem credits.

**Note 21 - Subsequent Events**

In preparing these consolidated financial statements, the Corporation has evaluated events and transactions for potential recognition or disclosure through the date the financial statements were issued.

**Note 22 Regulatory**

On April 16, 2009, Franklin Bank entered into a formal agreement ( Agreement ) with The Comptroller of the Currency ( OCC ). The Agreement required Franklin Bank to perform certain actions within designated time frames. The Agreement was intended to demonstrate Franklin Bank's commitment to review/enhance certain aspects of various policies and practices related to credit administration and liquidity. Franklin Bank achieved full compliance with the Agreement. The Agreement was terminated in August 2013.

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On June 17, 2009, MainStreet BankShares, Inc. entered into a Memorandum of Understanding ( MOU ) with the Federal Reserve Bank of Richmond ( Federal Reserve ). The MOU required the bank holding company to utilize its financial and managerial resources to assist Franklin Bank in functioning in a safe and sound manner and restricted MainStreet from conducting various activities. On January 26, 2011, we entered into a new MOU with the Federal Reserve which contained the same terms of the previous MOU (which was terminated) but added provisions regarding compliance with certain laws and regulations. This MOU was terminated in September 2013. There are no longer any restrictions or stipulations attributable to the MOU.

C-72



Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****December 31, 2013 and 2012****Note 23 Accumulated Other Comprehensive Income (Loss)**

Changes in each component of accumulated other comprehensive income (loss) were as follows:

	Net Unrealized Gains (Losses) on Securities available for sale (1)	Adjustments Related to Post Retirement Benefits (2)	Accumulated Other Comprehensive Income (Loss)
Balance at December 31, 2011	\$ 346,595	\$ 41,154	\$ 387,749
Net unrealized holding gains on securities available for sale during the period	37,218		37,218
Deferred income tax expense on unrealized holding gains on securities available for sale	(12,653)		(12,653)
Less reclassification adjustments for gains included in net income (3)	(1,848)		(1,848)
Tax related to gains on securities sold (4)	628		628
Change in actuarial gain on SERP		23,429	23,429
Deferred income tax expense		(7,966)	(7,966)
Balance at December 31, 2012	\$ 369,940	\$ 56,617	\$ 426,557
Net unrealized holding losses on securities available for sale during the period	(564,402)		(564,402)
Deferred income tax benefit on unrealized holding gains on securities available for sale	191,897		191,897
Less reclassification adjustments for gains included in net income (3)	(47,194)		(47,194)
Tax related to gains on securities sold (4)	16,046		16,046
Change in actuarial loss on SERP		(97,292)	(97,292)
Deferred income tax benefit		33,079	33,079
Balance at December 31, 2013	\$ (33,713)	\$ (7,596)	\$ (41,309)

(1) Represents the difference between the fair value and amortized cost of securities available for sale.

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- (2) Represents changes in the SERP liability due to prior service costs, gains and losses, and amortizations.
- (3) Reclassifications for gains on sales of securities available-for-sale are included in the gain on sale of securities available-for-sale line item on the Consolidated Statements of Income.
- (4) Income taxes related to gains on sales of securities available-for-sale are included in the income tax expense (benefit) line item on the Consolidated Statements of Income.

C-73

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**December 31, 2013 and 2012**

**Item 9. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure**  
None.

**PART III**

**Item 9A. Controls and Procedures**

MainStreet's principal executive officer and principal financial officer have reviewed MainStreet's disclosure controls and procedures (as defined in 204.13a-15(e) and 204.15d-15(e)) as of the end of the period covered by this annual report and based on their evaluation believe that MainStreet's disclosure controls and procedures are effective. There have not been any changes in our internal control over financial reporting that occurred during the period that has materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

**Management's Report on Internal Control Over Financial Reporting**

**To the Stockholders:**

Management is responsible for the preparation and fair presentation of the financial statements included in this annual report. The financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America and reflect management's judgments and estimates concerning effects of events and transactions that are accounted for or disclosed.

Management is also responsible for establishing and maintaining adequate internal control over financial reporting. The Corporation's internal control over financial reporting includes those policies and procedures that pertain to the Corporation's ability to record, process, summarize and report reliable financial data. Management recognizes that there are inherent limitations in the effectiveness of any internal control over financial reporting, including the possibility of human error and the circumvention or overriding of internal control. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Further, because of changes in conditions, the effectiveness of internal control over financial reporting may vary over time.

In order to ensure that the Company's internal control over financial reporting is effective, management regularly assesses such controls and did so most recently for its financial reporting as of December 31, 2013. This assessment was based on criteria for effective internal control over financial reporting described in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission in 1992. Based on this assessment, management has concluded that the internal control over financial reporting was effective as of December 31, 2013.

This annual report does not include an attestation report of the Company's independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's independent registered public accounting firm pursuant to the Securities and Exchange Commission final

rule effective September 21, 2010 providing this requirement shall not apply with respect to any audit report prepared for an issuer that is neither an accelerated filer nor a large accelerated filer as defined in Rule 12b-2 under the Securities Exchange Act of 1934.

**Item 9B. Other Information**

None.

C-74

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****December 31, 2013 and 2012****Item 10. Directors, Executive Officers and Corporate Governance****Directors of the Registrant**

MainStreet's Board of Directors are divided into three classes that serve staggered three-year terms. The members of one class are elected at each annual meeting of shareholders and hold office until the third annual meeting following their election or until successors are elected and qualified. The term of the Class A Directors expires in 2014, the term of the Class B Directors expires in 2015, and the term of the Class C Directors expires in 2016. The following tables set forth material information about MainStreet's current executive officers and directors.

<b>Name (Age)</b>	<b>Offices and Positions Held</b>
	<b>Class A Directors    Term Expires 2014</b>
Michael A. Turner (60)	Director since December 2002
	<b>Class B Directors    Term Expires 2015</b>
Charles L. Dalton (50)	Director since July 2001
Joel R. Shepherd (50)	Director since December 2002
	<b>Class C Directors    Terms Expires 2016</b>
John M. Deekens (66)	Director since July 2001
Danny M. Perdue (68)	Director since December 2002

Charles L. Dalton is Vice President, General Manager and partial owner of Dalton Insurance Agency, Inc. in Stuart, Virginia. He is a Member/Partial owner of Stuart Laurel Court, LLC. He has been a past president of the Stuart Rotary Club. He is a member of the Patrick County Chamber of Commerce where he has been a past President. He is a member of the Professional Insurance Agents of Virginia and is active in Patrick County American Legion Baseball. Mr. Dalton brings financial services/insurance industry and management experience to BankShares demonstrated by the success of his insurance agency. He has been active in his community and through these services he contributes experience to BankShares' board.

John M. Deekens is a retired General Manager for Stuart Forest Products in Stuart, Virginia. In addition he held the position of Plant Manager for Stuart Forest Products. Prior to that, he was the Quality Control Manager for Hooker Furniture Corporation in Martinsville, Virginia. He is a past member of the Stuart Rotary Club where he held various offices. He served as Mayor of Stuart for eight years and was a member of the Town council for an additional four years. After a break in service for a period of years, he is currently a member of the Stuart Town Council. He currently serves as chairman of the finance committee of the church he attends and is a member. Mr. Deekens brings managerial and financial skills to the Board of Directors. He also served on a Bi-County Economic Commission for four years and held various offices in the Stuart Rotary Club. Through his community services, he also contributes this experience to BankShares' Board.

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Danny M. Perdue is currently the owner of the Franklin Shopping Center. He is a partial owner and President of Redwood Minute Markets, Inc. He is a partial owner of First Minute Markets, LLC, FFH Operations, Inc. and FFH Investors, LLC. He is also an owner of Redwood Petroleum Products, Ferrum Petroleum Products, Franklin Petroleum Products, 604 Petroleum Products and Penhook Petroleum Products. He is Vice President of Perdue Properties, Inc. Mr. Perdue is also a Director of Franklin Community Bank, N.A. He is currently active in the Rocky Mount Rotary Club and served on the Board of Trustees of Ferrum College for many years. He is a past member and President of the Rocky Mount Chamber of Commerce and the United Way in Franklin County. He was a founding member of the Burnt Chimney Volunteer Fire Department. Mr. Perdue brings entrepreneurial, business management and financial skills to BankShares as demonstrated through the successful

C-75

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**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**December 31, 2013 and 2012**

businesses that he owns and manages. He also served as a board director for The Bank of Ferrum, a community bank in Franklin County from 1994 – 1999 and an advisory board member for BB&T in Franklin County from 1999 – 2001 which brings financial institution governance to BankShares Board. Mr. Perdue is very active in the community that Franklin Bank serves and brings that experience to the board.

Joel R. Shepherd is a partial owner and President of Virginia Home Furnishings, Inc., and 220 Self Storage, Inc. He is also a partial owner of Shepherd Properties, LLC, Wirtz Properties, LLC, Wirtz Services, LLC, Kyle Avenue, LLC, FFH Operations, Inc., FFH Investors, LLC, the Franklin LLC, Wirtz Lot 2, LLC, Shepherd Properties Roanoke, LLC, Shepherd Properties Bedford, LLC and King Street Properties, LLC. Prior to developing his current businesses, Mr. Shepherd served from 1986 to 1993 as a Vice President and Portfolio Manager in the Funds Management Division of Dominion Bankshares, Inc. (acquired by First Union). Mr. Shepherd is also a Director of Franklin Community Bank, N.A. He is also on the Business Advisory Council for Ferrum College. He is a member of the Board of Trustees of Faith Christian School in Roanoke, Virginia and a member of the finance committee for the school. Mr. Shepherd brings entrepreneurial, business building, finance and management skills to BankShares through the operations of his various companies which are diversified in their business. He also brings financial institution management and investment skills to BankShares. Mr. Shepherd is active in the community that Franklin Bank serves and brings that experience to the Board.

Michael A. Turner has served as the partial owner and CEO of Turner's Building, Inc. from 1976 to present. He also serves as a partner in T & J Property Associates, LC and Pigg Riverville, LLC. In addition, Mr. Turner was a partner in Deep River Investments (developer of real estate) from 1989 to 2003. He is also a Director of Franklin Community Bank, N.A. He is also a member of the Cool Branch Volunteer Rescue Squad. He helped organize the Smith Mountain Lake Partnership and served on the board for 15 years. Mr. Turner is an entrepreneur that brings financial and management experience to BankShares demonstrated by the building and successfulness of his own construction and real estate development companies. He also served as a board director for The Bank of Ferrum, a community bank in Franklin County from 1994 – 1999 and an advisory board member for BB&T in Franklin County from 1999 – 2001 which brings governance to BankShares as a board member. Mr. Turner has been active in the community where he lives and Franklin Bank operates.

There are no family relationships that need to be reported, nor are any directors serving as directors on boards of other reporting companies.

William L. Cooper, III is a partial owner and President of Cooper Classics, Inc. He is CEO and partial owner of CWP, Inc. He is a managing partner of Grassy Hill Investment and Grassy Hill Properties.

William L. Cooper, III resigned from the boards of directors of MainStreet and its wholly-owned banking subsidiary, Franklin Bank, effective Wednesday, February 5, 2014. Mr. Cooper was a member of the Human Resources and Executive Committees.

MainStreet believes Mr. Cooper resigned on account of a disagreement with Franklin Bank over the resolution of credit issues concerning outstanding loans owed by him and a related entity to Franklin Bank. Franklin Bank was unable to reach an agreement with Mr. Cooper that complied with its credit policies and associated regulatory

guidance to avoid the loans becoming criticized assets requiring significant additional amounts to be allocated to the allowance for loan losses.

C-76



**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****December 31, 2013 and 2012****Executive Officers Not a Director**

<b>Name (Age)</b>	<b>Offices and Positions Held</b>	<b>First Elected As an Officer</b>
Brenda H. Smith (54)	President, CEO and Corporate Secretary	8/99
Todd S. Hammock (51)	Executive Vice President and Senior Lender	10/12
Lisa J. Correll (48)	Senior Vice President and Chief Financial Officer	6/04
Sonya B. Smith (43)	Senior Vice President and Operations and Compliance Officer	11/99

Brenda H. Smith was appointed as President and Chief Executive Officer in July 2013 after the death of Larry Heaton, former President and CEO, in December 2012. Ms. Smith is also President, Chief Executive Officer and Director of Franklin Community Bank, N.A. since July 2013. She is also President, Treasurer, Secretary and a Director of MainStreet RealEstate, Inc. since July 2013. Ms. Smith joined BankShares in August 1999 as Senior Vice President and Chief Financial Officer. Ms. Smith was named Corporate Secretary in November 2001 and was promoted to Executive Vice President in September 2002. From 1995 to 1999, Ms. Smith was Vice President, Corporate Controller and Assistant Secretary of MainStreet Financial Corporation, a \$2 billion multi-bank holding company headquartered in Martinsville, Virginia. From 1988 to 1995, she was an Accounting Officer for Piedmont Trust Bank, a subsidiary of MainStreet Financial Corporation. Ms. Smith is a member of Pleasant Grove Christian Church and serves on the Safetynet Board of Trustees.

Todd S. Hammock was appointed as Executive Vice President and Senior Lender of Franklin Community Bank, N.A. in July 2013. Previously, Mr. Hammock was Vice President – Business Lending, having returned to the bank in October 2012. He was previously a Business Banker for Franklin Bank from September 2007 to October 2008. Prior to his return to Franklin Bank, he was the City President of SunTrust Bank in Martinsville after his promotion from Business Banking Relationship Manager. He was employed by SunTrust from September 2011 to October 2012. Prior to his employment at SunTrust, Mr. Hammock was a Commercial Relationship Manager for American National Bank and Trust Company in the Martinsville office, where he was employed from October 2008 to September 2011. Mr. Hammock is a Board member of the United Way of Franklin County and is active in the Rotary Club of Rocky Mount.

Lisa J. Correll was appointed as Senior Vice President and Chief Financial Officer in October 2013. Previously, Ms. Correll was Vice President and Corporate Controller for MainStreet, a position held since 2007. She joined MainStreet in June 2004 and was promoted to Assistant Vice President and Accounting Officer shortly thereafter. Prior to joining MainStreet, she was Vice President of Finance for Valley Bank in Roanoke, Virginia.

Sonya B. Smith was appointed as Senior Vice President and Operations and Compliance Officer in January 2014. Previously, Ms. Smith was Vice President and Operations and Compliance Officer for MainStreet. She joined MainStreet in November 1999 and has held the position of Vice President since April 2008.

MainStreet has a standing Audit Committee. The Audit Committee is responsible for the oversight of the Company's accounting policies, financial reporting and internal control. The Audit Committee of the Board of Directors is comprised entirely of outside directors who are independent of management. The Audit Committee is responsible for the appointment and compensation of the independent auditor and approves decisions regarding the appointment or removal of the Company's internal auditor. It meets periodically with management, the independent auditors and the internal auditors to ensure that they are carrying out their responsibilities. The Audit Committee is also responsible for performing an oversight role by reviewing and monitoring the financial, accounting and auditing procedures of the Company in addition to reviewing the Company's

C-77

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**December 31, 2013 and 2012**

financial reports. The independent auditors and the internal auditor have full and unlimited access to the Audit Committee, with or without management, to discuss the adequacy of internal control over financial reporting, and any other matter which they believe should be brought to the attention of the Audit Committee. The members of the Audit Committee are C. Laine Dalton, J. Mac Deekens, Joel R. Shepherd (Chairman), Michael A. Turner, and Danny M. Perdue.

MainStreet's Board of Directors has determined that MainStreet does not have a financial expert serving on its Audit Committee. MainStreet is a small corporation located outside a major metropolitan area. Because of our size and location, we have not pursued a financial expert and there is no certainty that one could be found. The Board of Directors believe that it, as a whole, has adequate financial expertise.

MainStreet has adopted a Code of Ethics for the Board of Directors and for all of its employees, including its Chief Executive and Chief Accounting Officers. A copy of the Code of Ethics may be obtained without charge upon request by writing to Brenda H. Smith, President, Chief Executive Officer and Corporate Secretary, 1075 Spruce Street, Martinsville, Virginia, 24112.

Other information required by Item 10 of Form 10-K appears on pages 8 through 11 of the Corporation's 2014 Proxy Statement and is incorporated herein by reference.

**Item 11. Executive Compensation**

The information required by Item 11 of Form 10-K appears on pages 11 through 14 of the Corporation's 2014 Proxy Statement and is incorporated herein by reference.

**Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

The information required by Item 12 of Form 10-K appears on pages 7 through 8 of the Corporation's 2014 Proxy Statement and is incorporated herein by reference.

**Item 13. Certain Relationships and Related Transactions, and Director Independence**

MainStreet's executive officers and directors, and other corporations, business organizations, and persons with which some of MainStreet's executive officers and directors are associated have banking relationships with Franklin Bank. All such transactions were made in the ordinary course of business on substantially the same terms, including interest rates and security for loans, as those prevailing at the time in comparable transactions with others and did not involve more than the normal risk of collectability or present other unfavorable features. None of such loans to our current related persons are classified as nonaccrual, past due, restructured or potential problem. All outstanding loans to current Executive officers and Directors and their associates are current as to principal and interest.

William L. Cooper, III resigned from the boards of directors of MainStreet and Franklin Bank effective Wednesday, February 5, 2014. Mr. Cooper was a member of the Human Resources and Executive committees. We believe he resigned on account of a disagreement with Franklin Bank over credit issues concerning outstanding loans owed by him and related parties to Franklin Bank. Franklin Bank was unable to reach an agreement with Mr. Cooper that complied with its credit policies and associated regulatory guidance to avoid the loans becoming criticized assets requiring significant additional amounts to be allocated to the allowance for loan losses.

Mr. Cooper and related entities had several loans with Franklin Bank at the time of the disagreement and subsequent resignation. Due to the inability to reach a resolution with Mr. Cooper, Franklin Bank determined that the entire relationship based on global analysis would become criticized. Subsequent to his resignation, Franklin Bank worked with Mr. Cooper to restructure certain outstanding credits in order to minimize the negative impact to Franklin Bank's allowance for loan losses and net income. As a result of this restructure, loans in the amount of \$640,141 were deemed to be troubled debt restructurings at year-end 2013. In addition, even though the amounts remain payable from the borrowers, Franklin Bank charged off \$453,883 in loans to the allowance for loan losses for Mr. Cooper and related entity credits.

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****December 31, 2013 and 2012**

Franklin Bank issued credit to four separate entity relationships associated with William L. Cooper, III. These entities were Cooper Classics, Inc., Grassy Hill Investments, LLC, William L. Cooper, III and a co-borrower, and William L. Cooper, III (individual). Mr. Cooper is President/CEO and Member/Owner of 58.88% and guarantor of Cooper Classics, Inc. He is a Member/Owner of 50% and a guarantor of Grassy Hill Investments, LLC. The following is information related to each entity relationship during 2013.

Name/Entity Relationship	Largest Outstanding Balance During 2013	Principal Paid 2013	Interest Paid 2013	Interest Earned 2013	Latest Practicable Balance 2/28/14	Rate of Interest
Cooper Classics, Inc. (1)	\$ 785,000	\$ 295,000	\$ 34,049	\$ 34,748	\$ 599,375	4.25% - 5.25%
Grassy Hill Investments, LLC	338,363	7,364	17,324	17,291	329,789	5.10% - 5.10%
William L. Cooper, III & co-borrower	182,862	11,796	9,001	8,982	169,068	5.00% - 5.00%
William L. Cooper, III (2)	410,000	50,000	15,453	16,025		4.25% - 4.25%

(1) This represents a line of credit in the amount of \$700,000 and a short-term note repaid during 2013. It also represents \$93,883 of the overall charge-off related to these entities.

(2) This note represents \$360,000 of the overall charge-off related to these entities.

Information related to loans to MainStreet's executive officers and directors and their related interests can be found in Part II, Item 8, Note 5 of this document. Deposit information related to MainStreet's executive officers and directors and their related interests can be found in Part II, Item 8, Note 7 of this document.

Franklin Community Bank, N.A., a subsidiary of MainStreet BankShares, Inc., leases its main office in Rocky Mount, Virginia, and its Westlake office. The owners of the buildings are directors of Franklin Bank.

The information required by Item 13 of Form 10-K concerning director independence appears on page 15 of the Corporation's 2014 Proxy Statement and is incorporated herein by reference.

**Item 14. Principal Accounting Fees and Services**

The information required by Item 14 of Form 10-K appears in the Corporation's 2014 Proxy Statement under the Audit Committee Report and is incorporated herein by reference.

**PART IV**

**Item 15. Exhibits and Financial Statement Schedules**

a) The following documents are filed as part of this report:

1. Financial Statements:

Report of Independent Registered Public Accounting Firm.

Consolidated Balance Sheets as of December 31, 2013 and 2012.

Consolidated Statements of Income for the Years Ended December 31, 2013 and 2012.

Consolidated Statements of Comprehensive Income (Loss) for the Years Ended December 31, 2013 and 2012.

Consolidated Statements of Changes in Shareholders' Equity for the Years Ended December 31, 2013 and 2012.

C-79

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**December 31, 2013 and 2012**

Consolidated Statements of Cash Flows for the Years Ended December 31, 2013 and 2012.

Notes to Consolidated Financial Statements.

2. Financial Statement Schedules:

All schedules are omitted as the required information is not applicable or the information is presented in the Consolidated Financial Statements or related notes.

3. Exhibits and Reports on Form 8-K:

See Index to Exhibits.

C-80

**Table of Contents****SIGNATURES**

In accordance with section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

MAINSTREET BANKSHARES, INC.

By: /s/ Brenda H. Smith  
Brenda H. Smith, President and Chief  
Executive Officer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

NAME	TITLE	DATE
/s/ Brenda H. Smith Brenda H. Smith	President and Chief Executive Officer Corporate Secretary President, CEO and Director of Franklin Community Bank, N.A.	03/25/14 Date
/s/ Lisa J. Correll Lisa J. Correll	Senior Vice President Chief Financial Officer	03/25/14 Date
/s/ Charles L. Dalton Charles L. Dalton	Director	03/25/14 Date
/s/ John M. Deekens John M. Deekens	Director	03/25/14 Date
/s/ Danny M. Perdue Danny M. Perdue	Director	03/25/14 Date
/s/ Joel R. Shepherd Joel R. Shepherd	Chairman of the Board	03/25/14 Date
/s/ Michael A. Turner Michael A. Turner	Director	03/25/14 Date



**Table of Contents****Index to Exhibits**

Number	Description of Exhibit
3(i)**	Restated Articles of Incorporation of the Corporation, dated March 6, 2001.
3(ii)	By-laws of the Corporation, dated August 5, 1999 amended February 20, 2001; amended October 16, 2002; amended September 17, 2003; amended July 13, 2005; amended April 20, 2006; and amended October 21, 2009; filed on Form 8-K on October 22, 2009 and herein incorporated by reference.
4.1	Warrant Plan and Certificates as adopted July 27, 1999 and amended August 26, 1999 and amended December 19, 2000 incorporated by reference to the Corporation's Quarterly Form 10-QSB for quarter ended September 30, 1999, filed December 20, 1999, and herein incorporated by reference.
4.2	Provision in Registrant's Articles of Incorporation and Bylaws defining the Rights of Holders of the Registrant's common stock (included in Exhibits 3.1 and 3.2, respectively).
4.3*	Form of Shares Subscription Agreement.
4.3.1***	Form of Shares Subscription Agreement.
4.4*	Form of Units Subscription Agreement.
4.5	2004 Key Employee Stock option Plan filed March 16, 2005 on Form S-8 and herein incorporated by reference.
10.1#	Employment Agreement by and between MainStreet, Franklin Bank, and Larry A. Heaton (President and CEO of Franklin Bank) dated December 30, 2005 incorporated by reference to the Corporation's Form 8-K filed January 4, 2006.
10.2#	Employment agreement with Executive Vice President, Brenda H. Smith, dated October 1, 2002, filed with the Corporation's Quarterly Form 10-QSB on November 7, 2002 and herein incorporated by reference. Amendment to employment agreement filed on Form 8-K on April 24, 2006 and herein incorporated by reference.
10.3#	Supplemental Executive Retirement Agreement by and between Franklin Community Bank, N.A. and Larry A. Heaton incorporated by reference to the Corporation's Form 10-KSB filed March 6, 2008.
10.4#	Supplemental Executive Retirement Agreement by and between Franklin Community Bank, N.A. and Brenda H. Smith incorporated by reference to the Corporation's Form 10-KSB filed March 6, 2008.
10.5#	Change in Control Agreement between MainStreet BankShares, Inc. and Lisa J. Correll incorporated by reference to the Corporation's Form 10-KSB filed March 6, 2008.
10.6#	Change in Control Agreement between MainStreet BankShares, Inc., Franklin Community Bank, N.A. and Robert W. Shorter incorporated by reference to the Corporation's Form 10-KSB filed March 6, 2008.
10.7#	Change in Control Agreement between MainStreet BankShares, Inc., Franklin Community Bank, N.A. and Debra B. Scott incorporated by reference to the Corporation's Form 10-KSB filed March 6, 2008.
10.8#	Change in Control Agreement between MainStreet BankShares, Inc., Franklin Community Bank, N.A. and Linda P. Adams incorporated by reference to the Corporation's Form 10-KSB filed March 6, 2008.
10.9	

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Formal agreement by and between The Comptroller of the Currency and Franklin Community Bank, National Association dated April 16, 2009 incorporated by reference to the Corporation's Form 8-K filed April 20, 2009.

- 10.10# Change in Control Agreement between MainStreet BankShares, Inc., Franklin Community Bank, N.A. and Todd Hammock included in this Form 10-K.
- 10.11# Change in Control Agreement between MainStreet BankShares, Inc. and Sonya B. Smith included in this Form 10-K.
- 14 Code of Ethics filed March 13, 2006 on Form 10-K and herein incorporated by reference.
- 21 Subsidiaries of the Registrant.
- 31.1 Certification of President and Chief Executive Officer Pursuant to Rule 13a-14(a) or 15(d)-14(a) under the Securities and Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of Senior Vice President and Chief Financial Officer Pursuant to Rule 13a-14(a) or 15(d)-14(a) under the Securities and Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 USC 1350).
- 101 Interactive Data File.

\* (Incorporated by reference to Registration statement #333-86993 on Form SB-2 filed September 13, 1999.)

\*\* (Incorporated by reference to the Corporation's Annual Report on Form 10-K filed March 15, 2001.)

\*\*\* (Incorporated by reference to Registration Statement # 333-63424 on Form SB-2 filed June 20, 2001.)

# Management contract or compensatory plan or agreement required to be filed as an Exhibit to this Form 10-K pursuant to Item 14(c).

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**Table of Contents**

**Exhibit 31.1**

**CERTIFICATIONS**

I, Brenda H. Smith, certify that:

1. I have reviewed this annual report on Form 10-K of MainStreet BankShares, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision; to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in the report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this annual report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

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6. This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this Annual Report.

Date: 03/25/14

/s/ Brenda H. Smith  
Brenda H. Smith  
President and Chief Executive Officer Corporate  
Secretary

C-83

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**Table of Contents**

**Exhibit 31.2**

**CERTIFICATIONS**

I, Lisa J. Correll, certify that:

1. I have reviewed this annual report on Form 10-K of MainStreet BankShares, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision; to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in the report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this annual report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

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6. This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this Annual Report.

Date: 03/25/14

/s/ Lisa J. Correll  
Lisa J. Correll  
Senior Vice President and Chief Financial  
Officer

C-84

**Table of Contents**

**Exhibit 32**

The undersigned, as the chief executive officer and chief financial officer of MainStreet BankShares, Inc., certify that to the best of our knowledge and belief the Form 10-K for the year ended December 31, 2013, fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934 and the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of MainStreet BankShares, Inc. at the dates and for the periods indicated. The foregoing certification is made solely for purposes of 18 USC, Section 1350 of the United States Code and is subject to the knowledge and willfulness qualifications contained in Title 18, Chapter 63, Section 1350(c).

Date: 03/25/14

/s/ Brenda H. Smith  
Brenda H. Smith  
President and Chief Executive Officer Corporate  
Secretary

Date: 03/25/14

/s/ Lisa J. Correll  
Lisa J. Correll  
Senior Vice President and Chief Financial  
Officer

C-85

**Table of Contents**

**APPENDIX D**

**MAINSTREET BANKSHARES, INC. S**  
**QUARTERLY REPORT ON FORM 10-Q**  
**FOR THE QUARTER ENDED JUNE 30, 2014**



**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-Q**

(Mark One)

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

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

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

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

**Commission file number 333-86993**

**MainStreet BankShares, Inc.**

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

<b>Virginia</b> <b>(State or other jurisdiction of</b>	<b>54-1956616</b> <b>(I.R.S. Employer</b>
<b>incorporation or organization)</b>	<b>Identification No.)</b>
<b>1075 Spruce Street, Martinsville, Virginia</b> <b>(Address of principal executive offices)</b>	<b>24112</b> <b>(Zip Code)</b>
<b>Registrant's telephone number <u>(276) 632-8054</u></b>	

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

Indicate by check mark whether the registrant has (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large Accelerated filer <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>
Non-accelerated filer <input type="checkbox"/>	Smaller reporting company <input checked="" type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

**APPLICABLE ONLY TO CORPORATE ISSUERS**

Indicate the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date: 1,713,375 as of August 11, 2014

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Form 10-Q**

**Index**

	Page No.
<b><u>PART I FINANCIAL INFORMATION</u></b>	
Item 1	<u>Financial Statements</u> D-3
Item 2	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> D-35
Item 3	<u>Quantitative and Qualitative Disclosures About Market Risk</u> D-55
Item 4	<u>Controls and Procedures</u> D-56
<b><u>PART II OTHER INFORMATION</u></b>	
Item 1	<u>Legal Proceedings</u> D-56
Item 1A	<u>Risk Factors</u> D-56
Item 2	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u> D-56
Item 3	<u>Defaults Upon Senior Securities</u> D-56
Item 4	<u>Mine Safety Disclosures</u> D-56
Item 5	<u>Other Information</u> D-56
Item 6	<u>Exhibits</u> D-56
	<u>Signatures</u> D-57
	<u>Index to Exhibits</u> D-58

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

The financial statements filed as part of Item 1 of Part I are as follows:

1. Consolidated Balance Sheets as of June 30, 2014 (unaudited) and December 31, 2013 (audited).
2. Consolidated Statements of Operations for the quarters ended June 30, 2014 (unaudited) and June 30, 2013 (unaudited).
3. Consolidated Statements of Operations for the year-to-date periods ended June 30, 2014 (unaudited) and June 30, 2013 (unaudited).
4. Consolidated Statements of Comprehensive Income (Loss) for the quarters ended June 30, 2014 (unaudited) and June 30, 2013 (unaudited).
5. Consolidated Statements of Comprehensive Income (Loss) for the year-to-date periods ended June 30, 2014 (unaudited) and June 30, 2013 (unaudited).
6. Consolidated Statements of Cash Flows for the year-to-date periods ended June 30, 2014 (unaudited) and June 30, 2013 (unaudited).
7. Notes to Consolidated Financial Statements.

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Balance Sheets**

	(Unaudited) June 30, 2014	(Audited) December 31, 2013
<b>ASSETS</b>		
Cash and due from banks	\$ 3,804,713	\$ 2,929,591
Interest-bearing deposits in banks	6,499,067	10,343,469
Federal funds sold	5,329,941	4,691,091
<b>Total Cash and Cash Equivalents</b>	<b>15,633,721</b>	<b>17,964,151</b>
Securities available-for-sale, at fair value	14,111,780	21,832,432
Securities held to maturity, at amortized cost	5,641,208	
Restricted equity securities	587,200	654,600
Loans held for sale		306,250
Loans:		
Total Gross Loans	126,528,906	123,637,386
Unearned deferred fees and costs, net	91,985	86,600
Loans, net of unearned deferred fees and costs	126,620,891	123,723,986
Less: Allowance for loan losses	(2,245,086)	(2,379,145)
Net Loans	124,375,805	121,344,841
Bank premises and equipment, net	1,485,786	1,509,562
Accrued interest receivable	440,754	462,081
Bank owned life insurance	1,926,688	1,898,736
Other real estate owned, net of valuation allowance	218,340	728,163
Other assets	1,859,728	2,330,201
<b>TOTAL ASSETS</b>	<b>\$ 166,281,010</b>	<b>\$ 169,031,017</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Deposits:		
Non-interest bearing demand deposits	\$ 26,543,867	\$ 26,856,990
Interest bearing deposits	112,931,286	115,964,448
Total Deposits	139,475,153	142,821,438
Accrued interest payable and other liabilities	2,005,696	2,222,038
Total Liabilities	141,480,849	145,043,476

## Commitments and contingencies

## Shareholders Equity:

Preferred stock, no par value, authorized 10,000,000 shares; none issued		
Common stock, no par value, authorized 10,000,000 shares; issued and outstanding 1,713,375 shares at June 30, 2014 and December 31, 2013, respectively	17,866,890	17,866,890
Retained earnings	6,759,696	6,161,960
Accumulated other comprehensive income (loss)	173,575	(41,309)
<b>Total Shareholders Equity</b>	<b>24,800,161</b>	<b>23,987,541</b>
<b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>	<b>\$ 166,281,010</b>	<b>\$ 169,031,017</b>

See accompanying notes to consolidated financial statements.

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Operations****(Unaudited)**

	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013
<b>Interest and Dividend Income:</b>		
Interest and fees on loans	\$ 1,610,480	\$ 1,717,012
Interest on interest-bearing deposits	2,842	10,971
Interest on federal funds sold	2,465	2,082
<b>Interest on securities:</b>		
Taxable	88,287	68,956
Nontaxable	18,148	17,571
Dividends on restricted equity securities	8,474	8,199
<b>Total Interest and Dividend Income</b>	<b>1,730,696</b>	<b>1,824,791</b>
<b>Interest Expense:</b>		
Interest on deposits	178,898	278,657
Interest on short-term borrowings	1	1
<b>Total Interest Expense</b>	<b>178,899</b>	<b>278,658</b>
Net Interest Income	1,551,797	1,546,133
Provision for loan losses	13,384	1,064,897
<b>Net Interest Income After Provision for Loan Losses</b>	<b>1,538,413</b>	<b>481,236</b>
<b>Noninterest Income:</b>		
Service charges on deposit accounts	64,758	59,217
Mortgage commissions	30,559	77,557
Electronic card fees	47,651	48,168
Investment fee income	56,640	48,754
Income on bank owned life insurance	14,115	9,533
Gain on securities sold/called		47,194
Other fee income and miscellaneous income	23,759	45,292
<b>Total Noninterest Income</b>	<b>237,482</b>	<b>335,715</b>
<b>Noninterest Expense:</b>		
Salaries and employee benefits	708,692	677,275

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Occupancy and equipment expense	184,168	189,243
Professional fees	61,735	59,373
Outside processing	76,435	104,055
FDIC assessment	32,321	50,866
Franchise tax	59,000	54,000
Regulatory examination fees	11,274	26,304
Other real estate and repossessions	(4,779)	42,761
Other expenses	134,522	136,436
Total Noninterest Expense	1,263,368	1,340,313
Net Income (Loss) Before Tax	\$ 512,527	\$ (523,362)
Income Tax Expense (Benefit)	163,017	(187,822)
Net Income (Loss)	\$ 349,510	\$ (335,540)
Basic Net Income (Loss) Per Common Share	\$ .20	\$ (.20)
Diluted Net Income (Loss) Per Common Share	\$ .20	\$ (.20)

See accompanying notes to consolidated financial statements.



**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Operations****(Unaudited)**

	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
<b>Interest and Dividend Income:</b>		
Interest and fees on loans	\$ 3,182,075	\$ 3,487,050
Interest on interest-bearing deposits	6,780	18,111
Interest on federal funds sold	5,086	3,668
<b>Interest on securities available:</b>		
Taxable	181,644	146,088
Nontaxable	36,130	34,215
Dividends on restricted equity securities	17,070	16,508
<b>Total Interest and Dividend Income</b>	<b>3,428,785</b>	<b>3,705,640</b>
<b>Interest Expense:</b>		
Interest on deposits	383,059	565,266
Interest on short-term borrowings	1	1
Interest on repurchase agreements		595
<b>Total Interest Expense</b>	<b>383,060</b>	<b>565,862</b>
<b>Net Interest Income</b>	<b>3,045,725</b>	<b>3,139,778</b>
Provision for loan losses	86,872	1,252,502
<b>Net Interest Income After Provision for Loan Losses</b>	<b>2,958,853</b>	<b>1,887,276</b>
<b>Noninterest Income:</b>		
Service charges on deposit accounts	121,838	129,205
Mortgage commissions	54,026	151,543
Electronic card fees	87,557	91,934
Investment fee income	107,987	89,998
Income on bank owned life insurance	27,952	18,972
Gain on securities sold/called		47,194
Other fee income and miscellaneous income	48,961	72,748
<b>Total Noninterest Income</b>	<b>448,321</b>	<b>601,594</b>
<b>Noninterest Expense:</b>		

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Salaries and employee benefits	1,416,856	1,341,604
Occupancy and equipment expense	380,475	379,430
Professional fees	115,544	119,514
Outside processing	161,434	208,848
FDIC assessment	59,868	104,795
Franchise tax	118,250	108,000
Regulatory examination fees	33,823	52,607
Other real estate and repossessions	(1,022)	104,999
Other expenses	249,947	249,886
<b>Total Noninterest Expense</b>	<b>2,535,175</b>	<b>2,669,683</b>
Net Income (Loss) Before Tax	\$ 871,999	\$ (180,813)
Income Tax Expense (Benefit)	274,263	(81,130)
Net Income (Loss)	\$ 597,736	\$ (99,683)
Basic Net Income (Loss) Per Common Share	\$ .35	\$ (.06)
Diluted Net Income (Loss) Per Common Share	\$ .35	\$ (.06)

See accompanying notes to consolidated financial statements.

D-6

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Income (Loss)****(Unaudited)**

	Three Months Ended June 30, 2014	Three Months Ended June 30, 2013
Net Income (Loss)	\$ 349,510	\$ (335,540)
Other Comprehensive Income (Loss):		
Net unrealized holding gains (losses) on securities available for sale during the period	177,667	(484,858)
Deferred income tax (expense) benefit on unrealized holding losses or gains on securities available for sale	(60,407)	164,851
Less reclassification adjustments for gains included in net Income (1)		(47,194)
Tax related to realized gain on securities sold (2)		16,046
Amortization of held to maturity transfer during period	(67)	
Tax effect of amortization of held to maturity transfer during period	23	
Other Comprehensive Income (Loss)	117,216	(351,155)
Total Comprehensive Income (Loss)	\$ 466,726	\$ (686,695)

- (1) Reclassifications for gains on sales of securities available-for-sale are included in the gain on securities sold/called line item on the Consolidated Statements of Operations.
- (2) Income taxes related to gains on sales of securities available-for-sale are included in the income tax expense (benefit) line item on the Consolidated Statements of Operations.
- See accompanying notes to consolidated financial statements.

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Comprehensive Income (Loss)****(Unaudited)**

	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
Net Income (Loss)	\$ 597,736	\$ (99,683)
Other Comprehensive Income (Loss):		
Net unrealized holding gains (losses) on securities available for sale during the period	325,649	(543,358)
Deferred income tax (expense) benefit on unrealized holding losses or gains on securities available for sale	(110,721)	184,741
Less reclassification adjustments for gains included in net Income (1)		(47,194)
Tax related to realized gain on securities sold (2)		16,046
Amortization of held to maturity transfer during period	(67)	
Tax effect of amortization of held to maturity transfer during period	23	
Other Comprehensive Income (Loss)	214,884	(389,765)
Total Comprehensive Income (Loss)	\$ 812,620	\$ (489,448)

- (1) Reclassifications for gains on sales of securities available-for-sale are included in the gain on securities sold/called line item on the Consolidated Statements of Operations.
- (2) Income taxes related to gains on sales of securities available-for-sale are included in the income tax expense (benefit) line item on the Consolidated Statements of Operations.
- See accompanying notes to consolidated financial statements.

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Consolidated Statements of Cash Flows****(Unaudited)**

	Six Months Ended June 30, 2014	Six Months Ended June 30, 2013
<b>Cash Flows From Operating Activities</b>		
Net income (loss)	\$ 597,736	\$ (99,683)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses	86,872	1,252,502
Depreciation and amortization	74,645	78,008
Amortization of discounts and premiums, net	77,819	98,928
Gain on sale of securities		(47,194)
(Gain) loss and impairment on other real estate owned and repossessions	(9,941)	61,074
Deferred tax expense	210,268	372,991
Change in loans held for sale	306,250	5,500
Decrease in accrued interest receivable	21,327	99,700
Decrease in other assets	149,507	205,709
Increase in value of bank owned life insurance	(27,952)	(18,972)
Change in reserve for unfunded lending commitments	7,393	(3,189)
Increase in executive retirement plan accrual	71,313	60,360
Payments on executive retirement plan	(140,628)	(140,628)
Decrease in accrued interest payable and other liabilities	(154,420)	(136,559)
Net cash provided by operating activities	1,270,189	1,788,547
<b>Cash Flows From Investing Activities</b>		
Purchases of bank premises and equipment	(50,869)	(68,073)
Purchases of securities available for sale		(4,220,991)
Calls/maturities/repayments of securities available for sale	2,327,207	3,137,179
Redemptions of restricted equity securities	67,400	86,400
Proceeds from sale of securities		1,086,283
Proceeds from sale of other real estate owned and repossessions	768,780	1,471,387
Loan originations and principal collections, net	(3,366,852)	5,066,776
Net cash provided by (used in) investing activities	(254,334)	6,558,961
<b>Cash Flows From Financing Activities</b>		
Increase (decrease) in non-interest bearing deposits	(313,123)	4,830,418
Decrease in interest bearing deposits	(3,033,162)	(1,464,690)

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Repayment of repurchase agreement		(6,000,000)
Net cash used in financing activities	(3,346,285)	(2,634,272)
Net increase (decrease) in cash and cash equivalents	\$ (2,330,430)	\$ 5,713,236
Cash and cash equivalents at beginning of period	17,964,151	24,038,353
Cash and cash equivalents at end of period	\$ 15,633,721	\$ 29,751,589
Supplemental disclosure of cash flow information:		
Cash paid during the period for interest	\$ 405,958	\$ 628,760
Cash paid during the period for taxes	\$ 64,000	\$
Unrealized (loss) gain on securities available for sale	\$ 335,261	\$ (590,552)
Transfer of securities available for sale to held to maturity	\$ 5,647,033	\$
Transfers between loans, other real estate & other assets	\$ 249,016	\$ 48,750
Amortization of net unrealized loss on securities moved to HTM	\$ (67)	\$

See accompanying notes to consolidated financial statements.

D-9

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**June 30, 2014**

**Note 1 Summary of Accounting Policies**

(a) General

The accompanying consolidated financial statements of MainStreet BankShares, Inc. are unaudited. However, in the opinion of management, all adjustments necessary for a fair presentation of the financial statements have been included. All adjustments were of a normal recurring nature, except as otherwise disclosed herein. The consolidated financial statements conform to generally accepted accounting principles and general banking industry practices. The information contained in the footnotes included in MainStreet BankShares, Inc.'s 2013 Annual Report on Form 10-K should be referred to in connection with the reading of these unaudited interim consolidated financial statements.

MainStreet BankShares, Inc. (the Corporation, MainStreet, or BankShares) was incorporated in Virginia on January 14, 1999. The Corporation was primarily organized to serve as a bank holding company. Its first wholly-owned subsidiary was located in Martinsville, Virginia and was sold on March 23, 2005. In 2002, MainStreet organized a second bank subsidiary, Franklin Community Bank, National Association (Franklin Bank). On February 8, 2007, MainStreet formed a wholly-owned real estate company, MainStreet RealEstate, Inc. (MainStreet RE) for the sole purpose of owning the real estate of the Corporation.

Franklin Bank was organized as a nationally chartered commercial bank and member of the Federal Reserve Bank of Richmond. Franklin Bank opened for business on September 16, 2002. Franklin Bank operates as a locally owned and operated commercial bank emphasizing personal customer service and other advantages incident to banking with a locally owned community bank. Franklin Bank's primary service area is Franklin County, Town of Rocky Mount and surrounding areas. It currently has three banking offices including its main office.

The Corporation reports its activities as a single business segment. In determining the appropriateness of segment definition, the Corporation considered components of the business about which financial information is available and will evaluate it regularly relative to resource allocation and performance assessment.

(b) Our accounting policies and basic principles have not changed since the summary disclosure of these in our Annual Report on Form 10-K. Please refer to the Form 10-K for these policies.

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014****Note 2 Securities**

The amortized costs, unrealized gains and losses and approximate market values of investment securities at June 30, 2014 and December 31, 2013 are shown in the following tables.

	June 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Approximate Market Value
Available for Sale:				
U.S. government sponsored agencies	\$ 1,489,192	\$ 423	\$ (20,405)	\$ 1,469,210
Mortgage backed securities	11,842,092	319,995	(20,232)	12,141,855
Corporates	496,316	4,399		500,715
<b>Total securities available for sale</b>	<b>\$ 13,827,600</b>	<b>\$ 324,817</b>	<b>\$ (40,637)</b>	<b>\$ 14,111,780</b>

	June 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Approximate Market Value
Held to Maturity:				
States and political subdivisions	\$ 5,641,208	\$ 2,400	\$ (21,674)	\$ 5,621,934
<b>Total securities held to maturity</b>	<b>\$ 5,641,208</b>	<b>\$ 2,400</b>	<b>\$ (21,674)</b>	<b>\$ 5,621,934</b>

	December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Approximate Market Value
Available for Sale:				
U. S. government sponsored agencies	\$ 2,688,955	\$ 555	\$ (66,510)	\$ 2,623,000
Mortgage backed securities	13,012,376	202,523	(59,744)	13,155,155
States and political subdivisions	5,686,412	11,784	(140,819)	5,557,377
Corporates	495,770	2,488	(1,358)	496,900
<b>Total securities available-for-sale</b>	<b>\$ 21,883,513</b>	<b>\$ 217,350</b>	<b>\$ (268,431)</b>	<b>\$ 21,832,432</b>



All of our mortgage backed securities are either guaranteed by U.S. government agencies or issued by U. S. government sponsored agencies.

D-11

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

The amortized costs and market values of the securities portfolio at June 30, 2014, by contractual maturity, are shown in the following table. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available for Sale		Held to Maturity	
	Amortized Cost	Approximate Market Value	Amortized Cost	Approximate Market Value
Due in one year or less	\$	\$	\$	\$
Due after one year but within five years	496,316	500,715	1,851,006	1,844,513
Due after five years but with ten years	3,652,672	3,705,651	3,790,202	3,777,421
Due after ten years	9,678,612	9,905,414		
	\$ 13,827,600	\$ 14,111,780	\$ 5,641,208	\$ 5,621,934

There were no gross gains or losses recorded on sales and calls of securities available for sale for the quarter-to-date and year-to-date periods ending June 30, 2014. There were gross gains of \$47,194 recorded on sales and calls of securities available for sale for the quarter-to-date and year-to-date periods ending June 30, 2013.

During the three months and six months periods ended June 30, 2014, available for sale securities with a market value of \$5.6 million were transferred to the held to maturity securities portfolio. The unrealized loss of \$(9,612) is now part of the amortized cost of the securities and will be amortized over the life of the securities as an adjustment to the yield.

Following demonstrates the unrealized loss position of securities at June 30, 2014 and December 31, 2013.

	June 30, 2014					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available for Sale:						
U. S. government sponsored agencies	\$ 492,655	\$ (7,345)	\$ 486,940	\$ (13,060)	\$ 979,595	\$ (20,405)
Mortgage backed securities			1,885,029	(20,232)	1,885,029	(20,232)
	\$ 492,655	\$ (7,345)	\$ 2,371,969	\$ (33,292)	\$ 2,864,624	\$ (40,637)

## Total temporarily impaired securities

	June 30, 2014					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Held to Maturity:						
States and political subdivisions	\$ 3,177,000	\$ (11,607)	\$ 2,153,947	\$ (10,067)	\$ 5,330,947	\$ (21,674)
Total temporarily impaired securities	\$ 3,177,000	\$ (11,607)	\$ 2,153,947	\$ (10,067)	\$ 5,330,947	\$ (21,674)

D-12

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

	December 31, 2013					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U. S. government sponsored agencies	\$ 1,921,845	\$ (66,510)	\$	\$	\$ 1,921,845	\$ (66,510)
Mortgage backed Securities	4,275,948	(59,744)			4,275,948	(59,744)
States and political Subdivisions	3,856,363	(140,819)			3,856,363	(140,819)
Corporates	248,135	(1,358)			248,135	(1,358)
<b>Total temporarily impaired securities</b>	<b>\$ 10,302,291</b>	<b>\$ (268,431)</b>	<b>\$</b>	<b>\$</b>	<b>\$ 10,302,291</b>	<b>\$ (268,431)</b>

An impairment is considered other than temporary if any of the following conditions are met: the Corporation intends to sell the security, it is more likely than not that the Corporation will be required to sell the security before the recovery of its amortized cost basis, or the Corporation does not expect to recover the security's entire amortized cost basis (even if the Bank does not intend to sell). At June 30, 2014 and December 31, 2013, there were \$8.2 million comprising twenty securities and \$10.3 million comprising twenty-three securities, respectively, in securities with unrealized losses based on market prices at the respective dates. Declines in fair value are due to interest rate fluctuations and not due to credit deterioration of the issuers. The Corporation does not have any securities that are considered other than temporarily impaired at June 30, 2014 and December 31, 2013.

Federal Reserve Bank stock is included in restricted equity securities and totaled \$435,100 at June 30, 2014 and December 31, 2013. The Corporation's investment in Federal Home Loan Bank (FHLB) stock totaled \$152,100 and \$219,500 at June 30, 2014 and December 31, 2013, respectively, and is also included in restricted equity securities. FHLB stock is generally viewed as a long term investment and as a restricted investment security which is carried at cost, because there is no market for the stock other than the FHLB or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on ultimate recoverability of the par value rather than by recognizing temporary declines in value.

**Note 3 Loans Receivable**

The major components of gross loans in the consolidated balance sheets at June 30, 2014 and December 31, 2013 are as follows:

	June 30, 2014	December 31, 2013
Commercial	\$ 10,194,933	\$ 9,426,188

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Real Estate:		
Construction and land development	15,738,882	16,394,964
Residential 1-4 families:		
First liens	34,287,121	33,787,645
Junior liens	7,079,779	6,331,233
Home equity lines	6,746,222	5,764,941
Commercial real estate	51,194,330	50,579,103
Consumer	1,287,639	1,353,312
Total Gross Loans	\$ 126,528,906	\$ 123,637,386
Unearned deferred fees and costs, net	91,985	86,600
Recorded Investment	\$ 126,620,891	\$ 123,723,986

D-13

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**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**June 30, 2014**

Overdrafts reclassified to loans at June 30, 2014 and December 31, 2013 were \$8,793 and \$6,196, respectively.

**Loan Origination/Risk Management:** Franklin Bank's Board of Directors annually approves and reviews policies and procedures to be utilized as tools by account officers for the purpose of making sound and prudent credit decisions. Every loan transaction is closely evaluated from the perspective of profitability realizing that there is no profit in a loan that becomes a loss. Each credit decision is based on merit and no other factors. Account officers carry a heavy burden of accountability in being assigned the responsibility for the development of Franklin Bank's loan portfolio by meeting the legitimate credit needs of our customers while also exercising prudence and seasoned judgment. A comprehensive reporting system has been developed to provide senior management timely information related to portfolio performance including growth, delinquency, adversely risk rated, and credit concentrations. The portfolio is constantly reviewed based on segments of concern, past due status, extension of credits along with stress testing the portfolio's collateral values and debt service coverages for a significant portion of loans within defined loan concentrations. Annually, a loan review plan is developed to identify and mitigate potential weakness in the loan portfolio. Scope is determined based upon a risk assessment of various concentrations and loan product types in which higher risk may exist. The developed plan is presented to the Loan Committee of Franklin Bank's Board of Directors each year for approval. Overall, the goal is to review 33% of the entire loan portfolio annually. Review segments vary from year to year to ensure a complete cycle of all significant loan product types. Results of each review segment are communicated to the Loan Committee of the Board of Directors of Franklin Bank with a response from Franklin Bank's senior lender or head of retail lending depending on the product type reviewed.

In general all loans exceeding \$100,000 are documented by three years of financial reports in conjunction with review and analysis by a credit analyst independent of the lending approval process. Generally all real estate loans are underwritten based on verified income, or cash flow, and margined at 80% or less depending upon the regulatory supervisory limit. All loans are underwritten based upon analysis of all identified primary and secondary repayment sources.

**Construction & Land Development:** Emphasis is placed on the estimated absorption period of the project based on the intimate knowledge of local demand and geographic concentrations by appraisers and account officers. Projects are monitored by Franklin Bank's in-house construction inspector to ensure adherence to project specifications and timely completion. Loan to values are manually tracked to ensure conforming collateral coverage is maintained throughout the development phase. Interest carry abilities are determined by analyzing global cash flow and available liquidity. Due to their complex nature, loans for speculative housing and speculative lot requests are underwritten by Franklin Bank's business lending group. Terms at origination for speculative lot loans are based on collateral margins and on qualifying the borrower to policy requirements based on a ten year amortization period. Speculative housing loan terms generally are held to eighteen months with allowance made for substantial curtailments.

**Commercial Real Estate:** Loans are generally underwritten based on verified income or cash flow to ensure a global coverage ratio of at least 1.25. In general, collateral margin is determined based on appraisal or evaluation market

value not to exceed 80 percent of appraised market value or cost, whichever is less. All properties receive proper environmental due diligence prior to funding of the credit. Account officers perform and document a market analysis which may include data on competing businesses and projects. When applicable, market analysis data may be obtained from independent sources. Cash flows and collateral margins are appropriately stress tested. Terms generally range from five to fifteen years, however, may be longer based on approval from Franklin Bank's President and Chief Credit Officer.

**Commercial Loans:** Loans are generally underwritten based on verified income or cash flow to ensure global debt service coverage ratio of at least 1.25. Terms can range up to seven years based on loan purpose and collateral offered. Based on policy, credit lines have maturities of one year. Generally inventory loans are margined at 50% while equipment loans, depending on age of collateral, range from 90%, if new, to 80%, if used. Receivables are margined at 80% based on the aging of receivables outstanding sixty days or less.

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

**Consumer /Residential 1-4 Families and Equity Lines:** Loans are generally underwritten based on a maximum debt to income ratio of 40 percent gross. Incomes are verified for all secured loans exceeding \$35,000 and unsecured loans totaling \$10,000 or more. Policy requires income verification to be documented for all real estate loans. Collateral margins and terms for non-real estate collateral are determined and made available to retail lenders by Franklin Bank's Chief Credit Officer. Cash flows for all self employed borrowers are determined by Franklin Bank's independent credit analyst. Policy defines unsecured loan terms at a maximum of thirty six months while individual unsecured lines are underwritten to maturities of less than one year with the line amount being based on a percentage of available liquidity and net worth. Construction loans for individuals are underwritten to policy based on cost overruns of at least fifteen percent. Debt to income ratios for equity lines are underwritten based on the borrower paying 1.5% of the total available line monthly. All equity lines are reviewed annually and filtered based on updated credit scores, average percentage drawn and delinquency. Watch accounts are identified based on filters and then individually reviewed by the responsible account officer.

**Note 4 Allowance for Loan Losses**

Changes in the allowance for loan losses for the six months ended June 30, 2014 and 2013 are as follows:

	2014	2013
Balance at beginning of year	\$ 2,379,145	\$ 2,602,098
Provision for loan losses	86,872	1,252,502
Recoveries	92,652	35,179
Charge-offs	(313,583)	(972,785)
Balance at period end	\$ 2,245,086	\$ 2,916,994

D-15



**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

A breakdown of the allowance by loan segment for the six months ended June 30, 2014 is as follows:

	Commercial	Construction and Land Development	Real Estate Residential 1-4 Families First Liens	Junior Liens	Home Equity Lines	Commercial Real Estate	Consumer	Unallocated	Total
Beginning									
Balance	\$ 151,289	\$ 353,391	\$ 601,276	\$ 100,906	\$ 100,351	\$ 1,061,037	\$ 10,895	\$	\$ 2,379,145
Charge-offs	(76,045)	(63,746)	(106,435)	(66,409)			(948)		(313,583)
Recoveries	16,644	30,793	8,029	8,559	16,730	6,388	5,509		92,652
Provision	16,227	(19,617)	(30,084)	71,945	498	24,829	(6,926)	30,000	86,872
Ending									
Balance	\$ 108,115	\$ 300,821	\$ 472,786	\$ 115,001	\$ 117,579	\$ 1,092,254	\$ 8,530	\$ 30,000	\$ 2,245,086

	Commercial	Construction and Land Development	Real Estate Residential 1-4 Families First Liens	Junior Liens	Home Equity Lines	Commercial Real Estate	Consumer	Unallocated	Total
Allowance for loan losses:									
Ending Balance:									
Individually evaluated for impairment	\$	\$	\$	\$ 189	\$	\$ 331,006	\$	\$	\$ 331,195
Ending Balance:									

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Collectively evaluated for impairment	108,115	300,821	472,786	114,812	117,579	761,248	8,530	30,000	1,913,891
	\$ 108,115	\$ 300,821	\$ 472,786	\$ 115,001	\$ 117,579	\$ 1,092,254	\$ 8,530	\$ 30,000	\$ 2,245,086

D-16

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

	June 30, 2014							
	Real Estate							
	Commercial	Construction and Land Development	Residential First Liens	1-4 Families Junior Liens	Home Equity Lines	Commercial Real Estate	Consumer	Gross Loans
Recorded investment in loans:								
Ending Balance:								
Individually evaluated for impairment	\$ 614,669	\$ 422,715	\$ 470,214	\$ 132,380	\$ 69,950	\$ 2,033,393	\$	\$ 3,743,321
Ending Balance:								
Collectively evaluated for impairment	9,580,264	15,316,167	33,816,907	6,947,399	6,676,272	49,160,937	1,287,639	122,785,585
	\$ 10,194,933	\$ 15,738,882	\$ 34,287,121	\$ 7,079,779	\$ 6,746,222	\$ 51,194,330	\$ 1,287,639	\$ 126,528,906

A breakdown of the allowance for loan losses by loan segment for the year ended December 31, 2013 is as follows:

	Real Estate								
	Residential 1-4 Families								
	Commercial	Construction and Land Development	First Liens	Junior Liens	Home Equity Lines	Commercial Real Estate	Consumer	Unallocated	Total
Beginning Balance	\$ 108,336	\$ 767,018	\$ 701,668	\$ 134,847	\$ 88,411	\$ 740,073	\$ 11,745	\$ 50,000	\$ 2,602,098
Charge-offs	(450,100)	(592,292)	(151,295)	(156,561)	(9,052)	(534,150)	(74,461)		(1,967,911)

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Recoveries	12,278	9,090	7,448	20,497		1,429	29,336		80,078
Provision	480,775	169,575	43,455	102,123	20,992	853,685	44,275	(50,000)	1,664,880
Ending Balance	\$ 151,289	\$ 353,391	\$ 601,276	\$ 100,906	\$ 100,351	\$ 1,061,037	\$ 10,895	\$	\$ 2,379,145

D-17

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

December 31, 2013

Real Estate

Residential 1-4  
Families

	Commercial	Construction and Land Development	First Liens	Junior Liens	Home Equity Lines	Commercial Real Estate	Consumer	Unallocated	Total
Allowance for loan losses:									
Ending Balance: Individually evaluated for impairment	\$ 50,000	\$ 10	\$ 101,540	\$	\$	\$ 424,376	\$	\$	\$ 575,926
Ending Balance: Collectively evaluated for impairment	101,289	353,381	499,736	100,906	100,351	636,661	10,895		1,803,219
	\$ 151,289	\$ 353,391	\$ 601,276	\$ 100,906	\$ 100,351	\$ 1,061,037	\$ 10,895	\$	\$ 2,379,145

December 31, 2013

Real Estate

Residential 1-4 Families  
First  
Liens

	Commercial	Construction and Land Development	First Liens	Junior Liens	Home Equity Lines	Commercial Real Estate	Consumer	Gross Loans
Recorded investment in loans:								

Ending Balance: Individually evaluated for impairment	\$ 725,863	\$ 576,552	\$ 1,130,961	\$ 182,170	\$ 71,338	\$ 3,308,733	\$	\$ 5,995,617
Ending Balance: Collectively evaluated for impairment	8,700,325	15,818,412	32,656,684	6,149,063	5,693,603	47,270,370	1,353,312	117,641,769
	\$ 9,426,188	\$ 16,394,964	\$ 33,787,645	\$ 6,331,233	\$ 5,764,941	\$ 50,579,103	\$ 1,353,312	\$ 123,637,386

D-18

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

An age analysis of past due loans as of June 30, 2014 is as follows:

	Loans 30-59 Days Past Due	Loans 60-89 Days Past Due	Loans 90 Or More Days Past Due	Total Past Due Loans	Current Loans	Gross Loans	Accruing Loans 90 or More Days Past Due (Not Included in Past Dues & Current)	Net Loans (Included in Past Dues & Current)
Commercial	\$ 63,281	\$	\$	\$ 63,281	\$ 10,131,652	\$ 10,194,933	\$	\$
Real Estate:								
Construction and land development		75,168	162,710	237,878	15,501,004	15,738,882		266,074
Residential 1-4 Families								
First Liens	177,088		196,275	373,363	33,913,758	34,287,121		470,214
Junior Liens	16,499	33,690	189	50,378	7,029,401	7,079,779		132,380
Home Equity lines					6,746,222	6,746,222		69,950
Commercial Real Estate					51,194,330	51,194,330		2,033,393
Consumer	62			62	1,287,577	1,287,639		
	\$ 256,930	\$ 108,858	\$ 359,174	\$ 724,962	\$ 125,803,944	\$ 126,528,906	\$	\$ 2,972,011

An age analysis of past due loans as of December 31, 2013 is as follows:

	Loans 30-59 Days Past Due	Loans 60-89 Days Past Due	Loans 90 Or More Days Past Due	Total Past Due Loans	Current Loans	Gross Loans	Accruing Loans 90 or More Days Past Due (Included in Past Dues & Current)	Net Loans (Included in Past Dues & Current)
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							Dues)	
Commercial	\$	\$	\$	\$	\$	9,426,188	\$	9,426,188
Real Estate:							\$	\$
Construction and land development	320,143		259,973	580,116	15,814,848	16,394,964		576,552
Residential 1-4 Families								
First Liens	893,473	33,154	802,830	1,729,457	32,058,188	33,787,645		1,125,187
Junior Liens	65,603		16,232	81,835	6,249,398	6,331,233		152,985
Home Equity lines					5,764,941	5,764,941		71,338
Commercial Real Estate	416,668			416,668	50,162,435	50,579,103		2,079,556
Consumer	50,244			50,244	1,303,068	1,353,312		
	\$ 1,746,131	\$ 33,154	\$ 1,079,035	\$ 2,858,320	\$ 120,779,066	\$ 123,637,386	\$	\$ 4,005,618

D-19



**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

Impaired loans at June 30, 2014 are as follows:

	Unpaid Contractual Principal Balance	Recorded Investment with Related Allowance	Recorded Investment with No Related Allowance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Commercial	\$ 614,669	\$	\$ 614,669	\$	\$ 654,747	\$
Real Estate:						
Construction and land development	568,707		422,715		436,091	4,299
Residential 1-4 Families						
First Liens	478,785		470,214		861,360	6,031
Junior Liens	157,347	189	132,191	189	162,387	
Home Equity lines	79,002		69,950		70,721	
Commercial Real Estate	2,033,393	2,033,393		331,006	2,500,840	3,313
Consumer						
	\$ 3,931,903	\$ 2,033,582	\$ 1,709,739	\$ 331,195	\$ 4,686,146	\$ 13,643

Impaired loans at December 31, 2013 are as follows:

	Unpaid Contractual Principal Balance	Recorded Investment with Related Allowance	Recorded Investment with No Related Allowance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Commercial	\$ 778,980	\$ 60,000	\$ 665,863	\$ 50,000	\$ 287,405	\$ 34,511
Real Estate:						
Construction and land development	890,255	162,710	413,842	10	960,164	24,249
Residential 1-4 Families						
First Liens	1,154,822	541,539	589,422	101,540	1,460,986	37,253

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Junior Liens	190,455		182,170		216,673	9,361
Home Equity lines	80,390		71,338		59,495	263
Commercial Real Estate	3,308,733	2,079,556	1,229,177	424,376	2,156,878	46,367
Consumer						
	\$ 6,403,635	\$ 2,843,805	\$ 3,151,812	\$ 575,926	\$ 5,141,601	\$ 152,004

D-20

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

The Corporation assesses all loan modifications to determine whether they are considered troubled debt restructurings (TDRs). During the six months ending June 30, 2014, the Corporation modified or renewed four loans that were considered to be TDRs, of which two are on nonaccrual. The construction and land development credits were loans restructured to allow the borrowers time to sell their properties. One commercial real estate credit was restructured into a new credit, waiving lost interest. The second commercial real estate loan was the renewal of an existing troubled debt restructuring that is interest only.

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Construction and land development	2	\$ 291,063	\$ 291,063
Commercial Real Estate	2	2,104,152	2,104,152
<b>Total</b>	<b>4</b>	<b>\$ 2,395,215</b>	<b>\$ 2,395,215</b>

During the three months ending June 30, 2014, the Corporation modified or renewed one loan that was considered to be a TDR. The construction and land development credit was a loan restructured to allow the borrower time to sell his properties.

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Construction and land development	1	\$ 158,282	\$ 158,282
<b>Total</b>	<b>1</b>	<b>\$ 158,282</b>	<b>\$ 158,282</b>

There were no troubled debt restructurings modified during the past twelve months that defaulted during the three month or six month periods ended June 30, 2014. For this purpose, if a note defaults it means at some point it has been greater than 60 days past due or we have received some information that leads us to believe the full collection of the principal and interest is doubtful.

During the three month and six month periods ending June 30, 2013, the Corporation modified one loan that was considered to be a TDR. The Corporation lowered the payment on the loan, which extended the amortization out of policy guidelines, in order to allow the borrower time to attract new tenants. The following table presents information

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relating to the loan modified as TDR during the three and six months ended June 30, 2013.

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial Real Estate	1	\$ 1,898,387	\$ 1,898,387
Total	1	\$ 1,898,387	\$ 1,898,387

There were no troubled debt restructurings modified during the past twelve months that defaulted during the three month and six month period ended June 30, 2013. For this purpose, if a note defaults it means at some point it has been greater than 60 days past due or we have received some information that leads us to believe the full collection of the principal and interest is doubtful.

D-21

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

At June 30, 2014 and December 31, 2013 the balance in loans under the terms of troubled debt restructurings not included in nonaccrual loans was \$771,310 and \$1,929,999, respectively. Troubled debt restructurings (not on nonaccrual) decreased from December 31, 2013 to June 30, 2014 because one restructured credit, with terms reflecting current market rates, is no longer being reported as a troubled debt restructuring due to sustained performance of six months and another small credit was paid off. These loans did not have any additional commitments at June 30, 2014 and December 31, 2013, respectively. Loan restructurings generally occur when a modification that would otherwise not be considered is granted to the borrower having financial difficulties. These loans may continue to accrue interest as long as the borrower complies with the revised terms and conditions and has demonstrated repayment performance with the modified terms. The borrowers were complying with the modified terms of their contracts at June 30, 2014 and December 31, 2013, respectively, that were not in nonaccrual status. Troubled debt restructurings are included in the impaired loan disclosures.

The following table describes the interest earned, reflected in income and lost for the six month periods.

	June 30, 2014	June 30, 2013
Interest that would have been earned	\$ 110,065	\$ 129,203
Interest reflected in income	13,643	42,261
Lost interest	\$ 96,422	\$ 86,942

The Corporation's internally assigned grades for credit quality are as follows:

**Prime (1.00)**

Exceptional credits are of the highest quality. These loans are supported by large, well-established borrowers with excellent financial stability and strength, and may be secured by cash or cash equivalents. Where applicable, guarantors have substantial net worth and personal cash flow, and could easily fulfill their obligation should the need arise.

**Good (2.00)**

Superior credits are supported by well-established borrowers with excellent financial stability and strength. The borrower's cash flow, liquidity, and equity are more than ample. These credits may be secured by cash or cash equivalents. For loans with personal guarantees, the guarantors are high net worth individuals, and have the resources available to satisfy their obligation if necessary.

**Acceptable (3.00)**

Loans in this category are supported by borrowers and guarantors that are financially sound. Cash flow, liquidity and equity are sufficient to provide a comfortable margin in the event of short-term economic disturbances. Assets pledged as collateral would provide a dependable secondary source of repayment.

**Pass/Watch (4.00)**

Credits in this category present the maximum acceptable risk for new facilities. Borrowers generate enough cash for debt service needs, but may not have sufficient resources to weather short-term market fluctuations. Management may lack depth or experience, and industry volatility may be an issue. Where applicable, guarantors have sufficient resources to provide an additional margin of protection.

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**June 30, 2014**

**Special Mention (5.00)**

Assets in this category demonstrate signs of potential weakness, which, if uncorrected, could result in default. The borrower's liquidity or equity may be marginal, trends in cash flow and profitability may point to a weakening financial condition, or the borrower's industry may be slightly unstable or showing early indications of decline.

Collateral may be illiquid or provide only a relatively small margin. Migration analysis data is performed and updated quarterly on these loans. It is based on loans downgraded originally into this category. Our loss factor is determined based on charge-offs during the quarter divided by the balance of special mention loans at the beginning of the quarter. This is then increased by the qualitative factors which increase the applied loss factor to 3%.

**Substandard (6.00)**

Loans in this category present an unacceptable credit risk. Borrowers and guarantors may be financially weak, and may lack the sufficient resources to adequately service debt. The abilities of management and industry stability may also be of concern. Collateral may be lacking in quality or liquidity, and offers little additional protection.

Migration analysis data is performed and updated quarterly on these loans. It is based on loans downgraded originally into this category. Our loss factor is determined based on charge-offs during the quarter divided by the balance of substandard loans at the beginning of the quarter. This is then increased by the qualitative factors which increases the applied loss factor to 8%. This does not apply to impaired loans where a specific reserve is determined based on the loss, if any, that is calculated.

**Doubtful (7.00)**

These loans have an extremely high probability of loss, though the timing and magnitude of the loss may remain unclear. Borrowers and guarantors exhibit major financial shortcomings, and clearly lack the sufficient resources to adequately service debt or honor their commitments. Collateral is lacking in quality or liquidity, and offers little, if any, additional protection.

**Loss (8.00)**

The probability of collection on these credits is so low that they may be properly classified as uncollectible.

Generally, consumer loans, home equity lines, and residential 1-4 family loans are not risk rated and considered a pass credit unless they are related to a risk rated commercial loan relationship or exhibit criticized asset characteristics.





**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

Internal Risk Rating Grades Grade:	June 30, 2014 Real Estate							Gross Loans by Internal Risk Rating Grade
	Commercial	Construction And Land Development	Residential 1-4 Families First Liens	Residential 1-4 Families Junior Liens	Home Equity Lines	Commercial Real Estate	Consumer	
Pass	\$ 9,959,470	\$ 13,979,539	\$ 33,493,578	\$ 6,447,283	\$ 6,671,388	\$ 45,281,845	\$ 1,275,388	\$ 117,108,491
Special Mention		892,166		14,961		2,162,990	2,061	3,072,178
Substandard	235,463	867,177	793,543	617,346	74,834	3,418,489	10,190	6,017,042
Doubtful				189		331,006		331,195
Loss								
	\$ 10,194,933	\$ 15,738,882	\$ 34,287,121	\$ 7,079,779	\$ 6,746,222	\$ 51,194,330	\$ 1,287,639	\$ 126,528,906

Internal Risk Rating Grades Grade:	December 31, 2013 Real Estate							Gross Loans by Internal Risk Rating Grade
	Commercial	Construction And Land Development	Residential 1-4 Families First Liens	Residential 1-4 Families Junior Liens	Home Equity Lines	Commercial Real Estate	Consumer	
Pass	\$ 9,179,636	\$ 14,308,667	\$ 32,126,801	\$ 5,773,125	\$ 5,693,603	\$ 47,028,384	\$ 1,342,215	\$ 115,452,431
Special Mention		907,175	204,731			711,413	907	1,824,226
Substandard	196,552	1,179,112	1,354,573	558,108	71,338	2,414,930	10,190	5,784,803
Doubtful	50,000	10	101,540			424,376		575,926
Loss								
	\$ 9,426,188	\$ 16,394,964	\$ 33,787,645	\$ 6,331,233	\$ 5,764,941	\$ 50,579,103	\$ 1,353,312	\$ 123,637,386

**Note 5 Borrowings**

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The Corporation has the ability to borrow from Federal Home Loan Bank of Atlanta ( FHLB ). Borrowing capacity is secured by a blanket lien on loans secured by commercial real estate and loans secured by 1-4 family first liens, second liens, and equity lines. The borrowing capacity at June 30, 2014, based upon lendable collateral value, was \$33,148,065. There were no FHLB advances outstanding at June 30, 2014 and December 31, 2013.

D-24

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

There were no overnight federal funds purchased at June 30, 2014 and December 31, 2013. The Corporation has \$14,500,000 in overnight federal funds lines with its correspondents.

The Corporation has an internal Corporate Cash Management account for customers to sweep their excess demand deposit accounts on an overnight basis in order to earn interest. This account is not FDIC insured but the Corporation is required to pledge agency funds at 100% towards these balances. There were no Corporate Cash Management sweep accounts at June 30, 2014 and December 31, 2013, respectively.

**Note 6 Repurchase Agreements**

The Corporation entered into a repurchase agreement with Barclays Capital on January 2, 2008 in the amount of \$6,000,000. The repurchase date was January 2, 2013. The interest rate was fixed at 3.57% until maturity or until it was called. Beginning January 2, 2009 the repurchase agreement became callable and could have been called quarterly with two business days prior notice. Interest was payable quarterly. The repurchase agreement was collateralized by agency mortgage backed securities.

**Note 7 Net Income (Loss) Per Common Share**

The following tables show the weighted average number of shares used in computing earnings (loss) per common share and the effect on weighted average number of shares of diluted potential common stock. Potential dilutive common stock had no effect on income available to common shareholders.

	Three Months Ended June 30, 2014		Three Months Ended June 30, 2013	
	Shares	Per Share Amount	Shares	Per Share Amount
Earnings (loss) per common share, basic	1,713,375	\$ .20	1,713,375	\$ (.20)
Effect of dilutive securities:				
Stock options and warrants				
Earnings (loss) per common share, diluted	1,713,375	\$ .20	1,713,375	\$ (.20)

Options and warrants not included in the calculation of diluted earnings per share because they were anti-dilutive were 67,023 and 128,272 for the quarter-to-date periods ending June 30, 2014 and 2013, respectively.

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	Six Months Ended June 30, 2014		Six Months Ended June 30, 2013	
	Shares	Per Share Amount	Shares	Per Share Amount
Earnings (loss) per common share, basic	1,713,375	\$ .35	1,713,375	\$ (.06)
Effect of dilutive securities:				
Stock options and warrants				
Earnings (loss) per common share, diluted	1,713,375	\$ .35	1,713,375	\$ (.06)

Options and warrants not included in the calculation of diluted earnings per share because they were anti-dilutive were 67,023 and 144,772 for the year-to-date periods ending June 30, 2014 and 2013, respectively.

D-25

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014****Note 8 Stock Options and Warrants**

The shareholders of MainStreet approved the 2004 Key Employee Stock Option Plan, (the Plan), at its Annual Meeting on April 15, 2004. The Plan permitted the grant of Non-Qualified Stock Options and Incentive Stock Options to persons designated as Key Employees of BankShares or its subsidiaries. The Plan was approved by the Board of Directors as of January 21, 2004 and terminated on January 21, 2009, except with respect to awards made prior to and outstanding on that date which remain valid in accordance with their terms. Option awards were granted with an exercise price equal to the market value of MainStreet's stock at the date of grant. The options issued in 2007 and 2006 had a vesting period of three years and have a ten year contractual term. The options issued in 2005 vested immediately upon grant and have a ten year contractual term. All share awards provided for accelerated vesting if there was a change in control (as defined in the Plan). The maximum number of shares that could have been issued under the Plan could not exceed 150,700. As of June 30, 2014, there were 136,527 stock options granted under this Plan of which 822 have been exercised, 61,249 options have expired, and 7,433 were forfeited. Options in the amount of 33,000 not under the plan expired in June 2013.

As of June 30, 2014 the Corporation has reserved 67,023 shares of authorized but unissued shares of common stock related to the stock option agreements.

Following is a status and summary of changes in stock options during the six months ended June 30, 2014:

	Six Month Period Ended June 30, 2014	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at Beginning of year	67,023	\$ 12.87		
Granted				
Exercised				
Forfeited				
Expired				
Outstanding at June 30, 2014	67,023	\$ 12.87	1.75	\$
Exercisable at June 30, 2014	67,023	\$ 12.87	1.75	\$

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The aggregate intrinsic value of a stock option in the table above represents the total pre-tax intrinsic value (the amount by which the current market value of the underlying stock exceeds the exercise price of the option) that would have been received by the option holders had all option holders exercised their options on June 30, 2014. This amount changes based on changes in the market value of the Corporation's stock.

As of June 30, 2014, there was no unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plan.

D-26

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

As of June 30, 2014, stock options and warrants outstanding and exercisable are summarized as follows:

Range of Exercise Prices	Stock Options and Warrants Outstanding And Exercisable	Remaining Contractual Life
\$12.09	43,977	1.40
12.09	9,066	1.50
15.00	7,464	3.45
16.75	6,516	2.50
\$12.09 \$16.75	67,023	

**Note 9 Financial Instruments With Off-Balance-Sheet Risk**

In the normal course of business to meet the financing needs of its customers, BankShares is a party to financial instruments with off-balance-sheet risk. These financial instruments involve commitments to extend credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheets.

The Corporation's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit is represented by the contractual amount of those instruments. The same credit policy is used in making commitments as is used for on-balance-sheet risk. At June 30, 2014, and December 31, 2013 outstanding commitments to extend credit including letters of credit were as follows:

	June 30, 2014	December 31, 2013
Commercial	\$ 4,184,605	\$ 4,258,081
Real Estate:		
Construction and land development	4,595,059	1,691,512
Residential 1-4 families		
First liens	383,629	918,377
Junior liens	867,188	359,672
Home Equity lines	7,672,203	7,790,927

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Commercial real estate	2,781,201	2,271,121
Consumer	381,895	391,967
Total Outstanding Commitments	\$ 20,865,780	\$ 17,681,657

There are no commitments to extend credit on impaired loans except for letters of credit that are outstanding and cannot be withdrawn. Commitments to extend credit are agreements to lend to a customer as long as there is no breach of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The commitments may expire without ever being drawn upon; therefore, the total commitment amounts do not necessarily represent future cash outlays for the Corporation.

**Note 10 Fair Value Measurements**

Generally accepted accounting principles specify a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect MainStreet's market assumptions. The three levels of the fair value hierarchy based on these two types of inputs are as follows:

Level 1 Valuation is based on quoted prices in active markets for identical assets and liabilities.

D-27



Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

Level 2 Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3 Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

The following describes the valuation techniques used by MainStreet to measure certain assets and liabilities recorded at fair value on a recurring basis in the financial statements:

Securities available for sale: Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). We only utilize third party vendors to provide fair value data for the purposes of recording amounts related to our fair value measurements of our securities available for sale portfolio. We obtain SSAE16 reports from our third party vendor on an annual basis. Our third party vendor also utilizes a reputable pricing company for security market data that utilizes a matrix pricing model. For government sponsored agencies the model gathers information from market sources and integrates relative credit information, observed market movements and sector news. For agency mortgage backed securities the model incorporates the current weighted average maturity and takes into account additional pool level information supplied directly by the agency or government sponsored enterprise. The third party vendor system has controls and edits in place for month-to-month market checks and zero pricing. We make no adjustments to the pricing service data received for our securities available for sale.

The following table presents the balances of financial assets measured at fair value on a recurring basis as of June 30, 2014 and December 31, 2013:

Description	Fair Value Measurements at June 30, 2014 Using			
	Balance as of June 30, 2014	Quoted Prices in Active Markets for	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)

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		Identical Assets (Level 1)		
Available-for-sale securities:				
U. S. government sponsored agencies	\$ 1,469,210	\$	\$ 1,469,210	\$
Mortgage backed securities	12,141,855		12,141,855	
Corporates	500,715		500,715	
Total available-for-sale securities	\$ 14,111,780	\$	\$ 14,111,780	\$

D-28

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

Description	Balance as of December 31, 2013	Fair Value Measurements at December 31, 2013 Using Quoted Prices in Active Markets for Identical Assets (Level 1)		
		Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
<b>Available-for-sale securities:</b>				
U. S. government sponsored agencies	\$ 2,623,000	\$	\$ 2,623,000	\$
Mortgage backed securities	13,155,155		13,155,155	
States and political Subdivisions	5,557,377		5,557,377	
Corporates	496,900		496,900	
Total available-for-sale securities	\$ 21,832,432	\$	\$ 21,832,432	\$

Certain assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by MainStreet to measure certain assets recorded at fair value on a nonrecurring basis in the financial statements:

**Loans held for sale:** Loans held for sale are recorded at fair value on a nonrecurring basis which is the carrying value. Loans held for sale, generally, are closed and sold within two weeks.

**Impaired Loans:** Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing recent appraisals conducted by an independent, licensed appraiser outside of MainStreet using observable market data (Level 2). However, if the appraisal of the real estate property is not current, or has been discounted, then the fair value is considered Level 3. It is also considered Level 3 if an evaluation is conducted by Franklin Bank, rather than by a third party. The value of business equipment is based upon an outside appraisal if deemed significant,

or the net book value on the applicable business financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Operations.

Other Real Estate Owned (OREO): Foreclosed assets are adjusted to fair value upon transfer of the loans to OREO. Subsequently, OREO is carried at the lower of carrying value or fair market value less selling costs. 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 a recent appraisal conducted by an independent licensed appraisal using observable market data, the Corporation records the OREO as nonrecurring Level 2. When

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

the appraisal of the real estate property is not current, or has been discounted, the Corporation records the OREO as nonrecurring Level 3. It is also considered Level 3 if an evaluation is conducted by Franklin Bank, rather than by a third party. Any fair value adjustments are recorded as other real estate and repossessions expense on the Consolidated Statements of Operations.

The following table summarizes MainStreet's assets that were measured at fair value on a nonrecurring basis as of June 30, 2014 and December 31, 2013.

Description	Balance as of June 30, 2014	Carrying value at June 30, 2014		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	2,457,728		362,829	2,094,899
Other real estate owned	218,340			218,340

Description	Balance as of December 31, 2013	Carrying value at December 31, 2013		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Loans held for sale	\$ 306,250	\$ 306,250		\$
Impaired loans	3,055,465		369,592	2,685,873
Other real estate owned	728,163		65,800	662,363

The following table displays quantitative information about Level 3 Fair Value Measurements for June 30, 2014:

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	Fair Value	Valuation Technique(s)	Unobservable Input	Range (Weighted Average)
<b>Assets</b>				
Impaired loans	\$ 444,926	Internal evaluations	Internal evaluations	13% - 17% (15%)
	1,649,973	Appraisal	Market discount/Timing discount	10% - 16% (16%)
Other real estate owned	\$ 35,980	Internal evaluations	Internal evaluations and market discount	8% (8%)
	\$ 182,360	Appraisal	Market discount	24% (24%)

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

(a) **Short-Term Financial Instruments**

The carrying value of short-term financial instruments including cash and cash equivalents, federal funds sold and interest-bearing deposits in domestic banks approximate the fair value of these instruments. These financial instruments generally expose the Corporation to limited credit risk and have no stated maturity or have an average maturity of 30-45 days and carry interest rates which approximate market value.

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**June 30, 2014**

**(b) Securities Available for Sale**

The fair value of investments is estimated based on quoted market prices or dealer quotes.

**(c) Securities Held to Maturity**

The fair value of investments is estimated based on quoted market prices or dealer quotes.

**(d) Restricted Equity Securities**

The carrying value of restricted equity securities approximates fair value based on the redemption provisions of the applicable entities.

**(e) Loans Held for Sale**

The carrying value of these loans approximates the fair value. With applications taken prior to mid-May of this year, we would close some mortgage loans in our name and then sell them to our partners within a short period of days. Beginning in mid-May, Franklin Bank no longer closes mortgage loans in our name for resale.

**(f) Loans**

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, real estate commercial, real estate construction, real estate mortgage and other consumer. Each loan category is further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories. The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan as well as estimates for operating expenses and prepayments. The estimate of maturity is based on management's assumptions with repayment for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions.

**(g) Accrued Interest**

The carrying amounts of accrued interest approximate fair value.

(h) **Bank Owned Life Insurance**

The carrying amount is a reasonable estimate of fair value.

(i) **Deposits**

The fair value of demand, interest checking, savings and money market deposits is the amount payable on demand. The fair value of fixed maturity time deposits and certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities and repayment characteristics.

(j) **Commitments to Extend Credit and Standby Letters of Credit**

The only amounts recorded for commitments to extend credit and standby letters of credit are the fees arising from these unrecognized financial instruments. The fair value of these commitments has been determined to be immaterial.

D-31



Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

The carrying values and estimated fair values of financial instruments at June 30, 2014 and December 31, 2013 are as follows:

	Carrying Value	Fair Value Measurements at June 30, 2014 using			Fair Value
		Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	
<b>FINANCIAL ASSETS:</b>					
Cash and due from banks	\$ 3,804,713	\$ 3,804,713	\$	\$	\$ 3,804,713
Interest-bearing deposits in banks	6,499,067	6,499,067			6,499,067
Federal funds sold	5,329,941	5,329,941			5,329,941
Securities available-for-sale	14,111,780		14,111,780		14,111,780
Securities held to maturity	5,641,208		5,621,934		5,621,934
Restricted equity securities	587,200		587,200		587,200
Loans, net	124,375,805		362,829	124,265,582	124,628,411
Accrued interest receivable	440,754		440,754		440,754
Bank owned life insurance	1,926,688		1,926,688		1,926,688
<b>FINANCIAL LIABILITIES:</b>					
<b>Deposits:</b>					
Non-interest bearing demand deposits	\$ 26,543,867	\$	\$ 26,543,867	\$	\$ 26,543,867
Interest bearing deposits	112,931,286		113,218,547		113,218,547
Accrued interest payable	63,677		63,677		63,677

D-32

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

	Fair Value measurements at December 31, 2013 using				
	Carrying	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Fair Value
	Value				
<b>FINANCIAL ASSETS:</b>					
Cash and due from banks	\$ 2,929,591	\$ 2,929,591	\$	\$	\$ 2,929,591
Interest-bearing deposits in other banks	10,343,469	10,343,469			10,343,469
Federal funds sold	4,691,091	4,691,091			4,691,091
Securities available-for-sale	21,832,432		21,832,432		21,832,432
Restricted equity securities	654,600		654,600		654,600
Loans held for sale	306,250		306,250		306,250
Loans, net	121,344,841		369,592	120,980,345	121,349,937
Accrued interest receivable	462,081		462,081		462,081
Bank owned life insurance	1,898,736		1,898,736		1,898,736
<b>FINANCIAL LIABILITIES:</b>					
<b>Deposits:</b>					
Non-interest bearing demand deposits	\$ 26,856,990	\$	\$ 26,856,990	\$	\$ 26,856,990
Interest bearing deposits	115,964,448		116,336,714		116,336,714
Accrued interest payable	86,575		86,575		86,575

Fair value estimates are made at a specific point in time, based on relevant market information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Corporation's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates. Fair value estimates are based on existing on-and-off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments.

The Corporation assumes interest rate risk (the risk that general interest rate levels will change) as a result of its normal operations. As a result, the fair values of the Corporation's financial instruments will change when interest rate

levels change and that change may be either favorable or unfavorable to the Corporation. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the Corporation's overall interest rate risk.

D-33

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**(Unaudited)**

**June 30, 2014**

**Note 11 Contingencies and Other Matters**

In the normal course of business, the Corporation may be involved in various legal proceedings. Based on the information presently available, management believes that the ultimate outcome in such proceedings, in the aggregate, will not have a material adverse effect on the business or the financial condition or results of operations of the Corporation.

**Note 12 Subsequent Events**

In preparing these financial statements, the Corporation has evaluated events and transactions for potential recognition or disclosure through the date the financial statements were filed.

**Note 13 Regulatory**

On April 16, 2009, Franklin Bank entered into a formal agreement ( Agreement ) with The Comptroller of the Currency ( OCC ). The Agreement required Franklin Bank to perform certain actions within designated time frames. The Agreement was intended to demonstrate the Bank s commitment to review/enhance certain aspects of various policies and practices related to credit administration and liquidity. Franklin Bank achieved full compliance with the Agreement. The Agreement was terminated in August 2013.

On June 17, 2009, MainStreet BankShares, Inc. entered into a Memorandum of Understanding ( MOU ) with the Federal Reserve Bank of Richmond ( Federal Reserve ). The MOU required the bank holding company to utilize its financial and managerial resources to assist Franklin Bank in functioning in a safe and sound manner and restricted MainStreet from conducting various activities. On January 26, 2011, we entered into a new MOU with the Federal Reserve which contained the same terms of the previous MOU (which was terminated) but added provisions regarding compliance with certain laws and regulations. This MOU was terminated in September 2013. There are no longer any restrictions or stipulations attributable to the MOU.

**Note 14 Changes in Accumulated Other Comprehensive Income (Loss)**

	For the Three Months Ended June 30, 2014	
Net Unrealized Gain/Adjustments on Securities Available for sale (1)	Net Securities Held to Maturity from Available for	Accumulated Other Comprehensive Income

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				Sale	
Balance at March 31, 2014	\$	63,955	\$(7,596)	\$	\$ 56,359
Other comprehensive income		123,604		(6,388)	117,216
Balance at June 30, 2014	\$	187,559	\$(7,596)	\$ (6,388)	\$ 173,575

D-34

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements****(Unaudited)****June 30, 2014**

	For the Three Months Ended June 30, 2013		
	Net		
	Unrealized		
	Gains		
	(Losses) on Securities	Adjustments Related to	Accumulated Other
	available	for sale (1) Post Retirement Benefits	Comprehensive Income
Balance at March 31, 2013	\$ 331,330	\$ 56,617	\$ 387,947
Other comprehensive loss	(351,155)		(351,155)
Balance at June 30, 2013	\$ (19,825)	\$ 56,617	\$ 36,792

	For the Six Months Ended June 30, 2014			
	Net Unrealized Gains	Adjustments	to Held to	Accumulated Other
	(Losses) on Securities	Related to Post	Maturity from	Comprehensive
	available for sale (1) Retirement Benefits	Retirement Benefits (2) Sale	Available for Sale	Income
	(Loss)			(Loss)
Balance at December 31, 2013	\$ (33,713)	\$ (7,596)	\$	\$ (41,309)
Other comprehensive income	221,272		(6,388)	214,884
Balance at June 30, 2014	\$ 187,559	\$ (7,596)	\$ (6,388)	\$ 173,575

	For the Six Months Ended June 30, 2013		
	Net Unrealized Gains		
	(Losses) on Securities		
	available		
	for sale (1) Post Retirement Benefits	Adjustments Related to	Accumulated Other
	(Loss)	for sale (2)	Comprehensive Income
Balance at December 31, 2012	\$ (33,713)	\$ (7,596)	\$ (41,309)
Other comprehensive income	221,272		214,884
Balance at June 30, 2013	\$ 187,559	\$ (7,596)	\$ 173,575

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Balance at December 31, 2012	\$ 369,940	\$ 56,617	\$ 426,557
Other comprehensive loss	(389,765)		(389,765)
Balance at June 30, 2013	\$ (19,825)	\$ 56,617	\$ 36,792

- (1) Represents the difference between the fair value and amortized cost of securities available for sale.
- (2) Represents changes in the SERP liability due to prior service costs, gains and losses, and amortizations.

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

Forward-Looking Statements

This report contains forward-looking statements that are subject to risks and uncertainties that could cause actual results to differ materially from those reflected in such forward-looking statements, which are representative only on the date hereof. Readers of this report should not rely solely on the forward-looking statements and should consider all uncertainties and risks discussed throughout this report. The Corporation takes no obligation to update any forward-looking statements contained herein. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements include, among others, the following possibilities: (1) competitive pressures among depository and other financial institutions may increase significantly; (2) changes in the interest rate environment may reduce margins; (3) general economic conditions, either nationally or regionally, may be less favorable than expected that could result in a deterioration of credit quality or a reduced demand for credit; and (4) legislative or regulatory changes including changes in accounting standards, may adversely affect the business.

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**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**June 30, 2014**

**General**

We use the term **MainStreet** or **Corporation** to refer to MainStreet BankShares, Inc. We use the term **Bank** or **Franklin Bank** to refer to Franklin Community Bank, National Association. We use **we**, **us**, or **our** to refer to the consolidated businesses of the Corporation and its subsidiaries unless the content indicates otherwise. MainStreet was incorporated on January 14, 1999 in the Commonwealth of Virginia and is the bank holding company for Franklin Bank which serves the Franklin County area of Virginia. MainStreet provides a wide variety of banking services through Franklin Bank. Franklin Bank operates as a locally-owned and operated commercial bank emphasizing personal customer service and other advantages incident to banking with a locally owned community bank. It relies on local advertising and the personal contacts of its directors, employees, and shareholders to attract customers and business to the Bank. Franklin Bank has three banking offices in Rocky Mount and Franklin County. MainStreet also has a wholly-owned real estate company, MainStreet RealEstate, Inc. which owns the real estate of the Corporation. MainStreet RealEstate, Inc. owns the Union Hall (Southlake) office of Franklin Bank.

On April 16, 2009, Franklin Bank entered into a formal agreement ( **Agreement** ) with The Comptroller of the Currency ( **OCC** ). The Agreement required Franklin Bank to perform certain actions within designated time frames. The Agreement was intended to demonstrate the Bank's commitment to review/enhance certain aspects of various policies and practices related to credit administration and liquidity. Franklin Bank achieved full compliance with the Agreement. The Agreement was terminated in August 2013.

On June 17, 2009, MainStreet BankShares, Inc. entered into a Memorandum of Understanding ( **MOU** ) with the Federal Reserve Bank of Richmond ( **Federal Reserve** ). The MOU required the bank holding company to utilize its financial and managerial resources to assist Franklin Bank in functioning in a safe and sound manner and restricted MainStreet from conducting various activities. On January 26, 2011, we entered into a new MOU with the Federal Reserve which contained the same terms of the previous MOU (which was terminated) but added provisions regarding compliance with certain laws and regulations. This MOU was terminated in September 2013. There are no longer any restrictions or stipulations attributable to the MOU.

**Critical Accounting Policies**

Our financial statements are prepared in accordance with accounting principles generally accepted in the United States (GAAP). The financial information contained within our statements is, to a significant extent, based on measures of the financial effects of transactions and events that have already occurred. A variety of factors could affect the ultimate value that is obtained either when earning income, recognizing an expense, recovering an asset or relieving a liability.

**Allowance for Loan Losses**

We use historical loss factors, peer comparisons, regulatory factors, concentrations of credit, past dues, and the trend in the economy as factors in determining the inherent loss that may be present in our loan portfolio. Actual losses could differ significantly from the historical factors that we use in estimating risk. The allowance for loan losses reflects our best estimate of the losses inherent in our loan portfolio. The allowance is based on two basic principles of accounting: (i) losses are accrued when they are probable of occurring and are capable of estimation and (ii)



D-36

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Table of Contents

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**June 30, 2014**

losses are accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance. The allowance for loan losses is maintained at a level, which reflects management's best estimate of probable credit losses inherent in the loan portfolio and is, therefore, believed to be appropriate.

The amount of the allowance is based on management's evaluation of the collectability of the loan portfolio, including the nature of the portfolio, credit concentrations, trends in historical loss experience, specific impaired loans, economic conditions and other risks inherent in the portfolio. Management reviews the past due reports and risk-rated loans and discusses individually the loans on these reports with the responsible loan officers. Management uses these tools and provides a quarterly analysis of the allowance based on our historical loan loss experience, risk-rated loans, past dues, concentrations of credit, unsecured loans, loan exceptions, and the economic trend. These are generally grouped by homogeneous loan pools. Impaired loans are reviewed individually to determine possible impairment based on one of the three recognized methods which are fair value of collateral, present value of expected cash flows, or observable market price. A specific reserve is allocated for the amount of the impairment. Although management uses available information to recognize losses on loans, the substantial uncertainties associated with local economic conditions, collateral values, and future cash flows on impaired loans, make it possible that a material change in the allowance for loan losses in the near term may be appropriate. However, the amount of the change cannot be estimated. The allowance is increased by a provision for loan losses, which is charged to expense, and reduced by charge-offs, net of recoveries. Changes in the allowance relating to impaired loans are charged or credited to the provision for loan losses. Past due status is determined based on contractual terms.

Deferred Tax Assets

The Corporation uses the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. If current available information raises doubt as to the realization of the deferred tax assets, a valuation allowance may be established.

Management considers the determination of this valuation allowance to be a critical accounting policy due to the need to exercise significant judgment in evaluating the amount and timing of recognition of deferred tax liabilities and assets, including projections of future taxable income.

These judgments and estimates are reviewed on a continual basis as regulatory and business factors change. A valuation allowance for deferred tax assets may be required if the amounts of taxes recoverable through loss carry backs decline, or if we project lower levels of future taxable income. If such a valuation allowance is deemed necessary in the future, it would be established through a charge to income tax expense that would adversely affect our operating results.

Overview

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We continue 2014 with a low interest rate environment and sluggish loan demand in our market, which has negatively impacted our net interest margin. Despite these continued challenges, we are pleased to report a decrease in our nonperforming assets and a moderate increase in our loan portfolio as compared to year end 2013. We continue to maintain an aggressive posture in resolving our problem assets. We believe this strategy will strengthen the Corporation's position and prepare us for future growth.

Total assets at June 30, 2014 were \$166.3 million compared to \$169.0 million at year-end December 31, 2013, a decline of \$2.7 million. Our balance sheet has declined since year-end due to our continued strategy to lower our deposit costs. At June 30, 2014, loans, net of unearned deferred fees and costs, increased \$2.9 million from year-end

D-37

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**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****June 30, 2014**

2013. Our overall strategy for 2014 also includes loan growth in an effort to improve our net interest margin and increase our net income. Despite the continued effort to resolve our problem credits and sluggish loan demand, our loan portfolio experienced an overall increase. Securities available for sale decreased \$7.7 million from December 31, 2013 primarily due to calls of securities, pay downs on mortgage backed securities, and the transfer of \$5.6 million of municipal bonds into the held to maturity category. Due to the maturity and repayment of all repurchase agreements, we now have additional securities that can be utilized and pledged for other purposes as needed. Deposits decreased \$3.3 million since year end 2013. Our higher cost time deposits have declined since year end 2013. Other real estate owned has declined by \$.5 million since December 31, 2013. Our continued aggressive approach to rid our balance sheet of nonperforming assets has worked as our balance in other real estate owned has declined to a balance of \$218,340. The intentional shrinkage in our balance sheet has had a positive impact on our capital ratios. Total cash and cash equivalents decreased from year-end 2013 by \$2.3 million. Liquidity continues to be an important focus for our Corporation during these tumultuous times and our liquid assets were 24.29% of total liabilities at June 30, 2014 which remains strong. We monitor our liquidity daily to ensure we have prudent levels of liquidity while we strive to lower our deposit costs. This strategy also resulted in a lowering of our overall interest bearing deposits. We maintained our core relationships as can be evidenced by the stability in demand deposits, which are our free funds.

We continue to focus on our asset quality due to the elevated level of nonperforming loans, criticized and classified assets, economic uncertainty and unemployment levels. Nonperforming loans decreased \$2.3 million from year end 2013 to June 30, 2014. Nonaccrual loans decreased by \$1.0 million during the first six months of 2014. Troubled debt restructurings (not on nonaccrual) decreased by \$1.2 million during the first six months of 2014. Other impaired loans decreased by \$60,000 in the first half of 2014. Our loans rated special mention or worse (excluding troubled debt restructurings and those in nonaccrual status) increased at June 30, 2014 as compared to year end 2013 in the amount of \$2.2 million. We transferred \$249,016 of loans into other real estate and other repossessed assets during the first six months of 2014. Our other real estate properties have declined to \$218,340 at June 30, 2014 compared to \$728,163 at December 31, 2013. A substantial amount of our foreclosed properties have been sold as of June 30, 2014. We continue to take an aggressive approach to our other real estate properties to rid our balance sheet of nonperforming assets.

Total shareholders' equity was \$24.8 million at June 30, 2014. MainStreet and Franklin Bank were well capitalized at June 30, 2014 under bank regulatory capital classifications. The book value of shareholders' equity at June 30, 2014 was \$14.47 per share.

Our year-to-date net income at June 30, 2014 was \$597,736, or \$.35 per common basic share. This net income equated to an annualized return on average assets of 0.73% and an annualized return on average shareholders' equity of 4.93%. The net loss for the same period in 2013 was \$(99,683), or \$(.06) per common basic share. This net income equated to an annualized return on average assets and annualized return on average shareholders' equity of (.11%) and (.82%), respectively. Credit related expenses such as the provision for loan losses, realized losses on sales of other real estate properties, impairment losses on other real estate properties, and loss of interest on nonaccrual loans continue to negatively impact our operating results, although to a lesser extent than the prior year. In addition, the lack of loan volume has negatively impacted loan fee income and interest income. Provision expense, other real estate and repossession expenses, write downs and losses on sales together accounted for \$85,850 and \$1,357,501 in expense for the six month periods ending June 30, 2014 and June 30, 2013, respectively.

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Net income for the second quarter of 2014 was \$349,510, or \$.20 per common basic share as compared to a net loss in the amount of \$(335,540), or \$(.20) per common basic share for the second quarter of 2013. Provision expense, other real estate and repossession expenses, write downs and losses on sales together accounted for \$8,605 and \$1,107,658 for the quarters ended June 30, 2014 and 2013, respectively. Credit related issues continue to have a negative impact on our Corporation's net income.

D-38

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Table of Contents

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**June 30, 2014**

Results of Operations

Net interest income is the difference between total interest income and total interest expense. The amount of net interest income is determined by the volume of interest-earning assets, the level of interest rates earned on those assets, and the cost of supporting funds. The difference between rates earned on interest-earning assets and the cost of supporting funds is measured by the net interest margin.

Net interest income for the six month periods ending June 30, 2014 and 2013 was \$3,045,725 and \$3,139,778, respectively, a modest decrease of \$94,053, or 3.00%. Both interest income and interest expense dollars dropped in comparison to last year, primarily due to volume and the lowering of deposit costs. The decline in interest income was also due to lost interest income on continued elevated levels of nonaccrual loans. For the six months ending June 30, 2014 and 2013, the net interest margin was 3.89% and 3.72%, respectively, a 17 basis point increase. The yield on interest earning assets for the year-to-date period ending June 30, 2014 was 4.37% compared to 4.38% for the year-to-date period ending June 30, 2013, a decrease of 1 basis point. However, the funding side of the interest margin also dropped during this time period by a favorable 18 basis points in the year-to-year comparison. The maturity and repayment of our repurchase agreements has had a positive impact on our net interest margin. We engaged a consultant to assist us in the lowering of our deposit costs. We have realized the positive impact of our strategic effort.

The yield on interest earning assets has declined due to the interest rate environment, sluggish loan demand reducing loan fee income, and continued lost interest on nonaccrual loans. Lost interest for the six month periods ending June 30, 2014 and 2013 was \$96,422 and \$86,942, respectively. Lost interest for the three month periods ending June 30, 2014 and 2013 was \$43,247 and \$54,118, respectively. Franklin Bank's growth is also quite dependent on the recovery in consumer and real estate based lending and there is concern over the timing of recoveries in these markets given the current economic environment. Franklin Bank's future growth and earnings may be negatively affected if real estate and consumer based markets remain depressed or deteriorate further.

The low interest rate environment continues with the Federal Reserve leaving short-term interest rates within a range of 0% - .25%. This low rate environment has been in effect since 2008. In determining how long to maintain the current target range, the Federal Reserve will assess progress towards its objectives of maximum employment and 2% inflation. It is anticipated that it will likely be appropriate to maintain the current target rate for a considerable time after the asset purchase program ends, especially if projected inflation runs below the 2% longer-run goal. It is also anticipated that economic conditions may for some time warrant keeping the target rate below levels the Federal Reserve views as normal in the longer run. Franklin Bank has a portfolio of variable rate loans. A rising interest rate environment generally has a positive impact on the net interest margin because deposits rates are slower to increase. Although low interest rates have been beneficial for our cost of funds, with prime presently at 3.25% which is the interest rate basis for many of our loans, MainStreet's net interest margin has been adversely affected by the prolonged, recessionary low interest rate environment.

The net interest margin and net interest income have shown improvement with the maturity of our repurchase agreements. The rates on these repurchase agreements were above current market rates. Of these repurchase agreements, \$7.5 million matured in September 2012 and \$6.0 million matured in early January 2013.

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Net interest income for the three month periods ending June 30, 2014 and 2013 was \$1,551,797 and \$1,546,133, respectively, a modest increase of \$5,664, or .37%. This equated to a net interest margin of 3.96% and 3.60% at June 30, 2014 and 2013, respectively.

### Provision for Loan Losses

A provision for loan losses is charged to earnings for the purpose of establishing an allowance for loan losses that is maintained at a level which reflects management's best estimate of probable credit losses inherent in the loan portfolio and is, therefore, believed to be appropriate. The amount of the allowance is based on management's

D-39

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**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****June 30, 2014**

evaluation of the collectability of the loan portfolio, including the nature of the portfolio, credit concentrations, trends in historical loss experience, specific impaired loans, economic conditions, and other risks inherent in the portfolio. Management reviews the past due reports and risk ratings and discusses individually the loans on these reports with the responsible loan officers. Management provides a detailed quarterly analysis of the allowance based on homogenous loan pools, identifying impairment, historical losses, credit concentrations, economic conditions, and other risks. As the allowance is maintained losses are, in turn, charged to this allowance rather than being reported as a direct expense.

Our methodology for determining the allowance is based on two basic principles of accounting as follows: i) losses are accrued when they are probable of occurring and are capable of estimation and (ii) losses are accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance. Our analysis is based on an individual review of all credits rated Pass/Watch and lower in our risk rating system by account officers in addition to a review of management information system reports on numerous portfolio segments. The analysis of the allowance is solely based on historical and qualitative factors with historical losses adjusted to higher factors for our criticized and classified loans compared to similar banks with comparable real estate concentrations nationally. Our process allows loan groups to be identified and properly categorized. Our impaired loans are individually reviewed to determine possible impairment based on one of three recognized methods which are fair value of collateral, present value of expected cash flows, or observable market price. A specific reserve is then allocated for the amount of the impairment. Impairment is defined as a loan in which we feel it is probable (meaning likely, not virtually certain) that we will be unable to collect all amounts due under the contractual terms of the loan agreement. Possible loss for loans risk rated special mention or lower are then allocated based on a historical loss migration and adjusted for qualitative factors. Remaining loans are pooled based on homogenous loan groups and allocated based on Franklin Bank's historical net loss experience. These pools are as follows: 1) commercial loans; 2) construction and land development; 3) residential 1-4 family first liens; 4) residential 1-4 family junior liens; 5) home equity lines; 6) commercial real estate; and 7) consumer loans. Historical loss is calculated based on a twelve-quarter average history. Historical net loss data is adjusted and applied to pooled loans based on qualitative factors. We utilize the following qualitative factors: 1) changes in the value of underlying collateral such as loans not conforming to supervisory loan to value limits; 2) national and local economic conditions; 3) changes in portfolio volume and nature such as borrower's living outside our primary trade area; 4) changes in past dues, nonaccruals; and 5) quality and impact and effects of defined credit concentrations. The methodology has continued to evolve as our company has grown and our loan portfolio has grown and become more diverse.

Provision expense for the first six months of 2014 was \$86,872 as compared to \$1,252,502 for the first six months of 2013. Our loan portfolio, net of unearned deferred fees and costs, increased \$2.9 million or 2.34% from year-end 2013. Gross charge-offs year-to-date 2014 were \$313,583 compared to \$972,785 year-to-date 2013. We transferred \$249,016 from loans to other real estate and other repossessed assets during the year-to-date period ending June 30, 2014. The allowance for loan losses was \$2.2 million at June 30, 2014 and \$2.4 million at December 31, 2013, a minimal decrease of \$.2 million, which is discussed below. The allowance for loan losses was 1.77% and 1.92% of loans net of unearned deferred fees and costs at June 30, 2014 and December 31, 2013, respectively. Our criticized and classified loans that are evaluated by historical loss migration increased \$2,178,197 at June 30, 2014 compared to year-end 2013. The loans evaluated collectively by pools increased \$2.9 million at June 30, 2014 versus December 31, 2013. Impaired loans evaluated individually were \$3.7 million and \$6.0 million at June 30, 2014 and December 31,



2013, respectively, with specific reserves of \$331,195 and \$575,926, respectively. The relatively unchanged balance in the allowance for loan losses from year end 2013 was primarily due to decreased specific reserves on nonaccrual loans and minimal reduced allocations on loan volumes evaluated collectively by pools in the amount of \$38,729, all offset by an increase in adversely rated loans. The primary factors contributing to the minimal reduction in loans evaluated collectively by pools are percentages due to historical charge offs and the level of past dues and nonaccruals present in the loan portfolio. There were no changes in the economy or second trade area factors. Despite a decrease in our past dues and nonaccrual loans, the level of adversely rated credits increased primarily due to one credit in the amount of \$1.2 million which was reported as a troubled debt restructuring (not on nonaccrual) at year end, but is considered a special mention credit at June 30, 2014. The ratio of the allowance for

D-40

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****June 30, 2014**

loan losses to loans, net of unearned fees and costs actually declined due to the increase in the loan portfolio since year end 2013. The allowance for loan losses was not replenished by the full \$313,583 of gross charge offs because approximately \$90,000 of that total gross charge off amount was provided for in our allowance for loan losses at year-end 2013 as a specific reserve. An unallocated amount of \$30,000 was included in the reserve at June 30, 2014, but there was no unallocated amount at December 31, 2013. Net charge-offs of \$220,931 and \$937,606 for the first six months of 2014 and 2013 equated to .35% and 1.44%, respectively, of average loans outstanding net of unearned income and deferred fees. The amount of charge-offs can fluctuate substantially based on the financial condition of the borrowers, business conditions in the borrower's market, collateral values and other factors which are not capable of precise projection at any point in time.

Provision expense for the second quarter of 2014 and 2013 was \$13,384 and \$1,064,897, respectively. The allowance for loan losses was \$2.2 million at June 30, 2014 and \$2.4 million at March 31, 2014. The allowance for loan losses was 1.77% and 1.86% of loans net of unearned at June 30, 2014 and March 31, 2014, respectively. Our criticized and classified loans that are evaluated by historical loss migration increased \$1.4 million at June 30, 2014 compared to prior quarter end. The loans evaluated collectively by pools decreased \$.4 million at June 30, 2014 versus March 31, 2014. Impaired loans evaluated individually were \$3.7 million and \$4.3 million at June 30, 2014 and March 31, 2014, respectively, with specific reserves of \$331,195 and \$481,885, respectively. The relatively unchanged balance in the allowance for loan losses from the end of the first quarter of 2014 was primarily due to decreased specific reserves on nonaccrual loans and reduced allocations on loan volumes evaluated collectively by pools, all offset by an increase in adversely rated loans. Gross charges offs and recoveries for the second quarter of 2014 were \$150,525 and \$30,192, respectively. Net charge-offs of \$120,333 for the second quarter of 2014 equated to .38%, of quarterly average loans outstanding net of unearned income and deferred fees.

Following is a breakdown of our nonperforming loans by balance sheet type which includes nonaccrual loans, loans past due 90 days and still accruing, troubled debt restructurings (not on nonaccrual), and other impaired loans.

	June 30, 2014	December 31, 2013
Commercial	\$ 614,669	\$ 725,863
Real Estate:		
Construction and land development	422,715	576,552
Residential 1-4 families:		
First liens	470,214	1,130,961
Junior liens	132,380	182,170
Home equity loans	69,950	71,338
Commercial real estate	2,033,393	3,308,733
Consumer		
<b>Total Nonperforming Loans</b>	<b>\$ 3,743,321</b>	<b>\$ 5,995,617</b>

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Total nonperforming loans decreased in the amount of \$2,252,296 or 37.57% at June 30, 2014 as compared to December 31, 2013. Nonaccrual loans (included in the impaired loans above) were \$2,972,011 and \$4,005,618 at June 30, 2014 and December 31, 2013, respectively, which represented 2.35% and 3.24%, respectively, of loans, net of unearned deferred fees and costs. Management considers these loans impaired along with loans 90 days or more past due and still accruing, troubled debt restructurings (not on nonaccrual), and other impaired loans. Loans once considered impaired are included in the reserve, but if well collateralized, no specific reserve is allocated for them. Please refer to Note 4 to the financial statements for a breakdown of the allowance by category, specific reserves by category, and impaired loans by category. Note 4 also gives information related to which categories of loans and dollar amounts had specific reserves allocated. At June 30, 2014 loans secured by commercial real estate were the largest category of impaired loans at \$2.0 million. At December 31, 2013 loans secured by commercial real estate were the largest category of impaired loans at \$3.3 million. Commercial loans were the next largest of the impaired loan categories at June 30, 2014 at \$.6 million. Residential 1-4 family first liens were the next largest of the impaired loan categories at December 31, 2013 at \$1.1 million.

D-41

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****June 30, 2014**

Many of the asset quality issues in our loan portfolio are the result of our borrowers having to sell various real estate properties to repay the loan. In order to sell the properties and repay the loan, there must be buyers in the marketplace to acquire the properties. Our market, mainly real estate, continues to produce few buyers. In addition, borrowers incomes have been reduced which increases their debt to income ratio. The overall economy in Franklin County has shown little improvement over the last year. We continue to struggle with high unemployment, a continued slowing of building activity, a slowing of transportation and warehousing, and excessive supply of real estate in the Smith Mountain Lake resort area as discussed below. There is continued economic pressure on consumers and business enterprises and unemployment is at 5.2% (March 2014 data), down from 5.4% at February 28, 2014. Absorption analysis in our market place shows increased turnover rates for various inventories over historical levels. Data obtained also revealed declines in real estate values based on listing prices to selling price. Locally and nationally there has been an overall loss of wealth in real estate and equities. Smith Mountain Lake is a core area for development in Franklin County. It is a resort area and largely follows the national trend rather than the local trend and has been particularly adversely affected as a result. Until unemployment declines and consumer confidence increases, these trends may continue. While we continue to address our asset quality issues and have shown great improvement, no assurance can be given that continuing adverse economic conditions or other circumstances will not result in increased provisions in the future.

Noninterest Income

Total noninterest income was \$448,321 and \$601,594 for the six months ending June 30, 2014 and 2013, respectively, a decrease of \$153,273, or 25.48%. The following chart demonstrates the categories of change:

Noninterest Income	YTD 6/30/14	YTD 6/30/13	Dollar Change	Percentage Change
Service charges on deposit accounts	\$ 121,838	\$ 129,205	\$ (7,367)	(5.70)%
Mortgage commissions	54,026	151,543	(97,517)	(64.35)
Electronic card fees	87,557	91,934	(4,377)	(4.76)
Investment fee income	107,987	89,998	17,989	19.99
Income on bank owned life insurance	27,952	18,972	8,980	47.33
Gain on securities sold/called		47,194	(47,194)	(100.00)
Other fee income & miscellaneous	48,961	72,748	(23,787)	(32.70)

As noted above, total noninterest income decreased \$153,273 for the six months ending June 30, 2014 compared to the six months ending June 30, 2013. Service charges on deposit accounts decreased \$7,367 in the year to year comparison. This decrease is primarily due to a decrease in NSF charges, returned deposit item fees, and miscellaneous service charges on accounts, all offset by increases in demand deposit service charges, business account charges, and a decline in demand deposit charge-offs. Mortgage commissions decreased in the year to year comparison by \$97,517, or 64.35%. Mortgage volumes have decreased in part by the economic environment and additional regulatory enactments. Franklin Bank partners with several organizations in which we originate residential mortgage loans that are sold to other companies. Franklin Bank receives the mortgage commission. With applications

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taken prior to mid-May of this year, we would close some mortgage loans in our name and then sell them to our partners within a short period of days. Beginning in mid-May, Franklin Bank no longer closes mortgage loans in our name for resale. Our partners provide the underwriting of the loans.

Electronic card fees experienced a decrease of \$4,377 or 4.76% for the six months ended June 30, 2014 as compared to June 30, 2013. Franklin Bank has an investment advisor which partners with Infinex Financial Group to advise

D-42

**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****June 30, 2014**

and manage investment portfolios for our clients. Franklin Bank receives fee income from this partnership based upon volume. Fee income received on investment income during the first six months of 2014 and 2013 was \$107,987 and \$89,998, respectively, an increase of \$17,989, or 19.99%. Franklin Bank has bank owned life insurance on the life of one of its current executive officers. Prior to the death of Larry Heaton in December 2012, Franklin Bank insured the lives of two executive officers. The balance at June 30, 2014 was \$1.9 million. Income on this investment increased \$8,980 or 47.33% compared to the prior year due to the purchase of an additional policy in late 2013. There were no gains on securities sold or called during the six months ending June 30, 2014. Other fee income and miscellaneous income experienced a decrease of \$23,787, or 32.70%. This decrease is primarily due to a decrease in title fee income and miscellaneous income, all offset by small increases in wire fee charges and checkbook charges. Title fee income decreased by \$10,301 in the year to year comparison. Title fee income is generated from a small interest purchased in a title insurance company by Franklin Bank. Franklin Bank elected to present assets and liabilities related to derivatives on its mortgage loans held for sale on a gross basis. Derivatives in a gain position were recorded as other assets and those in a loss position were recorded as other liabilities, with the offset being miscellaneous income and miscellaneous expense, respectively. This quarterly entry caused fluctuations in these accounts. Since Franklin Bank no longer closes its mortgage loans in its name to sell within a short period of days, there is no longer a mortgage loan derivative recorded as of June 30, 2014. A decrease to miscellaneous income was experienced in the amount of \$16,358 in the year to year comparison as a result of changes in mortgage derivative assets.

Total noninterest income was \$237,482 and \$335,715 for the three months ending June 30, 2014 and 2013, respectively, a decrease of \$98,233 or 29.26%. The following chart demonstrates the categories of change:

Noninterest Income	QTD 6/30/14	QTD 6/30/13	Dollar Change	Percentage Change
Service charges on deposit accounts	\$ 64,758	\$ 59,217	\$ 5,541	9.36%
Mortgage commissions	30,559	77,557	(46,998)	(60.60)
Electronic card fees	47,651	48,168	(517)	(1.07)
Investment fee income	56,640	48,754	7,886	16.18
Income on bank owned life insurance	14,115	9,533	4,582	48.06
Gain on securities sold/called		47,194	(47,194)	(100.00)
Other fee income & miscellaneous	23,759	45,292	(21,533)	(47.54)

Service charges on deposit accounts increased primarily due to an increase in NSF fee income. There were no gains on securities sold/called during the quarter ended June 30, 2014. The same comments concerning noninterest income in the year to year comparison are applicable to the quarterly comparisons of noninterest income for all other categories. Overall noninterest income decreased in four of the categories and increased in three of the categories.

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****June 30, 2014**Noninterest Expense

Total noninterest expense was \$2,535,175 and \$2,669,683 for the six month period ending June 30, 2014 and 2013, respectively, a decrease of \$134,508, or 5.04%. Excluding the nonrecurring expenses of other real estate and repossessions, noninterest expense decreased \$28,487, or 1.11%. The following chart shows the categories of noninterest expenses for the six month periods ending June 30, 2014 and 2013, the dollar change, and the percentage change:

Noninterest Expense	YTD 6/30/14	YTD 6/30/13	Dollar Change	Percentage Change
Salaries and employee benefits	\$ 1,416,856	\$ 1,341,604	\$ 75,252	5.61%
Occupancy and equipment	380,475	379,430	1,045	0.28
Professional fees	115,544	119,514	(3,970)	(3.32)
Outside processing	161,434	208,848	(47,414)	(22.70)
FDIC Assessment	59,868	104,795	(44,927)	(42.87)
Franchise tax	118,250	108,000	10,250	9.49
Regulatory examination fees	33,823	52,607	(18,784)	(35.71)
Other real estate and repossessions	(1,022)	104,999	(106,021)	(100.97)
Other expenses	249,947	249,886	61	0.02

MainStreet's employees continue to be its most valuable resource and asset. Salaries and employee benefits expense comprise the largest category of noninterest expense at 55.89% and 50.25%, respectively, of total noninterest expense for the six month periods ending June 30, 2014 and 2013. Salaries and employee benefits increased \$75,252 or 5.61% in the first six months of 2014 as compared to the first six months of 2013. Of this increase, total salaries increased \$63,257 and employee benefits increased \$11,995. Commissions were only paid to mortgage and investment personnel. Referral fees were also paid to employees for mortgage and investment referrals. The primary contributor to the increase in employee benefits was an increase in supplemental executive retirement plan expense. Occupancy and equipment costs include rent, utilities, janitorial service, repairs and maintenance, real estate taxes, equipment rent, service maintenance contracts and depreciation expense. This category increased a nominal amount of \$1,045 or .28% in the year to year comparison. Professional fees include fees for audit, legal, and other professional fees and showed a \$3,970 decrease in comparing the six months ended June 30, 2014 to the same period in 2013. Outside processing expenses decreased \$47,414 or 22.70% in the year to year comparison primarily due to a decrease in data processing fees. FDIC assessment declined \$44,927 or 42.87% due to changes in the factors used in the calculation of the assessment and an overall decline in our asset base. However, the overall premium is still burdensome. The turmoil in the financial services industry resulted in the need to increase prepaid FDIC insurance premiums 3 years ago to sustain the insurance fund. Depending on the length and depth of the recessionary environment, there could be additional increased prepaid assessments depending on the health of the financial services sector. Franchise tax increased by \$10,250 in the year to year comparison primarily due to anticipated increases in capital and a reduction of other real estate owned. Regulatory examination fees decreased \$18,784 in the first six months of 2014 as compared to the first six months of 2013. With the termination of the formal agreement with the OCC, the surcharge on our regulatory assessment fee is no longer applicable. Other real estate and repossessions are nonrecurring

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expenses in the category of noninterest expense. The losses, write-downs and expenses associated with our other real estate properties experienced a decrease of \$106,021, or 100.97%, compared to the same period in 2013. The Company continues to take an aggressive approach to disposing of its other real estate properties to rid its balance sheet of nonperforming assets. As of June 30, 2014 our other real estate owned balance has declined to \$218,340. Other expenses increased nominally in the amount of \$61 in the year to year comparison.

D-44



**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****June 30, 2014**

Total noninterest expense was \$1,263,368 and \$1,340,313 for the three month periods ending June 30, 2014 and 2013, respectively, a decrease of \$76,945 or 5.74%. Excluding the nonrecurring expenses of other real estate and repossessions, noninterest expense decreased \$29,405 or 2.27%. The following chart shows the categories of noninterest expenses for the three month periods ending June 30, 2014 and 2013, the dollar change, and the percentage change:

Noninterest Expense	QTD 6/30/14	QTD 6/30/13	Dollar Change	Percentage Change
Salaries and employee benefits	\$ 708,692	\$ 677,275	\$ 31,417	4.64%
Occupancy and equipment	184,168	189,243	(5,075)	(2.68)
Professional fees	61,735	59,373	2,362	3.98
Outside processing	76,435	104,055	(27,620)	(26.54)
FDIC Assessment	32,321	50,866	(18,545)	(36.46)
Franchise tax	59,000	54,000	5,000	9.26
Regulatory examination fees	11,274	26,304	(15,030)	(57.14)
Other real estate and repossessions	(4,779)	42,761	(47,540)	(111.18)
Other expenses	134,522	136,436	(1,914)	(1.40)

Overall, the same explanations for the year to date comparisons are applicable to the quarterly comparisons of noninterest expense. Noninterest expense increased in three of the categories and decreased in six of the categories.

**Income Taxes**

MainStreet is subject to both federal and state income taxes. Franklin Bank is not subject to state income taxes. A bank in Virginia is required to pay a franchise tax that is based on the capital of the entity. The liability (or balance sheet) approach is used in financial accounting and reporting for income taxes. Deferred income tax assets and liabilities are computed quarterly for differences between the financial statement and tax basis of assets and liabilities that will result in taxable or deductible amounts in the future. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. No valuation allowances were deemed necessary at June 30, 2014 and December 31, 2013. Income tax expense (benefit) is the tax payable or refundable for the period plus or minus the change during the period in deferred tax assets and liabilities. MainStreet recorded income tax expense and an income tax benefit in the amounts of \$274,263 and \$(81,130) for the six month periods ending June 30, 2014 and June 30, 2013, respectively. MainStreet recorded income tax expense and an income tax benefit in the amounts of \$163,017 and \$(187,822) for the three month periods ending June 30, 2014 and June 30, 2013, respectively.

**BALANCE SHEET****Investment Portfolio**

The Corporation's investment portfolio is used for several purposes as follows:

To maintain sufficient liquidity to cover deposit fluctuations and loan demand.

To use securities to fulfill pledging collateral requirements.

To utilize the maturity/repricing mix of portfolio securities to help balance the overall interest rate risk position of the balance sheet.

To make a reasonable return on investments.

Funds not utilized for capital expenditures or lending are invested in securities of the U.S. Government and its agencies, mortgage-backed securities, municipal bonds, corporate debt securities and certain equity securities. Currently, we have invested in U.S. Agencies, mortgage-backed securities, municipal bonds, corporate debt securities, Federal Reserve Bank stock and Federal Home Loan Bank stock. The value of our investment portfolio is susceptible to the impact of monetary and fiscal policies of the United States, particularly whether and how the

D-45

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****June 30, 2014**

current debate over fiscal issues are resolved. Our mortgage backed securities are either guaranteed by U.S. government agencies or issued by U.S. government sponsored agencies. Our securities portfolio, with the exception of our municipal bonds, was categorized as available for sale at June 30, 2014 and is carried at estimated fair value. Our municipal securities are now categorized as held to maturity and are carried at amortized cost. The unrealized market valuation gains and losses on securities classified as available for sale and the held to maturity transfer adjustment on our municipal bonds are recorded as separate components of shareholders' equity. Please refer to Note 2 of the Notes to Consolidated Financial Statements for the breakdown of the securities available for sale and securities held to maturity portfolios.

Loan Portfolio

We have established a credit policy detailing the credit process and collateral in loan originations. Loans to purchase real estate and personal property are generally collateralized by the related property with loan amounts established based on certain percentage limitations of the property's total stated or appraised value. Credit approval is primarily a function of the credit worthiness of the individual borrower or project based on pertinent financial information, the amount to be financed, and collateral. The loan portfolio was as follows:

	June 30, 2014		December 31, 2013	
Commercial	\$ 10,194,933	8.06%	\$ 9,426,188	7.63%
Real Estate:				
Construction & land development	15,738,882	12.44	16,394,964	13.26
Residential 1-4 families:				
First liens	34,287,121	27.10	33,787,645	27.33
Junior liens	7,079,779	5.59	6,331,233	5.12
Home equity lines	6,746,222	5.33	5,764,941	4.66
Commercial real estate	51,194,330	40.46	50,579,103	40.91
Consumer	1,287,639	1.02	1,353,312	1.09
Total Gross Loans	\$ 126,528,906	100.00%	\$ 123,637,386	100.00%
Unearned deferred fees & costs, net	91,985		86,600	
Recorded Investment	\$ 126,620,891		\$ 123,723,986	

Gross loans increased \$2,891,520, or 2.34% at June 30, 2014 compared to December 31, 2013. As can be seen by the chart above, Franklin Bank has a high concentration in real estate loans. These loans represented 90.92% and 91.28% of gross loans at June 30, 2014 and December 31, 2013, respectively. Accordingly, the Bank took steps to reduce certain concentrations within the real estate loans, including participating loans in our loan portfolio. The loan committee of the board of directors reviews all new loans and renewals of loans within our target concentrations for

approval. During this economic environment, the credit markets have tightened substantially and the real estate market continues to be soft. These and other factors indicate diminished economic activity, higher risk in these loans, and lower loan demand. Moreover, Franklin Bank's current concentration in real estate related loans reduces the Bank's ability to participate in these loan categories. Our loan to deposit ratio for June 30, 2014 was 90.78% compared to 86.63% at December 31, 2013, an increase of 4.15%. We lowered our policy loan to deposit ratio, thus increasing liquidity, and have maintained a lower percentage because of lower loan demand. However, the percentage has increased by 4.15% since year end and will be monitored on an ongoing basis. We will continue to serve our customers, but in doing so will be governed by the necessity of preserving the institution's history of safety and soundness during these difficult economic times.

Our loan portfolio is our primary source of profitability; therefore, our underwriting approach is critical and is designed throughout our policies to have an acceptable level of risk. Cash flow adequacy has always been a necessary condition of creditworthiness. If the debt cannot be serviced by the borrower's cash flow, there must be an additional secondary source of repayment. As we have discussed, many of our loans are real estate based so they are also secured by the underlying collateral, the value of which has been under stress due to economic conditions.

D-46

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**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**June 30, 2014**

We strive to build relationships with our borrowers, so it is very important to continually understand and assess our borrowers' financial strength and condition.

Our credit policy requires that new loans originated must have a maximum loan-to-value of 80% while certain loans have lower limits as follows: raw land (65%); improved land (75%); non-obsolete inventory (60% of value); used automobiles (75% of purchase price); and stock (75%). We do not require mortgage insurance; however, loans exceeding supervisory loan to value limits are one of our qualitative factors in the allowance for loan loss methodology.

Our credit policy requires updated appraisals to be obtained on existing loans whereby collateral value is critical to the repayment of the loan and market value may have declined by 15% or more. In regard to development projects a new appraisal should be obtained when the project sale out rate is less than 25% of the original assumptions documented by the existing appraisal in the file. Development loans must be reviewed at least annually or sooner in a declining real estate cycle. Once an appraisal exceeds 18 months it must be updated and reviewed before additional funding may occur. An appraisal in file may not be used for additional funding under any circumstances after 36 months. Loan account officers prepare criticized loan workout sheets for the Problem Loan Committee on all loans risk rated special mention or lower and any loan delinquent 60 days or more. Account officers who indicate a loan is impaired are required to determine collateral value by one of three recognized methods which are 1) fair value of collateral; 2) present value of expected cash flows; or 3) observable market value. The difference in the collateral value minus estimated selling expenses, the present value of expected future cash flows, or the observable market value as compared to the recorded loan balance is allocated as a specific reserve in the loan loss analysis. Any collateral declines dropping loans below supervisory loan to value limits is included in the qualitative factors based on loan pools in the loan loss analysis.

We continue to review and enhance our credit policies based on economic and environmental changes. We have developed a list of critical exceptions that require additional monitoring of loans which contain them. Financials are required for business and retail loans less than \$35,000 and annual financials are required on all business term loans exceeding \$250,000. Our credit policy requires detailed rent rolls on all commercial income producing properties at origination and renewal. We also require real estate site visits by the originating officer on loans over \$250,000. We believe there is great value in looking at the collateral upon which we are taking a lien. We have eliminated interest only periods for speculative lot loans and require amortization at origination. The bank introduced an interest only home equity line product in late 2013. These new lines require a loan to value of 80% or less with debt to income being calculated at 1.5% of the outstanding balance. Loans must be collateralized by a first or second deed of trust on the primary residence of the borrower. Other banks have similarly tightened credit availability, particularly for real estate related loans. Moreover higher standards for consumer real estate loans under the Dodd-Frank Act further restrict the ability to provide residential loans. Generally this has the effect of reducing qualified buyers for real estate and therefore the value of real estate. This in turn can lead to lower appraisals and additional charge offs within our loan portfolio and other real estate properties as well as increased provision which reduce income.

In addition, we hired an experienced in-house credit analyst and purchased software to assist lenders with cash flow and certain ratio analysis. We also purchased software to assist with the credit ratings of loans upon origination, renewal, and the receipt of new financials. Please refer to Notes #3 and #4 to the financial statements for further

discussion of underwriting and risk ratings of loans.

Approximately 27% of our loan portfolio consists of variable rate loans. Variable rate commercial loans are stressed 2% above the current rate to communicate the impact of potential rate increases to account officers. Retail loans with variable rate features are underwritten 2% over the current rate. Home equity lines are underwritten at 1.5% of the full committed loan amount for debt to income purposes.

We monitor our loan portfolio by the loan segments found in Note #3 of the financial statements. In addition, we look at the trends of significant industries within the loan segments. Loan segments are categorized primarily based

D-47

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****June 30, 2014**

upon regulatory guidelines, which follows the underlying collateral. For the most part, our business activity is with customers located in our primary market area. Accordingly, operating results are closely correlated with the economic trends within the region and influenced by the significant industries in the region including pre-built housing, real estate development, agriculture, and resort and leisure services. In addition, the ultimate collectability of the loan portfolio is susceptible to changes in the market condition of the region. The real estate market in our area, particularly Smith Mountain Lake, is also affected by the national economy because a substantial portion of our lending is real estate based and dependent on buyers who move into our region.

We continue to monitor portfolio concentrations and have established guide limits based on loss exposure and potential impact to capital. Our defined concentration limits are within regulatory guidelines. There are two industry concentrations that are broken out in the tables below by our loan segments. MainStreet does not currently consider its loans for construction of heavy and civil engineering buildings to be a concentration of credit because their total does not exceed 25% of total capital as of June 30, 2014.

June 30, 2014

	Loans for Construction of Buildings	Loans for Real Estate Including Construction	Total
Commercial	\$ 272,156	\$ 182,366	\$ 454,522
Real Estate			
Construction and land development	1,701,443	1,942,138	3,643,581
Residential, 1-4 families			
First Liens	3,321,860	8,788,251	12,110,111
Junior Liens	635,355	452,915	1,088,270
Home Equity Lines	9,597	343,178	352,775
Commercial real estate	2,591,600	24,874,239	27,465,839
Consumer	863	10,763	11,626
Total	\$ 8,532,874	\$ 36,593,850	\$ 45,126,724

December 31, 2013

Loans for Construction of Buildings	Loans for Construction of Heavy & Civil Engineering	Loans for Real Estate Including Construction	Total
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	Buildings			
Commercial Real Estate	\$ 296,178	\$ 687,341	\$ 221,608	\$ 1,205,127
Construction and land development	2,366,758	4,138,105	2,014,334	8,519,197
Residential, 1-4 families				
First Liens	3,666,276	795,653	8,179,695	12,641,624
Junior Liens	529,732		472,819	1,002,551
Home Equity Lines	9,880	34,667	334,442	378,989
Commercial real estate	2,552,156		24,556,483	27,108,639
Consumer	2,735		13,209	15,944
Total	\$ 9,423,715	\$ 5,655,766	\$ 35,792,590	\$ 50,872,071

D-48



**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****June 30, 2014**

Overall, our concentrations decreased nominally from year end to the end of the second quarter of 2014, excluding loans for construction of heavy and civil engineering buildings. We continue to monitor them on an ongoing basis in an effort to control their growth.

Disclosed below are concentrations in acquisition and development loans, speculative lot loans, and speculative single-family housing construction. Some of these amounts are also included in the above concentrations as shown below.

June 30, 2014

	Total Concentration	Concentrations Included Above	Net Addition to Concentrations
Acquisition & development	\$ 491,664	\$ 44,295	\$ 447,369
Speculative lot loans	3,295,859	433,372	2,862,487
Speculative single-family housing construction	3,144,681	569,371	2,575,310

December 31, 2013

	Total Concentration	Concentrations Included Above	Net Addition to Concentrations
Acquisition & development	\$ 455,405	\$	\$ 455,405
Speculative lot loans	4,007,894	3,138,066	869,828
Speculative single-family housing construction	1,971,059	1,399,864	571,195

MainStreet also considers its home equity lines of credit and its 1-4 family residential first and junior liens to be a concentration of credit.

Following is a breakdown of our nonperforming loans and assets.

	For the Periods Ended	
	June 30, 2014	December 31, 2013
Nonaccrual loans and leases	\$ 2,972,011	\$ 4,005,618
Loans past due 90 days or more and still accruing		
Troubled debt restructurings (not on nonaccrual)	771,310	1,929,999

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Other impaired loans		60,000
Total nonperforming loans	3,743,321	5,995,617
Foreclosed real estate	218,340	728,163
Other foreclosed property		
Total foreclosed property	218,340	728,163
Total nonperforming assets	\$ 3,961,661	\$ 6,723,780

Impaired loans totaled \$3,743,321 and \$5,995,617 at June 30, 2014 and December 31, 2013, respectively. Nonaccrual loans decreased \$1,033,607 at June 30, 2014 compared to year end 2013. Troubled debt restructurings (not on nonaccrual) decreased \$1,158,689 from year end 2013. There were no loans past due more than 90 days, and still accruing, at June 30, 2014 or December 31, 2013. Other impaired loans decreased by \$60,000 from December 31, 2013. We are continuing to work with our troubled borrowers. We move quickly to identify and resolve any problem loans. Please refer to Note #4 to the consolidated financial statements for detailed information of nonaccrual loans, impaired loans, and nonperforming assets. Also, please refer to Provision Expense in this Management's Discussion and Analysis.

D-49

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****June 30, 2014**

To ensure timely identification of nonaccrual loans, loan account officers review monthly their individual portfolios along with past due reports to determine the proper accrual status. Account officers also prepare criticized loan workout sheets for all loans risk rated special mention or lower and all loans 60-days or more delinquent are reported to the Franklin Bank's Problem Loan Committee made up of senior management. The accrual status of these loans is reviewed and approved by the Problem Loan Committee. Account officers must attest to the accrual status and risk rating of all loans in their portfolio on a monthly basis. Attestations are presented to and reviewed by the Problem Loan Committee. The criticized loan worksheets are presented to the Problem Loan Committee quarterly. The Committee meets monthly to review updates on these loans along with the attestation sheets completed by the account officers. The criticized loan worksheets were expanded to include a summary of the most recent financial analysis; most recent collateral valuation factoring possible liquidation and timing discount; and enhanced action plans with target dates. Primary and secondary repayment sources are detailed. A dedicated officer now manages our problem assets, although currently on a less than full-time basis due to decreased volumes. A credit analyst performs required financial analysis on all loans \$100,000 and over at origination or renewal and at the receipt of new financial statements. In addition, software was purchased to assist with this process. Software assists the credit analyst and lender in the risk rating of each loan.

We have an internal loan review function that has an annual loan review plan approved by the loan committee and the President. Enhanced reporting includes the overall quality of the loan portfolio; the identification, type, rating, and amount of problem loans; the identification and amount of delinquent loans; credit and collateral documentation exceptions; the identification and status of credit-related violations of law; the loan officer who originated each loan reported; concentrations of credit; and loans to executive officers and directors.

Deposits

Total deposits at June 30, 2014 and December 31, 2013 were \$139,475,153 and \$142,821,438, respectively, a decrease of \$3,346,285, or 2.34%. We continue in 2014 our strategy to lower overall deposit costs, which is discussed in more detail below. The deposit mix was as follows:

	June 30, 2014		December 31, 2013	
Demand deposits	\$ 26,543,867	19.03%	\$ 26,856,990	18.80%
Interest checking deposits	9,290,501	6.66	9,248,249	6.48
Money market deposits	25,891,481	18.57	23,660,000	16.57
Savings deposits	15,947,967	11.43	16,240,448	11.37
Time deposits \$100,000 and over	30,285,261	21.71	29,977,151	20.99
Other time deposits	31,516,076	22.60	36,838,600	25.79
<b>Total</b>	<b>\$ 139,475,153</b>	<b>100.00%</b>	<b>\$ 142,821,438</b>	<b>100.00%</b>

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The largest component of deposits continues to be time deposits including those \$100,000 and over representing 44.31% of total deposits at June 30, 2014 compared to 46.78% at December 31, 2013. As a percentage of total deposits, the mix continues to change somewhat. The levels and mix of deposits are influenced by such factors as customer service, interest rates paid, service charges, and the convenience of banking locations. Our core deposit relationships remained as can be seen in the table above. Demand deposits, which do not pay interest, are now 19.03% of total deposits as compared to 18.80% at December 31, 2013. However, the dollar amount of our demand deposits has decreased by a nominal amount since year end 2013. An increase in demand deposits would improve the net interest margin and the total yield on interest bearing deposits. Money market deposits and interest checking accounts each increased as a percentage of total deposits along with the dollar amount. Savings deposits increased nominally as a percentage of total deposits, but have decreased in dollar amount since year end 2013. Money market deposits have increased \$2,231,481 since year end 2013 and as a percentage of total deposits. Our

D-50

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**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**June 30, 2014**

total deposits have decreased \$3.3 million since year end 2013 primarily due to a \$5.0 million decline in our time deposits, offset by a total increase in our lower deposit cost accounts in the amount of \$1.7 million. This is all part of our strategic efforts to lower our deposit costs while maintaining ample liquidity to fill our needs and for contingency planning. As we lowered interest rates, our time deposits especially declined, although at a slower rate than last year, as they experienced a \$5.0 million decrease since year end.

Competition remains strong in our market from other depository institutions. Management attempts to identify and implement the pricing and marketing strategies that will help control the overall cost of deposits and to maintain a stable deposit mix. Our goal has been to strive to gather the whole customer relationship, including deposits and loans, and not just certificates of deposit. We have been successful in lowering our deposit costs and maintaining liquidity. Loan demand has been soft overall, despite our increase in loans since year end, and parallels our deposit strategy. Our strategic plan in 2014 includes continued lowering of our deposit costs to benefit net income, which includes increasing our demand deposits.

The overall cost of interest bearing deposits was .68% and .90%, respectively, for the six months ended June 30, 2014 and June 30, 2013. This decline of 22 basis points is due to the continued monitoring of deposit rates and the rollover of many deposits into lower current market interest rates. We monitor this closely to keep deposit costs low, but to maintain ample liquidity. We are a member of the CDARS programs and of QwickRate.

**Borrowings**

We have several sources for borrowings generally to assist with liquidity. At June 30, 2014 and December 31, 2013, we had no balances outstanding with the Federal Home Loan Bank of Atlanta ( FHLB ), overnight federal funds purchased, or corporate cash management accounts. The FHLB holds a blanket lien on loans secured by commercial real estate and loans secured by 1-4 family first liens, second liens, and equity lines, which provide a source of liquidity to the Corporation. Loans included in these portfolios at June 30, 2014 and December 31, 2013 were \$99,012,164 and \$96,223,160, respectively.

The Bank has an internal Corporate Cash Management account for customers into which excess demand deposit accounts are swept on an overnight basis in order to earn interest. This account is not FDIC insured but the Bank is required to pledge agency funds at 100% towards these balances. The Corporate Cash Management sweep accounts totaled \$0 at June 30, 2014 and December 31, 2013.

**Repurchase Agreements**

The Bank entered into a repurchase agreement with Barclays Capital ( Barclays ) on January 2, 2008 in the amount of \$6,000,000. The repurchase date was January 2, 2013. The interest rate was fixed at 3.57% until maturity or until it was called. Beginning January 2, 2009 the repurchase agreement became callable and could have been called quarterly with prior notice of two business days. Interest was payable quarterly. The repurchase agreement was collateralized by federal agency and agency mortgage backed securities.

**Shareholders Equity**

Total shareholders' equity was \$24,800,161 and \$23,987,541 at June 30, 2014 and December 31, 2013, respectively. Book value per share was \$14.47 and \$14.00 at June 30, 2014 and December 31, 2013, respectively. The maintenance of appropriate levels of capital is a priority and is continually monitored. MainStreet and Franklin Bank are subject to various regulatory capital requirements administered by the federal and state banking agencies. Quantitative measures established by regulations to ensure capital adequacy require MainStreet and Franklin Bank to maintain minimum capital ratios. Failure to meet minimum capital ratios can initiate certain mandatory, and possibly additional discretionary actions by regulators that, if undertaken, could have a material effect on the consolidated financial statements. Also, declining capital can impact the ability of Franklin Bank to grow other assets. The required level of capital can also be affected by earnings, asset quality, and other issues. While

D-51

Table of Contents**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****June 30, 2014**

MainStreet and Franklin Bank were considered well-capitalized under established regulatory classifications at June 30, 2014 and December 31, 2013, in the current economic circumstances, capital resources are a focus for the Corporation. Capital adequacy levels are also monitored to support the Bank's safety and soundness. Should it be necessary or appropriate to obtain additional capital, then the current shareholder base could suffer dilution.

The following are MainStreet's capital ratios at:

	June 30, 2014	December 31, 2013
Tier I Leverage Ratio (Actual)	14.36%	13.62%
Tier I Leverage Ratio (Quarterly Ave.)	14.45	13.59
Tier I Risk-Based Capital Ratio	19.50	18.98
Tier II Risk-Based Capital Ratio	20.75	20.24

Liquidity and Asset Liability Management

Asset liability management functions to maximize profitability within established guidelines for liquidity, capital adequacy, and interest rate risk. It also helps to ensure that there is adequate liquidity to meet loan demand or deposit outflows and interest rate fluctuations. Liquidity is the ability to meet maturing obligations and commitments, withstand deposit fluctuations, fund operations, and provide for loan requests. In this economic environment liquidity remains a concern. MainStreet's material off-balance sheet obligations were primarily loan commitments of the Bank in the amount of \$20,865,780 at June 30, 2014. We have a liquidity contingency plan that provides guidance on the maintenance of appropriate liquidity and what action is required under various liquidity scenarios. Our liquidity is provided by cash and due from banks, interest-bearing deposits, federal funds sold, securities available for sale, and loan repayments. The Bank has overnight borrowing lines available with their correspondent banks, the ability to borrow from the Federal Reserve Bank's discount window, and the ability to borrow long-term and short-term from the Federal Home Loan Bank of Atlanta. At June 30, 2014 and December 31, 2013, we had available credit from borrowing in the amounts of \$47,648,065 and \$43,687,459, respectively. Our ratio of liquid assets to total liabilities at June 30, 2014 and December 31, 2013 was 24.29% and 26.88%, respectively.

Core deposits are the primary foundation for our Corporation's liquidity. Our core deposit relationships remained as can be seen by the stability of our demand deposits. Competition in our markets is strong and customers seek higher interest rates especially during this low interest rate environment. Lines of credit are essential to our business while other funding sources may be utilized. Due to our strategic efforts to reduce deposit costs, total time deposits and savings deposits have decreased from year end 2013; however, interest checking accounts and money market deposits increased over 2013 levels. Demand deposits decreased nominally in the amount of \$313,123 since year end 2013. Total deposits actually decreased \$3.3 million from year end 2013. The shrinkage of the balance sheet has had a positive impact on our capital. We monitor the deposits and our liquidity daily to ensure we have ample liquidity. The Bank is a member of the Certificate of Deposit Account Registry Service (CDARS). This allows us to provide the Bank's depositors with up to \$50 million in FDIC insurance. In a reciprocal transaction, the Bank receives the deposits and forwards them to CDARS and receives deposits back, if wanted. We can also bid on deposits in a one-way buy transactions which would allow for new depositors. CDARS deposits are also considered brokered deposits. Franklin

Bank had accepted brokered deposits, including CDARS deposits, in the amount of \$5.1 million as of June 30, 2014. Franklin Bank became a member of QwickRate in order to bid for internet certificates of deposit as another source of liquidity. At June 30, 2014, Franklin Bank had \$3.4 million in internet certificates of deposit.

Interest rate sensitivity is measured by the difference, or gap, between interest sensitive earning assets and interest sensitive interest bearing liabilities and the resultant change in net interest income due to market rate fluctuations, and the effect of interest rate movements on the market. Management utilizes these techniques to manage interest rate risk in order to minimize change in net interest income with interest rate changes. MainStreet has partnered with Compass Bank using the Sendero model to help measure interest rate risk. The asset liability management



**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****June 30, 2014**

process requires a number of key assumptions. Management determines the most likely outlook for the economy and interest rates measuring the effect on net interest income in a rising and declining 100, 200, 300, and 400 interest rate environment, as applicable. A shock report for these rates along with a ramped approach with each is modeled. With the shock, net interest income is modeled assuming that interest rates move the full rate change in the first month. With the ramp, net interest income is modeled assuming rates move one quarter of the full rate change in each quarter. With this approach, management also reviews the economic value of equity which is the net present value of the balance sheet's cash flows or the residual value of future cash flows ultimately due to shareholders.

The following table demonstrates the percentage change in net interest income from the level prime rate of 3.25% at June 30, 2014 in a rising and declining 100, 200, 300, and 400 basis point interest rate environment, as applicable:

**Net Interest Income Percentage Change From Level Rates**

Rate Shift	Prime Rate	Change From Level	Change from Level Shock
+400 bp	7.25%	4.00%	7.00%
+300 bp	6.25	3.00	5.00
+200 bp	5.25	2.00	4.00
+100 bp	4.25	1.00	2.00
100 bp	2.25	1.00	1.00
200 bp	1.25	1.00	3.00
300 bp	.25	2.00	5.00

MainStreet is sensitive to change in the interest rate environment particularly due to the level of variable rate loans in our loan portfolio, the short-term of fixed rate loans, and the assumed repricing of our interest bearing liabilities. Management seeks to lower the impact on the net interest margin. The addition of floors to segments of our variable rate loan portfolio has contributed significantly to management of the interest income component of our net interest margin. Historically, Franklin Bank has been asset sensitive. However, due to the large amount of repricing deposit liabilities in the near term, the Bank has shifted to a liability sensitive position.

**Inflation**

Most of our assets are monetary in nature and therefore are sensitive to interest rate fluctuations. We do not have significant fixed assets or inventories. Fluctuations in interest rates and actions of the Board of Governors of the Federal Reserve System (FRB), including quantitative easing during the Great Recession, as well as whether and how the fiscal issues confronting the United States are resolved can have a great effect on our profitability. Management continually strives to manage the relationship between interest-sensitive assets and liabilities. MainStreet and Franklin Bank must comply with numerous federal and state laws and regulations. In light of the increasing government involvement in the financial services industry and to address the underlying causes of the recent credit crunch, it is likely that financial institutions like MainStreet and Franklin Bank will have to meet additional legal requirements, all of which add to our cost of doing business. In addition, regulatory concerns over real estate related assets on the balance sheets of financial institutions and liquidity due to deposit fluctuations and other factors are

likely to translate into higher regulatory scrutiny of financial institutions. This could impact MainStreet.

D-53

Table of Contents

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**June 30, 2014**

Stock Compensation Plans

BankShares approved the 2004 Key Employee Stock Option Plan at its Annual Meeting of Shareholders, April 15, 2004. This plan permitted the granting of Incentive and Non-Qualified stock options as determined by BankShares Board of Directors to persons designated as Key Employees of BankShares and its subsidiaries. The Plan terminated on January 21, 2009. Awards made under the Plan prior to and outstanding on that date remain valid in accordance with their terms.

Recent Accounting Developments

In January 2014, the FASB issued ASU 2014-04, *Receivables Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure* (a consensus of the FASB Emerging Issues Task Force). The amendments in this ASU clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. The Corporation is currently assessing the impact that ASU 2014-04 will have on its consolidated financial statements.

In April 2014, the FASB issued ASU 2014-08, *Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity*. The amendments in this ASU change the criteria for reporting discontinued operations while enhancing disclosures in this area. Under the new guidance, only disposals representing a strategic shift in operations should be presented as discontinued operations. Those strategic shifts should have a major effect on the organization's operations and financial results and include disposals of a major geographic area, a major line of business, or a major equity method investment. The new guidance requires expanded disclosures about discontinued operations that will provide financial statement users with more information about the assets, liabilities, income, and expenses of discontinued operations. Additionally, the new guidance requires disclosure of the pre-tax income attributable to a disposal of a significant part of an organization that does not qualify for discontinued operations reporting. The amendments in the ASU are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. The Corporation does not expect the adoption of ASU 2014-08 to have a material impact on its consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers: Topic 606*. This ASU applies to any entity using U.S. GAAP that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The guidance supersedes the revenue recognition requirements in Topic 605, *Revenue Recognition*, most

industry-specific guidance, and some cost guidance included in Subtopic 605-35, Revenue Recognition Construction-Type and Production-Type Contracts . The core principle of the guidance is that an

D-54

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**Table of Contents****MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES****June 30, 2014**

entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To be in alignment with the core principle, an entity must apply a five step process including: identification of the contract(s) with a customer, identification of performance obligations in the contract(s), determination of the transaction price, allocation of the transaction price to the performance obligations, and recognition of revenue when (or as) the entity satisfies a performance obligation. Additionally, the existing requirements for the recognition of a gain or loss on the transfer of nonfinancial assets that are not in a contract with a customer have also been amended to be consistent with the guidance on recognition and measurement. The amendments in this ASU are effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Early adoption is not permitted. The Corporation is currently assessing the impact that ASU 2014-09 will have on its consolidated financial statements.

In June 2014, the FASB issued ASU No. 2014-11, *Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures*. This ASU aligns the accounting for repurchase-to-maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. The new guidance eliminates sale accounting for repurchase-to-maturity transactions and supersedes the guidance under which a transfer of a financial asset and a contemporaneous repurchase financing could be accounted for on a combined basis as a forward agreement. The amendments in the ASU also require a new disclosure for transactions economically similar to repurchase agreements in which the transferor retains substantially all of the exposure to the economic return on the transferred financial assets throughout the term of the transaction. Additional disclosures will be required for the nature of collateral pledged in repurchase agreements and similar transactions accounted for as secured borrowings. The amendments in this ASU are effective for the first interim or annual period beginning after December 15, 2014; however, the disclosure for transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and interim periods beginning after March 15, 2015. Early adoption is not permitted. The Corporation is currently assessing the impact that ASU 2014-11 will have on its consolidated financial statements.

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

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

N/A

D-55

**Table of Contents**

**MAINSTREET BANKSHARES, INC. AND SUBSIDIARIES**

**June 30, 2014**

**Item 4. Controls and Procedures**

MainStreet's principal executive officer and principal financial officer has reviewed MainStreet's disclosure controls and procedures (as defined in 240.13a-15(e) and 240.15d-15(e)) as of the end of the period covered by this quarterly report and based on their evaluation believe that MainStreet's disclosure controls and procedures are effective. There have not been any changes in our internal control over financial reporting that occurred during the period that has materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

N/A

**Item 1A Risk Factors**

N/A

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

N/A

**Item 3. Defaults Upon Senior Securities**

N/A

**Item 4 Mine Safety Disclosures**

N/A

**Item 5. Other Information**

Lisa J. Correll was named as a Director of MainStreet RealEstate, Inc. at MainStreet's regularly scheduled Board meeting on Wednesday, August 6, 2014.

**Item 6. Exhibits**  
See index to exhibits.

D-56



**Table of Contents**

**SIGNATURES**

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: August 11, 2014

By /s/ Brenda H. Smith  
Brenda H. Smith  
President and Chief Executive Officer  
Corporate Secretary

Date: August 11, 2014

By /s/ Lisa J. Correll  
Lisa J. Correll  
Senior Vice President and Chief Financial Officer

D-57

**Table of Contents****Index to Exhibits**

Number	Description of Exhibit
3(i)*	Restated Articles of Incorporation of the Corporation, dated March 6, 2001.
3(ii)	By-laws of the Corporation, dated August 5, 1999 amended February 20, 2001; amended October 16, 2002; amended September 17, 2003; amended July 13, 2005; amended April 20, 2006; and amended October 21, 2009 filed on Form 8-K on October 22, 2009 and herein incorporated by reference.
4.1	Provision in Registrant's Articles of Incorporation and Bylaws defining the Rights of Holders of the Registrant's common stock (included in Exhibits 3.1 and 3.2, respectively).
4.2	2004 Key Employee Stock option Plan filed March 16, 2005 on Form S-8 and herein incorporated by reference.
10.2#	Employment Agreement with Executive Vice President, Brenda H. Smith, dated October 1, 2002, filed with the Corporation's Quarterly Form 10-QSB on November 7, 2002 and herein incorporated by reference. Amendment to employment agreement filed with on Form 8-K on April 24, 2006 and herein incorporated by reference.
10.3	Supplemental Executive Retirement Agreement by and between Franklin Community Bank, N.A. and Larry A. Heaton incorporated by reference to the Corporation's Form 10-KSB filed March 6, 2008.
10.4#	Supplemental Executive Retirement Agreement by and between Franklin Community Bank, N.A. and Brenda H. Smith incorporated by reference to the Corporation's Form 10-KSB filed March 6, 2008.
10.5#	Change in Control Agreement between MainStreet BankShares, Inc. and Lisa J. Correll incorporated by reference to the Corporation's Form 10-KSB filed March 6, 2008.
10.6#	Change in Control Agreement between MainStreet BankShares, Inc., Franklin Community Bank, N.A. and Robert W. Shorter incorporated by reference to the Corporation's Form 10-KSB filed March 6, 2008.
10.7#	Change in Control Agreement between MainStreet BankShares, Inc., Franklin Community Bank, N.A. and Debra B. Scott incorporated by reference to the Corporation's Form 10-KSB filed March 6, 2008.
10.8#	Change in Control Agreement between MainStreet BankShares, Inc., Franklin Community Bank, N.A. and Linda P. Adams incorporated by reference to the Corporation's Form 10-KSB filed March 6, 2008.
10.9	Formal Agreement by and between The Comptroller of the Currency and Franklin Community Bank, National Association dated April 16, 2009 incorporated by reference to the Corporation's Form 8-K filed April 20, 2009.
10.10#	Change in Control Agreement between MainStreet BankShares, Inc., Franklin Community Bank, N.A. and Todd Hammock incorporated by reference to the Corporation's Form 10-K filed March 25, 2014.
10.11#	Change in Control Agreement between MainStreet BankShares, Inc. and Sonya B. Smith incorporated by reference to the Corporation's Form 10-K filed March 25, 2014.
10.12#	Employment Agreement by and between Brenda H. Smith and MainStreet BankShares, Inc. incorporated by reference to the Corporation's Form 8-K filed April 28, 2014.
31.1	Certification of President and Chief Executive Officer, and Corporate Secretary Pursuant to Rule 13a-14(a) or 15(d)-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302

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of the Sarbanes-Oxley Act of 2002.

- 31.2 Certification of Senior Vice President and Chief Financial Officer Pursuant to Rule 13a-14(a) or 15(d)-14(a) under the Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).
- 101 Interactive Data File

\* (Incorporated by reference to the Corporation's Annual Form 10-KSB filed March 15, 2001.)

# Management contract or compensatory plan or agreement required to be filed as an Exhibit to this Form 10-Q.

D-58

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**Table of Contents**

**Exhibit 31.1**

**CERTIFICATIONS**

I, Brenda H. Smith, certify that:

1. I have reviewed this quarterly report on Form 10-Q of MainStreet BankShares, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision; to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in the report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 11, 2014

/s/ Brenda H. Smith  
Brenda H. Smith  
President and Chief Executive Officer  
Corporate Secretary

D-59

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**Table of Contents**

**Exhibit 31.2**

**CERTIFICATIONS**

I, Lisa J. Correll, certify that:

1. I have reviewed this quarterly report on Form 10-Q of MainStreet BankShares, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision; to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in the report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 11, 2014

/s/ Lisa J. Correll

Lisa J. Correll

Senior Vice President and Chief Financial Officer

D-60

**Table of Contents**

**Exhibit 32**

The undersigned, as the chief executive officer and chief financial officer of MainStreet BankShares, Inc., certify that to the best of our knowledge and belief the Form 10-Q for the quarter ended June 30, 2014, fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934 and the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of MainStreet BankShares, Inc. at the dates and for the periods indicated. The foregoing certification is made solely for purposes of 18 USC, Section 1350 of the United States Code and is subject to the knowledge and willfulness qualifications contained in Title 18, Chapter 63, Section 1350(c).

Date: August 11, 2014

/s/ Brenda H. Smith  
Brenda H. Smith  
President and Chief Executive Officer  
Corporate Secretary

Date: August 11, 2014

/s/ Lisa J. Correll  
Lisa J. Correll  
Senior Vice President and Chief Financial Officer

D-61



**Table of Contents**

**APPENDIX E**

**VIRGINIA STOCK CORPORATION ACT**

**ARTICLE 15**

**APPRAISAL RIGHTS**

**Table of Contents**

**Appendix E**

**APPRAISAL RIGHTS**

**Virginia Stock Corporation Act**

**Article 15**

**Appraisal Rights and Other Remedies**

**§ 13.1-729. Definitions.**

In this article:

**Affiliate** means a person who directly or indirectly through one or more intermediaries controls, is controlled by, or is under common control with another person or is a senior executive officer thereof.

**Beneficial shareholder** means a person who is the beneficial owner of shares held in a voting trust or by a nominee on the beneficial owner's behalf.

**Corporation** means the issuer of the shares held by a shareholder demanding appraisal and, for matters covered by §§ 13.1-734 through 13.1-740, includes the surviving entity in a merger.

**Fair value** means the value of the corporation's shares determined:

- a. Immediately before the effectuation of the corporate action to which the shareholder objects;
- b. Using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal; and
- c. Without discounting for lack of marketability or minority status except, if appropriate, for amendments to the articles pursuant to subdivision A 5 of § 13.1-730.

**Interest** means interest from the effective date of the corporate action until the date of payment, at the average rate currently paid by the corporation on its principal bank loans or, if none, at a rate that is fair and equitable under all the circumstances.

**Interested transaction** means a corporate action described in subsection A of § 13.1-730, other than a merger pursuant to § 13.1-719 or 13.1-719.1, involving an interested person in which any of the shares or assets of the corporation are being acquired or converted. As used in this definition:

1. **Beneficial owner** means any person who, directly or indirectly, through any contract, arrangement, or understanding, other than a revocable proxy, has or shares the power to vote, or to direct the voting of, shares; except that a member of a national securities exchange is not deemed to be a beneficial owner of securities held directly or indirectly by it on behalf of another person solely because the member is the record holder of the securities if the member is precluded by the rules of the exchange from voting without instruction on contested matters or matters that may affect substantially the rights or privileges of the holders of the securities to be voted. When two or more persons agree to act together for the purpose of voting their shares of the corporation, each member of the group formed

thereby is deemed to have acquired beneficial ownership, as of the date of the agreement, of all voting shares of the corporation beneficially owned by any member of the group.

2. Interested person means a person, or an affiliate of a person, who at any time during the one-year period immediately preceding approval by the board of directors of the corporate action:

a. Was the beneficial owner of 20% or more of the voting power of the corporation, excluding any shares acquired pursuant to an offer for all shares having voting power if the offer was made within one year prior to the corporate action for consideration of the same kind and of a value equal to or less than that paid in connection with the corporate action;

b. Had the power, contractually or otherwise, to cause the appointment or election of 25% or more of the directors to the board of directors of the corporation; or

**Table of Contents**

c. Was a senior executive officer or director of the corporation or a senior executive officer of any affiliate thereof, and that senior executive officer or director will receive, as a result of the corporate action, a financial benefit not generally available to other shareholders as such, other than:

- (1) Employment, consulting, retirement, or similar benefits established separately and not as part of or in contemplation of the corporate action;
- (2) Employment, consulting, retirement, or similar benefits established in contemplation of, or as part of, the corporate action that are not more favorable than those existing before the corporate action or, if more favorable, that have been approved on behalf of the corporation in the same manner as is provided in § 13.1-691; or
- (3) In the case of a director of the corporation who will, in the corporate action, become a director of the acquiring entity in the corporate action or one of its affiliates, rights and benefits as a director that are provided on the same basis as those afforded by the acquiring entity generally to other directors of such entity or such affiliate.

**Preferred shares** means a class or series of shares whose holders have preference over any other class or series of shares with respect to distributions.

**Record shareholder** means the person in whose name shares are registered in the records of the corporation or the beneficial owner of shares to the extent of the rights granted by a nominee certificate on file with the corporation.

**Senior executive officer** means the chief executive officer, chief operating officer, chief financial officer and anyone in charge of a principal business unit or function.

**Shareholder** means both a record shareholder and a beneficial shareholder.

**§ 13.1-730. Right to appraisal.**

A. A shareholder is entitled to appraisal rights, and to obtain payment of the fair value of that shareholder's shares, in the event of any of the following corporate actions:

1. Consummation of a merger to which the corporation is a party (i) if shareholder approval is required for the merger by § 13.1-718, except that appraisal rights shall not be available to any shareholder of the corporation with respect to shares of any class or series that remain outstanding after consummation of the merger, or (ii) if the corporation is a subsidiary and the merger is governed by § 13.1-719;
2. Consummation of a share exchange to which the corporation is a party as the corporation whose shares will be acquired, except that appraisal rights shall not be available to any shareholder of the corporation with respect to any class or series of shares of the corporation that is not exchanged;
3. Consummation of a disposition of assets pursuant to § 13.1-724 if the shareholder is entitled to vote on the disposition;
4. An amendment of the articles of incorporation with respect to a class or series of shares that reduces the number of shares of a class or series owned by the shareholder to a fraction of a share if the corporation has the obligation or right to repurchase the fractional share so created; or

5. Any other amendment to the articles of incorporation, or any other merger, share exchange or disposition of assets to the extent provided by the articles of incorporation, bylaws or a resolution of the board of directors.

B. Notwithstanding subsection A, the availability of appraisal rights under subdivisions A 1 through A 4 shall be limited in accordance with the following provisions:

1. Appraisal rights shall not be available for the holders of shares of any class or series of shares that is:

a. A covered security under § 18(b)(1)(A) or (B) of the federal Securities Act of 1933, as amended;

b. Traded in an organized market and has at least 2,000 shareholders and a market value of at least \$20 million, exclusive of the value of such shares held by the corporation's subsidiaries, senior executives, directors and beneficial shareholders owning more than 10 percent of such shares; or

c. Issued by an open end management investment company registered with the United States Securities and Exchange Commission under the Investment Company Act of 1940 and may be redeemed at the option of the holder at net asset value.

**Table of Contents**

2. The applicability of subdivision 1 of this subsection shall be determined as of:

a. The record date fixed to determine the shareholders entitled to receive notice of the meeting of shareholders to act upon the corporate action requiring appraisal rights; or

b. The day before the effective date of such corporate action if there is no meeting of shareholders.

3. Subdivision 1 of this subsection shall not be applicable and appraisal rights shall be available pursuant to subsection A for the holders of any class or series of shares who are required by the terms of the corporate action requiring appraisal rights to accept for such shares anything other than cash or shares of any class or any series of shares of any corporation, or any other proprietary interest of any other entity, that satisfies the standards set forth in subdivision 1 of this subsection at the time the corporate action becomes effective.

4. Subdivision 1 of this subsection shall not be applicable and appraisal rights shall be available pursuant to subsection A for the holders of any class or series of shares where the corporate action is an interested transaction.

C. Notwithstanding any other provision of this section, the articles of incorporation as originally filed or any amendment thereto may limit or eliminate appraisal rights for any class or series of preferred shares, but any such limitation or elimination contained in an amendment to the articles of incorporation that limits or eliminates appraisal rights for any of such shares that are outstanding immediately prior to the effective date of such amendment or that the corporation is or may be required to issue or sell thereafter pursuant to any conversion, exchange or other right existing immediately before the effective date of such amendment shall not apply to any corporate action that becomes effective within one year of that date if such action would otherwise afford appraisal rights.

**§ 13.1-731. Assertion of rights by nominees and beneficial owners.**

A. A record shareholder may assert appraisal rights as to fewer than all the shares registered in the record shareholder's name but owned by a beneficial shareholder only if the record shareholder objects with respect to all shares of the class or series owned by the beneficial shareholder and notifies the corporation in writing of the name and address of each beneficial shareholder on whose behalf appraisal rights are being asserted. The rights of a record shareholder who asserts appraisal rights for only part of the shares held of record in the record shareholder's name under this subsection shall be determined as if the shares as to which the record shareholder objects and the record shareholder's other shares were registered in the names of different record shareholders.

B. A beneficial shareholder may assert appraisal rights as to shares of any class or series held on behalf of the shareholder only if such shareholder:

1. Submits to the corporation the record shareholder's written consent to the assertion of such rights no later than the date referred to in subdivision B 2 b of § 13.1-734; and

2. Does so with respect to all shares of the class or series that are beneficially owned by the beneficial shareholder.

**§ 13.1-732. Notice of appraisal rights.**

A. Where any corporate action specified in subsection A of § 13.1-730 is to be submitted to a vote at a shareholders meeting, the meeting notice shall state that the corporation has concluded that shareholders are, are not or may be entitled to assert appraisal rights under this article.

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If the corporation concludes that appraisal rights are or may be available, a copy of this article and a statement of the corporation's position as to the availability of appraisal rights shall accompany the meeting notice sent to those record shareholders entitled to exercise appraisal rights.

B. In a merger pursuant to § 13.1-719, the parent corporation shall notify in writing all record shareholders of the subsidiary who are entitled to assert appraisal rights that the corporate action became effective. Such notice shall be sent within 10 days after the corporate action became effective and include the materials described in § 13.1-734.

C. Where any corporate action specified in subsection A of § 13.1-730 is to be approved by written consent of the shareholders pursuant to § 13.1-657:

1. Written notice that appraisal rights are, are not, or may be available must be given to each record shareholder from whom a consent is solicited at the time consent of such shareholder is first solicited and, if the corporation has concluded that appraisal rights are or may be available, must be accompanied by a copy of this article; and

**Table of Contents**

2. Written notice that appraisal rights are, are not, or may be available must be delivered together with the notice to nonconsenting and nonvoting shareholders required by subsections E and F of § 13.1-657, may include the materials described in § 13.1-734, and, if the corporation has concluded that appraisal rights are or may be available, must be accompanied by a copy of this article.

D. Where corporate action described in subsection A of § 13.1-730 is proposed, or a merger pursuant to § 13.1-719 is effected, the notice referred to in subsection A or C, if the corporation concludes that appraisal rights are or may be available, and in subsection B shall be accompanied by:

1. The annual financial statements specified in subsection A of § 13.1-774 of the corporation that issued the shares that may be subject to appraisal, which shall be as of a date ending not more than 16 months before the date of the notice and shall comply with subsection B of § 13.1-774; provided that, if such annual financial statements are not reasonably available, the corporation shall provide reasonably equivalent financial information; and

2. The latest available quarterly financial statements of such corporation, if any.

E. The right to receive the information described in subsection D may be waived in writing by a shareholder before or after the corporate action.

**§ 13.1-733. Notice of intent to demand payment.**

A. If a corporate action specified in subsection A of § 13.1-730 is submitted to a vote at a shareholders meeting, a shareholder who wishes to assert appraisal rights with respect to any class or series of shares:

1. Must deliver to the corporation before the vote is taken written notice of the shareholder's intent to demand payment if the proposed action is effectuated; and

2. Must not vote, or cause or permit to be voted, any shares of such class or series in favor of the proposed action.

B. If a corporate action specified in subsection A of § 13.1-730 is to be approved by less than unanimous written consent, a shareholder who wishes to assert appraisal rights with respect to any class or series of shares may not sign a consent in favor of the proposed action with respect to that class or series of shares.

C. A shareholder who fails to satisfy the requirements of subsection A or subsection B is not entitled to payment under this article.

**§ 13.1-734. Appraisal notice and form.**

A. If proposed corporate action requiring appraisal rights under § 13.1-730 becomes effective, the corporation shall deliver an appraisal notice and the form required by subdivision B 1 to all shareholders who satisfied the requirements of § 13.1-733. In the case of a merger under § 13.1-719, the parent corporation shall deliver an appraisal notice and form to all record shareholders who may be entitled to assert appraisal rights.

B. The appraisal notice shall be sent no earlier than the date the corporate action specified in subsection A of § 13.1-730 became effective and no later than 10 days after such date and shall:

1. Supply a form that (i) specifies the first date of any announcement to shareholders made prior to the date the corporate action became effective of the principal terms of the proposed corporate action, (ii) if such announcement



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was made, requires the shareholder asserting appraisal rights to certify whether beneficial ownership of those shares for which appraisal rights are asserted was acquired before that date, and (iii) requires the shareholder asserting appraisal rights to certify that such shareholder did not vote for or consent to the transaction;

### 2. State:

a. Where the form must be sent and where certificates for certificated shares must be deposited and the date by which those certificates must be deposited, which date may not be earlier than the date for receiving the required form under subdivision 2 b of this subsection;

b. A date by which the corporation must receive the form which date may not be fewer than 40 nor more than 60 days after the date the subsection A appraisal notice and form were sent, and state that the shareholder shall have waived the right to demand appraisal with respect to the shares unless the form is received by the corporation by such specified date;

E-4

**Table of Contents**

- c. The corporation's estimate of the fair value of the shares;
  - d. That, if requested in writing, the corporation will provide, to the shareholder so requesting, within 10 days after the date specified in subdivision 2 b of this subsection, the number of shareholders who returned the form by the specified date and the total number of shares owned by them; and
  - e. The date by which the notice to withdraw under § 13.1-735.1 must be received, which date must be within 20 days after the date specified in subdivision 2 b of this subsection; and
3. Be accompanied by a copy of this article.

**§ 13.1-735.1. Perfection of rights; right to withdraw.**

A. A shareholder who receives notice pursuant to § 13.1-734 and who wishes to exercise appraisal rights must complete, sign, and return the form sent by the corporation and, in the case of certificated shares, deposit the shareholder's certificates in accordance with the terms of the notice by the date referred to in the notice pursuant to subdivision B 2 b of § 13.1-734. If the form requires the shareholder to certify whether the beneficial owner of such shares acquired beneficial ownership of the shares before the date required to be set forth in the notice pursuant to subdivision B 1 of § 13.1-734, and the shareholder fails to make the certification, the corporation may elect to treat the shareholder's shares as after-acquired shares under § 13.1-738. Once a shareholder deposits that shareholder's certificates or, in the case of uncertificated shares, returns the signed form, that shareholder loses all rights as a shareholder, unless the shareholder withdraws pursuant to subsection B.

B. A shareholder who has complied with subsection A may nevertheless decline to exercise appraisal rights and withdraw from the appraisal process by so notifying the corporation in writing by the date set forth in the appraisal notice pursuant to subdivision B 2 e of § 13.1-734. A shareholder who fails to withdraw from the appraisal process may not thereafter withdraw without the corporation's written consent.

C. A shareholder who does not sign and return the form and, in the case of certificated shares, deposit that shareholder's share certificates where required, each by the date set forth in the notice described in subsection B of § 13.1-734, shall not be entitled to payment under this article.

**§ 13.1-737. Payment.**

A. Except as provided in § 13.1-738, within 30 days after the form required by subsection B 2 b of § 13.1-734 is due, the corporation shall pay in cash to those shareholders who complied with subsection A of § 13.1-735.1 the amount the corporation estimates to be the fair value of their shares plus interest.

B. The payment to each shareholder pursuant to subsection A shall be accompanied by:

1. The (i) annual financial statements specified in subsection A of § 13.1-774 of the corporation that issued the shares to be appraised, which shall be as of a date ending not more than 16 months before the date of payment and shall comply with subsection B of § 13.1-774; provided that, if such annual financial statements are not available, the corporation shall provide reasonably equivalent information, and (ii) the latest available quarterly financial statements of such corporation, if any;

2. A statement of the corporation's estimate of the fair value of the shares, which estimate shall equal or exceed the corporation's estimate given pursuant to subdivision B 2 c of § 13.1-734; and

3. A statement that shareholders described in subsection A have the right to demand further payment under § 13.1-739 and that if any such shareholder does not do so within the time period specified therein, such shareholder shall be deemed to have accepted such payment in full satisfaction of the corporation's obligations under this article.

**§ 13.1-738. After-acquired shares.**

A. A corporation may elect to withhold payment required by § 13.1-737 from any shareholder who was required to, but did not certify that beneficial ownership of all of the shareholder's shares for which appraisal rights are asserted was acquired before the date set forth in the appraisal notice sent pursuant to subdivision B 1 of § 13.1-734.

B. If the corporation elected to withhold payment under subsection A, it shall, within 30 days after the form required by subdivision B 2 b of § 13.1-734 is due, notify all shareholders who are described in subsection A:

1. Of the information required by subdivision B 1 of § 13.1-737;

**Table of Contents**

2. Of the corporation's estimate of fair value pursuant to subdivision B 2 of § 13.1-737 and its offer to pay such value plus interest;

3. That they may accept the corporation's estimate of fair value plus interest in full satisfaction of their demands or demand for appraisal under § 13.1-739;

4. That those shareholders who wish to accept such offer must so notify the corporation of their acceptance of the corporation's offer within 30 days after receiving the offer; and

5. That those shareholders who do not satisfy the requirements for demanding appraisal under § 13.1-739 shall be deemed to have accepted the corporation's offer.

C. Within 10 days after receiving a shareholder's acceptance pursuant to subsection B, the corporation shall pay in cash the amount it offered under subdivision B 2 to each shareholder who agreed to accept the corporation's offer in full satisfaction of the shareholder's demand.

D. Within 40 days after sending the notice described in subsection B, the corporation shall pay in cash the amount it offered to pay under subdivision B 2 to each shareholder described in subdivision B 5.

**§ 13.1-739. Procedure if shareholder dissatisfied with payment or offer.**

A. A shareholder paid pursuant to § 13.1-737 who is dissatisfied with the amount of the payment must notify the corporation in writing of that shareholder's stated estimate of the fair value of the shares and demand payment of that estimate plus interest (less any payment under § 13.1-737). A shareholder offered payment under § 13.1-738 who is dissatisfied with that offer must reject the offer and demand payment of the shareholder's estimate of the fair value of the shares plus interest.

B. A shareholder who fails to notify the corporation in writing of that shareholder's demand to be paid the shareholder's stated estimate of the fair value plus interest under subsection A within 30 days after receiving the corporation's payment or offer of payment under § 13.1-737 or 13.1-738, respectively, waives the right to demand payment under this section and shall be entitled only to the payment made or offered pursuant to those respective sections.

**§ 13.1-740. Court action.**

A. If a shareholder makes a demand for payment under § 13.1-739 that remains unsettled, the corporation shall commence a proceeding within 60 days after receiving the payment demand and petition the court to determine the fair value of the shares and accrued interest. If the corporation does not commence the proceeding within the 60-day period, it shall pay in cash to each shareholder the amount the shareholder demanded pursuant to § 13.1-737 plus interest.

B. The corporation shall commence the proceeding in the circuit court of the city or county where the corporation's principal office, or, if none in the Commonwealth, where its registered office, is located. If the corporation is a foreign corporation without a registered office in the Commonwealth, it shall commence the proceeding in the circuit court of the city or county in the Commonwealth where the principal office, or, if none in the Commonwealth, where the registered office of the domestic corporation merged with the foreign corporation was located at the time the transaction became effective.

C. The corporation shall make all shareholders, whether or not residents of the Commonwealth, whose demands remain unsettled parties to the proceeding as in an action against their shares, and all parties shall be served with a copy of the petition. Nonresidents may be served by registered or certified mail or by publication as provided by law.

D. The corporation may join as a party to the proceeding any shareholder who claims to have demanded an appraisal but who has not, in the opinion of the corporation, complied with the provisions of this article. If the court determines that a shareholder has not complied with the provisions of this article, that shareholder shall be dismissed as a party.

E. The jurisdiction of the court in which the proceeding is commenced under subsection B is plenary and exclusive. The court may appoint one or more persons as appraisers to receive evidence and recommend a decision on the question of fair value. The appraisers shall have the powers described in the order appointing them, or in any amendment to it. The shareholders demanding appraisal are entitled to the same discovery rights as parties in other civil proceedings. There shall be no right to a jury trial.

F. Each shareholder made a party to the proceeding is entitled to judgment (i) for the amount, if any, by which the court finds the fair value of the shareholder's shares plus interest exceeds the amount paid by the corporation to the shareholder for such shares or (ii) for the fair value plus interest of the shareholder's shares for which the corporation elected to withhold payment under § 13.1-738.

**Table of Contents**

**§ 13.1-741. Court costs and counsel fees.**

A. The court in an appraisal proceeding commenced under § 13.1-740 shall determine all costs of the proceeding, including the reasonable compensation and expenses of appraisers appointed by the court. The court shall assess the costs against the corporation, except that the court may assess costs against all or some of the shareholders demanding appraisal, in amounts the court finds equitable, to the extent the court finds such shareholders acted arbitrarily, vexatiously or not in good faith with respect to the rights provided by this article.

B. The court in an appraisal proceeding may also assess the fees and expenses of counsel and experts for the respective parties, in amounts the court finds equitable:

1. Against the corporation and in favor of any or all shareholders demanding appraisal if the court finds the corporation did not substantially comply with the requirements of § 13.1-732, 13.1-734, 13.1-737 or 13.1-738; or

2. Against either the corporation or a shareholder demanding appraisal, in favor of any other party, if the court finds that the party against whom the fees and expenses are assessed acted arbitrarily, vexatiously or not in good faith with respect to the rights provided by this article.

C. If the court in an appraisal proceeding finds that the services of counsel for any shareholder were of substantial benefit to other shareholders similarly situated, and that the fees for those services should not be assessed against the corporation, the court may award to such counsel reasonable fees to be paid out of the amounts awarded the shareholders who were benefited.

D. To the extent the corporation fails to make a required payment pursuant to § 13.1-737, 13.1-738 or 13.1-739, the shareholder may sue directly for the amount owed and, to the extent successful, shall be entitled to recover from the corporation all costs and expenses of the suit, including counsel fees.

**§ 13.1-741.1. Limitations on other remedies for fundamental transactions.**

A. Except for action taken before the Commission pursuant to § 13.1-614 or as provided in subsection B, the legality of a proposed or completed corporate action described in subsection A of § 13.1-730 may not be contested, nor may the corporate action be enjoined, set aside or rescinded, in a legal or equitable proceeding by a shareholder after the shareholders have approved the corporate action.

B. Subsection A does not apply to a corporate action that:

1. Was not authorized and approved in accordance with the applicable provisions of:

a. Article 11 (§ 13.1-705 et seq.), Article 12 (§ 13.1-715.1 et seq.), or Article 13 (§ 13.1-723 et seq.);

b. The articles of incorporation or bylaws; or

c. The resolutions of the board of directors authorizing the corporate action;

2. Was procured as a result of fraud, a material misrepresentation, or an omission of a material fact necessary to make statements made, in light of the circumstances in which they were made, not misleading;

3. Is an interested transaction, unless it has been authorized, approved or ratified by the board of directors in the same manner as is provided in subsection B of § 13.1-691 and has been authorized, approved or ratified by the shareholders in the same manner as is provided in subsection C of § 13.1-691 as if the interested transaction were a director's conflict of interests transaction; or

4. Is adopted or taken by less than unanimous consent of the voting shareholders pursuant to § 13.1-657 if:

a. The challenge to the corporate action is brought by a shareholder who did not consent and as to whom notice of the adoption or taking of the corporate action was not effective at least 10 days before the corporate action was effected; and

**Table of Contents**

b. The proceeding challenging the corporate action is commenced within 10 days after notice of the adoption or taking of the corporate action is effective as to the shareholder bringing the proceeding.

C. Any remedial action with respect to corporate action described in subsection A of § 13.1-730 shall not limit the scope of, or be inconsistent with, any provision of § 13.1-614.

E-8



**Table of Contents****PART II****INFORMATION NOT REQUIRED IN PROSPECTUS****Item 20. Indemnification of Directors and Officers.**

The laws of the Commonwealth of Virginia pursuant to which American National Bankshares Inc. ( American National ) is incorporated permit it to indemnify its officers and directors against certain liabilities with the approval of its shareholders. The articles of incorporation of American National, which have been approved by its shareholders, provide for the indemnification of each director and officer (including former directors and officers and each person who may have served at the request of American National as a director or officer of any other legal entity and, in all such cases, his or her heirs, executors and administrators) against liabilities (including expenses) reasonably incurred by him or her in connection with any actual or threatened action, suit or proceeding to which he or she may be made party by reason of his or her being or having been a director or officer of American National, except in relation to any action, suit or proceeding in which he or she has been adjudged liable because of willful misconduct or a knowing violation of the criminal law.

American National has purchased officers and directors liability insurance policies. Within the limits of their coverage, the policies insure (1) the directors and officers of American National against certain losses resulting from claims against them in their capacities as directors and officers to the extent that such losses are not indemnified by American National and (2) American National to the extent that it indemnifies such directors and officers for losses as permitted under the laws of Virginia.

**Item 21. Exhibits and Financial Statement Schedules.**

The exhibits and financial statement schedules filed as a part of this Registration Statement are as follows:

## (a) List of Exhibits:

<b>Exhibit No.</b>	<b>Description of Exhibit</b>
2.1	Agreement and Plan of Reorganization, dated August 24, 2014, between American National Bankshares Inc. and MainStreet BankShares, Inc. ( MainStreet ), and the related Plan of Merger (filed as Appendix A to the Proxy Statement/Prospectus included in this Registration Statement and incorporated herein by reference).
2.2	Affiliate Agreement, dated as of August 24, 2014, by and among American National, MainStreet and each of the directors and executive officers of MainStreet.*
3.1	Articles of Incorporation of American National, as amended (incorporated herein by reference to Exhibit 3.1 to American National's Current Report on Form 8-K filed July 5, 2011).
3.2	Bylaws of American National, as amended (incorporated herein by reference to Exhibit 3.2 to American National's Current Report on Form 8-K filed April 18, 2014).
4.0	Specimen certificate of American National common stock (incorporated herein by reference to Exhibit 4.1 to American National's Amendment No. 1 to Registration Statement on Form S-4 filed

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March 29, 2011).

- 5.0 Opinion of LeClairRyan, A Professional Corporation ( LeClairRyan ), regarding the legality of the securities being registered.\*
- 8.0 Opinion of LeClairRyan regarding certain tax matters.\*

II-1

**Table of Contents**

<b>Exhibit No.</b>	<b>Description of Exhibit</b>
10.0	Form of Employment Agreement, by and between American National Bank and Trust Company and Brenda H. Smith.*
21.0	Subsidiaries of American National (incorporated herein by reference to Exhibit 21.0 to American National's Annual Report on Form 10-K for the year ended December 31, 2013 filed March 12, 2014).
23.1	Consent of Yount, Hyde & Barbour, P.C., as independent registered public accountants for American National.*
23.2	Consent of Yount, Hyde & Barbour, P.C., as independent registered public accountants for MainStreet.*
23.3	Consent of LeClairRyan (included as part of Exhibit 5.0).
23.4	Consent of LeClairRyan (included as part of Exhibit 8.0).
99.1	Form of proxy card of MainStreet.*
99.2	Consent of BB&T Capital Markets, a division of BB&T Securities, LLC.*

\* Filed herewith.

(b) **Financial Statement Schedules.**

No financial statement schedules are filed because the required information is not applicable or is included in the consolidated financial statements or related notes.

**Item 22. Undertakings.**

(a) The undersigned registrant hereby undertakes:

(1) To file, during any period in which offers or sales are being made, a post-effective amendment to this registration statement:

(i) To include any prospectus required by Section 10(a)(3) of the Securities Act of 1933;

(ii) To reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement. Notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b) if, in the aggregate, the changes in volume and price represent no more than 20% change in the maximum aggregate offering price set forth in the Calculation of Registration Fee table in the effective registration statement;

(iii) To include any material information with respect to the plan of distribution not previously disclosed in the registration statement or any material change to such information in the registration statement.



**Table of Contents**

(2) That, for the purpose of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial, bona fide offering thereof.

(3) To remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering.

(b) The undersigned registrant hereby undertakes that, for purposes of determining any liability under the Securities Act of 1933, each filing of the registrant's annual report pursuant to Sections 13(a) or 15(d) of the Securities Exchange Act of 1934 (and, where applicable, each filing of an employee benefit plan's annual report pursuant to Section 15(d) of the Securities Exchange Act of 1934) that is incorporated by reference in the registration statement shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(c)(1) The undersigned registrant hereby undertakes as follows: that before any public reoffering of the securities registered hereunder through use of a prospectus which is a part of this registration statement, by any person or party who is deemed to be an underwriter within the meaning of Rule 145(c), the issuer undertakes that such reoffering prospectus will contain the information called for by the applicable registration form with respect to reofferings by persons who may be deemed underwriters, in addition to the information called for by the other items of the applicable form.

(2) The registrant undertakes that every prospectus: (i) that is filed pursuant to paragraph (1) immediately preceding, or (ii) that purports to meet the requirements of Section 10(a)(3) of the Act and is used in connection with an offering of securities subject to Rule 415, will be filed as part of an amendment to the registration statement and will not be used until such amendment is effective, and that, for purposes of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof.

(d) Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the registrant pursuant to the foregoing provisions, or otherwise, the registrant has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the registrant of expenses incurred or paid by a director, officer or controlling person of the registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

(e) The undersigned registrant hereby undertakes to respond to requests for information that is incorporated by reference into the prospectus pursuant to Item 4, 10(b), 11, or 13 of this form, within one business day of receipt of such request, and to send the incorporated documents by first class mail or other equally prompt means. This includes information contained in documents filed subsequent to the effective date of the registration statement through the date of responding to the request.

(f) The undersigned registrant hereby undertakes to supply by means of a post-effective amendment all information concerning a transaction, and the company being acquired involved therein, that was not the subject of and included in

the registration statement when it became effective.

II-3

**Table of Contents****SIGNATURES**

Pursuant to the requirements of the Securities Act of 1933, the registrant has duly caused this registration statement to be signed on its behalf by the undersigned, thereunto duly authorized in the City of Danville, Commonwealth of Virginia on October 15, 2014.

**AMERICAN NATIONAL BANKSHARES,  
INC.**

By: /s/ Jeffrey V. Haley  
 Jeffrey V. Haley  
 President and Chief Executive Officer

Pursuant to the requirements of the Securities Act of 1933, this registration statement has been signed by the following persons in the capacities and on the dates indicated. Each person whose signature appears below constitutes and appoints Jeffrey V. Haley and William W. Traynham, and each of them singly, as his true and lawful attorneys-in-fact and agents, with full power of substitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments or post-effective amendments to this registration statement, hereby ratifying and confirming such person's signature as it may be signed by said attorneys to any and all amendments.

<b>Signature</b>	<b>Capacity</b>	<b>Date</b>
/s/ Jeffrey V. Haley Jeffrey V. Haley	President, Chief Executive Officer and Director (principal executive officer)	October 15, 2014
/s/ Charles H. Majors Charles H. Majors	Executive Chairman of the Board Directors	October 15, 2014
/s/ Fred A. Blair Fred A. Blair	Director	October 15, 2014
/s/ Frank C. Crist, Jr. Frank C. Crist, Jr.	Director	October 15, 2014
/s/ Ben J. Davenport, Jr. Ben J. Davenport, Jr.	Director	October 15, 2014
/s/ Michael P. Haley Michael P. Haley	Director	October 15, 2014

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**Table of Contents**

<b>Signature</b>	<b>Capacity</b>	<b>Date</b>
/s/ Charles S. Harris Charles S. Harris	Director	October 15, 2014
/s/ F.D. Hornaday, III F.D. Hornaday, III	Director	October 15, 2014
/s/ John H. Love John H. Love	Director	October 15, 2014
/s/ Franklin W. Maddux Franklin W. Maddux	Director	October 15, 2014
/s/ Claude B. Owen, Jr. Claude B. Owen, Jr.	Director	October 15, 2014
/s/ Dan M. Pleasant Dan M. Pleasant	Director	October 15, 2014
/s/ Robert A. Ward Robert A. Ward	Director	October 15, 2014
/s/ William W. Traynham William W. Traynham	Senior Vice President and Chief Financial Officer (principal financial and accounting officer)	October 15, 2014



**Table of Contents**

**EXHIBIT LIST**

<b>Exhibit No.</b>	<b>Description of Exhibit</b>
2.1	Agreement and Plan of Reorganization, dated August 24, 2014, between American National Bankshares Inc. and MainStreet BankShares, Inc. ( MainStreet ), and the related Plan of Merger (filed as Appendix A to the Proxy Statement/Prospectus included in this Registration Statement and incorporated herein by reference).
2.2	Affiliate Agreement, dated as of August 24, 2014, by and among American National, MainStreet and each of the directors and executive officers of MainStreet.*
3.1	Articles of Incorporation of American National, as amended (incorporated herein by reference to Exhibit 3.1 to American National s Current Report on Form 8-K filed July 5, 2011).
3.2	Bylaws of American National, as amended (incorporated herein by reference to Exhibit 3.2 to American National s Current Report on Form 8-K filed April 18, 2014).
4.0	Specimen certificate of American National common stock (incorporated herein by reference to Exhibit 4.1 to American National s Amendment No. 1 to Registration Statement on Form S-4 filed March 29, 2011).
5.0	Opinion of LeClairRyan, A Professional Corporation ( LeClairRyan ), regarding the legality of the securities being registered.*
8.0	Opinion of LeClairRyan regarding certain tax matters.*
10.0	Form of Employment Agreement, by and between American National Bank and Trust Company and Brenda H. Smith.*
21.0	Subsidiaries of American National (incorporated herein by reference to Exhibit 21.0 to American National s Annual Report on Form 10-K for the year ended December 31, 2013 filed March 12, 2014).
23.1	Consent of Yount, Hyde & Barbour, P.C., as independent registered public accountants for American National.*
23.2	Consent of Yount, Hyde & Barbour, P.C., as independent registered public accountants for MainStreet.*
23.3	Consent of LeClairRyan (included as part of Exhibit 5.0).
23.4	Consent of LeClairRyan (included as part of Exhibit 8.0).
99.1	Form of proxy card of MainStreet.*
99.2	Consent of BB&T Capital Markets, a division of BB&T Securities, LLC.*

\* Filed herewith.