Annual Disclosure Statement

The attached annual report serves as Bank of Tennessee's 2012 Annual Disclosure Statement as required by the Federal Deposit Insurance Corporation ("FDIC"). The Annual Report has not been reviewed, or confirmed for accuracy or relevance, by the FDIC.

Please contact either Roy L. Harmon, Jr. (President & CEO) or Darla M. Scott (EVP & CFO) for any additional information.

Contact Information

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Darla M. Scott, CPA

Darla M. Scott

Bank of Tennessee
EVP and CFO

BancTenn Corporation

2012 ANNUAL REPORT

BANCTENN CORP. AND SUBSIDIARY

CONSOLIDATED FINANCIAL REPORT

DECEMBER 31, 2012

CONTENTS

Hazlett, Lewis & Bieter, PLLC
Certified Public Accountants and Business Advisors

Independent Auditors' Report on the Financial Statements

To the Stockholders and Board of Directors
BancTenn Corp.
Kingsport, Tennessee

We have audited the accompanying consolidated financial statements of BancTenn Corp. and subsidiary, which comprise the consolidated balance sheets as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditors consider internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of BancTenn Corp. and subsidiary as of December 31, 2012 and 2011, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Hazlett, Lewis & Bieter, PLLC

Chattanooga, Tennessee
April 8, 2013

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BANCTENN CORP. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS
December 31, 2012 and 2011

	2012	2011
ASSETS		
Cash and due from banks:		
Noninterest-bearing	$ 11,012,349	$ 10,331,355
Interest-bearing	63,450	26,567,145
Total cash and due from banks	11,075,799	36,898,500
Certificates of deposit with other financial institutions	490,000	-
Securities available for sale	133,559,263	105,383,792
Investment in Paragon Commercial Corporation	10,438,500	10,438,500
Investment in Appalachian Fund for Growth II	3,285,443	3,204,959
Restricted investments, at cost	2,437,300	2,426,700
Federal funds sold	-	615,000
Loans, net of allowance for loan losses	455,334,092	439,967,927
Premises and equipment	28,479,752	27,624,190
Accrued interest receivable	1,648,908	1,620,214
Cash surrender value of life insurance	15,320,206	14,689,753
Foreclosed real estate	1,308,304	3,233,420
Other assets	4,717,557	5,615,431
Total assets	$ 668,095,124	$ 651,718,386
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing	$ 143,015,858	$ 120,277,115
Interest-bearing	400,724,075	404,083,946
Total deposits	543,739,933	524,361,061
Securities sold under agreements to repurchase	15,626,159	17,453,611
Federal funds purchased	2,795,317	949,001
Federal Home Loan Bank advances	30,646,693	35,733,183
Subordinated debentures	15,465,000	15,465,000
Accrued interest payable	216,909	260,834
Accrued expenses and other liabilities	5,534,650	5,322,045
Total liabilities	614,024,661	599,544,735
Stockholders' equity:		
Common stock, $8 par value, 6,000,000 shares authorized, 1,583,695 shares outstanding in 2012 and 2011	12,669,560	12,669,560
Additional paid-in capital	11,850,443	11,846,417
Retained earnings	27,822,153	26,751,446
Accumulated other comprehensive income	2,668,255	1,394,021
Unallocated ESOP shares	(939,948)	(487,793)
Total stockholders' equity	54,070,463	52,173,651
Total liabilities and stockholders' equity	$ 668,095,124	$ 651,718,386

The Notes to Consolidated Financial Statements are an integral part of these statements.

BANCTENN CORP. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME
Years Ended December 31, 2012 and 2011

	2012	2011
INTEREST INCOME		
Loans, including fees	$ 22,154,742	$ 23,949,977
Securities	2,649,372	2,282,057
Federal funds sold	3,607	9,300
	24,807,721	26,241,334
INTEREST EXPENSE	4,031,881	5,464,190
Net interest income	20,775,840	20,777,144
Provision for loan losses	2,029,000	3,200,000
Net interest income after provision for loan losses	18,746,840	17,577,144
NONINTEREST INCOME		
Customer service fees	1,400,831	1,485,785
Service revenue	3,675,515	3,525,039
Other	2,845,066	2,565,471
	7,921,412	7,576,295
NONINTEREST EXPENSES		
Salaries and employee benefits	12,576,557	11,563,508
Occupancy expenses	1,314,000	1,400,963
Other operating expenses	7,896,503	7,505,116
Loss on other assets	1,289,161	2,515,048
	23,076,221	22,984,635
Income before income taxes	3,592,031	2,168,804
Income taxes	(133,450)	(500,823)
Net income	$ 3,725,481	$ 2,669,627

The Notes to Consolidated Financial Statements are an integral part of these statements.

BANCTENN CORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
Years Ended December 31, 2012 and 2011

	2012	2011
Net income	$ 3,725,481	$ 2,669,627
Other comprehensive income, before tax:		
Unrealized gains and losses on securities -		
Unrealized holding gains arising during the year	1,319,857	3,173,688
Reclassification adjustment for losses included in net income	(5,463)	(4,735)
Amount related to unrealized gains on securities	1,325,320	3,178,423
Unrealized gains and losses on derivative contracts -		
Unrealized holding gains (losses) arising during the year	37,497	(679,625)
Amount related to unrealized gains (losses) on derivative contracts	37,497	(679,625)
Other comprehensive income, before tax	1,362,817	2,498,798
Income tax expense related to other comprehensive income items	(88,583)	(162,421)
Other comprehensive income, net of tax	1,274,234	2,336,377
Comprehensive income	$ 4,999,715	$ 5,006,004

The Notes to Consolidated Financial Statements are an integral part of these statements.

BANCTENN CORP. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

Years Ended December 31, 2012 and 2011

	Total Stockholders' Equity	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Unallocated ESOP Shares
BALANCE, December 31, 2010	$ 49,525,491	$ 12,659,200	$ 11,871,981	$ 26,587,655	$ (942,356)	$ (650,989)
Net income	2,669,627	-	-	2,669,627	-	-
Other comprehensive income, net of tax:	2,336,377	-	-	-	2,336,377	-
Purchase of 6,797 common shares	(228,972)	(54,376)	(174,596)	-	-	-
Employee stock ownership plan:						
Shares released to participants	163,196	-	-	-	-	163,196
Distributions to unallocated shares	26,004	-	-	26,004	-	-
Distributions to stockholders	(2,531,840)	-	-	(2,531,840)	-	-
Issuance of 8,092 common shares pursuant to stock option plan	209,178	64,736	144,442	-	-	-
Stock compensation expense, net of tax benefits	4,590	-	4,590	-	-	-
BALANCE, December 31, 2011	52,173,651	12,669,560	11,846,417	26,751,446	1,394,021	(487,793)
Net income	3,725,481	-	-	3,725,481	-	-
Other comprehensive income, net of tax:	1,274,234	-	-	-	1,274,234	-
Employee stock ownership plan:						
Security acquisition loans	(615,351)	-	-	-	-	(615,351)
Shares released to participants	163,196	-	-	-	-	163,196
Distributions to unallocated shares	37,508	-	-	37,508	-	-
Distributions to stockholders	(2,692,282)	-	-	(2,692,282)	-	-
Stock compensation expense, net of tax benefits	4,026	-	4,026	-	-	-
BALANCE, December 31, 2012	$ 54,070,463	$ 12,669,560	$ 11,850,443	$ 27,822,153	$ 2,668,255	$ (939,948)

The Notes to Consolidated Financial Statements are an integral part of these statements.

BANCTENN CORP. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
Years Ended December 31, 2012 and 2011

	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 3,725,481	$ 2,669,627
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	1,637,862	1,692,575
Provision for loan losses	2,029,000	3,200,000
Deferred income taxes	(133,450)	(500,823)
Stock compensation expense	4,026	4,590
Net amortization on securities	806,070	668,897
Undistributed earnings of equity investments	(184,224)	(94,742)
Other losses, net	1,284,657	2,508,387
Change in operating assets and liabilities:		
Accrued interest receivable	(28,694)	118,403
Accrued interest payable	(43,925)	(58,640)
Other assets and liabilities	506,582	448,362
Net cash provided by operating activities	9,603,385	10,656,636
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales, maturities, prepayments and calls of securities available for sale	23,878,732	24,558,367
Purchase of securities available for sale	(51,540,417)	(51,129,627)
Purchase of equity investments	-	(307,600)
Proceeds from sale of equity investments	-	49,000
Purchase of restricted investments	(10,600)	-
Distributed earnings of equity investments	103,740	117,488
Decrease (increase) in certificates of deposit with other financial institutions	(490,000)	248,000
Decrease (increase) in federal funds sold	615,000	(275,000)
Proceeds from sale of foreclosed real estate	751,761	4,805,256
Proceeds from sale of repossessions	-	365,520
Loan originations and principal collections, net	(18,442,165)	17,721,938
Purchase of premises and equipment	(1,614,924)	(1,209,979)
Proceeds from disposal of premises and equipment	118,469	11,914
Net cash used in investing activities	(46,630,404)	(5,044,723)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in demand deposits and NOW, money market, and savings accounts	34,437,596	33,790,008
Net decrease in time deposits	(15,058,723)	(30,936,684)
Net increase in federal funds purchased and securities sold under agreements to repurchase	18,864	776,722
Net decrease in Federal Home Loan Bank advances	(5,086,490)	(84,599)
Net decrease in borrowings under line of credit	-	(160,000)
Issuance of common stock	-	209,178
Purchase of common stock	-	(228,972)
Net ESOP transactions	(414,647)	189,200
Distributions to stockholders	(2,692,282)	(2,531,840)
Net cash provided by financing activities	11,204,318	1,023,013
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(25,822,701)	6,634,926
CASH AND CASH EQUIVALENTS, beginning of year	36,898,500	30,263,574
CASH AND CASH EQUIVALENTS, end of year	$ 11,075,799	$ 36,898,500
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Cash paid during the year for interest	$ 4,075,806	$ 5,522,830
Cash paid during the year for income taxes	21,200	166,250
NONCASH INVESTING ACTIVITIES		
Real estate acquired in settlement of loans	$ 1,047,000	$ 3,177,562

The Notes to Consolidated Financial Statements are an integral part of these statements.

Note 1. Summary of Significant Accounting Policies

The accounting and reporting policies of BancTenn Corp. (the Company) conform with United States generally accepted accounting principles (GAAP) and practices within the banking industry. The Financial Accounting Standards Board (FASB) has adopted the FASB Accounting Standards Codification (ASC) as the single source of authoritative nongovernmental GAAP.

The policies that materially affect financial position and results of operations are summarized as follows:

Nature of operations:

BancTenn Corp. is a bank holding company whose principal activity is the ownership and management of its wholly owned subsidiary, Bank of Tennessee (the Bank). The Bank generates commercial, mortgage and consumer loans and receives deposits from customers located primarily in the Tri-Cities area of upper east Tennessee. The Bank's primary deposit products are transaction and savings accounts and certificates of deposit. Its primary lending products are commercial loans, residential real estate loans, and consumer loans. The Bank also provides data processing and other operating services to other financial institutions. Other operating services include deposit operations, item processing, and human resources.

Basis of consolidation:

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Bank of Tennessee. All material intercompany balances and transactions have been eliminated in consolidation.

Use of estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America 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 revenue and expenses during the reporting period. Actual results could differ from those estimates.

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 obtains independent appraisals for significant collateral.

Note 1. Summary of Significant Accounting Policies (continued)

Significant group concentrations of credit risk:

Most of the Company's activities are with customers located in eastern Tennessee. The types of securities that the Company invests in are included in Note 3. The types of lending the Company engages in are included in Note 5. The Company does not have any significant concentrations to any one industry or customer.

Residential real estate represented 46 percent of the loan portfolio at December 31, 2012, and 47 percent of the loan portfolio at December 31, 2011.

Securities available for sale:

Securities available for sale are carried at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Realized gains and losses on securities available for sale are included in other income and, when applicable, are reported as a reclassification adjustment, net of tax, in other comprehensive income.

Gains and losses on sales of securities are determined on the specific-identification method. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities.

The Company conducts a regular assessment of its securities portfolio to determine whether any are other-than-temporarily impaired. In estimating other-than-temporary impairment losses, management considers, among other factors, the length of time and extent to which the fair value has been less than cost, the financial condition and near term prospects of the issuer, and the intent and ability of the Company to retain its investment for a period of time sufficient to allow for any anticipated recovery. The term "other-than-temporary" is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value for a debt security is determined to be other-than-temporary, the other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income. For equity securities, the full amount of the other-than-temporary impairment is recorded in non-interest income as an impairment loss on investment securities.

Note 1. Summary of Significant Accounting Policies (continued)

Equity investment:

The Company is accounting for its investment in Appalachian Fund for Growth II, a 25% owned affiliate, by the equity method of accounting. The Company's share of the net income of the affiliate is recognized as income in the Company's income statement and added to the investment account. Dividends received are treated as a reduction of the investment account.

Loans:

The Bank grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by real estate loans secured by properties located in Tennessee. The ability of the Bank's debtors to honor their contracts is somewhat dependent on the real estate and economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity are stated at unpaid principal balances less the allowance for loan losses.

The Bank does not defer loan fees and related loan origination costs. Based on management's assessment, the difference between deferral and immediate recognition of such fees and related costs is not material.

Interest income is accrued based on the unpaid principal balance. The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Credit card loans and other consumer loans are typically charged off between 90 and 120 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Allowance for loan losses:

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

Note 1. Summary of Significant Accounting Policies (continued)

Allowance for loan losses: (continued)

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

As part of management's assessment of the allowance, management divides the loan portfolio into five segments: commercial real estate, residential real estate, construction and land development, commercial and industrial, and consumer and other. Each segment is then analyzed such that a specific and general allocation of the allowance is estimated for each loan segment.

The general component of the Bank's allowance for loan losses covers all loans for which there is not a specific reserve and is based on historical charge-off experience. The model includes each of the five loan portfolio segments and utilizes the incurred losses over the last twenty four months to estimate future losses. The historic loss percentages derived from this model are then applied to the outstanding non-impaired loan balance for each loan category. An additional general allocation may be made to the allowance for loan losses after an assessment of internal and external influences on credit quality that are not fully reflected on historical loss data.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower.

Note 1. Summary of Significant Accounting Policies (continued)

Allowance for loan losses: (continued)

The unallocated component of the allowance reflects the uncertainties inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Derivatives:

Derivatives are recognized as assets and liabilities on the consolidated balance sheets and measured at fair value. For exchange-traded contracts, fair value is based on quoted market prices. For nonexchange traded contracts, fair value is based on dealer quotes, pricing models, discounted cash flow methodologies, or similar techniques for which the determination of fair value may require significant management judgment or estimation.

For asset/liability management purposes, the Company and Bank use interest rate swap agreements to hedge various exposures or to modify interest rate characteristics of various balance sheet accounts. Interest rate swaps are contracts in which a series of interest rate flows are exchanged over a prescribed period. The notional amount on which the interest payments are based is not exchanged. These swap agreements are derivative instruments and generally convert a portion of the Company’s and Bank’s variable-rate debt to a fixed rate.

The effective portion of the gain or loss on a derivative designated and qualifying as a cash flow hedging instrument is initially reported as a component of other comprehensive income and subsequently reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. The ineffective portion of the gain or loss on the derivative instrument, if any, is recognized in current earnings.

Interest rate derivative financial instruments receive hedge accounting treatment only if they are designated as a hedge and are expected to be, and are, effective in substantially reducing interest rate risk arising from the assets and liabilities identified as exposing the Company and Bank to risk. Those derivative financial instruments that do not meet specified hedging criteria are recorded at fair value with changes in fair value recorded in income. If periodic assessment indicates derivatives no longer provide an effective hedge, the derivative contracts would be closed out and settled, or classified as a trading activity.

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 Bank, (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 Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before maturity.

Note 1. Summary of Significant Accounting Policies (continued)

Premises and equipment:

Land is carried at cost. Other premises and equipment are carried at cost net of accumulated depreciation. Depreciation is computed using the straight-line and the declining balance methods based principally on the estimated useful lives of the assets. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized. Gains and losses on dispositions are included in current operations.

Foreclosed assets:

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenues and expenses from operations and changes in the valuation allowance are included in net expenses from foreclosed assets.

Income taxes:

The Company accounts for income taxes in accordance with income tax accounting guidance in ASC Topic 740. The income tax accounting guidance results in two components of income tax expense – current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to taxable income or loss. The Company determines deferred income taxes using the liability method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities. The Company's deferred taxes relate primarily to differences between the basis of the allowance for loan losses and accumulated depreciation. Deferred tax assets and liabilities are reflected at income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. The Company files consolidated income tax returns with its subsidiary. With few exceptions, the Company is no longer subject to tax examinations by tax authorities for years before 2009.

The Company has elected to be taxed under the provisions of Subchapter S of the Internal Revenue Code. Earnings and losses are included in the personal income tax returns of the stockholders and taxed depending on their personal tax strategies. Accordingly, the Company does not incur federal income tax obligations, and the financial statements do not include a provision for federal income taxes.

The Company recognizes deferred tax assets if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The Company follows the statutory requirements for its income tax accounting and generally avoids risks associated with potentially problematic tax positions that may be challenged upon examination. The Company recognizes interest and penalties on income taxes as a component of income tax expense.

Note 1. Summary of Significant Accounting Policies (continued)

Advertising costs:

The Company follows the policy of charging the costs of advertising to expense as incurred. Advertising expense charged to operations was $133,550 and $301,659 for the years ended December 31, 2012 and 2011, respectively.

Statements of cash flows:

The Company considers all cash and amounts due from depository institutions to be cash equivalents for purposes of the statements of cash flows.

Stock option plan:

The Company recognizes compensation cost relating to share-based payment transactions in accordance with ASC Topic 718. Compensation cost has been measured based on the grant date fair value of the equity or liability instruments issued. Compensation cost is calculated and recognized over the employee service period, generally defined as the vesting period. The Company uses a stock option pricing model to determine the fair value of the award on the grant date.

Variable interest entities:

An entity is referred to as a variable interest entity (VIE) if it meets the criteria outlined in ASC Topic 810, which are: (1) the entity has equity that is insufficient to permit the entity to finance its activities without additional subordinated financial support from other parties, or (2) the entity has equity investors that cannot make significant decisions about the entity’s operations or that do not absorb the expected losses or receive the expected returns of the entity. A VIE must be consolidated by the Company if it is deemed to be the primary beneficiary of the VIE, which is the party involved with the VIE that has a majority of the expected losses, expected residual returns, or both. The Company has two wholly-owned subsidiary grantor trusts which are deemed to be VIEs. These two VIEs have not been consolidated by the Company as BancTenn Corp is not the primary beneficiary.

Subsequent events:

Management performed an evaluation of subsequent events through April 8, 2013 the date these financial statements were available to be issued.

Note 2. Restrictions on Cash and Due From Banks

The Bank is required to maintain average balances on hand or with the Federal Reserve Bank based on a percentage of deposits. These reserve balances were approximately $484,000 and $25,000 at December 31, 2012 and 2011, respectively.

Note 3. Securities Available for Sale

Securities have been classified in the consolidated balance sheets according to management's intent as securities available for sale. The amortized cost and fair value of investment securities at December 31, 2012 and 2011 are as follows:

	2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities:				
U.S. Government-sponsored enterprises (GSEs)	$ 22,517,177	$ 711,507	$ -	$ 23,228,684
Obligations of states and political subdivisions	42,144,008	2,083,960	(18,886)	44,209,082
Mortgage-backed securities:				
Government National Mortgage Association guaranteed	22,654,423	790,463	(10,282)	23,434,604
GSE residential	41,786,644	831,839	(38,905)	42,579,578
Equity securities	236,569	-	(129,254)	107,315
	$ 129,338,821	$ 4,417,769	$ (197,327)	$ 133,559,263

	2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Debt securities:				
U.S. Government-sponsored enterprises (GSEs)	$ 4,147,829	$ 125,830	$ -	$ 4,273,659
Obligations of states and political subdivisions	32,504,583	2,034,798	(2,957)	34,536,424
Mortgage-backed securities:				
Government National Mortgage Association guaranteed	21,025,311	377,002	(1,247)	21,401,066
GSE residential	44,574,377	588,600	(39,285)	45,123,692
Equity securities	236,569	-	(187,618)	48,951
	$ 102,488,669	$ 3,126,230	$ (231,107)	$ 105,383,792

Note 3. Securities Available for Sale (continued)

U.S. Government sponsored enterprises include entities such as Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Federal Home Loan Banks.

Upon acquisition of a security, the Company determines the appropriate impairment model that is applicable. If the security is a beneficial interest in securitized financial assets, the Company uses the beneficial interests in securitized financial assets impairment model. If the security is not a beneficial interest in securitized financial assets, the Company uses the debt and equity securities impairment model. The Company conducts periodic reviews to evaluate each security to determine whether an other-than-temporary impairment has occurred. The Company does not have any securities that have been classified as other-than-temporarily-impaired at December 31, 2012.

The scheduled maturities of securities available for sale at December 31, 2012, are as follows:

	Amortized Cost	Fair Value
Due in one year or less	$ 1,433,535	$ 1,439,642
Due from one year to five years	16,538,858	17,053,056
Due from five years to ten years	21,649,132	22,944,982
Due after ten years	25,039,660	26,000,086
Mortgage-backed and related securities	64,441,067	66,014,182
Securities with no stated maturity	236,569	107,315
	$ 129,338,821	$ 133,559,263

Sales of available for sale securities for the years ended December 31, 2012 and 2011 were as follows:

	2012	2011
Proceeds	$ 7,438,138	$ 8,014,088
Gross gains realized	34,789	10,390
Gross losses realized	(40,252)	(15,125)

At December 31, 2012 and 2011, gross unrealized losses on investments were insignificant in relation to the Company’s investment portfolio.

Securities with an amortized cost of approximately $75,876,000 and $64,708,000 at December 31, 2012 and 2011, respectively, were pledged to secure various deposits and borrowings.

Note 4. Equity Investments

Investment in Paragon Commercial Corporation:

During 2009, the Company determined Paragon Commercial Corporation (Paragon) experienced declining asset quality and would need additional capital. Subsequently, Paragon conducted a capital raise, but the Company did not participate and thus did not maintain its level of ownership to have significant influence over the operations of Paragon. Accordingly, the Company stopped accounting for this investment using the equity method of accounting and the investment is accounted for at cost.

Investment in Appalachian Fund for Growth II:

During 2006, the Company invested $3,000,000 for a 25% share of the Appalachian Fund for Growth II partnership (AFG), which is managed by the Southeast Local Development Corporation (General Partner). AFG will use the investments received in formation to make below-market rate senior and subordinated debt products to businesses seeking to build, renovate, expand and equip their business facilities. AFG will target high job creation and retention businesses and businesses providing important community services. The funds will be deployed to help: (1) attract new businesses to its under-served service area by offering creative financing; (2) supply creative financing for businesses to rehabilitate existing distressed properties to facilitate community development; and (3) leverage other private investment into its targeted communities. In return for their investment the Company and the other investors will receive new market tax credits. For 2012 the Company received approximately $180,000 in new market tax credits.

AFG meets the criteria of a VIE outlined in ASC Topic 810. AFG has not been consolidated by the Company as the Company is not the primary beneficiary.

Note 5. Loans and Allowance for Loan Losses

At December 31, 2012 and 2011, loans consist of the following (in thousands):

	2012	2011
Commercial real estate	$ 154,447	$ 145,010
Residential real estate	211,480	208,778
Construction and land development	38,392	30,077
Commercial and industrial	40,084	43,668
Consumer and other	18,698	19,940
Total loans	463,101	447,473
Allowance for loan losses	(7,767)	(7,505)
Net loans	$ 455,334	$ 439,968

Note 5. Loans and Allowance for Loan Losses (continued)

In the normal course of business, the Bank makes loans to directors and executive officers of the Bank on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other borrowers. Loans to directors and executive officers totaled $278,353 and $855,746 at December 31, 2012 and 2011, respectively.

A summary of transactions in the allowance for loan losses for the year ended December 31, 2012 and 2011, is as follows (in thousands):

	2012	2011
Balance, beginning of year	$ 7,505	$ 7,670
Provision charged to operating expense	2,029	3,200
Recoveries of loans charged off	547	521
Loans charged off	(2,314)	(3,886)
Balance, end of year	$ 7,767	$ 7,505

The Bank follows the loan impairment accounting guidance in ASC Topic 310, "Receivables". Impaired loans include nonperforming loans and loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in interest rates, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collections.

The composition of loans by primary loan classification as well as impaired and performing loan status at December 31, 2012 and 2011, is summarized in the tables below (in thousands):

	December 31, 2012					
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	$ 142,205	$ 200,570	$ 33,501	$ 39,320	$ 17,358	$ 432,954
Impaired loans	12,242	10,910	4,891	764	1,340	30,147
Total loans	$ 154,447	$ 211,480	$ 38,392	$ 40,084	$ 18,698	$ 463,101

	December 31, 2011					
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	$ 128,974	$ 202,204	$ 23,270	$ 43,418	$ 17,546	$ 415,412
Impaired loans	16,036	6,574	6,807	250	2,394	32,061
Total loans	$ 145,010	$ 208,778	$ 30,077	$ 43,668	$ 19,940	$ 447,473

Note 5. Loans and Allowance for Loan Losses (continued)

The following tables show the allowance for loan losses allocation by loan classification for impaired and performing loans as of December 31, 2012 and 2011 (in thousands):

	December 31, 2012						
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Unallocated	Total
Performing loans	$ 461	$ 653	$ 1,123	$ 6	$ 402	$ 2,342	$4,987
Impaired loans	1,253	474	805	200	48	-	2,780
Total allowance	$ 1,714	$ 1,127	$ 1,928	$ 206	$ 450	$ 2,342	$7,767

	December 31, 2011						
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Unallocated	Total
Performing loans	$ 301	$ 612	$ 1,585	$ 2	$ 513	$ 1,791	$4,804
Impaired loans	510	568	852	-	771	-	2,701
Total allowance	$ 811	$ 1,180	$ 2,437	$ 2	$ 1,284	$ 1,791	$7,505

The following tables detail the changes in the allowance for loan losses for the years ending December 31, 2012 and 2011, by loan classification (in thousands):

	December 31, 2012						
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Unallocated	Total
Balance, beginning of year	$ 811	$ 1,180	$ 2,437	$ 2	$ 1,284	$ 1,791	$7,505
Provision for loan losses	1,432	388	(44)	204	(502)	551	2,029
Recoveries of loans charged off	28	198	-	9	312	-	547
Loans charged off	(557)	(639)	(465)	(9)	(644)	-	(2,314)
Balance, end of year	$ 1,714	$ 1,127	$ 1,928	$ 206	$ 450	$ 2,342	$7,767

Note 5. Loans and Allowance for Loan Losses (continued)

	December 31, 2011						
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Unallocated	Total
Balance, beginning of year	$ 392	$ 609	$ 1,486	$ 936	$ 2,836	$ 1,411	$ 7,670
Provision for loan losses	625	1,056	3,051	(939)	(973)	380	3,200
Recoveries of loans charged off	125	156	50	7	183	-	521
Loans charged off	(331)	(641)	(2,150)	(2)	(762)	-	(3,886)
Balance, end of year	$ 811	$ 1,180	$ 2,437	$ 2	$ 1,284	$ 1,791	$ 7,505

Federal regulations require the Bank to review and classify its assets on a regular basis. To fulfill this requirement the Bank systematically reviews its loan portfolio to ensure the Bank’s large loan relationships are being maintained within its loan policy guidelines, remain properly underwritten, and are properly classified by loan grade. This review process is performed by the Bank's management, loan reviewers, and state and federal regulators.

The Bank’s loan grading process is as follows:

- All loans are assigned a loan grade at the time of origination by the relationship manager.
- Loan relationships greater than or equal to $750 thousand are reviewed annually by internal and / or external loan review.
- Generally, all loans exceeding $25 thousand on the Bank’s internal watchlist and those graded special mention or below are reviewed quarterly by the relationship manager and a Rated Loan Memorandum is prepared. Upon completion, this memorandum is reviewed by internal loan review.
- Approximately 40 to 50 percent of the Bank’s loan portfolio is reviewed annually by the Bank’s internal and / or external loan review.

Note 5. Loans and Allowance for Loan Losses (continued)

If a loan is classified as a problem asset it will be assigned one of the following loan grades: substandard, doubtful, or loss. Substandard assets must have one or more defined weaknesses and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values questionable and there is a high possibility of loss. An asset classified loss is considered uncollectible and of such little value that continuance as an asset of the Bank is not warranted. Regulations also provide for a special mention category, described as assets which do not currently expose an institution to a sufficient degree of risk to warrant classification but do possess credit deficiencies or potential weaknesses deserving close attention. When the Bank classifies an asset as substandard or doubtful, a specific allowance for loan losses may be established.

The following tables outline the amount of each loan classification and the amount categorized into each risk rating as of December 31, 2012 and 2011 (in thousands):

	December 31, 2012					
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	$ 140,052	$ 196,820	$ 33,894	$ 39,562	$ 17,610	$ 427,938
Special mention	-	96	-	-	8	104
Substandard	14,395	14,564	4,498	522	1,080	35,059
Doubtful	-	-	-	-	-	-
Total	$ 154,447	$ 211,480	$ 38,392	$ 40,084	$ 18,698	$ 463,101

	December 31, 2011					
	Commercial Real Estate	Residential Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	$ 125,345	$ 197,967	$ 23,481	$ 43,228	$ 16,593	$ 406,614
Special mention	536	969	-	37	499	2,041
Substandard	19,129	9,842	6,596	403	2,848	38,818
Doubtful	-	-	-	-	-	-
Total	$ 145,010	$ 208,778	$ 30,077	$ 43,668	$ 19,940	$ 447,473

Note 5. Loans and Allowance for Loan Losses (continued)

At the end of each quarter, management analyzes the collectability of its loan and leases, and a loan impairment analysis is performed on loans and loan relationships greater than $500,000 graded substandard or worse as well as those loans designated as troubled debt restructurings. Loans designated as troubled debt restructurings and less than $500,000 are aggregated by call code and evaluated for impairment as a group. The following tables present summary information pertaining to impaired loans by loan classification as of December 31, 2012 and 2011 (in thousands):

	As of December 31, 2012			For the Year Ended December 31, 2012	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Commercial real estate	$ 7,331	$ 7,331	$ -	$ 10,263	$ 120
Residential real estate	6,061	6,061	-	4,291	324
Construction and land development	-	-	-	1,004	55
Commercial and industrial	357	397	-	304	5
Consumer and other	206	206	-	276	50
Total	13,955	13,995	-	16,138	554
Impaired loans with a valuation allowance:					
Commercial real estate	4,911	4,951	1,253	3,877	673
Residential real estate	4,849	4,853	474	4,452	267
Construction and land development	4,891	5,221	805	4,846	69
Commercial and industrial	407	419	200	204	6
Consumer and other	1,134	1,956	48	1,590	-
Total	16,192	17,400	2,780	14,969	1,015
Total impaired loans	$ 30,147	$ 31,395	$ 2,780	$ 31,107	$ 1,569

Note 5. Loans and Allowance for Loan Losses (continued)

	As of December 31, 2011			For the Year Ended December 31, 2011	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Commercial real estate	$ 13,194	$ 13,194	$ -	$ 12,573	$ 961
Residential real estate	2,520	2,520	-	3,012	444
Construction and land development	2,007	2,007	-	2,856	171
Commercial and industrial	250	250	-	225	15
Consumer and other	349	358	-	179	52
Total	18,320	18,329	-	18,845	1,643
Impaired loans with a valuation allowance:					
Commercial real estate	2,842	2,848	510	3,494	106
Residential real estate	4,054	4,054	568	2,502	74
Construction and land development	4,800	5,499	852	5,454	57
Commercial and industrial	-	-	-	-	-
Consumer and other	2,045	2,399	771	1,297	33
Total	13,741	14,800	2,701	12,747	270
Total impaired loans	$ 32,061	$ 33,129	$ 2,701	$ 31,592	$ 1,913

The following tables present an aged analysis of past due loans as of December 31, 2012 and 2011 (in thousands):

	December 31, 2012					
	30-89 Days Past Due and Accruing	Past Due 90 Days or More and Accruing	Nonaccrual	Total Past Due and Nonaccrual	Current Loans	Total Loans
Commercial real estate	$ 74	$ -	$ 1,397	$ 1,471	$ 152,976	$154,447
Residential real estate	1,195	79	1,012	2,286	209,194	211,480
Construction and land development	614	-	1,943	2,557	35,835	38,392
Commercial and industrial	152	-	434	586	39,498	40,084
Consumer and other	18	-	745	763	17,935	18,698
Total	$ 2,053	$ 79	$ 5,531	$ 7,663	$ 455,438	$463,101

Note 5. Loans and Allowance for Loan Losses (continued)

	December 31, 2011					
	30-89 Days Past Due and Accruing	Past Due 90 Days or More and Accruing	Nonaccrual	Total Past Due and Nonaccrual	Current Loans	Total Loans
Commercial real estate	$ 492	$ -	$ 1,397	$ 1,889	$ 143,121	$145,010
Residential real estate	1,123	66	1,454	2,643	206,135	208,778
Construction and land development	834	-	3,080	3,914	26,163	30,077
Commercial and industrial	19	-	202	221	43,447	43,668
Consumer and other	295	-	1,160	1,455	18,485	19,940
Total	$ 2,763	$ 66	$ 7,293	$ 10,122	$ 437,351	$447,473

Nonperforming loans include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

Impaired loans also include loans that the Bank has elected to formally restructure when, due to the weakening credit status of a borrower, the restructuring may facilitate a repayment plan that seeks to minimize the potential losses that the Bank may have to otherwise incur. Included in impaired loans are loans that have been restructured and are reported as troubled debt restructurings. If on nonaccruing status as of the date of restructuring, the loans are included in nonperforming loans and are classified as impaired. At December 31, 2012 and 2011, there were approximately $7,501,000 and $6,773,000, respectively, of troubled debt restructurings that were performing and in compliance with modified terms. Troubled loans are restructured by specialists within the Special Asset department and are approved through appropriate channels independent of the originating officer.

The following tables present a summary of loans that were modified as troubled debt restructurings during the years ended December 31, 2012 and 2011 (in thousands):

	December 31, 2012		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial real estate	7	$ 3,167	$ 3,167
Residential real estate	7	1,550	1,550
Construction and land development	1	369	369
Commercial and industrial	-	-	-
Consumer and other	3	474	474

Note 5. Loans and Allowance for Loan Losses (continued)

	December 31, 2011		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial real estate	1	$ 200	$ 200
Residential real estate	6	1,237	1,237
Construction and land development	3	1,913	1,913
Commercial and industrial	1	33	33
Consumer and other	9	2,046	2,046

The following table presents a summary of loans that were modified as troubled debt restructurings during the years ended December 31, 2012 and 2011, and for which there was a subsequent payment default during the year (in thousands):

	December 31, 2012		December 31, 2011	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
Commercial real estate	1	$ 74	-	$ -
Residential real estate	1	70	1	45
Construction and land development	1	369	1	1,726
Commercial and industrial	-	-	1	33
Consumer and other	2	269	3	771

Note 6. Premises and Equipment

A summary of premises and equipment at December 31, 2012 and 2011, is as follows:

	2012	2011
Land	$ 6,222,566	$ 5,377,122
Buildings and leasehold improvements	27,129,255	26,744,019
Furniture and equipment	10,379,394	9,863,004
Transportation equipment	1,339,640	1,288,941
Construction in progress	509,663	162,454
	45,580,518	43,435,540
Accumulated depreciation	(17,100,766)	(15,811,350)
	$ 28,479,752	$ 27,624,190

Note 7. Foreclosed real estate

Foreclosed real estate is held for sale and is initially recorded at fair value less estimated selling cost at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed and any write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its cost or fair value less cost to sell. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. The portion of interest costs relating to development of real estate (if any) is capitalized.

Expenses applicable to foreclosed real estate during 2012 and 2011, include the following:

	2012	2011
Net (gain)/loss on sales of real estate	$ (29,263)	$ 1,126,951
Provision for losses	1,262,617	1,285,584
Property taxes	60,016	71,225
Maintenance and insurance	15,923	56,923
Other	42,938	43,929
	$ 1,352,231	$ 2,584,612

Note 8. Deposits

The composition of deposits at December 31, 2012 and 2011, is as follows:

	2012	2011
Demand deposits, noninterest bearing	$ 143,015,858	$ 120,277,115
NOW accounts	104,424,033	101,788,448
Money market accounts	171,173,880	166,363,015
Savings accounts	44,361,663	40,109,259
Time deposits	80,764,499	95,823,224
Total	$ 543,739,933	$ 524,361,061

The aggregate amount of time deposits in denominations of $100,000 or more at December 31, 2012, were approximately $38,612,000. At December 31, 2012, the scheduled maturities of time deposits are as follows (in thousands):

Less than one year	$ 64,412
One through three years	11,423
Three years and greater	4,929
	$ 80,764

Note 9. Federal Home Loan Bank Advances

The Bank has an agreement with the Federal Home Loan Bank (FHLB) that can provide short-term and long-term funding to the Bank in an amount up to $125,233,775. The Bank has pledged its loans secured by one to four single-family mortgages, second mortgages and home equity lines, multi-family, commercial real estate, and agricultural real estate properties. The collateral to loan ratio ranges from 131% to 232%.

At December 31, 2012, the Bank held a letter of credit from the Federal Home Loan Bank totaling $10,000,000. The letter of credit is used by the Bank as collateral for public deposits.

At December 31, 2012 and 2011, FHLB advances consist of the following:

	2012	2011
Long-term advance requiring monthly interest payments, fixed at 2.86% until December 2017, principal due in December 2017	$ 10,000,000	$ 10,000,000
Long-term advance requiring monthly interest payments, fixed at 3.90% until June 2013, principal due in June 2013	5,000,000	5,000,000
Long-term advance requiring monthly interest payments, fixed at 3.73% until August 2013, principal due in August 2013	10,000,000	10,000,000
Long-term advance requiring monthly interest payments, fixed at 2.76% until October 2013, principal due in October 2013	-	5,000,000
Long-term advance requiring monthly interest payments, fixed at 2.85% until September 2014, principal due in September 2014	-	3,000,000
Long-term amortizing advance requiring monthly principal and interest payments, fixed at 2.30% until February 2023, final payment due in February 2023	2,107,115	2,168,248
Long-term amortizing advance requiring monthly principal and interest payments, fixed at 2.00% until July 2030, final payment due in July 2030	539,578	564,935
Cash management advance requiring monthly interest payments, variable interest rate, principal due in March 2013	3,000,000	-
	$ 30,646,693	$ 35,733,183

Note 9. Federal Home Loan Bank Advances (continued)

The long-term advances may be prepaid subject to a prepayment penalty as defined in the agreements. The FHLB has the right to exercise a put on certain of these advances as defined in the agreements.

Maturities by year at December 31, 2012, are as follows:

2013	$ 18,000,000
2017	10,000,000
Thereafter	2,646,693
	$ 30,646,693

Note 10. Securities Sold Under Agreements to Repurchase

Securities sold under agreements to repurchase represent the purchase of interest in securities by commercial checking customers. The Company may also enter into structured repurchase agreements with other financial institutions. Repurchase agreements with commercial checking customers generally settle the following business day, while structured repurchase agreements with other financial institutions will have varying terms.

At December 31, 2012 and 2011, the Company had securities sold under agreements to repurchase of $5,626,159 and $7,453,611, respectively, with commercial checking customers. The Company had structured repurchase agreements with other financial institutions of $10,000,000 at December 31, 2012 and 2011.

At December 31, 2012, the structured repurchase agreement has a ten-year term with a fixed interest rate of 3.72%. This agreement matures in 2018. The Company has pledged securities with an amortized cost of approximately $12,696,000 to secure this agreement.

Note 11. Subordinated Debentures

Effective June 22, 2004 and December 4, 2006, two wholly-owned subsidiary grantor trusts were established by the Company, BancTenn Capital Trust II and BancTenn Capital Trust III, respectively. These subsidiaries issued $6,000,000 and $9,000,000 of pooled Trust Preferred Securities ("trust preferred securities"), respectively. Trust preferred securities accrue and pay distributions periodically at specified annual rates as provided in the indentures. The trust used the net proceeds from the offering to purchase a like amount of Junior Subordinated Debentures (the "Debentures") of the Company. The Debentures are the sole assets of the trust. The trust preferred securities are mandatorily redeemable upon the maturity of the Debentures, or upon earlier redemption as provided in the indentures. The Company has the right to redeem the Debentures in whole on or in part after specific dates, at a redemption price specified in the indenture plus any accrued but unpaid interest to the redemption date. The trust preferred securities have a maturity of 30 years and are redeemable at the Company's option with certain exceptions. At December 31, 2012, the floating-rate securities in BancTenn Capital Trust II had a 2.97% interest rate which resets quarterly at the three-month LIBOR rate plus 2.65% and BancTenn Capital Trust III had a 1.96% interest rate which resets quarterly at the three-month LIBOR rate plus 1.65%.

Note 11. Subordinated Debentures (continued)

For regulatory capital purposes, these trust-preferred securities qualify as a component of Tier I capital, subject to certain limitations.

ASC Topic 810 resulted in the Company's investment in the common equity of the trust being included in the consolidated balance sheets as other assets, totaling $465,000 at December 31, 2012 and 2011. The outstanding balance of the subordinated debentures was $15,465,000 at December 31, 2012 and 2011.

Note 12. Derivatives Instruments – Interest Rate Contracts

Cash flow hedges:

The Company currently has two interest rate swap derivative instruments, used to minimize interest rate volatility on trust preferred securities, which are designated and qualify as cash flow hedges.

In March 2008, the Company, relating to the Company's subordinated debentures, entered into an interest rate swap agreement with Compass Bank to pay a fixed rate of 5.49% while receiving a variable rate of the three-month LIBOR plus 165 basis points. This swap has a $9 million notional value and the termination date is March 2015.

In December 2008, the Company, relating to the Company's subordinated debentures, entered into a second interest rate swap agreement with Compass Bank to pay a fixed rate of 5.48% while receiving a variable rate of the three-month LIBOR plus 265 basis points. This swap has a $6 million notional value and the termination date is January 2019.

At December 31, 2012 and 2011, the estimated fair value of the cash flow hedge derivative instruments recorded in other liabilities was $1,366,695 and $1,404,192, respectively. Changes in the fair value of the derivative instruments are reported in accumulated other comprehensive income. These amounts subsequently are reclassified into interest expense as a yield adjustment in the same period in which the related interest on the subordinated debentures affects earnings. Included in interest expense is $455,958 which resulted from the reclassification of accumulated other comprehensive income into earnings during 2012. The interest expense recorded for the hedged derivatives in 2011 was $475,203. Hedge ineffectiveness recognized into income during 2012 and 2011 was insignificant.

Note 12. Derivatives Instruments – Interest Rate Contracts (continued)

Non-hedged derivatives:

The Company also entered into three interest rate swap agreements with Compass Bank to pay a fixed rate of 5.21% while receiving a variable rate of the one-month LIBOR plus 225 basis points. The Company then entered into reciprocal agreements with three customers. These swaps had an initial notional value of $13,010,517 and will decline until the termination dates from May 2013 through February 2014 based on a set amortization schedule. At December 31, 2012, the estimated fair value of the non-hedged derivative instruments recorded in other assets and liabilities was $272,691. At December 31, 2011, the estimated fair value of the non-hedge derivative instruments recorded in other assets and liabilities was $545,705. Included in interest income and interest expense are offsetting revenues and expenses of approximately $334,138 in 2012 and $341,362 in 2011 related to the non-hedged derivatives.

Note 13. Stock Option Plan

The Company has a stock option plan, which is administered by the Board of Directors, that provides for both incentive stock options and nonqualified stock options. The Company also grants non-qualified stock options to the Board of Directors. The maximum number of common shares that can be sold or optioned under the plan is 670,000 shares. Under the plan, the exercise price of each option shall not be less than 100 percent of the fair market value of the common stock on the date of grant. The effect of stock options forfeited is recognized as the forfeitures occur. For the years ended December 31, 2012 and 2011, the Company recognized $4,026 and $4,590 respectively, in compensation expense for stock options. At December 31, 2012, there is $1,237 remaining compensation expense to be recognized on non-vested options.

There were no options granted in 2012 or 2011.

A summary of activity in the stock option plan for the years ended December 31, 2012 and 2011, is as follows:

	2012		2011	
	Number of Shares	Weighted Average Exercise Price	Number of Shares	Weighted Average Exercise Price
Outstanding, at beginning of year	100,880	$ 45.85	110,972	$ 44.44
Options granted	-	-	-	-
Options exercised	-	-	(8,092)	(25.85)
Options forfeited/expired	(5,000)	(48.55)	(2,000)	(48.55)
Outstanding at end of year	95,880	45.70	100,880	45.85

Note 13. Stock Option Plan (continued)

The aggregate intrinsic value of options outstanding at December 31, 2012, is $24,360. The aggregate intrinsic value 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, 2012. This amount changes based on changes in the market value of the Company's stock. The fair value (present value of the estimated future benefit to the option holder) of each option grant is estimated on the date of grant using the Black-Scholes option pricing model.

Information pertaining to options outstanding at December 31, 2012, is as follows:

Options Outstanding			Options Exercisable	
Number Outstanding	Weighted Average Remaining Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
7,000	0.2 Years	$ 28.67	7,000	$ 28.67
2,800	0.9 Years	32.30	2,800	32.30
10,080	2.0 Years	36.25	10,080	36.25
5,500	4.9 Years	46.20	3,900	46.20
19,000	3.0 Years	48.50	19,000	48.50
39,500	5.1 Years	48.55	31,900	48.55
2,000	4.7 Years	49.10	2,000	49.10
10,000	0.2 Years	53.41	8,000	53.41
95,880	3.3 Years	45.70	84,680	45.26

Information related to non-vested options for the year ended December 31, 2012, is as follows:

	Number of Shares	Weighted Average Grant Date Fair Value
Non-vested options, December 31, 2011	24,000	$ 49.13
Granted	-	-
Vested	(9,400)	(49.42)
Forfeited	(3,400)	(48.55)
Non-vested options, December 31, 2012	11,200	$ 49.08

Note 14. Income Taxes

The Company files consolidated income tax returns with its subsidiary, Bank of Tennessee. Under the terms of a tax-sharing agreement, the subsidiary's allocated portion of the consolidated tax liability is computed as if it were reporting its income and expenses as a separate entity.

The provision for income taxes in the consolidated statements of income for the years ended December 31, 2012 and 2011, includes the following:

	2012	2011
Current tax expense:		
State	$ -	$ -
Deferred income taxes related to:		
Provision for loan losses	(17,000)	10,700
Depreciation	4,000	8,700
Deferred compensation retirement plans	(25,100)	2,500
Cash method of accounting	2,800	7,100
Reversal of over accrual of prior year tax	-	(385,000)
Tennessee tax credits carryover	(95,400)	(202,500)
Other	(2,750)	57,677
Provision for income taxes	$ (133,450)	$ (500,823)

Deferred tax assets recognized for deductible temporary differences totaled $981,045 and $894,688 at December 31, 2012 and 2011, respectively. Deferred tax liabilities for taxable temporary differences totaled $282,730 and $200,378 at December 31, 2012 and 2011, respectively.

The Company files its consolidated tax return as an S Corporation under the Internal Revenue Code. Consequently, the Company no longer pays normal federal income tax. The federal income tax effects of the Company's operations will be included in each stockholder's personal tax return.

Note 15. Employee Retirement Plans

The Company has a salary reduction/profit-sharing plan under the provisions of Section 401(k) of the Internal Revenue Code. All employees are eligible to participate immediately upon hire. The Plan provides for contributions by the Company in such amounts as determined by the Board of Directors not to exceed 6 percent of the participant's annual compensation. In addition, the Plan provides for the Company to match employee contributions to the Plan equal to 50 percent of the first 6 percent of the participant's annual compensation. The Company contributed $210,589 and $195,553 to the Plan for the years ended December 31, 2012 and 2011, respectively.

The Company and the Bank provide deferred compensation agreements for the benefit of senior and executive officers. The Bank records the estimated amount of future payments to be made over the active service periods of the officers. Deferred compensation expense under these agreements was $342,526 and $295,391 for the years ended December 31, 2012 and 2011, respectively.

Note 16. Employee Stock Ownership Plan

Effective January 1, 2004, the Company established an Employee Stock Ownership Plan (the Plan), within the guidelines as defined by the Internal Revenue Code, for the purpose of enabling participants to acquire an ownership interest in the Company. All employees are eligible to participate in the Plan after completing one year of service with a minimum of 1,000 hours. Initial funding for the purchase of the Company's common stock was provided by Security Acquisition Loans from the Company to the Plan. The Security Acquisition Loans call for principal and interest to be repaid in ten equal annual installments of principal and interest. Shares obtained in connection with Security Acquisition Loans are held in a suspense account and are classified as unallocated shares.

Contributions are made to the Plan as determined by the Company's Board of Directors, generally commensurate with the debt service requirements set forth in the loan agreements. Unallocated shares held in suspense by the Plan are released based on the ratio of principal payments made in the current year to total required future principal payments. Shares of the Company's common stock owned by the Plan are allocated as of each year end to each participant based on the ratio of individual compensation to total covered compensation, as defined by the agreement. Contributions can be in the form of cash, shares of Company stock, or other property as determined by the Board.

S Corporation distributions related to unallocated shares are used to fund the debt service requirements defined in the Security Acquisition Loans. Any remaining distributions are allocated proportionately to the participant, as defined by the plan agreement. At the Board's discretion, S Corporation distributions related to allocated shares may be used to make payments on Securities Acquisition Loans or shall be allocated to the participants, in accordance with the plan agreement.

Note 16. Employee Stock Ownership Plan (continued)

The Company recognizes compensation expense for contributions and for allocated shares that were previously unallocated. The fair value, as determined by an independent appraisal, is used to calculate the compensation expense. Compensation expense recognized in association with the Plan for 2012 and 2011 totaled $222,392 and $206,885, respectively.

When a participant retires or otherwise terminates from the Plan, the Company is required to offer the participant the fair value for any allocated, vested shares of company stock. If the participant declines this option, the Company retains the right of first refusal of such shares. At December 31, 2012 and 2011, there were no repurchase obligations outstanding.

The fair value of unallocated shares at December 31, 2012, was $32.15 per share as determined by the most recent stock valuation performed as of December 31, 2011. The number of shares allocated, unallocated and committed to be released totaled 40,198, 26,749 and zero, respectively, as of December 31, 2012.

Note 17. Financial Instruments With Off-Balance-Sheet Risk

In the normal course of business, the Bank has outstanding commitments and contingent liabilities, such as commitments to extend credit and standby letters of credit, which are not included in the accompanying financial statements. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual or notional amount of those instruments. The Bank uses the same credit policies in making such commitments as it does for instruments that are included in the balance sheet. At December 31, 2012, commitments under standby letters of credit were approximately $180,000, and undisbursed loan commitments aggregated approximately $75,800,000.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Standby letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank's policy for obtaining collateral, and the nature of such collateral, is essentially the same as that involved in making commitments to extend credit.

Note 17. Financial Instruments With Off-Balance-Sheet Risk (continued)

At December 31, 2012 and 2011, the financial guarantees the Bank was required to fund were insignificant. The Bank has not incurred any losses on its commitments in either 2012 or 2011.

Note 18. Fair Value Disclosures

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with ASC Topic 820, “Fair Value Measurements and Disclosures”, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

ASC Topic 820 provides a consistent definition of fair value, which focuses on exit price in an orderly transaction between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

ASC Topic 820 also establishes a three-tier fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value, as follows:

Level 1 - Quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access.

Level 2 - Significant other observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities in active markets, quoted prices in markets that are not active and other inputs that are observable or can be corroborated by observable market data.

Level 3 - Significant unobservable inputs that reflect a company’s own assumptions about the assumptions that market participants would use in pricing an asset or liability.

A financial instrument’s categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Note 18. Fair Value Disclosures (continued)

The following methods and assumptions were used by the Company in estimating fair value disclosures for financial instruments:

Cash and due from banks:

The carrying amounts of cash and due from banks approximate fair values based on the short-term nature of the assets.

Certificates of deposit with other financial institutions:

The carrying amount of certificates of deposit with other financial institutions approximates fair value based on the short-term nature of these assets.

Securities available for sale:

Fair values are estimated using pricing models and discounted cash flows that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, and credit spreads. Securities classified as available for sale are reported at fair value utilizing Level 2 inputs.

Restricted investments:

The carrying value of restricted investments approximates fair value based on the stock redemption provisions of the respective entities.

Federal funds sold:

For federal funds sold, the carrying amount is a reasonable estimate of fair value.

Loans:

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for fixed-rate loans are estimated using discounted cash flow analyses, using market interest rates for comparable loans. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with ASC Topic 310, “Accounting by Creditors for Impairment of a Loan”. The fair value of impaired loans is estimated using several methods including collateral value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At December 31, 2012 and 2011, substantially all impaired loans were evaluated based on the fair value of collateral. In accordance with ASC Topic 820, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the impaired loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3.

Note 18. Fair Value Disclosures (continued)

Cash surrender value of life insurance:

The carrying amounts of cash surrender value of life insurance approximate their fair value. The carrying amount is based on information received from the insurance carriers indicating the financial performance of the policies and the amount the Company would receive should the policies be surrendered. The Company reflects these assets within Level 2 of the valuation hierarchy.

Foreclosed real estate and repossessed assets:

Foreclosed real estate and repossessed assets, consisting of properties and other assets obtained through foreclosure, repossession or in satisfaction of loans, is initially recorded at fair value, determined on the basis of current appraisals, comparable sales, and other estimates of value obtained principally from independent sources, adjusted for estimated selling costs. At the time of foreclosure or repossession, any excess of the loan balance over the fair value of the asset held as collateral is treated as a charge against the allowance for loan losses. Gains or losses on sale and any subsequent adjustment to the fair value are recorded as a component of foreclosed real estate or repossession expense. When the fair value is based on an observable market price or a current appraised value, the Company records the asset as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the asset is further impaired below the appraised value and there is no observable market price, the Company records the asset as nonrecurring Level 3.

Deposits:

The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits and NOW, money market, and savings accounts, is equal to the amount payable on demand at the reporting date. The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates on comparable instruments to a schedule of aggregated expected monthly maturities on time deposits.

Securities sold under agreements to repurchase and federal funds purchased:

For securities sold under agreements to repurchase with commercial checking customers and federal funds purchased, the estimated fair value approximates their carrying value.

The fair value of structured repurchase agreements is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates.

Subordinated debentures:

The carrying amount of the subordinated debentures with floating interest rates is a reasonable estimate of fair value.

Note 18. Fair Value Disclosures (continued)

Interest rate swaps:

Substantially all interest rate swaps held or issued by the Company for risk management are traded in over-the-counter markets where quoted market prices are not readily available. For these derivatives, the Company measures fair value using models that use primarily market observable inputs, such as yield curves and option volatilities, and include the value associated with counterparty risk. The Company classifies interest rate swaps held or issued for risk management activities as Level 2 inputs.

Federal Home Loan Bank advances:

Fair values of advances are estimated using discounted cash flow analyses based on current market rates for similar types of borrowing arrangements.

Accrued interest:

The carrying amounts of accrued interest approximate fair value.

The tables below present the recorded amount of assets and liabilities measured at fair value on a recurring basis.

	Balance as of December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Financial Assets:				
Securities available for sale:				
U.S. Government sponsored enterprises	$ 23,228,684	$ -	$ 23,228,684	$ -
Obligations of states and political subdivisions	44,209,082	-	44,209,082	-
Mortgage-backed securities -				
Government National Mortgage Association guaranteed	23,434,604	-	23,434,604	-
GSE residential	42,579,578	-	42,579,578	-
Equity securities	107,315	-	107,315	-
Total securities available for sale	$ 133,559,263	$ -	$ 133,559,263	$ -
Cash surrender value of life insurance	$ 15,320,206	$ -	$ 15,320,206	$ -
Financial Liabilities:				
Interest rate swaps	$ 1,366,695	$ -	$ 1,366,695	$ -

Note 18. Fair Value Disclosures (continued)

	Balance as of December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Financial Assets:				
Securities available for sale:				
U.S. Government sponsored enterprises	$ 4,273,659	$ -	$ 4,273,659	$ -
Obligations of states and political subdivisions	34,536,424	-	34,536,424	-
Mortgage-backed securities - Government National Mortgage Association guaranteed	21,401,066	-	21,401,066	-
GSE residential	45,123,692	-	45,123,692	-
Equity securities	48,951	-	48,951	-
Total securities available for sale	$ 105,383,792	$ -	$ 105,383,792	$ -
Cash surrender value of life insurance	$ 14,689,753	$ -	$ 14,689,753	$ -
Financial Liabilities:				
Interest rate swaps	$ 1,404,192	$ -	$ 1,404,192	$ -

The Company has no assets or liabilities whose fair values are measured on a recurring basis using Level 3 inputs.

Certain assets and liabilities are measured at fair value on a nonrecurring basis, which means the assets and liabilities are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment).

Note 18. Fair Value Disclosures (continued)

The tables below present information about assets on the consolidated balance sheets at December 31, 2012 and 2011, for which a nonrecurring change in fair value was recorded (in thousands):

	Balance as of December 31, 2012	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	$ 13,412	$ -	$ 5,647	$ 7,765
Foreclosed real estate	1,308	-	471	837
Repossessed assets	-	-	-	-
Investment in Paragon Commercial Corporation	10,439	-	10,439	-
Other assets	7	-	-	7

	Balance as of December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	$ 11,040	$ -	$ 2,708	$ 8,332
Foreclosed real estate	3,233	-	1,215	2,018
Repossessed assets	56	-	-	56
Investment in Paragon Commercial Corporation	10,439	-	10,439	-
Other assets	7	-	-	7

Loans include impaired loans held for investment for which an allowance for loan losses has been calculated based upon the fair value of the collateral at December 31, 2012 and 2011. Losses derived from Level 2 inputs were calculated by models incorporating significant observable market data. Losses derived from Level 3 inputs were calculated primarily by models utilizing management’s estimate of the collateral value.

Note 18. Fair Value Disclosures (continued)

The carrying amount and estimated fair value of the Company's financial instruments at December 31, 2012 and 2011, are as follows (in thousands):

	2012		2011	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Assets:				
Cash and due from banks	$ 11,076	$ 11,076	$ 36,899	$ 36,899
Certificates of deposit with other financial institutions	490	490	-	-
Securities available for sale	133,559	133,559	105,384	105,384
Restricted investments	2,437	2,437	2,427	2,427
Federal funds sold	-	-	615	615
Net loans	455,334	458,949	439,968	446,756
Cash surrender value of life insurance	15,320	15,320	14,690	14,690
Interest rate swaps	273	273	546	546
Accrued interest receivable	1,649	1,649	1,620	1,620
Liabilities:				
Noninterest-bearing demand deposits	143,016	143,016	120,277	120,277
NOW accounts	104,424	104,424	101,788	101,788
Savings and money market accounts	215,536	215,536	206,472	206,472
Time deposits	80,764	81,066	95,823	96,375
Securities sold under agreements to repurchase	15,626	17,333	17,454	18,976
Federal funds purchased	2,795	2,795	949	949
Subordinated debentures	15,465	15,465	15,465	15,465
Interest rate swaps	1,640	1,640	1,950	1,950
Federal Home Loan Bank advances	30,647	31,843	35,733	37,717
Accrued interest payable	217	217	261	261

Note 19. Liquidity and Capital Resources

The Company's primary source of funds with which to pay its future obligations is the receipt of dividends from its subsidiary bank. Bank regulations limit the amount of dividends that may be paid without prior approval of the Bank's regulatory authorities. It is management's intent to limit the amount of dividends paid in order to maintain compliance with capital guidelines and to maintain a strong capital position in the Bank.

Note 20. Related-Party Transactions

Carter County Bancorp, Inc. (CCBI) and Carter County Bank (CCB) are affiliated with the Company through common management and ownership. The Bank provides data processing and other banking operational services to CCBI and CCB. Service revenue from CCBI and CCB totaled $1,149,051 and $1,111,065 in 2012 and 2011, respectively.

On October 18, 2012, the Company entered into an Agreement and Plan of Merger with CCBI whereby CCBI would be merged with and into the Company. This merger was effective January 1, 2013, and shareholders of CCBI received 3.89967 shares of BancTenn Corp. stock plus cash for any fractional shares. This merger will be accounted for as a combination of entities under common control.

Note 21. Regulatory Matters

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by the State of Tennessee Department of Financial Institutions and the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices.

The Company's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2012 and 2011, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2012, the most recent notification from the regulators categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's prompt corrective action category.

Note 21. Regulatory Matters (continued)

The Company’s and the Bank's actual capital amounts and ratios are also presented in the table. Dollar amounts are presented in thousands.

	Actual		For Capital Adequacy	
	Amount	Ratio	Amount	Ratio
As of December 31, 2012:				
Total capital to risk-weighted assets:				
Consolidated	$ 72,413	14.81%	$ 39,113	8.00%
Bank of Tennessee	60,717	12.69%	38,281	8.00%
Tier I capital to risk-weighted assets:				
Consolidated	66,281	13.56%	19,556	4.00%
Bank of Tennessee	54,726	11.44%	19,141	4.00%
Tier I capital to average assets:				
Consolidated	66,281	9.99%	26,546	4.00%
Bank of Tennessee	54,726	8.39%	26,083	4.00%
As of December 31, 2011:				
Total capital to risk-weighted assets:				
Consolidated	$ 71,517	15.17%	$ 37,709	8.00%
Bank of Tennessee	59,552	12.92%	36,880	8.00%
Tier I capital to risk-weighted assets:				
Consolidated	65,605	13.92%	18,855	4.00%
Bank of Tennessee	53,770	11.66%	18,440	4.00%
Tier I capital to average assets:				
Consolidated	65,605	10.06%	26,088	4.00%
Bank of Tennessee	53,770	8.39%	25,628	4.00%

Note 22. Contingencies

During the normal course of business, the Company is subject to various lawsuits and claims. As of December 31, 2012, management believes that there are no current proceedings that would materially impact the consolidated financial statements of the Company.

Note 23. Concentrations in Deposits

The Company had a concentration in its deposits of one customer totaling approximately $38,987,000 and $39,482,000 at December 31, 2012 and 2011, respectively.

Hazlett, Lewis & Bieter, PLLC
CERTIFIED PUBLIC ACCOUNTANTS AND BUSINESS ADVISORS

Independent Auditors' Report

on the Supplementary Information

To the Stockholders and
Board of Directors
BancTenn Corp.
Kingsport, Tennessee

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information is presented for purposes of additional analysis rather than to present the financial position and results of operations of the individual companies and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Hazlett, Lewis & Bieter, PLLC

Chattanooga, Tennessee
April 8, 2013

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BANCTENN CORP. AND SUBSIDIARY

CONSOLIDATING BALANCE SHEET
December 31, 2012

	Bank of Tennessee	BancTenn Corp.	Eliminations	Consolidated
ASSETS				
Cash and due from banks:				
Noninterest-bearing	$ 11,012,349	$ 96,777	$ 96,777	$ 11,012,349
Interest-bearing	63,450	-	-	63,450
Total cash and due from banks	11,075,799	96,777	96,777	11,075,799
Certificates of deposit with other financial institutions	490,000	-	-	490,000
Securities available for sale	133,451,948	107,315	-	133,559,263
Investment in Paragon Commercial Corporation	-	10,438,500	-	10,438,500
Investment in Appalachian Fund for Growth II	3,285,443	-	-	3,285,443
Restricted investments, at cost	2,437,300	-	-	2,437,300
Loans, net of allowance for loan losses	455,334,092	-	-	455,334,092
Premises and equipment	28,111,631	368,121	-	28,479,752
Accrued interest receivable	1,648,908	-	-	1,648,908
Cash surrender value of life insurance	15,320,206	-	-	15,320,206
Foreclosed real estate	1,308,304	-	-	1,308,304
Other assets	4,076,419	3,081,287	2,440,149	4,717,557
Investment in subsidiary	-	58,792,479	58,792,479	-
Total assets	$ 656,540,050	$ 72,884,479	$ 61,329,405	$ 668,095,124
LIABILITIES AND STOCKHOLDERS' EQUITY				
Deposits:				
Noninterest-bearing	$ 143,112,635	$ -	$ 96,777	$ 143,015,858
Interest-bearing	400,724,075	-	-	400,724,075
Total deposits	543,836,710	-	96,777	543,739,933
Securities sold under agreements to repurchase	15,626,159	-	-	15,626,159
Federal funds purchased	2,795,317	-	-	2,795,317
Federal Home Loan Bank advances	30,646,693	-	-	30,646,693
Subordinated debentures	-	15,465,000	-	15,465,000
Borrowings under line of credit	-	939,948	939,948	-
Accrued interest payable	131,929	84,980	-	216,909
Accrued expenses and other liabilities	4,710,763	2,324,088	1,500,201	5,534,650
Total liabilities	597,747,571	18,814,016	2,536,926	614,024,661
Stockholders' equity:				
Common stock, no par value; 250,000 shares authorized; 209,148 shares outstanding	1,673,184	-	1,673,184	-
Common stock, $8 par value; 6,000,000 shares authorized; 1,583,695 shares outstanding	-	12,669,560	-	12,669,560
Additional paid-in capital	14,877,811	11,850,443	14,877,811	11,850,443
Retained earnings	38,174,517	27,822,153	38,174,517	27,822,153
Accumulated other comprehensive income	4,066,967	2,668,255	4,066,967	2,668,255
Unallocated ESOP shares	-	(939,948)	-	(939,948)
Total stockholders' equity	58,792,479	54,070,463	58,792,479	54,070,463
Total liabilities and stockholders' equity	$ 656,540,050	$ 72,884,479	$ 61,329,405	$ 668,095,124

BANCTENN CORP. AND SUBSIDIARY

CONSOLIDATING STATEMENT OF INCOME
Year Ended December 31, 2012

	Bank of Tennessee	BancTenn Corp.	Eliminations	Consolidated
INTEREST INCOME				
Loans, including fees	$ 22,154,742	$ -	$ -	$ 22,154,742
Securities	2,649,372	-	-	2,649,372
Federal funds sold	3,607	-	-	3,607
	24,807,721	-	-	24,807,721
INTEREST EXPENSE	3,178,873	853,008	-	4,031,881
Net interest income (expense)	21,628,848	(853,008)	-	20,775,840
Provision for loan losses	2,029,000	-	-	2,029,000
Net interest income (expense) after provision for loan losses	19,599,848	(853,008)	-	18,746,840
NONINTEREST INCOME				
Customer service fees	1,400,831	-	-	1,400,831
Service revenue	3,675,515	-	-	3,675,515
Other	2,834,522	31,272	20,728	2,845,066
Equity in subsidiary's earnings	-	6,070,290	6,070,290	-
	7,910,868	6,101,562	6,091,018	7,921,412
NONINTEREST EXPENSES				
Salaries and employee benefits	11,743,064	833,493	-	12,576,557
Occupancy expenses	1,314,000	-	-	1,314,000
Other operating expenses	7,094,201	823,030	20,728	7,896,503
Loss on other assets	1,289,161	-	-	1,289,161
	21,440,426	1,656,523	20,728	23,076,221
Income before income taxes	6,070,290	3,592,031	6,070,290	3,592,031
Income taxes	-	(133,450)	-	(133,450)
Net income	$ 6,070,290	$ 3,725,481	$ 6,070,290	$ 3,725,481