

SOUTHEASTERN BANKING CORP

Form 10-Q

May 15, 2012

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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the**  
**Securities Exchange Act of 1934**

**For the Quarterly Period Ended March 31, 2012**

**Commission File Number 000-32627**

(Exact name of registrant as specified in its charter)

Georgia

58-1423423

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(State or other jurisdiction of

(IRS Employer

incorporation or organization)

Identification No.)

P. O. Box 455, 1010 North Way, Darien, Georgia 31305

(Address of principal executive offices) (Zip Code)

(912) 437-4141

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

As of May 10, 2012, the Registrant had 3,129,388 shares of common stock, par value \$1.25 per share, outstanding.

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	March 31, 2012 (Unaudited)	December 31, 2011
<b>ASSETS</b>		
Cash and due from banks	\$ 8,658,466	\$ 13,054,299
Interest-bearing deposits in other banks	101,006,159	83,943,754
Federal funds sold	2,150,000	2,150,000
<b>Cash and cash equivalents</b>	<b>111,814,625</b>	<b>99,148,053</b>
Investment securities available-for-sale	85,235,183	88,001,673
Loans, gross	192,552,313	202,308,311
Unearned income	(43,476)	(45,166)
Allowance for loan losses	(6,511,814)	(6,776,601)
<b>Net loans</b>	<b>185,997,023</b>	<b>195,486,544</b>
Premises and equipment, net	11,515,253	11,710,593
Bank-owned life insurance, at cash surrender value	6,032,527	5,973,805
Other real estate	16,664,485	12,653,580
Other assets	3,429,062	3,635,630
<b>Total assets</b>	<b>\$ 420,688,158</b>	<b>\$ 416,609,878</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Deposits:		
Noninterest-bearing demand deposits	\$ 75,921,426	\$ 63,612,851
Interest-bearing demand, savings, and time deposits	298,267,646	306,258,941
<b>Total deposits</b>	<b>374,189,072</b>	<b>369,871,792</b>
Federal Home Loan Bank advances	5,000,000	5,000,000
Other liabilities	1,514,438	1,613,431
<b>Total liabilities</b>	<b>380,703,510</b>	<b>376,485,223</b>

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**Shareholders' Equity:**

Common stock, \$1.25 par value	<b>4,475,996</b>	4,475,996
Additional paid-in-capital	<b>1,549,228</b>	1,541,027
Retained earnings	<b>42,078,986</b>	42,467,569
Treasury stock, at cost	<b>(8,894,461)</b>	(8,894,461)
Accumulated other comprehensive income	<b>774,899</b>	534,524
Total shareholders' equity	<b>39,984,648</b>	40,124,655
Total liabilities and shareholders' equity	<b>\$ 420,688,158</b>	\$ 416,609,878
Common shares issued	<b>3,580,797</b>	3,580,797
Common shares authorized	<b>10,000,000</b>	10,000,000
Common shares outstanding	<b>3,129,388</b>	3,129,388
Treasury shares	<b>451,409</b>	451,409

See accompanying notes to consolidated financial statements.

**Table of Contents****SOUTHEASTERN BANKING CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****THREE MONTHS ENDED MARCH 31, 2012 AND 2011****(Unaudited)**

	2012	2011
<b>Interest income:</b>		
Interest and fees on loans	\$ 2,821,763	\$ 3,377,795
Interest on investment securities:		
Taxable	494,364	455,343
Tax-exempt	109,887	146,520
Other interest income	54,199	51,186
<b>Total interest income</b>	<b>3,480,213</b>	<b>4,030,844</b>
<b>Interest expense:</b>		
Interest on deposits	503,745	917,767
Interest on Federal Home Loan Bank advances	32,571	32,301
<b>Total interest expense</b>	<b>536,316</b>	<b>950,068</b>
<b>Net interest income</b>	<b>2,943,897</b>	<b>3,080,776</b>
<b>Provision for loan losses</b>	<b>600,000</b>	<b>660,000</b>
<b>Net interest income after provision for loan losses</b>	<b>2,343,897</b>	<b>2,420,776</b>
<b>Noninterest income:</b>		
Service charges on deposit accounts	527,690	550,877
Net loss on sales of investment securities available-for-sale	(10,866)	(18,191)
Other noninterest income	350,659	337,434
<b>Total noninterest income</b>	<b>867,483</b>	<b>870,120</b>
<b>Noninterest expense:</b>		
Salaries and employee benefits	1,709,092	1,682,707
Occupancy and equipment expense, net	637,663	612,777
Net (gain) loss on sales of assets	15,631	(22,029)
Write-downs on other real estate	469,790	161,127
Other noninterest expense	767,787	830,127
<b>Total noninterest expense</b>	<b>3,599,963</b>	<b>3,264,709</b>

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Income (loss) before income tax benefit	(388,583)	26,187
<b>Income tax benefit</b>	<b>0</b>	<b>0</b>
<b>Net income (loss)</b>	<b>\$ (388,583)</b>	<b>\$ 26,187</b>
<b>Basic and diluted earnings (loss) per common share</b>	<b>\$ (0.12)</b>	<b>\$ 0.01</b>
Basic and diluted weighted average common shares outstanding	<b>3,129,388</b>	<b>3,129,388</b>

See accompanying notes to consolidated financial statements.

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**SOUTHEASTERN BANKING CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

**THREE MONTHS ENDED MARCH 31, 2012 AND 2011**

**(Unaudited)**

	2012	2011
Net income (loss)	\$ (388,583)	\$ 26,187
Other comprehensive income:		
Unrealized holding gains on investment securities available-for-sale arising during the period, net of tax of \$120,135 and \$14,334	233,203	27,825
Reclassification adjustment for net loss on sales of investment securities available-for-sale included in net income (loss), net of tax benefit of (\$3,694) and (\$6,185)	7,172	12,006
	<b>240,375</b>	<b>39,831</b>
Comprehensive income (loss)	\$ (148,208)	\$ 66,018

See accompanying notes to consolidated financial statements.



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## SOUTHEASTERN BANKING CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

THREE MONTHS ENDED MARCH 31, 2012 AND 2011

(Unaudited)

	Common Stock		Additional	Retained	Treasury	Accumulated	
	Shares	Par Value	Paid-In Capital	Earnings	Stock	Other Comprehensive Income	Total
<b>Balance, December 31, 2010</b>	3,129,388	\$ 4,475,996	\$ 1,495,668	\$ 47,459,963	\$ (8,894,461)	\$ 268,393	\$ 44,805,559
Net income	0	0	0	26,187	0	0	26,187
Other comprehensive income	0	0	0	0	0	39,831	39,831
Stock-based compensation	0	0	11,340	0	0	0	11,340
<b>Balance, March 31, 2011</b>	3,129,388	\$ 4,475,996	\$ 1,507,008	\$ 47,486,150	\$ (8,894,461)	\$ 308,224	\$ 44,882,917
<b>Balance, December 31, 2011</b>	3,129,388	\$ 4,475,996	\$ 1,541,027	\$ 42,467,569	\$ (8,894,461)	\$ 534,524	\$ 40,124,655
Net loss	0	0	0	(388,583)	0	0	(388,583)
Other comprehensive income	0	0	0	0	0	240,375	240,375
Stock-based compensation	0	0	8,201	0	0	0	8,201
<b>Balance, March 31, 2012</b>	3,129,388	\$ 4,475,996	\$ 1,549,228	\$ 42,078,986	\$ (8,894,461)	\$ 774,899	\$ 39,984,648

See accompanying notes to consolidated financial statements.

**Table of Contents****SOUTHEASTERN BANKING CORPORATION AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****THREE MONTHS ENDED MARCH 31, 2012 AND 2011****(Unaudited)**

	2012	2011
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income (loss)	\$ (388,583)	\$ 26,187
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation, amortization and accretion, net	432,062	192,511
Provision for loan losses	600,000	660,000
Net loss on sales of investment securities available-for-sale	10,866	18,191
Increase in cash surrender value of bank-owned life insurance	(58,722)	(57,919)
Net (gain) loss on sales of assets	15,631	(22,029)
Write-downs on other real estate	469,790	161,127
Stock-based compensation	8,201	11,340
(Increase) decrease in interest receivable	(6,954)	100,213
Decrease in interest payable	(331,712)	(102,013)
Net change in income tax receivable	28,496	9,953
Decrease in prepaid FDIC assessments	132,000	189,000
Net decrease in other assets	27,298	36,557
Net increase in other liabilities	108,890	65,740
<b>Net cash provided by operating activities</b>	<b>1,047,263</b>	<b>1,288,858</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchase of investment securities available-for-sale	(5,113,194)	(152,101,435)
Proceeds from sales of investment securities available-for-sale	2,834,050	474,000
Proceeds from maturities, calls, and paydowns of investment securities available-for-sale	5,168,700	150,115,547
Net decrease in loans	4,201,775	5,742,537
Capital expenditures, net	(1,200)	(51,525)
Proceeds from sales of assets	211,898	615,125
<b>Net cash provided by investing activities</b>	<b>7,302,029</b>	<b>4,794,249</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in deposits	4,317,280	6,393,214
Net increase in U. S. Treasury demand note	0	279,727
<b>Net cash provided by financing activities</b>	<b>4,317,280</b>	<b>6,672,941</b>
<b>Net increase in cash and cash equivalents</b>	<b>12,666,572</b>	<b>12,756,048</b>
<b>Cash and cash equivalents at beginning of period</b>	<b>99,148,053</b>	<b>80,868,505</b>

<b>Cash and cash equivalents at end of period</b>	<b>\$ 111,814,625</b>	<b>\$ 93,624,553</b>
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	2012	2011
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b>		
Cash paid (received) during the period for:		
Interest	\$ 868,028	\$ 1,052,081
Income taxes refunded	\$ (28,496)	\$ (9,953)
<b>NONCASH INVESTING AND FINANCING TRANSACTIONS</b>		
Change in unrealized gains on investment securities available-for-sale	\$ 364,204	\$ 60,350
Property acquired through foreclosure or repossession	\$ 4,702,866	\$ 2,032,875
Loans made in connection with sales of other real estate	\$ 15,120	\$ 0
See accompanying notes to consolidated financial statements.		

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**NOTE 1. BASIS OF PRESENTATION**

Southeastern Banking Corporation (the Company) is a bank holding company whose business is conducted primarily by its wholly-owned commercial bank subsidiary, Southeastern Bank (the Bank). The Bank was founded in 1888 in Darien, McIntosh County, Georgia. Through the Bank's 16 branch offices, the Company offers a broad range of commercial and consumer banking products and services to customers located primarily in southeast Georgia and northeast Florida. The Company and the Bank are subject to the regulations of certain federal and state agencies and are periodically examined by those regulatory agencies.

The Company also owns SBC Financial Services, Inc., a Georgia corporation. This subsidiary was created to provide insurance services. However, there has been no activity in this subsidiary in recent years.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP) for interim financial information and the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, these financial statements do not include all of the information and footnotes required by U.S. GAAP for complete financial statements and should be read in conjunction with the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

The accounting and reporting policies followed in the presentation of the accompanying unaudited consolidated financial statements are consistent with those described in Note 1 of the notes to the consolidated financial statements included in the Company's 2011 Form 10-K, as updated by the information contained in this Form 10-Q. In the opinion of management, these consolidated financial statements reflect all adjustments necessary to fairly present such information for the periods and dates indicated. Such adjustments, which include transactions typically determined or settled at year-end, are normal and recurring in nature. All significant intercompany accounts and transactions have been eliminated. The consolidated balance sheet as of December 31, 2011 has been extracted from the audited consolidated balance sheet included in the Company's 2011 Form 10-K. Certain reclassifications, with no effect on total assets or net operating results, have been made to prior period amounts to conform to the current period presentation.

In preparing the consolidated financial statements in accordance with U.S. GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the balance sheet date and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, the valuation of foreclosed assets, the valuation of deferred taxes, other-than-temporary impairment of securities, and fair value measurements. Results of operations for interim periods are not necessarily indicative of trends or results to be expected for the full year, due in part to seasonal variations and unusual or infrequently occurring items.

**Earnings (Loss) Per Share**

Basic earnings (loss) per share represents income (loss) available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings (loss) per share reflects additional potential common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income (loss) that would result from the assumed issuance. Potential common shares that may be issued by the Company relate solely to outstanding stock options, and are determined using the treasury stock method. Since they were non-dilutive, 70,250 equivalent shares related to stock options were excluded from the computation of diluted earnings (loss) per share at March 31, 2012 and 2011.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**NOTE 2. NEW ACCOUNTING PRONOUNCEMENTS**

The following are summaries of recently issued accounting pronouncements that impact the accounting and reporting practices of the Company:

In May 2011, the Financial Accounting Standards Board ( FASB ) issued additional guidance on fair value measurement. The new guidance results in common fair value measurement and disclosure requirements in U.S. GAAP and International Financial Reporting Standards. The amendments do not require additional fair value measurements and are not intended to establish valuation standards or affect valuation practices outside of financial reporting. The amendments clarify the proper application of the highest and best use and valuation premise concepts and the fair value measurement of an instrument classified in shareholders' equity. Additionally, the amendments permit a reporting entity that manages financial instruments on the basis of its net exposure, rather than gross exposure, to measure the underlying financial assets and liabilities at the price that would be received to sell a net asset position or transfer a net liability position for a particular risk in an orderly transaction between market participants at the measurement date and clarify that premiums and discounts in fair value measurements relate to the unit of account, and not size, as a characteristic of an entity's holding. Expanded disclosure must be provided about valuation processes used for level 3 instruments, including quantitative information on unobservable inputs and sensitivity of fair value measurement to changes in unobservable inputs; use of nonfinancial assets if that use varies from its highest and best use, and that an asset is measured at fair value on the statements of condition or its fair value is based on highest and best use; and categorization by level of the fair value hierarchy for items not measured at fair value on the statements of condition but for which fair value must be disclosed. The amendments are effective for interim and annual periods beginning after December 15, 2011. Adoption of the new guidance has not had a material impact on the Company's financial position or results of operations.

In June 2011, the FASB amended existing guidance and eliminated the option to present the components of other comprehensive income as part of the statement of changes in shareholders' equity. The amendment requires that comprehensive income be presented in either a single continuous statement or in two separate consecutive statements. The amendments in this guidance are effective as of the beginning of a fiscal reporting year that begins after December 15, 2011. The adoption of this guidance has not had a material impact on the Company's financial statements.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****NOTE 3. INVESTMENT SECURITIES**

The amortized cost and fair value of securities available-for-sale as of March 31, 2012 and December 31, 2011 are summarized as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<i>March 31, 2012</i>				
U. S. Government and agency securities	\$ 14,592,058	\$ 194,593	\$ 37,688	\$ 14,748,963
U. S. Government-sponsored enterprise securities	6,250,697	99,960	0	6,350,657
Agency residential mortgage-backed securities	41,356,751	731,242	53,070	42,034,923
Obligations of states and political subdivisions	14,877,161	352,454	48,987	15,180,628
Corporate debt obligations	6,984,426	64,260	128,674	6,920,012
<b>Total investment securities</b>	<b>\$ 84,061,093</b>	<b>\$ 1,442,509</b>	<b>\$ 268,419</b>	<b>\$ 85,235,183</b>
<i>December 31, 2011</i>				
U. S. Government and agency securities	\$ 13,405,548	\$ 203,704	\$ 35,436	\$ 13,573,816
U. S. Government-sponsored enterprise securities	6,539,649	97,362	0	6,637,011
Agency residential mortgage-backed securities	41,362,196	703,588	81,120	41,984,664
Obligations of states and political subdivisions	16,539,431	474,377	1,486	17,012,322
Corporate debt obligations	9,344,963	26,158	577,261	8,793,860
<b>Total investment securities</b>	<b>\$ 87,191,787</b>	<b>\$ 1,505,189</b>	<b>\$ 695,303</b>	<b>\$ 88,001,673</b>

The amortized cost and fair value of debt securities by contractual maturity at March 31, 2012 are shown in the table below. In some cases, issuers may have the right to call or prepay obligations without call or prepayment penalties prior to the contractual maturity date.

Mortgage-backed securities and U.S. Small Business Administration ( SBA ) securities (included in U.S. Government and agency securities) are shown separately from other debt securities due to customary prepayment features which cause average lives to differ significantly from contractual maturities.

	Amortized Cost	Fair Value
Due within one year	\$ 2,065,680	\$ 2,082,964
Due from one to five years	12,691,253	12,975,272
Due from five to ten years	3,858,621	3,945,667
Due after ten years	9,496,730	9,447,394
	<b>28,112,284</b>	<b>28,451,297</b>
Agency residential mortgage-backed securities	41,356,751	42,034,923
SBA securities	14,592,058	14,748,963

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Total investment securities	<b>\$ 84,061,093</b>	<b>\$ 85,235,183</b>
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Securities with a carrying value of \$60,303,801 and \$66,506,077 at March 31, 2012 and December 31, 2011, respectively, were pledged to secure public deposits and certain borrowing arrangements.

Gains and losses on sales of investment securities for the three months ended March 31, 2012 and 2011 consist of the following:

<i>Three Months Ended March 31,</i>	<b>2012</b>	2011
Gross realized gains	<b>\$ 67,880</b>	\$ 0
Gross realized losses	<b>78,746</b>	18,191
<b>Net realized gain (loss)</b>	<b>\$ (10,866)</b>	\$ (18,191)

The following table shows the gross unrealized losses and fair value of the entity's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at March 31, 2012 and December 31, 2011.

	Less Than Twelve Months		Over Twelve Months		Total Gross Unrealized Losses
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	
<b>March 31, 2012</b>					
U. S. Government and agency securities	\$ 4,512,163	\$ 37,688	\$ 0	\$ 0	\$ 37,688
U. S. Government-sponsored enterprise securities	0	0	0	0	0
Agency residential mortgage-backed securities	13,338,020	53,070	0	0	53,070
Obligations of states and political subdivisions	2,617,673	48,987	0	0	48,987
Corporate debt obligations	2,426,738	18,001	1,905,396	110,673	128,674
<b>Total investment securities</b>	<b>\$ 22,894,594</b>	<b>\$ 157,746</b>	<b>\$ 1,905,396</b>	<b>\$ 110,673</b>	<b>\$ 268,419</b>

*December 31, 2011*

U. S. Government and agency securities	\$ 6,411,426	\$ 35,436	\$ 0	\$ 0	\$ 35,436
U. S. Government-sponsored enterprise securities	0	0	0	0	0
Agency residential mortgage-backed securities	17,388,801	81,120	0	0	81,120
Obligations of states and political subdivisions	1,056,886	1,486	0	0	1,486
Corporate debt obligations	2,414,813	32,706	3,825,764	544,555	577,261
<b>Total investment securities</b>	<b>\$ 27,271,926</b>	<b>\$ 150,748</b>	<b>\$ 3,825,764</b>	<b>\$ 544,555</b>	<b>\$ 695,303</b>

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Management evaluates the Company's debt securities for other-than-temporary impairment at least on an annual basis, and more frequently when economic or market conditions warrant.

At March 31, 2012, there were three corporate debt securities with a fair value of \$1,905,396 in the investment portfolio that had been in a continuous unrealized loss position for twelve months or longer. All three corporate debt securities were issued by corporations in the financial services sector in the southeastern United States. The unrealized losses are primarily caused by decreases in profitability and increases in nonperforming assets caused by the economic recession. The Company currently does not believe it is probable that it will be unable to collect all amounts due according to the contractual terms of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of its par value, which may be at maturity, it does not consider these investments to be other-than-temporarily impaired at March 31, 2012.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

**NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES**

The composition of the loan portfolio at March 31, 2012 and December 31, 2011 follows.

	March 31, 2012	December 31, 2011
Commercial real estate:		
Construction and development	\$ 54,585,016	\$ 61,947,478
Owner-occupied	35,429,350	36,389,057
Non owner-occupied	28,449,221	27,772,007
Residential real estate - mortgage	43,198,837	44,201,750
Other commercial, financial, and agricultural	21,932,452	22,446,349
Consumer, including credit cards	8,957,437	9,551,670
Loans, gross	192,552,313	202,308,311
Unearned income	(43,476)	(45,166)
Allowance for loan losses	(6,511,814)	(6,776,601)
Net loans	\$ 185,997,023	\$ 195,486,544

In accordance with U.S. GAAP, the loan portfolio is disaggregated into four segments and further disaggregated into classes for certain disclosures. A portfolio segment is defined as the level in which an entity develops and documents a systematic method for determining its allowance for loan losses. The segments used in the portfolio include commercial real estate; residential real estate mortgage; other commercial, financial, agricultural; and consumer. Commercial real estate has been divided into three classes, including construction and development, owner-occupied, and non owner-occupied credits. All land and lot development loans have been included in the construction and development class, regardless of whether the underlying real estate is zoned commercial or residential. This classification of construction and development loans corresponds with definitions used by banking regulators for examination and other purposes.

**Past Due and Nonaccrual Loans**

In accordance with bank regulatory guidance, a loan is placed on nonaccrual status if:

it is maintained on a cash basis because of deterioration in the financial condition of the borrower,

payment in full of principal or interest is not expected, or

principal or interest has been in default for a period of 90 days or more unless the loan is both well secured and in the process of collection.



**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)**

An aging of past due loans at March 31, 2012 and December 31, 2011 is presented by segment in the following table. Balances presented are based on book balance, or recorded investment.

	Current	Accruing 30 - 89 Days Past Due	Accruing 90+ Days Past Due	Total Accruing Past Due	Nonaccrual	Total
<i>March 31, 2012</i>						
<b>Commercial real estate:</b>						
<b>Construction and development</b>	\$ 35,922,152	\$ 485,727	\$ 0	\$ 485,727	\$ 18,177,137	\$ 54,585,016
<b>Owner-occupied</b>	34,327,716	594,251	0	594,251	507,383	35,429,350
<b>Non owner-occupied</b>	25,852,023	2,309,519	0	2,309,519	287,679	28,449,221
<b>Residential real estate - mortgage</b>	36,472,947	637,898	0	637,898	6,087,992	43,198,837
<b>Other commercial, financial, and agricultural</b>	20,995,213	546,674	13,065	559,739	377,500	21,932,452
<b>Consumer, including credit cards</b>	8,503,168	223,669	8,086	231,755	222,514	8,957,437
<b>Loans, gross</b>	<b>\$ 162,073,219</b>	<b>\$ 4,797,738</b>	<b>\$ 21,151</b>	<b>\$ 4,818,889</b>	<b>\$ 25,660,205</b>	<b>\$ 192,552,313</b>
<i>December 31, 2011</i>						
<b>Commercial real estate:</b>						
<b>Construction and development</b>	\$ 37,244,104	\$ 1,237,685	\$ 15,241	\$ 1,252,926	\$ 23,450,448	\$ 61,947,478
<b>Owner-occupied</b>	35,577,301	296,252	202,945	499,197	312,559	36,389,057
<b>Non owner-occupied</b>	27,577,932	41,809	0	41,809	152,266	27,772,007
<b>Residential real estate - mortgage</b>	36,877,541	1,079,051	25,231	1,104,282	6,219,927	44,201,750
<b>Other commercial, financial, and agricultural</b>	21,862,254	199,638	0	199,638	384,457	22,446,349
<b>Consumer, including credit cards</b>	8,934,708	334,259	4,853	339,112	277,850	9,551,670
<b>Loans, gross</b>	<b>\$ 168,073,840</b>	<b>\$ 3,188,694</b>	<b>\$ 248,270</b>	<b>\$ 3,436,964</b>	<b>\$ 30,797,507</b>	<b>\$ 202,308,311</b>

The gross amount of interest income that would have been recorded on nonaccrual loans if all such loans had been accruing interest at their contractual rates approximated \$394,000 and \$410,000 in the three months ended March 31, 2012 and 2011, respectively. Cash basis interest income actually recognized on nonaccrual loans during the three months ended March 31, 2012 and 2011 totaled approximately \$12,000 and \$15,000, respectively. The average balance of loans on nonaccrual status during the three months ended March 31, 2012 and 2011 approximated \$29,692,000 and \$36,229,000, respectively.

**Credit Quality Indicators**

Internal risk-ratings, or grades, are assigned to each loan at origination (and renewal as applicable) based on an analysis of the financial strength, collateral, and other credit attributes underlying each loan. Subsequent to origination (and renewal), management periodically analyzes the

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resulting ratings, as well as other external statistics and factors such as delinquency, to track the migration performance of the portfolio balances. Loans with a risk-rating of Special Mention (Grade 5) or worse and a balance of \$100,000 or more are reviewed at least annually for grading accuracy. The rating methodology complies with the asset classification system promulgated by the federal banking agencies.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)**

Loan grades range from one to eight, with one-graded loans having the least credit risk, as defined as follows:

**Pass (Grades 1 -4):** Loans included in or migrating towards a pass grade of one to four carry the lowest risk of loss. Such loans are well-protected by the current net worth and paying capacity of the obligor (or guarantors, if any) or by the fair value, less selling costs, of underlying collateral.

**Special Mention (Grade 5):** Loans in this category have potential weaknesses requiring additional monitoring. These loans are not adversely classified and do not currently have sufficient risk to warrant adverse classification. Substantially all special mention loans are performing.

**Substandard (Grade 6):** These loans are inadequately supported by the current worth and paying capacity of the obligor or collateral pledged, if any. A distinct possibility of loss exists if the underlying deficiencies are not corrected. At March 31, 2012 and December 31, 2011, all nonaccrual loans were graded substandard.

**Doubtful (Grade 7):** These loans have all the weaknesses of a substandard loan with the added detriment that full collection or liquidation is highly questionable and improbable on the basis of currently known facts, conditions, and values.

**Loss (Grade 8):** These loans are deemed uncollectible and have, at best, nominal value. Maintaining these loans on the books, without establishment of specific valuation allowances, is not warranted.

Loans considered doubtful or loss are normally charged-off upon such determination and hence, no balances apply to these categories.

A summary of the loan portfolio by loan risk grade at March 31, 2012 and December 31, 2011 follows.

	Pass (1 -4)	Special Mention (5)	Substandard (6)	Doubtful (7)	Loss (8)	Total
<i>March 31, 2012</i>						
<b>Commercial real estate:</b>						
<b>Construction and development</b>	\$ 27,107,196	\$ 3,979,384	\$ 23,498,436	\$ 0	\$ 0	\$ 54,585,016
<b>Owner-occupied</b>	31,623,726	2,552,395	1,253,229	0	0	35,429,350
<b>Non owner-occupied</b>	19,322,806	5,620,172	3,506,243	0	0	28,449,221
<b>Residential real estate - mortgage</b>	35,249,541	938,425	7,010,871	0	0	43,198,837
<b>Other commercial, financial, and agricultural</b>	18,858,212	673,654	2,400,586	0	0	21,932,452
<b>Consumer, including credit cards</b>	8,420,752	197,713	338,972	0	0	8,957,437
<b>Loans, gross</b>	<b>\$ 140,582,233</b>	<b>\$ 13,961,743</b>	<b>\$ 38,008,337</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 192,552,313</b>

*December 31, 2011*

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Commercial real estate:						
Construction and development	\$ 28,144,755	\$ 4,783,547	\$ 29,019,176	\$ 0	\$ 0	\$ 61,947,478
Owner-occupied	32,314,164	2,803,772	1,271,121	0	0	36,389,057
Non owner-occupied	15,730,741	8,655,785	3,385,481	0	0	27,772,007
Residential real estate - mortgage	34,213,755	2,157,630	7,830,365	0	0	44,201,750
Other commercial, financial, and agricultural	19,096,155	740,654	2,609,540	0	0	22,446,349
Consumer, including credit cards	9,053,857	145,613	352,200	0	0	9,551,670
Loans, gross	\$ 138,553,427	\$ 19,287,001	\$ 44,467,883	\$ 0	\$ 0	\$ 202,308,311



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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

## NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

## Impaired Loans

A loan is considered impaired when it is probable, based on current information and events, the Company will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Impaired loans include loans placed on nonaccrual status as well as troubled debt restructurings ( TDRs ), loans past due 90 days or more and still accruing, and other accruing loans individually evaluated for impairment. All of the Company's impaired loans have a valuation allowance. Impaired loans comprised the following at March 31, 2012 and December 31, 2011:

	March 31, 2012	December 31, 2011
Nonaccrual loans	\$ 25,660,205	\$ 30,797,507
Troubled debt restructurings not included above	10,150,434	9,777,841
Loans past due 90 days or more and still accruing	21,151	248,270
Other accruing loans individually evaluated for impairment	3,029,092	4,138,142
<b>Total impaired loans</b>	<b>\$ 38,860,882</b>	<b>\$ 44,961,760</b>
Valuation allowance related to total impaired loans	\$ 2,458,249	\$ 2,378,113

Total impaired loans are disaggregated by segment and class at March 31, 2012 and December 31, 2011 below:

	Recorded Investment	Unpaid Principal Balance	Related Allowance
<i>As of March 31, 2012</i>			
<b>Impaired loans with a valuation allowance:</b>			
<b>Commercial real estate:</b>			
<b>Construction and development</b>	\$ 23,767,592	\$ 36,563,856	\$ 1,587,389
<b>Owner-occupied</b>	2,156,970	2,372,607	243,861
<b>Non owner-occupied</b>	3,506,243	3,614,308	116,796
<b>Residential real estate - mortgage</b>	6,784,513	9,697,931	408,418
<b>Other commercial, financial, and agricultural</b>	2,412,968	2,533,191	90,882
<b>Consumer, including credit cards</b>	232,596	349,235	10,903
<b>Total impaired loans</b>	<b>\$ 38,860,882</b>	<b>\$ 55,131,128</b>	<b>\$ 2,458,249</b>

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*As of December 31, 2011*

Impaired loans with a valuation allowance:

Commercial real estate:

Construction and development	\$ 29,137,602	\$ 41,439,776	\$ 1,560,695
Owner-occupied	2,175,425	2,376,712	251,506
Non owner-occupied	3,385,481	3,386,699	119,603
Residential real estate - mortgage	7,557,085	10,455,670	337,994
Other commercial, financial, and agricultural	2,421,126	2,535,378	90,425
Consumer, including credit cards	285,041	406,508	17,890

Total impaired loans	\$ 44,961,760	\$ 60,600,743	\$ 2,378,113
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The average investment in impaired loans for the three months ended March 31, 2012 and 2011 was \$43,515,387 and \$40,690,240, respectively.

Impaired loans with a valuation allowance include pools of impaired loans. At March 31, 2012, these pools had a recorded investment, or book balance, of \$3,051,373, unpaid principal balance of \$4,031,632, and related allowance of \$114,505. The recorded investment, unpaid principal and related allowance in such pools totaled \$3,028,009, \$3,939,653, and \$117,618, respectively, at December 31, 2011.

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

## NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

## Troubled Debt Restructurings

The following table summarizes the carrying balances of TDRs as of March 31, 2012 and December 31, 2011.

	March 31, 2012	December 31, 2011
Performing	\$ 10,150,434	\$ 9,777,841
Nonperforming	9,665,864	9,304,350
<b>Total troubled debt restructurings</b>	<b>\$ 19,816,298</b>	<b>\$ 19,082,191</b>
 Unfunded commitments to borrowers whose loans were modified in troubled debt restructurings	 \$ 0	 \$ 0

The following table summarizes loans that were modified and recognized as TDRs during the three months ended March 31, 2012.

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial real estate:			
Construction and development	4	\$ 800,521	\$ 800,521
Owner-occupied	0	0	0
Non owner-occupied	0	0	0
Residential real estate - mortgage	1	75,031	75,031
Other commercial, financial, and agricultural	0	0	0
Consumer, including credit cards	0	0	0
 Total loans modified and recognized as TDRs during the first quarter of 2012	 5	 \$ 875,552	 \$ 875,552

There was one construction and development loan in the amount of \$271,435 modified as a troubled debt restructuring during the prior twelve-month period ended March 31, 2012 for which there was a subsequent payment default. At the time of default, there was a \$50,222 impact on the allowance for loan losses as a result of the default on this loan.



**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)****Allowance for Loan Losses**

Changes in the allowance for loan losses for the three months ended March 31, 2012 and 2011 are summarized by loan segment below:

	Commercial Real Estate	Residential Real Estate	Other Commercial, Financial, & Agricultural	Consumer	Unallocated	Total
<i>As of and for the Three Months Ended March 31, 2012</i>						
<b>Allowance for loan losses:</b>						
Balance, beginning of year	\$ 4,775,449	\$ 1,484,763	\$ 331,024	\$ 133,748	\$ 51,617	\$ 6,776,601
Provision for loan losses	350,065	316,822	(18,043)	(19,488)	(29,356)	600,000
Charge-offs	(595,365)	(289,265)	(5,597)	(22,954)	0	(913,181)
Recoveries	2,418	22,480	3,241	20,255	0	48,394
<b>Ending balance</b>	<b>\$ 4,532,567</b>	<b>\$ 1,534,800</b>	<b>\$ 310,625</b>	<b>\$ 111,561</b>	<b>\$ 22,261</b>	<b>\$ 6,511,814</b>
<b>Ending balance, individually evaluated for impairment</b>	<b>\$ 1,881,790</b>	<b>\$ 374,195</b>	<b>\$ 85,763</b>	<b>\$ 1,996</b>	<b>n/a</b>	<b>\$ 2,343,744</b>
<b>Ending balance, collectively evaluated for impairment</b>	<b>\$ 2,650,777</b>	<b>\$ 1,160,605</b>	<b>\$ 224,862</b>	<b>\$ 109,565</b>	<b>\$ 22,261</b>	<b>\$ 4,168,070</b>
<b>Loans, gross:</b>						
<b>Ending balance</b>	<b>\$ 118,463,587</b>	<b>\$ 43,198,837</b>	<b>\$ 21,932,452</b>	<b>\$ 8,957,437</b>	<b>n/a</b>	<b>\$ 192,552,313</b>
<b>Ending balance, individually evaluated for impairment</b>	<b>\$ 28,096,745</b>	<b>\$ 5,664,872</b>	<b>\$ 2,045,896</b>	<b>\$ 1,996</b>	<b>n/a</b>	<b>\$ 35,809,509</b>
<b>Ending balance, collectively evaluated for impairment</b>	<b>\$ 90,366,842</b>	<b>\$ 37,533,965</b>	<b>\$ 19,886,556</b>	<b>\$ 8,955,441</b>	<b>n/a</b>	<b>\$ 156,742,804</b>

*As of and for the Three Months Ended  
March 31, 2011***Allowance for loan losses:**

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Balance, beginning of year	\$ 7,442,941	\$ 1,747,843	\$ 405,830	\$ 262,223	\$ 56,722	\$ 9,915,559
Provision for loan losses	211,790	445,255	(49,913)	(52,295)	105,163	660,000
Charge-offs	(2,016,469)	(180,426)	(12,849)	(36,111)	0	(2,245,855)
Recoveries	287	7,081	4,394	28,725	0	40,487
Ending balance	\$ 5,638,549	\$ 2,019,753	\$ 347,462	\$ 202,542	\$ 161,885	\$ 8,370,191
Ending balance, individually evaluated for impairment	\$ 1,123,722	\$ 1,277,339	\$ 562	\$ 0	n/a	\$ 2,401,623
Ending balance, collectively evaluated for impairment	\$ 4,514,827	\$ 742,414	\$ 346,900	\$ 202,542	\$ 161,885	\$ 5,968,568
<b>Loans, gross:</b>						
Ending balance	\$ 145,534,917	\$ 47,971,601	\$ 31,380,986	\$ 10,816,136	n/a	\$ 235,703,640
Ending balance, individually evaluated for impairment	\$ 28,221,913	\$ 6,362,967	\$ 18,741	\$ 26,610	n/a	\$ 34,630,231
Ending balance, collectively evaluated for impairment	\$ 117,313,004	\$ 41,608,634	\$ 31,362,245	\$ 10,789,526	n/a	\$ 201,073,409

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## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

## NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (Continued)

Changes in the allowance for loan losses for the three months ended March 31, 2012 and 2011 within the commercial real estate loan segment are summarized below:

	Construction & Development	Owner- Occupied	Non Owner- Occupied	Total Commercial Real Estate
<i>As of and for the Three Months Ended March 31, 2012</i>				
<b><u>Allowance for loan losses:</u></b>				
Balance, beginning of year	\$ 4,226,536	\$ 368,114	\$ 180,799	\$ 4,775,449
Provision for loan losses	240,819	(20,564)	129,810	350,065
Charge-offs	(490,804)	0	(104,561)	(595,365)
Recoveries	1,118	1,300	0	2,418
<b>Ending balance</b>	<b>\$ 3,977,669</b>	<b>\$ 348,850</b>	<b>\$ 206,048</b>	<b>\$ 4,532,567</b>
<b>Ending balance, individually evaluated for impairment</b>	<b>\$ 1,522,675</b>	<b>\$ 242,856</b>	<b>\$ 116,259</b>	<b>\$ 1,881,790</b>
<b>Ending balance, collectively evaluated for impairment</b>	<b>\$ 2,454,994</b>	<b>\$ 105,994</b>	<b>\$ 89,789</b>	<b>\$ 2,650,777</b>
<b><u>Loans, gross:</u></b>				
<b>Ending balance</b>	<b>\$ 54,585,016</b>	<b>\$ 35,429,350</b>	<b>\$ 28,449,221</b>	<b>\$ 118,463,587</b>
<b>Ending balance, individually evaluated for impairment</b>	<b>\$ 22,901,908</b>	<b>\$ 1,838,573</b>	<b>\$ 3,356,264</b>	<b>\$ 28,096,745</b>
<b>Ending balance, collectively evaluated for impairment</b>	<b>\$ 31,683,108</b>	<b>\$ 33,590,777</b>	<b>\$ 25,092,957</b>	<b>\$ 90,366,842</b>
<i>As of and for the Three Months Ended March 31, 2011</i>				
<b><u>Allowance for loan losses:</u></b>				
Balance, beginning of year	\$ 7,133,461	\$ 124,729	\$ 184,751	\$ 7,442,941
Provision for loan losses	(4,043)	51,372	164,461	211,790
Charge-offs	(1,852,280)	0	(164,189)	(2,016,469)

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Recoveries	287	0	0	287
Ending balance	\$ 5,277,425	\$ 176,101	\$ 185,023	\$ 5,638,549
Ending balance, individually evaluated for impairment	\$ 966,023	\$ 55,106	\$ 102,593	\$ 1,123,722
Ending balance, collectively evaluated for impairment	\$ 4,311,402	\$ 120,995	\$ 82,430	\$ 4,514,827
<b>Loans, gross:</b>				
Ending balance	\$ 80,361,545	\$ 36,197,929	\$ 28,975,443	\$ 145,534,917
Ending balance, individually evaluated for impairment	\$ 23,538,459	\$ 1,263,690	\$ 3,419,764	\$ 28,221,913
Ending balance, collectively evaluated for impairment	\$ 56,823,086	\$ 34,934,239	\$ 25,555,679	\$ 117,313,004



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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**NOTE 5. FAIR VALUE**  
**Determination of Fair Value**

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and for disclosure purposes. Accounting guidance on fair value measurements and disclosures specifies that 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 defined using quoted market prices, but in many instances, quoted market prices for the Company's various financial instruments may not be available. Under these circumstances, fair values are estimated using present value or other variation techniques. Those techniques are significantly affected by the underlying assumptions, including the discount rate and estimates of future cash flows; accordingly, the resulting fair value estimate may not be realized in an immediate settlement of the instrument.

Recent fair value guidance clarifies that exit prices based on orderly transactions between market participants under current market conditions, not forced liquidations or distressed sales, should be the basis for determining fair value. If the volume and level of activity for the asset or liability has declined significantly, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In this instance, determining the price at which willing market participants would transact depends on the various facts and circumstances and requires significant judgment. The resulting fair value is a reasonable point within the determined range that best indicates fair value under current conditions.

**Fair Value Hierarchy**

In accordance with accounting guidance, the Company groups its financial assets and liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities trade and the reliability of the assumptions used to determine fair value:

**Level 1**

Valuation is based on unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access. Level 1 assets and liabilities generally include debt and equity securities that are traded on an active exchange. Valuations are obtained from readily available pricing sources for market transactions involving such assets or liabilities.

**Level 2**

Valuation is based on inputs other than level 1 prices that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability. Level 2 inputs may incorporate interest rates and yield curves that are observable at commonly quoted intervals, volatilities, prepayment speeds, credit risks, and default rates.

**Level 3**

Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments whose valuation requires significant management judgment or estimation. Level 3 valuation also includes observable inputs for single dealer nonbinding quotes not corroborated by observable market data.

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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. Risk premiums that a market participant would require must be considered.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****NOTE 5. FAIR VALUE (Continued)****Assets Measured at Fair Value on a Recurring Basis**

Fair value is the primary basis of accounting for investment securities available-for-sale. The Company does not currently measure any other assets or liabilities at fair value on a recurring basis. When quoted market prices for identical securities are available in an active market, these securities are classified within level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, such as U.S. Treasury notes, or exchange-traded equities. If quoted market prices for identical securities are not available, then fair values are estimated using matrix models, quoted prices of securities with similar characteristics, or discounted cash flows. Examples of such instruments, which would generally be classified within level 2, include U.S. Government-sponsored enterprise securities, agency mortgage-backed securities, obligations of states and political subdivisions, and certain corporate debt obligations. Due to limited activity and less transparency regarding input factors, one corporate debt obligation was classified in level 3 at March 31, 2012 and December 31, 2011.

Securities measured at fair value on a recurring basis are presented as follows.

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Fair Value Measurements Using		Total Carrying Value
		Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
<b>March 31, 2012</b>				
<b>Investment securities available-for-sale:</b>				
U. S. Government and agency securities	\$ 0	\$ 14,748,963	\$ 0	\$ 14,748,963
U. S. Government-sponsored enterprise securities	0	6,350,657	0	6,350,657
Agency residential mortgage-backed securities	0	42,034,923	0	42,034,923
Obligations of states and political subdivisions	0	15,180,628	0	15,180,628
Corporate debt obligations	0	6,420,012	500,000	6,920,012
<b>Total investment securities</b>	<b>\$ 0</b>	<b>\$ 84,735,183</b>	<b>\$ 500,000</b>	<b>\$ 85,235,183</b>
<b>December 31, 2011</b>				
<b>Investment securities available-for-sale:</b>				
U. S. Government and agency securities	\$ 0	\$ 13,573,816	\$ 0	\$ 13,573,816
U. S. Government-sponsored enterprise securities	0	6,637,011	0	6,637,011
Agency residential mortgage-backed securities	0	41,984,664	0	41,984,664
Obligations of states and political subdivisions	0	17,012,322	0	17,012,322
Corporate debt obligations	0	8,293,860	500,000	8,793,860

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Total investment securities	\$ 0	\$ 87,501,673	\$ 500,000	\$ 88,001,673
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The corporate debt obligation measured at fair value using level 3 inputs at March 31, 2012 and December 31, 2011 comprised one trust preferred security with a cost basis of \$500,000, for which there is currently no active market. Like most of the Company's other corporate debt holdings, this security is also an issue of a bank/bank holding company domiciled in the southeastern United States. No transfers or activity involving other securities occurred within the level 3 category during the three months ended March 31, 2012 or 2011. Should transparency in input factors diminish, additional obligations could be classified as level 3 assets in the future. No transfers were made between level 1 or 2 assets measured at fair value on a recurring basis during the three months ended March 31, 2012 or 2011.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**NOTE 5. FAIR VALUE (Continued)**

**Assets Measured at Fair Value on a Nonrecurring Basis**

Certain instruments are measured at fair value on a nonrecurring basis; in other words, these instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances—for example, when evidence of impairment exists. Such instruments include impaired loans and other real estate. Loan impairment is reported when full payment under the original loan terms is not expected. Impaired loans are carried at the present value of estimated future cash flows using the loan's existing rate or the fair value of collateral if the loan is collateral-dependent. When management believes the uncollectibility of all or any portion of a loan is confirmed, a loss is charged against the allowance. Any necessary increase to the allowance resulting from impaired loans is recorded as a component of the provision for loan losses.

During the three months ended March 31, 2012, the Company recognized losses of \$944,512 on impaired loans outstanding through the allowance for loan losses. At March 31, 2012, impaired loans with an aggregate outstanding book balance of \$38,860,882 were measured and reported net of specific allowances at a fair value of \$36,402,633. During the three months ended March 31, 2011, the Company recognized losses of \$836,916 on impaired loans outstanding through the allowance for loan losses. At March 31, 2011, impaired loans with an aggregate outstanding book balance of \$37,466,216 were measured and reported net of specific allowances at a fair value of \$34,968,803. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company records the loan impairment as a level 2 instrument. When an appraised value is not available or management determines the fair value of the collateral is impaired beyond appraised value and no observable market price exists, the Company records the loan impairment in level 3. Given the current difficulties in obtaining comparable sales and other observable inputs due to high inventories and distressed sales prevalent in the market, particularly for certain real estate collateral, the Company classified all impaired loans in level 3 at March 31, 2012 and December 31, 2011.

Other real estate is recorded at fair value upon transfer of the underlying loan to foreclosed balances. Fair value is based upon independent market prices, appraised values, or management's estimate of collateral value. When the fair value of the collateral is based on an observable market price or a current appraised value, the Company classifies other real estate as level 2; otherwise, other real estate is classified as level 3. Any write-down to fair value at foreclosure is charged to the allowance for loan losses while subsequent devaluations resulting primarily from updated appraisals or observations of comparable sales prices are included in noninterest expense. During the three months ended March 31, 2012, devaluations (or write-downs) of other real estate outstanding at March 31, 2012 totaled \$469,790. In the first quarter of 2011, devaluations of other real estate outstanding at March 31, 2011 amounted to \$161,127. Given the current difficulties in obtaining comparable sales and other observable inputs due to high inventories and distressed sales prevalent in the market, particularly for certain real estate types, the Company classified all foreclosed real estate that are measured at fair value in level 3 at March 31, 2012 and December 31, 2011.

Level 3 assets also include Federal Home Loan Bank of Atlanta (FHLB) stock, which is only redeemable with the issuer at par and cannot be traded in the market; as such, no observable market data for this holding is available. The Company evaluated its holding in FHLB stock at March 31, 2012 and December 31, 2011 and determined no impairment charge was necessary. Other assets are similarly evaluated under fair value accounting on a nonrecurring basis.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****NOTE 5. FAIR VALUE (Continued)**

The table below presents the Company's outstanding assets for which a nonrecurring change in fair value was recorded during the three months ended March 31, 2012 and 2011, aggregated by the level in the fair value hierarchy within which those measurements fall. Assets reviewed for impairment such as level 3 FHLB stock, but for which no corresponding impairment charge was recorded, are not included in these totals.

	Fair Value Measurements Using				
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Net Carrying Value	Total Losses for the Quarter
<i>For the Three Months Ended</i>					
<i>March 31, 2012</i>					
Impaired loans	\$ 0	\$ 0	\$ 36,402,633	\$ 36,402,633	\$ (944,512)
Other real estate	0	0	1,753,020	1,753,020	(469,790)
<b>Total fair value of assets on a nonrecurring basis</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 38,155,653</b>	<b>\$ 38,155,653</b>	<b>\$ (1,414,302)</b>
<i>March 31, 2011</i>					
Impaired loans	\$ 0	\$ 0	\$ 34,968,803	\$ 34,968,803	\$ (836,916)
Other real estate	0	0	1,188,740	1,188,740	(161,127)
<b>Total fair value of assets on a nonrecurring basis</b>	<b>\$ 0</b>	<b>\$ 0</b>	<b>\$ 36,157,543</b>	<b>\$ 36,157,543</b>	<b>\$ (998,043)</b>

As disclosed above, the loss amount shown for impaired loans include charge-offs as well as the provision allocated for those loans during the three months ended March 31, 2012 and 2011. The loss amount for other real estate does not include charge-offs recognized on those credits prior to foreclosure of the underlying collateral. No transfers were made between level 1, 2, and 3 assets evaluated under fair value accounting on a nonrecurring basis during the three months ended March 31, 2012 or 2011. Additionally, no nonrecurring change in fair value was recognized on any liabilities during the three months ended March 31, 2012 or 2011.

**Fair Value of Financial Instruments**

Methodologies for estimating the fair value of financial assets and liabilities that are measured at fair value on a recurring or nonrecurring basis are discussed above. For certain other financial assets and liabilities, fair value approximates carrying value due to the nature of the financial instrument. These instruments include cash and cash equivalents, demand and other non-maturity deposits, and overnight borrowings. The following methods and assumptions were used in estimating the fair value of other level 3 financial instruments:

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Variable rate loans that reprice frequently and have no significant change in credit risk are fairly valued at their carrying amounts. For fixed rate loans, fair values are estimated based on discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The Company did not use an incremental market risk and liquidity discount in deriving loan fair values as management has no present intention to sell any portion of the loan portfolio. Impaired loans are valued using discounted cash flow analyses or underlying collateral values, as discussed.

Fair values for certificates of deposit are estimated using a discounted cash flow calculation that applies current interest rates to a schedule of aggregated expected maturities. The intangible value of long-term relationships with depositors is not considered in estimating fair values.

U.S. Treasury demand notes and other variable rate borrowings are fairly valued at their carrying amounts. Fair values for other borrowings, including FHLB advances with fixed rates, are based on quoted market prices for similar instruments or estimated using discounted cash flow analysis and the Company's current incremental borrowing rate for similar instruments.

The carrying amount of accrued interest and other financial assets approximates their fair values.

**Table of Contents****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(Unaudited)****NOTE 5. FAIR VALUE (Continued)**

The table below presents the fair value of financial assets and liabilities carried on the Company's consolidated statements of condition at March 31, 2012 and December 31, 2011, including those financial assets and liabilities that are not measured and reported at fair value on a recurring or nonrecurring basis:

	March 31, 2012		December 31, 2011	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial assets:</b>				
Cash and cash equivalents	\$ 111,814,625	\$ 111,814,625	\$ 99,148,053	\$ 99,148,053
Investment securities available-for-sale	85,235,183	85,235,183	88,001,673	88,001,673
Net loans	185,997,023	186,873,409	195,486,544	196,444,309
Accrued interest receivable	1,251,463	1,251,463	1,244,509	1,244,509
Other financial assets	964,700	964,700	964,700	964,700
<b>Financial liabilities:</b>				
Deposits	\$ 374,189,072	\$ 374,794,599	\$ 369,871,792	\$ 370,622,206
FHLB advances	5,000,000	5,131,125	5,000,000	5,130,998
Accrued interest payable	486,745	486,745	818,457	818,457

Bank premises and equipment, customer relationships, deposit base, and other information needed to compute the Company's aggregate fair value are not included in the table above. Accordingly, the fair values above are not intended to represent the underlying market value of the Company.



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**CAUTIONARY NOTICE REGARDING FORWARD-LOOKING STATEMENTS**

Certain statements set forth in this Quarterly Report on Form 10-Q for the period ended March 31, 2012 (the *Report*) or incorporated herein by reference, including, without limitation, matters discussed under the caption *Management's Discussion and Analysis of Financial Condition and Results of Operations* (the *Analysis*) are forward-looking statements within the meaning of the federal securities laws, including, without limitation, statements regarding our outlook on earnings, stock performance, asset quality, economic conditions, real estate markets and projected growth, and are based upon management's beliefs as well as assumptions made based on data currently available to management. In this Report, the terms the *Company*, the *Bank*, *we*, *us*, or *our* refer to Southeastern Banking Corporation and its wholly-owned subsidiaries, Southeastern Bank and SBC Financial Services, Inc. When words like *anticipate*, *believe*, *intend*, *plan*, *may*, *continue*, *project*, *would*, *estimate*, *could*, *should*, *will*, and similar expressions are used, you should consider them as identifying forward-looking statements. These forward-looking statements are not guarantees of future performance, and a variety of factors could cause our actual results to differ materially from the anticipated or expected results expressed in these forward-looking statements. Many of these factors are beyond our ability to control or predict, and readers are cautioned not to put undue reliance on such forward-looking statements. The following list, which is not intended to be an all-encompassing list of risks and uncertainties affecting us, summarizes several factors that could cause our actual results to differ materially from those anticipated or expected in these forward-looking statements: (1) general economic conditions (both generally and in our markets) may be less favorable than expected, resulting in, among other things, a continued deterioration in credit quality, a further reduction in demand for credit and/or a further decline in real estate values; (2) the general decline in the real estate and lending market, particularly the market areas of Coastal Georgia and North Florida, may continue to negatively affect our financial results; (3) our ability to raise additional capital may be impaired if current levels of market disruption and volatility continue or worsen; (4) restrictions or conditions imposed by our regulators on our operations may make it more difficult for us to achieve our goals; (5) legislative or regulatory changes, including changes in accounting standards and compliance requirements, may adversely affect the businesses in which we are engaged; (6) competitive pressures among depository and other financial institutions may increase significantly; (7) changes in the interest rate environment may reduce margins or the volumes or values of the loans we make; (8) competitors may have greater financial resources and develop products that enable those competitors to compete more successfully than we can; (9) our ability to attract and retain key personnel can be affected by the increased competition for experienced employees in the banking industry; (10) adverse changes may occur in the bond and equity markets; (11) war or terrorist activities may cause further deterioration in the economy or cause instability in credit markets; and (12) the risk factors discussed from time to time in the *Company's* periodic reports filed with the Securities and Exchange Commission (the *SEC*), including but not limited to, this Report. We undertake no obligation to, and we do not intend to, update or revise these statements following the date of this filing, whether as a result of new information, future events or otherwise, except as may be required by law. All written or oral forward-looking statements attributable to us are expressly qualified in their entirety by this Cautionary Notice. Our actual results may differ significantly from those we discuss in these forward-looking statements. For other factors, risks and uncertainties that could cause our actual results to differ materially from estimates and projections contained in these forward-looking statements, please read the *Risk Factors* section of our Annual Report on Form 10-K for the year ended December 31, 2011. Any forward-looking statement speaks only as of the date that the statement was made, and, except as required by law, we expressly disclaim any obligation or undertaking to disseminate any updates or revisions to any forward-looking statement to reflect events or circumstances after the date on which we made the statement or to reflect the occurrence of unanticipated events.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*This Analysis should be read in conjunction with our 2011 Annual Report on Form 10-K and the Consolidated Financial Statements & related Notes included in this Report. The Company's accounting policies, which are described in detail in Form 10-K, are integral to understanding the results reported. The Company's accounting policies require management's judgment in valuing assets, liabilities, commitments and contingencies. A variety of factors could affect the ultimate value that is obtained when earning income, recognizing an expense, recovering an asset or relieving a liability. This Analysis contains forward-looking statements with respect to business and financial matters. Actual results may vary significantly from those contained in these forward-looking statements. See the sections entitled "Critical Accounting Estimates" and "Cautionary Notice Regarding Forward-Looking Statements" within this Report.*

**DESCRIPTION OF BUSINESS**

Southeastern Banking Corporation, with assets exceeding \$420 million, is a financial services company with operations in southeast Georgia and northeast Florida. Southeastern Bank (the "Bank"), the Company's wholly-owned commercial bank subsidiary chartered in 1888, offers a full line of commercial and retail services to meet the financial needs of its customer base through its 16 branch locations and ATM network. Services offered include traditional deposit and credit services, long-term mortgage originations, and credit cards. The Bank also offers 24-hour delivery channels, including internet and telephone banking and through an affiliation with a third party broker-dealer, provides insurance and investment brokerage services.

The table below provides a summary of the Bank's markets as of March 31, 2012.

<i>Market/ County</i>	<i>Number of Offices</i>	<i>Total Loans<sup>1</sup></i>	<i>Total Deposits<sup>1</sup></i>	<i>Market Share (%)<sup>2</sup></i>	<i>Market Share Rank<sup>2</sup></i>
<b>Georgia</b>					
McIntosh	2	\$ 56,551	\$ 66,273	72.0	1
Brantley	2	16,508	58,928	70.8	1
Bryan	1	17,260	7,097	1.8	5
Camden	3	26,552	60,211	19.7	2
Charlton	1	2,803	52,954	55.3	1
Coffee	2	8,075	21,006	3.2	9
Glynn	1	41,000	18,079	1.2	15
Jeff Davis	1	2,728	22,027	17.0	3
	13	\$ 171,477	\$ 306,575	8.7	3
<b>Florida</b>					
Nassau	3	\$ 21,075	\$ 67,614	7.6	5
<b>Totals</b>	16	\$ 192,552	\$ 374,189	8.5	3

<sup>1</sup> Dollar amounts are presented in thousands as of March 31, 2012.

<sup>2</sup> Based on the FDIC Summary of Deposits report as of June 30, 2011.

**Table of Contents****FINANCIAL CONDITION****Overview**

Consolidated assets totaled \$420.7 million at March 31, 2012, an increase of \$4.1 million (or 1.0%) since the end of 2011. The increase in total assets was driven largely by a \$4.3 million (or 1.2%) increase in total deposits. Net loans decreased \$9.5 million (or 4.9%) and cash and cash equivalents increased \$12.7 million (or 12.8%) since December 31, 2011. The increase in deposits during the first quarter is expected to reverse trend in the second and third quarters as public deposit customers draw down on their tax receipts for operating and capital expenditures. The continued decline in loans outstanding and low interest yields available on other investment alternatives coupled with our election to maintain a highly liquid balance sheet during this weak economic environment has hampered our ability to improve our net interest margin and earnings. The elevated level of nonperforming assets further hampered our profitability in the first quarter of 2012, and this factor is expected to continue to create a drag on earnings through the remainder of 2012.

**Investment Securities**

The composition of our investment portfolio as of the indicated dates is presented below. Changes in the mix of our investment portfolio will vary over time in response to changes in market conditions, interest rates, pledging requirements and liquidity needs of the Bank.

	March 31, 2012		December 31, 2011	
	Fair Value	% of Total	Fair Value	% of Total
<i>(Dollars in thousands)</i>				
U.S. Government and agency securities	\$ 14,749	17.3%	\$ 13,574	15.4%
U.S. Government-sponsored enterprise securities	6,351	7.5%	6,637	7.6%
Agency residential mortgage-backed securities	42,035	49.3%	41,985	47.7%
Obligations of states and political subdivisions	15,180	17.8%	17,012	19.3%
Corporate debt obligations	6,920	8.1%	8,794	10.0%
Total investment securities	\$ 85,235	100.0%	\$ 88,002	100.0%
Total investments as a percentage of total assets	20.3%		21.1%	

The objectives of our investment portfolio policy stress quality and liquidity. At the time of acquisition, the bonds were either assigned an investment grade credit rating by a nationally-recognized statistical rating organization ( NSRO ) or reviewed for credit and market risk and deemed appropriate for the Company's portfolio by management. The portfolio is monitored to assure there is no unreasonable concentration of securities in the obligations of a single issuer. We do not carry any sub-prime mortgages, structured investment vehicles, or collateralized debt obligations in our portfolio. We also monitor the insurers of our state and political subdivision securities, and the distribution of such securities among the insurers. At March 31, 2012, we had no obligations of state and political subdivisions rated below investment grade by an NSRO, but we had 11 issues of state and political subdivisions with an amortized cost of \$3.0 million and a fair market value of \$3.1 million that were not rated by an NSRO, of which 93% were issued by state and political subdivisions of Georgia or Florida. At March 31, 2012, we had one corporate debt obligation with an amortized cost of \$1.0 million and a fair market value of \$0.9 million rated below investment grade by an NSRO and three corporate debt obligations with an amortized cost of \$3.5 million and a fair market value of \$3.4 million that were not rated by an NSRO.

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The corporate bond portfolio primarily includes debt issuances of banks and bank holding companies domiciled in the southeastern United States. During the first quarter of 2012, we sold one corporate bond for a loss of \$79,000. There is a \$64,000 net unrealized loss on the remainder of the corporate bond portfolio. Although the NSROs have downgraded certain of these securities since our acquisition and uncertainty and volatility continues to surround a few of these issuers, recent profitability and long-term earnings forecasts by industry analysts reflect continued improvement. To illustrate this fact, those bonds with a \$64,000 net unrealized loss at March 31, 2012 were carried at a \$223,000 net unrealized loss position at December 31, 2011.

At March 31, 2012, \$63.1 million (or approximately 74%) of the fair market value of the Company's investment portfolio, including mortgage-backed securities, is supported by the U.S. Government, a U.S. Government agency or a U.S. Government-sponsored enterprise (GSE). In 2011, Standard & Poor's rating agency, an NSRO, lowered the long-term rating of the U.S. Government, its federal agencies and GSEs from AAA to AA+. The rating agency maintained the AAA rating for short-term (one year or less) obligations of the U.S. Government, its federal agencies and GSEs. Despite this downgrade, management believes the credit quality of the bonds issued by the U.S. Government, its federal agencies and GSEs in the Company's investment portfolio remains fundamentally sound.

At March 31, 2012, \$39.0 million (or approximately 46%) of the fair market value of the Company's investment portfolio is invested in mortgage-backed securities issued by Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac), each a GSE. In addition to the issuers' guarantee, these obligations are collateralized by the underlying mortgages in each investment pool which serves to further enhance and diversify the credit risk of the investment. The U.S. Treasury continues to reiterate its support for Fannie Mae and Freddie Mac although changes are expected in these entities' business model going forward.

Management evaluates investment securities for other-than-temporary impairment on an annual basis, and more frequently when conditions warrant. This analysis requires us to consider various factors, including the duration and magnitude of the decline in value; the financial condition of the issuer or issuers; structure of the security; and, notwithstanding classification of the portfolio as available-for-sale, our intent to sell the security or whether it is more likely than not that we would be required to sell the security before the anticipated recovery in market value. At March 31, 2012, we reviewed those securities with an unrealized loss and concluded that no material individual securities were other-than-temporarily impaired. However, impairment charges could become necessary in the future if the economic crisis facing the banking industry does not fully abate and various issuers' financial condition weakens.

## **Loans**

Loans, net of unearned income, decreased \$9.8 million (or 4.8%) since the end of 2011 to \$192.5 million at March 31, 2012. The net loans-to-deposits ratio dropped to 51.5% at March 31, 2012 versus 54.7% at December 31, 2011. Due to economic uncertainties within the Company's markets, particularly in the real estate sector, and resultant concerns regarding credit opportunities, management does not expect loan volumes to materially increase for the remainder of 2012.

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The amount of loans outstanding at the indicated dates is presented in the following table according to type of loan.

<i>Quarters Ended</i> <i>(Dollars in thousands)</i>	<b>March 31, 2012</b>	December 31, 2011	September 30, 2011	June 30, 2011	March 31, 2011
<b>Commercial real estate:</b>					
Construction and development	<b>\$ 54,585</b>	\$ 61,947	\$ 64,995	\$ 77,178	\$ 80,362
Owner-occupied	<b>35,429</b>	36,389	37,534	36,406	36,198
Non owner-occupied	<b>28,449</b>	27,772	27,905	28,624	28,975
Residential real estate - mortgage	<b>43,199</b>	44,202	45,998	47,383	47,972
Other commercial, financial, and agricultural	<b>21,933</b>	22,446	28,644	29,720	31,381
Consumer, including credit cards	<b>8,957</b>	9,552	9,814	10,462	10,816
Loans, gross	<b>192,552</b>	202,308	214,890	229,773	235,704
Unearned income	<b>(43)</b>	(45)	(49)	(59)	(61)
Allowance for loan losses	<b>(6,512)</b>	(6,777)	(8,564)	(8,604)	(8,370)
<b>Net loans</b>	<b>\$ 185,997</b>	\$ 195,486	\$ 206,277	\$ 221,110	\$ 227,273

The percentage of gross loans at the indicated dates is presented in the following table according to type of loan.

<i>Quarters Ended</i>	<b>March 31, 2012</b>	December 31, 2011	September 30, 2011	June 30, 2011	March 31, 2011
<b>Commercial real estate:</b>					
Construction and development	<b>28.3%</b>	30.6%	30.2%	33.6%	34.1%
Owner-occupied	<b>18.4%</b>	18.0%	17.5%	15.8%	15.4%
Non owner-occupied	<b>14.8%</b>	13.7%	13.0%	12.5%	12.3%
Residential real estate - mortgage	<b>22.4%</b>	21.9%	21.4%	20.6%	20.3%
Other commercial, financial, and agricultural	<b>11.4%</b>	11.1%	13.3%	12.9%	13.3%
Consumer, including credit cards	<b>4.7%</b>	4.7%	4.6%	4.6%	4.6%
Loans, gross	<b>100.0%</b>	100.0%	100.0%	100.0%	100.0%

Commercial real estate loans, which included construction and development loans, represented approximately 61.5% and 62.3% of the total loan portfolio at March 31, 2012 and December 31, 2011, respectively. Due to continued instability of real estate values, loans in the commercial real estate portfolio may have a greater risk of uncollectability than other loans. Additionally, because a substantial portion of the loan portfolio is secured by real estate in southeast Georgia and northeast Florida, the loan portfolio is particularly susceptible to changes in market conditions in those areas.

The largest change within the portfolio since the end of 2011 was in construction and development loans, which declined \$7.4 million (or 11.9%) due primarily to collections, foreclosures and charge-offs of delinquent loans during the first three months of 2012. These loans, which are primarily loans for the acquisition and development of residential properties, are concentrated in the Company's coastal markets. With the exception of existing commitments, the Company is only originating new construction and development loans to customers with extraordinary equity injections, outside financial strength, or other performance metrics with low dependence on the underlying collateral.

Many commercial and commercial real estate loans with floating rates have reached their contractual floors. Additionally, many recent originations and renewals have been priced at fixed rather than adjustable rates, unless floors applied. Loans with floating rates that had reached a contractual floor approximated \$86.2 million at March 31, 2012 compared to \$88.7 million at December 31, 2011. The average yield on these particular outstanding loans, which included all loan types, was 5.81% or 256 basis points above the Company's prime rate of interest (3.25%), at March 31, 2012. Management continues to shorten maturity options on commercial loans as feasible, a move that should mitigate the Company's interest sensitivity position when the prime rate adjusts upward.



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Although the Company's loan portfolio is diversified, significant portions of its loans are collateralized by real estate. At March 31, 2012, loans with real estate as the primary collateral comprised approximately 85.3% of the loan portfolio. As required by policy, real estate loans are collateralized based on certain loan-to-appraised value ratios at origination. A geographic concentration in loans exists given the Company's operations within a regional area of southeast Georgia and northeast Florida. The Company continues to closely monitor real estate valuations in its markets and consider any implications on the allowance for loan losses and the related provision.

On an aggregate basis, commitments to extend credit and standby letters of credit approximated \$19.9 million at March 31, 2012, compared to \$22.5 million at the end of 2011. The decline in overall commitments results from the Company's decision to reduce its exposure to higher risk areas, including acquisition and development lending, as well as customer decisions not to renew their lines. Because a substantial amount of these contracts expire without being drawn upon, total contractual amounts do not necessarily represent future credit exposure or liquidity requirements.

**Nonperforming Assets**

Nonperforming assets, which consist of nonaccrual loans, restructured loans, other accruing loans past due 90 days or more, foreclosed real estate, and other repossessions, totaled \$51.92 million at March 31, 2012. The aggregate balance of nonperforming assets decreased \$1.00 million (or 1.9%) since the end of 2011. As a percent of total assets, nonperforming assets totaled 12.34% at March 31, 2012 versus 12.70% at December 31, 2011.

Since 2008, the elevated level of nonperforming assets has materially and adversely affected our business, financial resources, and operating results, and we expect continued adverse effects until real estate markets, particularly the coastal markets, stabilize and improve. The gradual transition of defaulted construction and development loans to troubled debt restructurings or foreclosed real estate and the increase in residential real estate loans on nonaccrual status are the primary factor in the nonperforming trends. A summary of trends in our nonperforming assets over the last five quarters is provided in the following table.

<i>Quarters Ended</i> <i>(Dollars in thousands)</i>	<b>March 31, 2012</b>	December 31, 2011	September 30, 2011	June 30, 2011	March 31, 2011
<b>Nonaccrual loans:</b>					
Commercial real estate:					
Construction and development	\$ 18,177	\$ 23,450	\$ 22,735	\$ 23,550	\$ 20,609
Owner-occupied	507	313	418	521	377
Non owner-occupied	288	152	80	6	533
Residential real estate - mortgage	6,088	6,220	4,558	4,506	4,538
Other commercial, financial, and agricultural	377	385	262	289	338
Consumer, including credit cards	223	278	259	276	257
<b>Total nonaccrual loans</b>	<b>25,660</b>	30,798	28,312	29,148	26,652
Troubled debt restructurings not included above	10,151	9,778	6,772	6,781	5,670
Accruing loans past due 90 days or more	21	248	75	65	68
<b>Total nonperforming loans</b>	<b>35,832</b>	40,824	35,159	35,994	32,390
Foreclosed real estate	16,077	12,063	14,232	15,185	12,315
Other repossessed assets	12	32	15	26	28
<b>Total nonperforming assets</b>	<b>\$ 51,921</b>	\$ 52,919	\$ 49,406	\$ 51,205	\$ 44,733
Nonperforming loans to total loans, net of unearned income	18.61%	20.18%	16.37%	15.67%	13.75%
Nonperforming assets to total assets	12.34%	12.70%	12.08%	11.92%	10.30%

**Table of Contents***Nonaccrual Loans*

Nonaccrual loans totaled \$25.66 million at March 31, 2012; a \$5.14 million (or 16.7%) decrease since the end of 2011. During the first quarter of 2012, approximately \$2.28 million of loans were placed on nonaccrual status, \$0.91 million charged-off, \$4.70 million transferred out by foreclosure or repossession, and \$1.81 million reduced by payments or other activity. As of March 31, 2012, the unpaid principal balance owed on nonaccrual loans totaled \$40.66 million. Thus, as a result of partial charge-offs, the \$25.66 million in recorded balances on our books represented 63.1% of the balances owed by our customers, a 36.9% discount.

Loans restructured in troubled debt restructurings that are on nonaccrual status at March 31, 2012 totaled \$9.67 million, a 3.9% increase compared to \$9.30 million at December 31, 2011.

At March 31, 2012, real estate-secured loans comprised 98.5% of total nonaccrual balances. The collateral underlying nonaccrual balances at March 31, 2012 and December 31, 2011 is presented in the following table.

	March 31, 2012	December 31, 2011
<i>(Dollars in thousands)</i>		
Collateral type:		
Real estate:		
Land tracts	\$ 7,955	\$ 6,527
Lots within developments	8,145	13,363
Residential dwellings	8,514	10,040
Commercial buildings	664	476
<b>Total real estate</b>	<b>25,278</b>	<b>30,406</b>
Equipment	267	263
Other	115	129
<b>Total nonaccrual loans</b>	<b>\$ 25,660</b>	<b>\$ 30,798</b>

Relationships above \$250,000 comprised 82.3% or \$21.13 million of nonaccrual balances at March 31, 2012. The table below presents nonaccrual loans by relationship tiers.

<i>(Dollars in thousands)</i>	Number of Relationships	Balances	Percent of Total Balance	Average Balance within Tier
<i>As of March 31, 2012</i>				
<b>Relationship tier:</b>				
£ \$250,000	159	\$ 4,529	17.7%	\$ 28
> \$250,000 and £ \$750,000	7	2,883	11.2%	412
> \$750,000	9	18,248	71.1%	2,028
<b>Total nonaccrual loans</b>	<b>175</b>	<b>\$ 25,660</b>	<b>100.0%</b>	<b>147</b>
<i>As of December 31, 2011</i>				
Relationship tier:				
£ \$250,000	181	\$ 4,457	14.5%	\$ 25
> \$250,000 and £ \$750,000	3	1,408	4.6%	469
> \$750,000	11	24,933	80.9%	2,267



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Total nonaccrual loans	195	\$ 30,798	100.0%	158
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At March 31, 2012, the largest nonaccrual loan relationship had a \$4.34 million book balance. It is anticipated that the majority of the collateral securing the loans in this relationship will be foreclosed on in the second quarter of 2012. Unless pricing and demand in the real estate markets improve, management expects other borrowers, including other borrowers with collateral-dependent loan balances above \$250,000, may also stop servicing their loans. This expectation is factored in the methodology for determining the adequacy of the allowance for loan losses at March 31, 2012.

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The accrual of interest on loans is discontinued when, in our judgment, the borrower may be unable to meet payments as they become due, unless the loan is well secured. All interest accrued on loans that are placed on nonaccrual status is reversed against interest income. Interest income on nonaccrual loans is subsequently recognized only to the extent cash payments are received or until the loan is returned to accrual status. For the quarter ended March 31, 2012, the gross interest income that would have been recorded if our nonaccrual loans had been current in accordance with their original terms was approximately \$394,000. The amount of interest income on the above nonaccrual loans that was included in net income for the quarter ended March 31, 2012 was approximately \$12,000. The average balance of loans on nonaccrual status during the first quarter of 2012 was \$29.69 million. The allowance for loan losses related to our nonaccrual loans amounted to approximately \$1.20 million at March 31, 2012.

Management continues to evaluate collateral underlying nonaccrual loans and adjusts valuations based on appraisal and similar information available. Unfortunately, valuation estimates can change, resulting in additional charge-offs and provisioning for loan losses. The Company has adopted the following policy for obtaining updated appraisals for impaired loans, which is differentiated based on terms, loan balance and status of the loan.

Impaired loans with interest-only payment terms or on nonaccrual status with:

Balances greater than or equal to \$250,000 Updated external appraisals are obtained at least every two years. For such loans, internal evaluations are required for each year in which an external appraisal is not obtained.

Balances less than \$250,000 Updated external appraisals are obtained at least every two years on more complex properties. For less complex properties, such as single-family residences, internal evaluations may be utilized.

Impaired loans with amortizing principal and interest terms that are performing:

The underlying collateral on these loans are reevaluated each time the loan matures and is considered for renewal, or when the terms of the loan are materially modified. The decision of whether to order an external appraisal or perform an internal evaluation varies based on the age of original appraisal, the complexity of property, and the credit risk characteristics of the loan relationship.

### *Troubled Debt Restructurings*

Troubled debt restructurings ( TDRs ) are loans where concessions were granted by the Company to borrowers experiencing financial difficulties. At March 31, 2012, the Company had \$19.82 million in TDRs. Based on performance in accordance with the restructured terms, the Company has elected to accrue interest on \$10.15 million in TDRs outstanding at March 31, 2012. Certain TDRs are on nonaccrual status due to a lack of performance or management's concern regarding future repayment ability or performance. The TDRs that are on nonaccrual status at March 31, 2012 totaled \$9.67 million. These TDRs are included with other nonaccrual loans in this Report.

Since the end of 2011, the amount of accruing TDRs outstanding increased \$373,000 (or 3.8%). At March 31, 2012, the specific allowance allocated to the accruing TDR balance approximated \$938,000.

**Table of Contents***Potential Problem Loans*

At March 31, 2012, we had \$2.65 million in loans not counted as TDRs that were past due 30-89 days and still accruing interest, or 1.37% of total loans, representing a decrease from \$3.19 million, or 1.58% at December 31, 2011.

Accruing loans classified as individually impaired under accounting guidance to creditors on impairment of loans totaled \$3.03 million at March 31, 2012, a \$1.11 million (or 26.8%) decrease since the end of 2011. These loans are predominately to borrowers whose loan repayment was expected to come foremost from sales of underlying real estate collateral. Due to lagging sales and lingering distress in the real estate markets, payment of principal and interest on these loans has come from borrower reserves or other resources, constituting a change in the initial source of payment/terms of these loans. Although these loans continue to perform and we have no evidence to suggest that the borrowers might cease to perform in the future, their performance has been through other resources and the value of the underlying collateral has diminished. We review all classified loans with total credit exposure of \$250,000 or more on a monthly basis and evaluate underlying collateral, assuming salvage values and estimating any allowance necessary to cover projected losses at worse case scenario liquidation. After adjustments for collateral value shortfalls, the allowance for loan losses allocated to these classified credits approximated \$317,000 at March 31, 2012.

All of these loans are at a higher risk of becoming nonperforming loans in future periods.

*Other Real Estate Owned*

During the first quarter of 2012, the balance of real estate acquired through foreclosure or in settlement of debts previously contracted ( foreclosed real estate ) increased \$4.02 million (or 33.3%) to \$16.08 million at March 31, 2012. Of the \$16.66 million reported as other real estate owned (or OREO ) on our books at March 31, 2012, \$587,000 is not categorized as foreclosed real estate . This property was acquired by the Bank as a real estate venture, and it is under a lease-purchase agreement with a local municipality. Foreclosures, sales, and subsequent devaluations (or write-downs ) within foreclosed real estate balances totaled \$4.69 million, \$176,000, and \$470,000, respectively, during the first quarter of 2012. The total life-to-date write-downs taken on our quarter-end OREO portfolio subsequent to foreclosure amounted to \$4.55 million through March 31, 2012, a 22.0% discount to the amounts recorded when the properties were initially taken into OREO.

A schedule of the foreclosed real estate by asset type held at March 31, 2012 and December 31, 2011 is presented in the following table.

	March 31, 2012	December 31, 2011
<i>(Dollars in thousands)</i>		
Land tracts	\$ 6,690	\$ 6,349
Lots within developments	5,663	2,490
Residential dwellings	2,969	2,394
Commercial buildings	755	830
<b>Total foreclosed real estate</b>	<b>\$ 16,077</b>	<b>\$ 12,063</b>

Approximately 87.4% of these holdings were located in Georgia with the balance in Nassau County, Florida.

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At March 31, 2012, we owned 17 properties valued in excess of \$250,000 per property with an aggregate basis of \$12.76 million, representing 79.3% of the total foreclosed real estate portfolio. The table below presents foreclosed real estate by property valuations.

<i>(Dollars in thousands)</i>	Number of Properties	Carrying Values	Percent of Total Value	Average Value within Tier
<b>As of March 31, 2012</b>				
<b>Property value:</b>				
<b>£ \$250,000</b>	<b>61</b>	<b>\$ 3,321</b>	<b>20.7%</b>	<b>\$ 54</b>
<b>&gt; \$250,000 and £ \$750,000</b>	<b>10</b>	<b>4,326</b>	<b>26.9%</b>	<b>433</b>
<b>&gt; \$750,000</b>	<b>7</b>	<b>8,430</b>	<b>52.4%</b>	<b>1,204</b>
<b>Total foreclosed real estate</b>	<b>78</b>	<b>\$ 16,077</b>	<b>100.0%</b>	<b>206</b>
<b>As of December 31, 2011</b>				
<b>Property value:</b>				
<b>£ \$250,000</b>	<b>68</b>	<b>\$ 3,303</b>	<b>27.4%</b>	<b>\$ 49</b>
<b>&gt; \$250,000 and £ \$750,000</b>	<b>7</b>	<b>3,128</b>	<b>25.9%</b>	<b>447</b>
<b>&gt; \$750,000</b>	<b>6</b>	<b>5,632</b>	<b>46.7%</b>	<b>939</b>
<b>Total foreclosed real estate</b>	<b>81</b>	<b>\$ 12,063</b>	<b>100.0%</b>	<b>149</b>

Our foreclosed real estate holdings can be viewed via a link from our website at [www.southeasternbank.com](http://www.southeasternbank.com) or directly at [www.liveatthecoast.com](http://www.liveatthecoast.com).

Although foreclosed properties continue to be marketed aggressively, when estimating their carrying value, we expect to incur carrying costs for at least one year. Any additional devaluation subsequent to foreclosure will be charged to operations. Under state law, all foreclosed property is required to be appraised annually commencing within one year from acquisition by an independent appraiser knowledgeable in the fair market value of such assets, and if the book value of the property does not exceed two percent of the statutory capital base of the Bank (or \$759,000 at March 31, 2012), the appraisals may be made by a qualified officer of the Bank. The Company has adopted the following policy for obtaining subsequent reevaluations for foreclosed properties, which is differentiated primarily based on the carrying value of the property.

Balances less than \$100,000 New internal evaluations or external appraisals will be obtained as needed by management in order to make informed decisions in a deteriorating market environment.

Balances greater than \$100,000 but less than \$250,000 New internal evaluations will be prepared on at least an annual basis. Management may elect to order an external appraisal in certain situations.

Balances of \$250,000 and greater An updated external appraisal will be obtained on at least an annual basis. However, management may elect to utilize an internal evaluation in lieu of an external appraisal in the following situations:

If, based on the previous external appraisal, an understanding of the changes in market conditions since that appraisal, or recent sales or appraisals of similar properties in the same market, management determines that the carrying balance of the property is significantly below market value.

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If recent sales of comparable properties in the same market are readily available, and management concludes the valuation assumptions can be supported by market data.

If the property is under an executed sales contract at the appraisal anniversary date. In this situation, the expected net proceeds from the sales contract will represent the market value of the property.

**Table of Contents****Allowance for Loan Losses**

The following table summarizes the activity in the allowance for loan losses, the average balance of loans outstanding, and the ratio of net losses experienced for each of the last five quarters.

<i>Quarters Ended</i> <i>(Dollars in thousands)</i>	<b>March 31, 2012</b>	December 31, 2011	September 30, 2011	June 30, 2011	March 31, 2011
Allowance for loan losses at beginning of quarter	\$ 6,777	\$ 8,564	\$ 8,604	\$ 8,370	\$ 9,916
Provision for loan losses	600	1,925	2,700	900	660
Charge-offs:					
Commercial real estate:					
Construction and development	491	2,102	2,076	414	1,852
Owner-occupied				6	164
Non owner-occupied	105	39	41	6	
Residential real estate - mortgage	289	1,550	590	203	181
Other commercial, financial, and agricultural	5	29	11	42	13
Consumer, including credit cards	23	49	69	59	36
<b>Total charge-offs</b>	<b>913</b>	<b>3,769</b>	<b>2,787</b>	<b>730</b>	<b>2,246</b>
Recoveries:					
Commercial real estate:					
Construction and development	1	4	1	18	
Owner-occupied	1	1			
Non owner-occupied					
Residential real estate - mortgage	23	25	21	7	7
Other commercial, financial, and agricultural	3	(8)	4	9	4
Consumer, including credit cards	20	35	21	30	29
<b>Total recoveries</b>	<b>48</b>	<b>57</b>	<b>47</b>	<b>64</b>	<b>40</b>
<b>Net charge-offs</b>	<b>865</b>	<b>3,712</b>	<b>2,740</b>	<b>666</b>	<b>2,206</b>
Allowance for loan losses at end of quarter	\$ 6,512	\$ 6,777	\$ 8,564	\$ 8,604	\$ 8,370
Net loans outstanding at end of quarter	\$ 192,509	\$ 202,263	\$ 214,841	\$ 229,715	\$ 235,643
Average net loans outstanding during quarter	\$ 198,391	\$ 210,497	\$ 225,928	\$ 233,018	\$ 240,554
Ratios:					
Allowance to net loans	3.38%	3.35%	3.99%	3.75%	3.55%
Net charge-offs to average loans (annualized)	1.75%	7.00%	4.81%	1.15%	3.67%
Provision to average loans (annualized)	1.22%	3.63%	4.74%	1.55%	1.11%
Recoveries to total charge-offs	5.26%	1.51%	1.69%	8.77%	1.78%

The Company continuously reviews its loan portfolio and maintains an allowance for loan losses available to absorb estimated losses inherent in the portfolio. We prepare a comprehensive analysis of the allowance for loan losses on a monthly basis. This analysis is divided into two

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components: specific allowances for individual loans and general allowances for pools of loans based on similar risk characteristics such as loan type, credit risk grades and delinquency status. Such evaluation considers numerous factors, including, but not limited to, net charge-off trends, internal risk ratings, loss forecasts, collateral values, geographic location, delinquency rates, nonperforming loans, underwriting practices, industry conditions, and economic trends. The Bank's Board of Directors is responsible for affirming the allowance methodology and assessing the general and specific allowance factors in relation to estimated and actual net charge-off trends.

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This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. While we use the best information available to make the evaluation, future adjustments to the allowance may be necessary if there are significant changes in economic conditions or other environmental factors. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses, and may require the Bank to make additions to the allowance based on their judgment about information available to them at the time of their examinations.

*Specific Reserves*

The first component of the allowance for loan loss methodology covers the measurement of specific allowances for individual impaired loans as required by FASB ASC 310-10-35, *Accounting by Creditors for Impairment of a Loan*. Specific allowances for loan losses are established for large impaired loans evaluated on an individual basis. The specific allowance established for these loans is based on a thorough analysis of the most probable source of repayment, including the present value of the loan's expected future cash flows, the loan's estimated market value, or the estimated fair value of the underlying collateral.

Impaired loans comprised the following at March 31, 2012 and December 31, 2011:

	March 31, 2012	December 31, 2011
<i>(Dollars in thousands)</i>		
Nonaccrual loans	\$ 25,660	\$ 30,798
Troubled debt restructurings not included above	10,151	9,778
Loans past due 90 days or more and still accruing	21	248
Other accruing loans individually evaluated for impairment	3,029	4,138
<b>Total impaired loans</b>	<b>\$ 38,861</b>	<b>\$ 44,962</b>
Valuation allowance related to total impaired loans	\$ 2,458	\$ 2,378
Valuation allowance as a percentage of impaired loans	<b>6.33%</b>	5.29%

The following table summarizes the carrying value and unpaid principal balance of impaired loans and the allowance for loan losses allocated to those loans by loan type as of March 31, 2012 and December 31, 2011.

	Carrying Value	Unpaid Principal Balance	Related Allowance	% Allowance to Carrying Value
<i>(Dollars in thousands)</i>				
<b>As of March 31, 2012</b>				
<b>Impaired loans with a valuation allowance:</b>				
<b>Commercial real estate:</b>				
Construction and development	\$ 23,768	\$ 36,564	\$ 1,587	6.68%
Owner-occupied	2,157	2,373	244	11.31%
Non owner-occupied	3,506	3,614	117	3.34%
Residential real estate - mortgage	6,784	9,698	408	6.01%
Other commercial, financial, and agricultural	2,413	2,533	91	3.77%
Consumer, including credit cards	233	349	11	4.72%
<b>Total impaired loans</b>	<b>\$ 38,861</b>	<b>\$ 55,131</b>	<b>\$ 2,458</b>	<b>6.33%</b>
<b>Carrying value as a percentage of the unpaid principal balance of impaired loans</b>	<b>70.5%</b>			





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<i>(Dollars in thousands)</i>	Carrying Value	Unpaid Principal Balance	Related Allowance	% Allowance to Carrying Value
<i>As of December 31, 2011</i>				
Impaired loans with a valuation allowance:				
Commercial real estate:				
Construction and development	\$ 29,138	\$ 41,440	\$ 1,561	5.36%
Owner-occupied	2,175	2,377	251	11.54%
Non owner-occupied	3,386	3,387	120	3.54%
Residential real estate - mortgage	7,557	10,456	338	4.47%
Other commercial, financial, and agricultural	2,421	2,535	90	3.72%
Consumer, including credit cards	285	406	18	6.32%
 Total impaired loans	 \$ 44,962	 \$ 60,601	 \$ 2,378	 5.29%
 Carrying value as a percentage of the unpaid principal balance of impaired loans	 74.2%			

The aggregate amount of impaired loans decreased \$6.10 million (or 13.6%) since the end of 2011 due primarily to foreclosures and partial charge-offs taken during the first quarter of 2012. At March 31, 2012, our recorded investment in impaired loans represented 70.5% of the unpaid principal balance on those loans. Effectively, we have already recognized a \$16.27 million (or 29.5%) discount through partial charge-offs and/or application of payments received to principal rather than interest and fees on those impaired loans.

*General Reserves*

The second component of the allowance for loan loss methodology addresses all loans that are not individually evaluated for impairment. General reserves are established for loans grouped into pools based on similar credit risk characteristics. Credit risk is a dynamic risk that fluctuates due to changes in borrowers' repayment capacity, changes in interest rates, market changes, and other economic changes. For loans evaluated collectively in the general reserve component of the allowance for loan loss, the loan portfolio is segmented into groups of loans with common credit risk characteristics.

The loan segment groups currently used, and a description of their specific risks, are summarized as follows:

**Commercial, financial, and agricultural**

**Unsecured commercial** Loans in this category are entirely reliant on the repayment capacity of the business and any guarantors. Risks common to commercial loans are potential industry and geographic concentrations. Deteriorating economic conditions increase the potential risk of cash flow difficulties in the ongoing business, which could impair the likelihood of repayment.

**Equipment** In addition to risks common to unsecured commercial loans noted above, collateralized equipment may depreciate faster than the repayment of the loan, which means the outstanding balance on the loan may exceed the value of the collateral at some point during the loan term. Also, if repossession becomes necessary, it can be difficult to find the collateral. There is industry risk when financing equipment. For example, the logging industry has endured significant turmoil over the past decade, which has added to the credit risk for the financing of logging equipment.

**Farm real estate** Loans in this category include farm and timber loans secured by real estate. These loans are susceptible to deterioration in the primary source of repayment, which is often the cash flow of the ongoing operation of farm or timber production. These industries tend to be cyclical in nature. In addition, there is the risk that weather can hamper production and harvesting, which can have immediate and unforeseen adverse impacts on the borrower's financial condition. There is also

some risk of deterioration in collateral value.

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**Other commercial** Loans in this category include the following:

**Farm other than real estate** These loans bear many of the same inherent risks as farm real estate loans and unsecured commercial loans.

**Business assets** these loans include assigned notes, inventory, accounts receivable, furniture, fixtures, etc. Monitoring the condition and existence of this collateral can be difficult. Deteriorating economic conditions increase the risk of cash flow difficulties in the ongoing business, which could impair the likelihood of repayment.

### **Real estate construction**

This category includes loans for the acquisition, development or construction of residential and commercial properties. Risks in this category include geographic, industry and borrower concentrations. Repayment is often dependent on the resale of the underlying collateral. Construction loans bear unique risks, including the potential for cost overruns. Consumer residential construction loans bear the risk that the borrower will be unable to secure long-term financing arrangements. Contract construction loans bear the risk that the contract to purchase will not be honored after construction is completed. Speculative construction loans bear the risk that demand will soften and values will deteriorate such that the borrower cannot sell the property in a timely fashion or at a price sufficient to repay the debt in full.

### **Real estate commercial mortgage**

**Owner-occupied** This category includes loans secured by commercial buildings that house the borrower's primary business, and the primary source of repayment is the cash flow of the borrower and not the rental income or sale of the collateral. These loans are deemed to bear less credit risk than non owner-occupied commercial real estate loans because there is a source of repayment apart from the collateral. Nevertheless, as with risks associated with other commercial loans, the cash flow of these businesses is often detrimentally impacted during economic downturns potentially to such a degree that the primary source of repayment is not sufficient to service the debt.

**Non owner-occupied** This category includes loans secured by hotels, apartment buildings, and other commercial buildings for which the repayment of the loan is dependent predominantly on the rental income or sale of the real estate. Deteriorating economic conditions can reduce occupancy rates and the sales potential of investment properties. Loans secured by buildings purchased for investment and resale bear the risk that real estate market conditions could deteriorate and detrimentally impact the value of the collateral to a degree that jeopardizes full repayment.

### **Real estate residential mortgage**

These loans are susceptible to risk factors common to the consumer loans described below that reduce a consumer's capacity to repay. This includes increased unemployment and increases in the cost of living. Declining real estate values can reduce or eliminate the borrower's equity in their homes which can affect the value of home equity lines of credit and second mortgages.

### **Consumer, including credit cards**

**Consumer unsecured** Loans in this category are susceptible to many of the same risks as consumer credit cards, especially overdraft protection lines of credit, which also have no maturity dates. There is no collateral, so a bankruptcy filing results in immediate charge-off. Risks common to consumer loans include unemployment and changes in local economic conditions.

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**Credit cards** Loans in this category are revolving unsecured lines of credit. They are susceptible to delinquency due to strains on consumers in the form of such factors as unemployment, inflation, and lifestyle changes. They have no maturity date, which adds to the risks of changes in repayment capacity over time.

**Other consumer** Loans in this category include the following:

**Vehicles, boats, recreational vehicles, mobile homes and other depreciating collateral** Loans in this category have the same collateral risks as those in the commercial equipment pool. They also have the risks common to unsecured consumer loans, including a weakened capacity to pay due to unforeseen changes in cash flow.

**Securities** Loans in this category are susceptible to weakening collateral positions when the value of the securities declines to unacceptable levels. Security values can be volatile.

On each loan, credit risk ratings are assigned at loan origination and re-evaluated on performing credits at each renewal thereafter. Risk ratings are reviewed for loans past due over 29 days on a monthly basis and updated as necessary. Secured loans that reach 90 days past due are placed on nonaccrual status and downgraded to substandard. In addition, during the normal course of monitoring loan relationships, when we obtain information that reflects deterioration in the repayment capacity of a particular borrower, the risk grading for the loan is reviewed for accuracy and updated at that time.

In addition to our internal reviews of risk rating, as discussed above, we have established an external loan review function, which is currently carried out by an independent loan review firm. On a quarterly basis, the firm reviews a sample of the portfolio to independently evaluate the following: 1) timely and accurate assignment of risk ratings; 2) compliance with our loan policy; and 3) documentation and enforceability of borrower obligations and our interest in collateral. On an annual basis, the external loan review plan includes a minimum of:

All loan relationships with balances in excess of \$500,000;

All loan relationships with balances in excess of \$50,000 with a risk rating of substandard or worse.

General reserve factors for each loan segment are established based on an analysis of historical charge-off experience and expected loss-given-default derived from our internal risk rating process. At March 31, 2012, we used a trailing twelve-quarter historical average loss rate for each pool of loans. At December 31, 2011, we used a trailing eleven-quarter historical average loss rate for each pool of loans. By comparison, at December 31, 2010, we used a trailing six-quarter historical average loss rate for each pool of loans, and at December 31, 2009, we used a trailing four-quarter historical average loss rate for each pool of loans. The historical period has been gradually expanded to continue to include loss rates incurred early in the cycle. We believe that excluding those losses would not provide an accurate estimate that best reflects the inherent risk in the loan portfolio. However, we do not expect to expand the historical look-back period beyond the current twelve-quarter period.

Other adjustments may be made to the historical loss rates for the pools after an assessment of internal and external influences on credit quality that are not fully reflected in the historical loss or risk rating data. The environmental factors considered in developing our loss measurements include:

lending policies and procedures, including changes in underwriting standards and collection, charge-off and recovery practices;

changes in international, national, regional and local economic and business conditions that affect the collectability of the portfolio;

changes in the nature and volume of the loan portfolio;

experience, ability, and depth of lending management and other relevant staff;

levels of and trends in delinquencies and impaired loans;

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changes in the quality of our loan review system;

value of underlying collateral for collateral-dependent loans;

existence and effect of any concentrations of credit, and changes in the level of such concentrations; and

other external factors such as competition and legal and regulatory requirements.

This component requires a high degree of managerial judgment to anticipate the impact that economic trends, legislative or governmental actions, or other unique market and/or portfolio issues will have on credit losses.

*Loan Loss Experience*

The following table summarizes the historical loss rates and adjustments made for qualitative and environmental factors used in assessing the general reserves for all loans not individually evaluated for impairment at March 31, 2012 and December 31, 2011.

	March 31, 2012		December 31, 2011	
	Twelve- Quarter Historical Loss Rate	Adjustments for Qualitative/ Environmental Factors	Eleven- Quarter Historical Loss Rate	Adjustments for Qualitative/ Environmental Factors
Loan Segment:				
Commercial real estate:				
Construction and development	7.44%	0.04%	7.79%	0.04%
Owner-occupied	0.28%	0.04%	0.30%	0.04%
Non owner-occupied	0.32%	0.04%	0.21%	0.04%
Residential real estate - mortgage	3.02%	0.04%	3.05%	0.04%
Commercial, financial, and agricultural	0.09 - 1.61%	0.04 - 0.06%	0.03 - 1.76%	0.04 - 0.06%
Consumer, including credit cards	4.37 - 5.27%	0.08%	4.62 - 5.42%	0.08%

Unallocated allowances relate to inherent losses that are not included elsewhere in the allowance. The qualitative factors associated with unallocated allowances include the inherent imprecision in models and lagging or incomplete data. Because of their subjective nature, these risk factors are carefully reviewed and revised as conditions indicate.

Deterioration in the real estate portfolio, particularly land acquisition and development loans, has been the overriding factor in the provisions made to the allowance for loan losses since 2008. We expect additional losses to occur in 2012 in our portfolio of loans for land acquisition and development as many of those loans migrate into OREO and/or updated appraisals are obtained on the underlying collateral. Additional provisions for loan losses in 2012 may be warranted if, among other factors, further weakness in real estate is observed in our markets, if our asset quality continues to deteriorate from current levels or if we aggressively liquidate the collateral on our impaired loans under the current adverse market conditions. Annualized net charge-offs represented 1.75% of average loans in the first quarter of 2012, a 192 basis point improvement from 3.67% in the same period of 2011.

A loan is charged-off our books at any point in time when it is not considered a bankable asset within the parameters of policy. Our charge-off policy is differentiated between unsecured and secured loans. The general parameters of the charge-off policy are as follows:

An unsecured loan is charged-off when it is 90 days past due.



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A partially-secured loan is written-down to the fair value of the collateral when the loan reaches 90 days past due.

A fully-secured loan is not written-down when the loan reaches 90 days past due.

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The following are situations in which we might elect to record a specific reserve against an impaired loan rather than charge-off a portion of the loan:

The loan is an accruing TDR and performing as agreed.

The loan has already been written-down by the confirmed loss (the deficiency between the fair value of the collateral and the current balance of the loan), and an additional specific reserve is required above and beyond the initial write-down due to conservative discounts for such factors as estimated market deterioration, margining collateral according to federal supervisory limits, selling costs/commissions, etc.

There is outside financial repayment capacity in the form of either recurring cash flow or liquidity of the borrowers or guarantors.

We are in the process of re-evaluating the fair value of the collateral. A write-down decision would be premature in such instances.

We are in the process of negotiating or employing an alternative repayment plan.

If none of the above conditions are true, the loan will be written-down to the fair value of the collateral.

The following table summarizes the amount of impaired loans for which we have recorded partial charge-offs and the amount charged-off as of March 31, 2012 and December 31, 2011.

	Recorded Investment	March 31, 2012 Unpaid Principal Balance	Amount Partially Charged-off	Recorded Investment	December 31, 2011 Unpaid Principal Balance	Amount Partially Charged-off
<i>(Dollars in thousands)</i>						
Impaired loans with a partial charge-off:						
Commercial real estate:						
Construction and development	\$ 12,277	\$ 24,813	\$ 12,444	\$ 17,373	\$ 29,441	\$ 11,980
Owner-occupied	189	265	50	191	265	50
Non owner-occupied	138	244	106			
Residential real estate - mortgage	3,376	5,962	2,523	3,468	6,081	2,552
Other commercial, financial, and agricultural Consumer, including credit cards						
<b>Total impaired loans</b>	<b>\$ 15,980</b>	<b>\$ 31,284</b>	<b>\$ 15,123</b>	<b>\$ 21,032</b>	<b>\$ 35,787</b>	<b>\$ 14,582</b>

Partial charge-offs as a % of unpaid principal balance **48.3%** 40.7%

Partial charge-offs taken on impaired loans are reflected in the charge-off history for each general reserve loan pool used in our loan loss methodology. By recognizing a partial charge-off, we are absorbing the loss through the allowance for loan losses and reducing our recorded investment in the loan. These partial charge-offs reduce our coverage ratio which is the ratio of the allowance for loan losses to total nonperforming loans.

The following table illustrates the impact that these partial charge-offs had on our coverage ratio as of March 31, 2012.

<i>As of March 31, 2012</i> <i>(Dollars in thousands)</i>	<b>As Reported</b>	<b>Partial Charge- offs</b>	<b>Proforma Adjusted</b>
Allowance for loan losses	\$ 6,512	\$ 15,123	\$ 21,635
Nonperforming loans	35,832	15,123	50,955
Coverage ratio	18.2%		42.5%

**Table of Contents***Allocation of the Allowance for Loan Losses*

We have allocated the allowance for loan losses according to the amount deemed to be reasonably necessary at each year end to provide for the possibility of losses being incurred within the categories of loans set forth in the following table. The allocation of the allowance to each category is not necessarily indicative of future losses and does not restrict the use of the allowance to absorb losses in any other category. The components of the allowance for loan losses for each of the past five quarters are presented below.

<i>As of Quarter Ended (Dollars in thousands)</i>	<b>March 31, 2012</b>	December 31, 2011	September 30, 2011	June 30, 2011	March 31, 2011
<b>Allocation of allowance for loan losses by loan category:</b>					
Commercial real estate:					
Construction and development	<b>\$ 3,978</b>	\$ 4,226	\$ 5,217	\$ 5,438	\$ 5,277
Owner-occupied	<b>349</b>	368	364	254	176
Non owner-occupied	<b>206</b>	181	190	219	185
Residential real estate - mortgage	<b>1,535</b>	1,485	2,194	2,081	2,020
Commercial, financial, and agricultural	<b>311</b>	331	403	448	347
Consumer, including credit cards	<b>111</b>	134	127	200	203
Unallocated	<b>22</b>	52	69	(36)	162
<b>Total allowance for loan losses</b>	<b>\$ 6,512</b>	\$ 6,777	\$ 8,564	\$ 8,604	\$ 8,370

**Allowance by category as a percentage of total allowance:**

Commercial real estate:					
Construction and development	<b>61.1%</b>	62.3%	60.9%	63.2%	63.1%
Owner-occupied	<b>5.3%</b>	5.4%	4.3%	3.0%	2.1%
Non owner-occupied	<b>3.2%</b>	2.7%	2.2%	2.5%	2.2%
Residential real estate - mortgage	<b>23.6%</b>	21.9%	25.6%	24.2%	24.1%
Commercial, financial, and agricultural	<b>4.8%</b>	4.9%	4.7%	5.2%	4.2%
Consumer, including credit cards	<b>1.7%</b>	2.0%	1.5%	2.3%	2.4%
Unallocated	<b>0.3%</b>	0.8%	0.8%	-0.4%	1.9%
<b>Total allowance for loan losses</b>	<b>100.0%</b>	100.0%	100.0%	100.0%	100.0%

**Loans by category as a percentage of total loans:**

Commercial real estate:					
Construction and development	<b>28.3%</b>	30.6%	30.2%	33.6%	34.1%
Owner-occupied	<b>18.4%</b>	18.0%	17.5%	15.8%	15.4%
Non owner-occupied	<b>14.8%</b>	13.7%	13.0%	12.5%	12.3%
Residential real estate - mortgage	<b>22.4%</b>	21.9%	21.4%	20.6%	20.3%
Commercial, financial, and agricultural	<b>11.4%</b>	11.1%	13.3%	12.9%	13.3%
Consumer, including credit cards	<b>4.7%</b>	4.7%	4.6%	4.6%	4.6%
<b>Total loans</b>	<b>100.0%</b>	100.0%	100.0%	100.0%	100.0%

**Deposits**

Total deposits increased \$4.32 million (or 1.2%) in the first three months of 2012. Noninterest-bearing demand deposits increased \$12.31 million (or 19.3%), while interest-bearing deposits decreased \$7.99 million (or 2.6%). We believe the increase in noninterest-bearing demand deposits can be attributed in part to the unlimited deposit insurance provided in these accounts by the FDIC through the end of 2012. This temporary unlimited coverage is in addition to, and separate from, the coverage of at least \$250,000 available to depositors under the FDIC's general deposit insurance rules.



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The decrease in interest-bearing deposits is also attributed to lower rates offered by the Bank relative to other local financial institutions and other investment options for those deposit funds. The average rate paid on time deposits decreased 78 basis points from 1.95% in the first quarter of 2011 to 1.17% in the first quarter of 2012. As with most community banks, loan demand and loan volume is the driver for the remainder of our statements of condition. When we have had strong loan demand, we have been more competitive for retail time deposits within our markets and when loan demand is less, we have been less competitive in pricing for retail time deposits in our markets.

The amounts on deposit at the indicated dates are presented in the following table according to type of deposit account:

<i>As of Quarter End</i> <i>(Dollars in thousands)</i>	<b>March 31, 2012</b>	December 31, 2011	September 30, 2011	June 30, 2011	March 31, 2011
Noninterest-bearing demand	<b>\$ 75,921</b>	\$ 63,613	\$ 64,071	\$ 58,155	\$ 56,965
Interest-bearing demand	<b>125,357</b>	129,875	107,319	131,643	134,163
Savings	<b>60,670</b>	57,854	59,593	57,550	57,529
Time under \$100,000	<b>60,414</b>	63,166	65,646	66,610	67,166
Time \$100,000 to \$250,000	<b>34,758</b>	38,850	41,647	41,727	42,145
Time over \$250,000	<b>17,069</b>	16,514	19,338	20,986	23,620
<b>Total deposits</b>	<b>\$ 374,189</b>	\$ 369,872	\$ 357,614	\$ 376,671	\$ 381,588

The percentage of total deposits at the indicated dates is presented in the following table according to type of deposit account.

<i>As of Quarter End</i>	<b>March 31, 2012</b>	December 31, 2011	September 30, 2011	June 30, 2011	March 31, 2011
Noninterest-bearing demand	<b>20.3%</b>	17.2%	17.9%	15.4%	14.9%
Interest-bearing demand	<b>33.5%</b>	35.1%	30.0%	34.9%	35.2%
Savings	<b>16.2%</b>	15.6%	16.7%	15.3%	15.1%
Time under \$100,000	<b>16.1%</b>	17.1%	18.4%	17.7%	17.6%
Time \$100,000 to \$250,000	<b>9.3%</b>	10.5%	11.6%	11.1%	11.0%
Time over \$250,000	<b>4.6%</b>	4.5%	5.4%	5.6%	6.2%
<b>Total deposits</b>	<b>100.0%</b>	100.0%	100.0%	100.0%	100.0%

The local municipalities and governmental agencies hold public funds on deposit at the Bank. At March 31, 2012 and December 31, 2011, these public funds totaled \$68.63 million (or 18.3% of total deposits) and \$68.06 million (or 18.3% of total deposits), respectively. The deposits of one local municipality totaled \$25.89 million and \$24.57 million at March 31, 2012 and December 31, 2011, respectively. The Company had no brokered, Internet or other out-of-market deposits as of March 31, 2012 or December 31, 2011.

The Bank's time deposit customers have typically preferred one-year terms. At March 31, 2012, approximately 91.4% of time deposits mature within one year. The maturities of time deposits as of March 31, 2012 are summarized below.

<i>(Dollars in thousands)</i>	<b>Less Than \$100,000</b>	<b>\$100,000 &amp; Over</b>	<b>Total</b>
Months to maturity:			
3 or less	<b>\$ 15,636</b>	<b>\$ 10,681</b>	<b>\$ 26,317</b>
Over 3 through 12	<b>38,385</b>	<b>37,868</b>	<b>76,253</b>
Over 12 through 36	<b>4,916</b>	<b>2,668</b>	<b>7,584</b>
Over 36	<b>1,477</b>	<b>610</b>	<b>2,087</b>

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Total time deposits	\$ 60,414	\$ 51,827	\$ 112,241
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**FHLB Advances**

Advances outstanding with the FHLB totaled \$5.0 million at March 31, 2012, unchanged from December 31, 2011. The advances outstanding included a \$2.5 million fixed rate advance due July 30, 2012 with an effective rate of 2.35% and another \$2.5 million fixed rate advance due July 29, 2013 with an effective rate of 2.89%. At March 31, 2012, the two advances were collateralized by cash balances held at the FHLB. Additional funding is not currently available from the FHLB.

**RESULTS OF OPERATIONS**

The Company recorded a net loss of \$388,583 for the three months ended March 31, 2012 compared to net income of \$26,187 during the same period in 2011. On a per share basis, the first quarter loss totaled \$0.12, a decline compared to the \$0.01 net earnings per share for the first quarter of 2011. Major variances in the Company's results of operations for the three months ended March 31, 2012 compared to the same period in 2011 included:

\$137,000 decline in net interest income;

\$60,000 improvement in the provision for loan losses;

\$3,000 decline in noninterest income;

\$309,000 increase in write-downs on other real estate; and

\$62,000 decrease in other noninterest expenses.

Variations in net interest income and noninterest income and expenses are further discussed in the following subsections of this Analysis; the variation in the provision for loan losses is more fully discussed within the *Financial Condition* section of the Analysis.

**Net Interest Income**

Like most community banks, the primary component of our profitability is net interest income, or the difference between the interest income earned on assets, primarily loans and investments, and interest paid on liabilities, primarily deposits and other borrowed funds. For the first quarter of 2012, our net interest income (on a tax-equivalent basis) decreased by \$185,000 (or 5.8%) as compared to the same period in 2011. The decline was due to a shift in earning assets from higher-yielding loans to lower-yielding investments and cash and cash equivalents offset in part by a decrease in interest expense as rates paid on deposit accounts continued to re-price downward. Interest income (on a tax-equivalent basis) decreased \$599,000 (or 14.4%), and interest expense decreased \$414,000 (or 43.6%) in the three months ended March 31, 2012 compared to the same period in 2011. The decrease in interest income is the result of a 50 basis point decline in the average yield on our earning assets, from 4.24% in the first quarter of 2011 to 3.74% in 2012 and a \$16.3 million decrease in the average balance of those earning assets. The decrease in interest expense is the result of a 47 basis point decline in the average rate paid on our interest-bearing liabilities, from 1.17% in the first quarter of 2011 to 0.70% in 2012 and a \$24.3 million decrease in the average balance of those interest-bearing liabilities. Reductions in the cost of funds in the current economic cycle have not kept pace with declines in asset yields since liquidity and regulatory constraints have compelled other banks in our markets to rely more heavily on in-market deposits, particularly time deposits, for funding; this reliance has kept deposit rates in our markets higher than national averages. In addition, new competitor banks in several of our markets have promoted higher deposit rates in an attempt to increase their market share.



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The net interest margin is net interest income expressed as a percentage of average earning assets. Our net interest margin decreased to 3.18% in the first quarter of 2012 from 3.26% for the same period in 2011. Net interest income and resultant margins and spreads are projected to continue to remain compressed in 2012 due to: a) yield reductions on a year-over-year basis, due largely to higher cash equivalent balances and shortened maturities on investment securities; b) overall lower average balances on loans; and c) continued elevated levels in nonperforming assets, also on an average basis.

The following table details the average balance of interest-earning assets and interest-bearing liabilities, the amount of interest earned and paid, and the average yields and rates realized for three months ended March 31, 2012 and 2011. Federally tax-exempt income is presented on a taxable-equivalent basis assuming a 34% Federal tax rate. Loan average balances include loans on nonaccrual status. Other interest-earning assets include interest-bearing deposits in other banks, federal funds sold and FHLB stock. Interest-bearing demand deposits includes NOW and money market accounts.

<i>For the Quarters Ended March 31, (Dollars in thousands)</i>	<b>Average Balance</b>	<b>2012 Interest Income/ Expense</b>	<b>Average Yield/ Rate</b>	Average Balance	2011 Interest Income/ Expense	Average Yield/ Rate
<b>Interest-earning assets:</b>						
Loans	\$ 198,391	\$ 2,833	5.74%	\$ 240,554	\$ 3,424	5.77%
Taxable securities	73,878	494	2.69%	63,442	455	2.91%
Nontaxable securities	10,683	167	6.27%	13,231	217	6.65%
Other interest-earning assets	98,154	54	0.22%	80,173	51	0.26%
<b>Total interest-earning assets</b>	<b>381,106</b>	<b>3,548</b>	<b>3.74%</b>	397,400	4,147	4.24%
<b>Interest-bearing liabilities:</b>						
Interest-bearing demand deposits	\$ 126,388	\$ 115	0.37%	\$ 132,997	\$ 186	0.57%
Savings deposits	58,983	53	0.36%	55,272	77	0.56%
Time deposits	115,473	336	1.17%	136,115	655	1.95%
FHLB advances	5,000	32	2.57%	5,000	32	2.60%
Other short-term borrowings			0.00%	728		0.00%
<b>Total interest-bearing liabilities</b>	<b>305,844</b>	<b>536</b>	<b>0.70%</b>	330,112	950	1.17%
Excess of interest-earning assets over interest-bearing liabilities	\$ 75,262			\$ 67,288		
<b>Interest rate spread</b>			<b>3.04%</b>			<b>3.07%</b>
Net interest income		\$ 3,012			\$ 3,197	
<b>Net interest margin</b>			<b>3.18%</b>			<b>3.26%</b>

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The following table shows a summary of the changes in interest income and interest expense on a fully taxable-equivalent basis resulting from changes in volume and changes in rates for each category of interest-earning assets and interest-bearing liabilities. The change in interest attributable to rate has been determined by applying the change in rate between periods to average balances outstanding in the later period. The change in interest due to volume has been determined by applying the rate from the earlier period to the change in average balances outstanding between periods. Thus, changes that are not solely due to volume have been consistently attributed to rate.

<i>For the Quarters Ended March 31, (Dollars in thousands)</i>	<b>Increase (Decrease)</b>	<b>2012 vs. 2011</b>	
		<b>Rate</b>	<b>Changes Due To Volume</b>
<b>Increase (decrease) in income from interest-earning assets:</b>			
Loans	\$ (591)	\$ 14	\$ (605)
Taxable securities	39	(36)	75
Nontaxable securities	(50)	(8)	(42)
Other interest-earning assets	3	(9)	12
<b>Total interest income</b>	<b>(599)</b>	<b>(39)</b>	<b>(560)</b>
<b>Increase (decrease) in expense from interest-bearing liabilities:</b>			
Interest-bearing demand deposits	(71)	(62)	(9)
Savings deposits	(24)	(29)	5
Time deposits	(319)	(219)	(100)
FHLB advances			
Other short-term borrowings			
<b>Total interest expense</b>	<b>(414)</b>	<b>(310)</b>	<b>(104)</b>
<b>Net interest income</b>	<b>\$ (185)</b>	<b>\$ 271</b>	<b>\$ (456)</b>

The decline in interest income is due primarily to declines in the volume of loans outstanding and the yield on taxable investment securities for the three months ended March 31, 2012 compared to 2011. The decline in interest expense is due primarily to declines in rates paid on deposits and the volume of time deposits outstanding.

**Provision for Loan Losses**

The provision for loan losses is the charge to operating earnings necessary to maintain an adequate allowance for loan losses after loan charge-offs and recoveries are recorded during a reporting period. Through the provision, we maintain an allowance for loan losses that we believe is adequate to absorb losses inherent in our loan portfolio. However, future additions to the allowance may be necessary based on growth in the loan portfolio, changes in economic conditions and other internal and external environmental factors. In addition, various regulatory agencies, as an integral part of their examination procedures, periodically review our allowance for loan losses. Based on their judgments about information available to them at the time of their examination, such agencies may require us to recognize additions to the allowance for loan losses.

For the three months ended March 31, 2012, we recorded \$600,000 as a provision for loan losses, a 9.1% decrease compared to the \$660,000 provision for loan losses recorded during the same period in 2011. In first quarter of 2012, we recorded \$865,000 in net charge-offs (or an annualized 1.75% of average loans), a decrease compared to \$2,206,000 in net charge-offs (or an annualized 3.67% of average loans) during the same period in 2011. The changes in the provision for loan losses are discussed in more detail in the *Financial Condition* section of this Analysis.

**Table of Contents****Noninterest Income**

Total noninterest income decreased \$3,000 (or 0.3%) in the first three months of 2012 compared to 2011. The following table summarizes the key components of noninterest income during the first quarter of the last two years.

<i>For the quarters ended March 31, (Dollars in thousands)</i>	<b>2012</b>	<b>Percentage Change 2012 vs. 2011</b>	2011
Routine service charges on deposit accounts	<b>\$ 200</b>	<b>-2.4%</b>	\$ 204
Return check and other charges on deposit accounts	<b>328</b>	<b>-5.3%</b>	346
Net loss on sales of investment securities	<b>(11)</b>	<b>-40.3%</b>	(18)
Commissions, insurance products	<b>12</b>	<b>-31.7%</b>	18
Mortgage origination fees	<b>12</b>	<b>222.6%</b>	4
Bank card and credit card fees	<b>164</b>	<b>9.8%</b>	150
Earnings on bank-owned life insurance	<b>59</b>	<b>1.4%</b>	58
Other noninterest income	<b>103</b>	<b>-4.4%</b>	108
<b>Total noninterest income</b>	<b>\$ 867</b>	<b>-0.3%</b>	\$ 870
 Noninterest income as a percentage of average assets (annualized)	 <b>0.84%</b>		 0.81%

Deposit service charge fee income declined 2.4% in 2012 due to a decline in the aggregate number of active demand deposit accounts and an increase in collected balances maintained in demand deposit accounts that avoid a monthly fee.

A 4.6% decline in transaction volume of return checks and overdrafts on deposit accounts was the main factor in the 5.3% decline in fees in 2012.

Fee income for credit life insurance sales decreased 31.7% in 2012 due to a decline in new consumer loan volume.

Fee income on mortgage originations increased in 2012 due to an increase in volume of mortgage loan originations.

Fees earned on bank card and credit card activity increased 9.8% in 2012 due to an increase in volume of card transactions and a change in vendors that allowed us to earn more per card transaction than in prior years. However, due to recent regulatory restrictions on card transaction fees enacted by the Dodd-Frank Act, we expect to see a decline in card fee income going forward.

Earnings on bank-owned life insurance increased 1.4% in 2012 as a result of a higher rate of return on these policies compared to the first quarter of 2011.

**Table of Contents****Noninterest Expense**

Noninterest expense increased \$335,000 (or 10.3%) in the first three months of 2012 compared to the same period in 2011. Excluding the net (gain) loss on sales of assets and write-downs on other real estate, noninterest expense decreased \$11,000 (or 0.4%) as we focused our efforts on cost savings initiatives and operational efficiencies. The following table summarizes the key components of noninterest expense during the first quarter of the last two years.

<i>For the quarters ended March 31, (Dollars in thousands)</i>	<b>2012</b>	<b>Percentage Change 2012 vs. 2011</b>	2011
Salaries and wages	<b>\$ 1,326</b>	<b>3.1%</b>	\$ 1,287
Employee benefits	<b>382</b>	<b>-3.3%</b>	396
Net occupancy expense of premises	<b>271</b>	<b>-2.1%</b>	277
Furniture, equipment and computer expense	<b>367</b>	<b>9.1%</b>	336
Net (gain) loss on sales of assets	<b>16</b>	<b>-170.9%</b>	(22)
Write-downs on other real estate	<b>470</b>	<b>191.6%</b>	161
FDIC insurance	<b>138</b>	<b>-35.4%</b>	214
Legal and accounting fees	<b>92</b>	<b>-12.8%</b>	106
Taxes and insurance expense	<b>26</b>	<b>-13.4%</b>	30
Director and committee fees	<b>27</b>	<b>-0.2%</b>	27
Advertising, marketing and supplies	<b>41</b>	<b>-19.2%</b>	51
Postage and courier expense	<b>64</b>	<b>-5.9%</b>	68
Service charges and fees	<b>129</b>	<b>-4.0%</b>	134
Other real estate and repossessed asset expense	<b>93</b>	<b>78.2%</b>	52
Other operational losses	<b>28</b>	<b>26.2%</b>	22
Other noninterest expense	<b>130</b>	<b>3.0%</b>	126
<b>Total noninterest expense</b>	<b>\$ 3,600</b>	<b>10.3%</b>	\$ 3,265
 Noninterest expense as a percentage of average assets (annualized)	 <b>3.47%</b>		 3.05%

Combined, salaries and employee benefits increased \$25,000 (or 1.5%) in 2012 compared to 2011. The increase is due in part to a 2.1% increase in the employee workforce from 140 at March 31, 2011 to 143 at March 31, 2012 offset, in part, to a decrease in employee benefits costs. The Company has not provided annual salary increases for its employees since 2009.

Combined, net occupancy, furniture and equipment expenses increased \$25,000 (or 4.1%) in 2012 compared to 2011. Using the half-year convention, the Company recognized the final half-year's amortization on its core banking system and depreciation of furniture and fixtures on the 2005 Darien office remodel in the first quarter of 2012. This amounted to \$15,000 more than the amount amortized on the system in the first quarter of 2011.

The expense for FDIC insurance decreased \$76,000 (or 35.4%) in 2012 compared to 2011. The decrease is due to a change in the FDIC assessment calculation methodology. The FDIC changed the assessment base from total deposits to total assets net of Tier 1 capital. This change resulted in a lower quarterly assessment for the Bank.

Legal and accounting fees decreased \$14,000 (or 12.8%) in 2012 compared to 2011. The Company's expenses were higher in this area in the first quarter of 2011 due to its use of consultants for special projects and collection litigation.

Other real estate and repossessed asset expense increased \$41,000 (or 78.2%) in 2012 compared to 2011 due to the increased level of foreclosed real estate owned by the Company. These expenses include property taxes, repairs and maintenance, insurance and appraisal costs.



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Other operation losses increased \$6,000 (or 26.2%) in 2012 compared to 2011 due primarily to an increase in losses incurred on fraudulent debit card transactions on customer accounts.

### **Income Taxes**

The Company did not record an income tax expense or benefit in the first quarter of 2012 or 2011 due to the amount of its tax loss carryforwards. Until we return to a period of sustained profitability, we will not record income tax expense or benefits or deferred tax assets or liabilities.

### **LIQUIDITY AND CAPITAL RESOURCES**

Liquidity is managed to ensure sufficient cash flow to satisfy demands for credit, deposit withdrawals, and other corporate needs. Liquidity is vital to any financial institution and its importance cannot be overstated, particularly during periods of economic crisis. Overall liquidity position is determined by the types of assets, and their duration, on the statements of condition; encumbrances; borrowing capacity from customer deposits or other sources; and retained earnings. In short, assets, predominantly loans and investment securities, are funded by customer deposits, borrowed funds, and retained earnings. In the last few years, in an effort to remain more liquid through the economic recession and subsequent tepid recovery, we increased our holdings in cash and cash equivalents. Cash and cash equivalents, which comprise cash and due from banks, interest-bearing deposits in other banks, and federal funds sold, represented 26.6% and 23.7% of total assets at March 31, 2012 and December 31, 2011, respectively.

At March 31, 2012, our ratio of short-term investments (defined as the sum of interest-bearing deposits in other banks (excluding \$5.0 million pledged to the FHLB), federal funds sold, and investment securities maturing within one year) to total assets was 23.8%. It is our policy to maintain a ratio of short-term investments to total assets of at least 5%. At March 31, 2012, our liquidity position, which is an internally-calculated ratio of short-term funds available to short-term and potentially volatile liabilities, was 43.5% and our net noncore funding dependency ratio, which is the difference between regulatory defined non-core liabilities and short-term investments, divided by long-term assets, was -33.8%. Our liquidity and funding policy provides that we maintain a liquidity position of greater than or equal to 20% and a net noncore funding dependency ratio of less than or equal to 25%.

Cash flows from the loan and securities portfolios represent important components of the Company's overall liquidity position. At March 31, 2012, approximately \$66.54 million in loans and investment securities (at amortized cost) were contractually scheduled to mature within the next twelve months. The actual cash flows from loans and investment securities can vary significantly from contractual maturities. Loans are subject to refinancing, prepayment or even default. Investment securities, especially mortgage-backed securities and SBA securities, have prepayment and call provisions that result in cash flows earlier than the contractual maturities. The scheduled and unscheduled payments from mortgage-backed securities and SBA securities are estimated to provide an additional \$22.71 million in cash flows over the next twelve months.

If necessary, we have the ability to sell a portion of our unpledged investment securities to provide additional liquidity. At March 31, 2012, approximately \$60.30 million (or 70.8%) of our securities portfolio was pledged to secure public deposits and certain borrowing arrangements. However, when adjusted for over-pledging due to cyclical variations in public deposits and contingency pledging to the Federal Reserve Bank discount window, approximately \$8.92 million of the securities pledged was unencumbered at March 31, 2012. The entities to which the excess collateral is pledged have no legal claim on such collateral unless amounts are owed under other obligations.

We have long benefited from a relatively large, stable deposit base. Customer-based core deposits, traditionally our largest and most cost-effective source of funding, includes our demand and savings deposits and time deposits with balances of \$250,000 or less. Core deposits funded 84.9% of total assets at March 31, 2012.

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We currently do not accept brokered deposits or other out-of-market deposits. Alternative sources of funding have traditionally encompassed U.S. Treasury demand notes, Federal Reserve discount window borrowings, federal funds purchased, and FHLB advances. At March 31, 2012, the outstanding balance of these alternative sources of funding totaled \$5.00 million, or 1.2% of total assets.

The Company has also historically generated net cash flows from operations. For the quarter ended March 31, 2012, net cash provided by operating activities amounted to \$1.05 million compared to \$1.29 million during the same period in 2011. The consolidated statements of cash flows within Item 1 of this Report provide a summary of cash flows provided by or used in operating, investing, and financing activities for the three months ended March 31, 2012 and 2011.

In the third quarter of 2009, the FDIC announced a plan to restore its Deposit Insurance Fund balances depleted as a result of recent bank failures. The restoration plan required all FDIC-insured banks to prepay their risk-based assessments for the years 2010, 2011, and 2012. The assessments, usually due quarterly, were instead estimated for the three future years and paid prior to December 31, 2009. We paid our required assessment on December 29, 2009 and concurrently recorded a prepaid asset within other assets on the consolidated statements of condition. This prepaid asset totaled \$413,000 at March 31, 2012. Any differences between the prepaid and actual amounts due each quarter will be funded using existing available liquidity.

*Commitments of Capital*

At March 31, 2012, there were no binding commitments for material capital expenditures.

*Shareholders' Equity*

We are required to comply with capital adequacy standards established by our federal and state bank regulatory agencies. At March 31, 2012, the Bank had the requisite capital level to qualify as well capitalized under the regulatory framework for prompt corrective action. Refer to sections titled *Capital Adequacy* and *Prompt Corrective Action* under the caption *Supervision and Regulation* in Item 1 of our Annual report on Form 10-K for the year ended December 31, 2011 for more information on the regulatory capital adequacy standards. The following table summarizes our consolidated regulatory capital ratios at March 31, 2012 and December 31, 2011.

	March 31, 2012	December 31, 2011	Minimum Regulatory Requirement
Total capital to risk-weighted assets	<b>18.11%</b>	17.63%	8.00%
Tier 1 capital to risk-weighted assets	<b>16.84%</b>	16.37%	4.00%
Tier 1 capital to average assets	<b>9.40%</b>	9.70%	4.00%

Shareholders' equity represented 9.50% of total assets at March 31, 2012, a decrease compared to 9.63% at December 31, 2011. Total shareholders' equity decreased \$140,000 (or 0.4%) since the end of 2011. This decrease is primarily the result of our net loss of \$389,000 offset in part by a \$240,000 increase in accumulated other comprehensive gains.

In July 2010, our Board of Directors voted to suspend dividends and treasury stock purchases until our operating performance improved and credit losses abated. Regulatory approval will be required prior to payment of future dividends or treasury stock purchases. Accordingly, we did not declare a dividend or purchase treasury stock in 2011 or the first quarter of 2012.

On April 20, 2012, we filed Form 15 with the SEC to deregister our stock and suspend our duty to file periodic reports with the SEC. As an Exchange Act filer, the regulatory burden is extensive. For a small reporting company like us, the cost of compliance with these regulations, in terms of management time, legal and accounting fees and other costs, is significant. We estimate this compliance cost to be approximately \$120,000 per year. We believe deregistration will benefit our shareholders by allowing us to eliminate costs incurred to satisfy the disclosure, reporting and compliance requirements of an SEC registrant.

We expect the deregistration of our stock and the duty to continue to file periodic reports with the SEC to be effective by July 30, 2012. After deregistration, we expect our stock will continue to be traded through a network of broker-dealer firms over-the-counter (OTC) as an OTC stock. Shareholders should be able to look up trade information on our stock using our SEBC stock symbol on the OTC Bulletin Board website at [www.otcbb.com](http://www.otcbb.com).





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### **CRITICAL ACCOUNTING ESTIMATES**

The preparation of financial statements and the related disclosures in conformity with accounting principles generally accepted in the United States requires that management make estimates and assumptions which affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. We believe that our determination of the allowance for loan losses, the fair value of assets and the accounting for income taxes affect our most significant judgments and estimates used in the preparation of our consolidated financial statements. Our accounting policies are described in detail in the Notes to our Consolidated Financial Statements provided in Form 10-K for the year ended December 31, 2011. The following is a brief description of our critical accounting policies involving significant management valuation judgment.

#### *Allowance for Loan Losses*

The allowance for loan losses represents our estimate of losses inherent in the existing loan portfolio. The allowance for loan losses is increased by the provision for loan losses charged to expense and reduced by loans charged off, net of recoveries. The allowance for loan losses is determined based on our assessment of several factors including, but not limited to, reviews and evaluations of specific loans, changes in the nature and volume of the loan portfolio, current economic conditions and the related impact on segments of the loan portfolio, historical loan loss experiences and the level of classified and nonperforming loans.

Loans are considered impaired if, based on current information and events, it is probable that we will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The measurement of impaired loans is based on either the fair value of the underlying collateral, the present value of the future cash flows discounted at the historical effective interest rate stipulated in the loan agreement, or the estimated market value of the loan. In measuring the fair value of the collateral, we use assumptions (e.g., discount rate) and methodologies (e.g., comparison to the recent selling price of similar assets) consistent with those that would be utilized by unrelated third parties.

Collateral valuations are based on appraisals, recent sales of comparable properties, and other relevant market and property-specific information. The value estimate is based on an orderly disposition and marketing period of the property. In limited instances, we will discount externally provided appraisals for justifiable and well-supported reasons, such as an appraiser not being aware of certain property-specific factors or recent sales information; we do not make upward adjustments to third party appraisals. Appraisals are further discounted to reflect estimated selling costs. Appraisals generally represent the as is value of the property unless improvements are being made, in which case as completed values are used.

Our assessment is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available. Changes in various internal and external environmental factors including, but not limited to, the financial condition of individual borrowers, economic conditions, historical loss experience, or the condition of the various markets in which collateral may be sold may affect the required level of the allowance for loan losses and the associated provision for loan losses. Should these environmental factors change, a different amount may be reported for the allowance for loan losses and the associated provision for loan losses.

#### *Estimates of Fair Value*

The estimation of fair value is significant to a number of our assets, including, but not limited to, investment securities, other real estate owned, and other repossessed assets. These assets are all recorded at either fair value or at the lower of cost or fair value. Fair values are volatile and may be influenced by a number of factors. Circumstances that could cause estimates of the fair value of certain assets and liabilities to change include a change in prepayment speeds, discount rates, or market interest rates. Our estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the consolidated financial statements in the period they are determined to be necessary.

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Fair values for most investment securities are based on quoted market prices. If quoted market prices are not available, fair values are based on the quoted prices of similar instruments. The fair values of foreclosed real estate and other repossessions are typically determined based on appraisals by third parties, less estimated costs to sell.

### *Accounting for Income Taxes*

The estimation of our income tax liability in each of the jurisdictions in which we operate, and the measurement of income tax expense (or benefit) and the related asset and liability balances involve a high degree of judgment and subjectivity. Adjustments in tax estimates occur periodically due to changes in tax rates, interpretations of tax laws, examinations by tax authorities, and newly enacted regulation. These changes, when they occur, can impact accrued taxes and have a material effect on our operating results.

Accounting guidance requires a valuation allowance to be recorded for deferred tax assets if, based on available evidence, it is more likely than not that all or some portion of the asset may not be realizable due to inability to generate sufficient taxable income in the requisite period and/or character necessary to utilize the deferred tax asset. In making this assessment, all sources of taxable income available to utilize the deferred tax asset are considered, including taxable income in carryback years, future reversals of existing temporary differences, any tax planning strategies, and future taxable income. Whether or not future taxable income, exclusive of temporary differences being reversed, will occur is the most subjective of these four sources. The presence of cumulative losses in recent years, or a significant loss in a single year, is considered significant negative evidence, rendering reliance on future taxable income to realize a deferred tax asset difficult. Judgment is necessarily involved in making this assessment. Changes in judgment about the realization of deferred tax assets and hence, the valuation allowance, in future years are recorded through income tax expense.

### **Recent Accounting Pronouncements**

There were no recent accounting pronouncements that have had a material impact on our earnings or financial condition as of or for the quarter ended March 31, 2012. For more detailed disclosure on recent accounting developments, see Note 1 to the Consolidated Financial Statements included in Item 1 of this Report.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We are subject to exposure from U.S. dollar interest rate changes and accordingly, we manage our exposure by considering the possible changes in the net interest margin. We do not engage in trading activity nor do we classify any portion of the investment portfolio as held-for-trading. Finally, we have no material direct exposure to foreign currency exchange rate risk, commodity price risk, and other market risks.

Interest rates play a major part in the net interest income of a financial institution. The sensitivity to rate changes is known as interest rate risk. The repricing of interest earning assets and interest-bearing liabilities can influence the changes in net interest income. Fluctuations in interest rates may result in changes in the fair market value of our financial instruments, cash flows, and net interest income. We have an asset/liability committee that periodically reviews our exposure to interest rate risk and formulates strategies based on acceptable levels of interest rate risk. The overall objective of this process is to optimize our financial position, liquidity, and net interest income, while limiting volatility to net interest income from changes in interest rates.

We use simulation modeling to test the interest rate sensitivity of net interest income. Contractual maturity and repricing characteristics of loans are incorporated into the model, as are prepayment assumptions, maturity data, and call options within the investment portfolio. Non-maturity deposit accounts are modeled based on past experience. Simulation results quantify interest rate risks under various interest rate scenarios over twelve-month and twenty-four-month periods. Based on the latest analysis, we continue to be asset sensitive and exposed to declining earnings if interest rates fall. The simulation model estimates changes in net interest income based on various gradual and immediate rate change scenarios. Our policy has limitations on the impact to net interest income for the various interest rate scenarios.

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As of March 31, 2012, the simulation model projected net interest income would increase 7.6% over the next year if market rates immediately rose by 200 basis points and the model projected net interest income would decrease 0.3% over the next year if market rates immediately fell by 100 basis points. As summarized in the following table, the model projects that our earnings will increase as rates rise and decrease if rates drop.

Market Rate Change	12-Month Horizon			24-Month Horizon		
	Gradual	Immediate	Policy Limit	Gradual	Immediate	Policy Limit
+400 basis points	14.2%	25.3%	-25.0%	16.1%	20.9%	-30.0%
+300 basis points	9.5%	16.3%	-20.0%	10.1%	12.8%	-25.0%
+200 basis points	5.4%	7.6%	-15.0%	4.6%	5.0%	-20.0%
+100 basis points	2.2%	2.4%	-10.0%	1.0%	0.7%	-15.0%
-100 basis points	-0.2%	-0.3%	-10.0%	0.3%	-0.2%	-15.0%

Limitations inherent with simulation modeling include: a) in a down rate environment, competitive and other factors constrain timing of rate cuts on other deposit products whereas loans tied to prime and other variable indexes reprice instantaneously and securities with call or other prepayment features are likely to be redeemed prior to stated maturity and replaced at lower rates (lag effect); and b) changes in balance sheet mix, for example, unscheduled pay-offs of large commercial loans and significant increases in nonaccrual loans, are oftentimes difficult to forecast.

We have not utilized interest rate swaps, financial options, financial futures contracts, or other off-balance sheet derivative financial instruments to hedge interest rate, cash flow and market risks.

**Impact of Inflation**

The effects of inflation on the local economy and our operating results have been relatively modest the last several years. Since substantially all of our assets and liabilities, including cash, securities, loans, and deposits, are monetary in nature, their values are less sensitive to the effects of inflation than to changing interest rates. As discussed in other parts to Item 3 of this Report, we attempt to control the impact of interest rate fluctuations by managing the relationship between our rate sensitive assets and liabilities.

**Item 4. Controls and Procedures**

A review and evaluation was performed by the Company's management, including the Company's principal executive officer and principal financial officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this Report. Based on that review and evaluation, the Company's principal executive officer and principal financial officer have concluded that the Company's current disclosure controls and procedures, as designed and implemented, were effective as of the end of the period covered by this Report in alerting them on a timely basis to material information relating to the Company required to be included in the Company's reports filed or submitted under the Securities Exchange Act of 1934. There have been no changes in the Company's internal control over financial reporting that occurred during the Company's most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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**Part II - Other Information**

**Item 1. Legal Proceedings**

The nature of the business of the Company and the Bank ordinarily results in a certain amount of litigation. Accordingly, we are party to a limited number of lawsuits incidental to our respective businesses. In our opinion, the ultimate disposition of these matters will not have a material adverse impact on our consolidated financial position or results of operations.

**Item 1A. Risk Factors**

There were no material changes to the Company's risk factors during the first three months of 2012.

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

None

**Item 3. Defaults Upon Senior Securities**

Not Applicable

**Item 4. (Removed and Reserved)**

**Item 5. Other Information**

On April 20, 2012, the Company filed Form 15 with the SEC to deregister its common stock and suspend its duty to file periodic reports with the SEC. The Company is relying on Section 12(g)(4) of the Securities Exchange Act of 1934, as amended by the Jumpstart Our Business Startups Act, to terminate the registration of its common stock and its duty to file reports with respect to the common stock. The Company's registration will be terminated 90 days after the filing of the Form 15 which will be on July 30, 2012.

**Item 6. Exhibits**

- 31.1 Rule 13a-14(a) Certification of CEO.
- 31.2 Rule 13a-14(a) Certification of Treasurer.
- 32 Section 1350 Certification of CEO and Treasurer.
- 101 Interactive Data File.

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**Signatures**

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

**SOUTHEASTERN BANKING CORPORATION**  
*(Registrant)*

By: /s/ DONALD J. TORBERT, JR.  
**Donald J. Torbert, Jr., Treasurer**  
*(Principal Accounting Officer)*

Date: May 15, 2012