



2016 Annual Report

**CAROLINA ALLIANCE BANK AND SUBSIDIARY
2016 ANNUAL REPORT**

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April 10, 2017

Dear Fellow Shareholders:

We appreciate the opportunity to present our annual financial report to you. This has been another exciting and interesting year. As the year began, our efforts were focused on completing the integration of Pinnacle Bank, which came on board in October of 2015. Once we were comfortable with the level of integration achieved, we redirected our focus and analyzed operating processes bank wide. With two mergers in less than two years, it was a priority to ensure consistent and efficient operations across the organization. Our goal was to achieve operational efficiency both in terms of operating costs and the customer experience.

Moving on to the financial highlights of the year, our loan portfolio grew less than our expectations due to unprecedented unscheduled principal reductions and payoffs in 2016. We have studied these payoffs, and the vast majority were not lost to competing institutions but were for other reasons, which typically represented positive business opportunities for our customers. Fortunately, these principal inflows were offset by record loan originations by our lenders, which allowed us to increase gross loans and leases 4.5% during the year. Credit quality continued to improve in 2016 in terms of delinquencies and charge-offs.

With a full year of the benefits of the earning assets and customer base added in the Pinnacle merger late last year and by having no merger expenses in 2016, earnings were substantially improved over the prior year. Net income was \$4.1 million in 2016 compared to \$1.8 million in 2015. Net interest margin compression continues to challenge our industry, and we expect the compression to persist in the rising interest rate environment predicted for 2017, as we believe that the repricing of our deposits will outpace our loan portfolio's upward repricing. We are diligently monitoring and taking defensive measures to mitigate the potential impact.

Our secondary market mortgage program flourished under the legacy Pinnacle model, with origination volume and income exceeding expectations. Our leasing operations experienced a very strong year as well.

We redeemed the \$5.0 million of preferred stock that had been issued through the U.S. Treasury's Small Business Lending Fund. This redemption was done without obtaining replacement capital. Our capital position remains strong even with the absence of the preferred stock.

More in-depth financial analysis and reports follow this letter. We welcome any questions about any information in this annual report.

To further our growth opportunities, our Board approved the creation of a holding company for our bank, which will be subject to regulatory and shareholder approval. We believe that this is a necessary addition to our overall corporate structure and will give us more operational and capital management flexibility as we move forward. Details on this proposed holding company formation can be found in the proxy statement for our 2017 Annual Meeting of Shareholders.

In summary, we are pleased with the bank's performance in 2016, particularly since the Pinnacle merger was only three months behind us as we started the year. Even with continuing integration efforts in the first part of the year, our people made great strides in advancing our growth plan and building value. We thank them, and we thank our loyal shareholders for their continuing support. We believe that the bank is well positioned for growth, is in excellent markets, and has the right team assembled to achieve our goals. We are truly excited about the prospect of ongoing achievement in 2017.

Thank you for your continuing support.

Yours truly,



John S. Poole
Chief Executive Officer
CAB Financial Corporation (*In Organization*)



John D. Kimberly
President and Chief Executive Officer
Carolina Alliance Bank

CAROLINA ALLIANCE BANK

Selected Financial Information

The following table sets forth certain selected financial data concerning Carolina Alliance Bank as of and for the years ended December 31, 2016, 2015, 2014, 2013, and 2012. This information should be read in conjunction with the consolidated financial statements, the notes thereto and the following "Management's Discussion and Analysis of Financial Condition and Results of Operations."

	(Audited)				
	As of or for the Years Ended December 31,				
	2016	2015	2014	2013	2012
Selected Financial Condition Data:					
Total assets	\$ 642,932,989	\$ 608,290,613	\$ 417,799,499	\$ 247,384,613	\$ 249,643,118
Securities available for sale	97,976,406	90,475,629	60,776,574	44,547,635	46,902,315
Total loans and leases	493,091,012	473,285,065	330,819,139	182,845,748	175,365,997
Allowance for loan and lease losses	(4,954,610)	(4,678,907)	(3,946,405)	(3,515,034)	(3,082,443)
Deposits	527,599,212	495,822,876	338,391,498	203,499,827	209,353,951
Other borrowings	38,211,164	36,248,088	25,592,085	11,142,253	7,311,528
Shareholders' equity	70,295,444	71,878,214	52,269,444	31,977,872	31,758,736
Book value per common share ⁽¹⁾	\$ 10.76	\$ 10.27	\$ 9.88	\$ 9.31	\$ 9.27
Selected Operating Data:					
Interest income	\$ 24,799,870	\$ 19,524,408	\$ 15,718,103	\$ 9,618,045	\$ 10,004,944
Interest expense	2,547,920	1,410,329	1,042,487	820,938	1,212,427
Net interest income before provision for loan losses	22,251,950	18,114,079	14,675,616	8,797,107	8,792,517
Provision for loan losses	210,000	910,210	1,098,129	475,000	1,080,000
Net interest income after provision for loan losses	22,041,950	17,203,869	13,577,487	8,322,107	7,712,517
Non-interest income	4,823,706	2,740,059	5,738,354	367,742	390,721
Non-interest expense	20,724,199	16,674,631	12,115,887	6,817,654	5,687,875
Income before income tax provision	6,141,457	3,269,297	7,199,954	1,872,195	2,415,363
Income tax provision	1,987,384	1,369,955	1,095,054	789,402	862,482
Net income	4,154,073	1,899,342	6,104,900	1,082,793	1,552,881
Preferred stock redemption	25,000	-	-	-	-
Preferred stock dividends	7,085	50,000	50,000	50,000	50,000
Net income available to common shareholders	\$ 4,121,988	\$ 1,849,342	\$ 6,054,900	\$ 1,032,793	\$ 1,502,881
Income per common share ⁽¹⁾ :					
Basic	\$ 0.63	\$ 0.35	\$ 1.41	\$ 0.35	\$ 0.52
Diluted	\$ 0.62	\$ 0.35	\$ 1.38	\$ 0.35	\$ 0.52

⁽¹⁾ Per share amounts have been adjusted to reflect stock dividends of 5% in February 2016 and 10% in September 2014.

Earnings Performance Ratios:

Return on average assets	0.66 %	0.40 %	1.65 %	0.44 %	0.63 %
Return on average shareholders' equity	5.89 %	3.28 %	13.10 %	3.38 %	5.00 %
Average shareholders' equity to average assets	11.26 %	12.28 %	12.61 %	13.09 %	12.71 %

Asset Quality Ratios:

Net loans and leases charged off (recovered) to net loans and leases	(0.01) %	0.04 %	0.20 %	0.21 %	1.03 %
Non-accrual loans and leases to gross loans and leases	0.39 %	0.87 %	0.71 %	0.37 %	0.88 %
Non-performing assets to total assets	0.32 %	0.92 %	0.97 %	0.72 %	0.98 %

Regulatory Capital Ratios:

Tier 1 leverage ratio	10.60 %	11.20 %	12.00 %	12.60 %	12.30 %
Common equity tier 1 risk-based	11.70 %	11.90 %	n/a	n/a	n/a
Tier 1 risk-based	11.70 %	12.80 %	14.10 %	15.60 %	16.01 %
Total risk-based	12.60 %	13.70 %	15.20 %	16.90 %	17.27 %

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis should be read in conjunction with our "Selected Financial Information" table and the financial statements and notes included in this annual report. The discussion in this annual report contains forward-looking statements that involve risks and uncertainties, such as Carolina Alliance's plans, objectives, expectations and intentions. The cautionary statements made in this annual report should be read as applying to all related forward-looking statements wherever they appear in this annual report. Carolina Alliance's actual results could differ materially from those discussed in this annual report. As used in the following discussion and analysis, the terms "we," "our," and "us" refer to Carolina Alliance Bank.

OVERVIEW

We are a state-chartered commercial banking institution which was incorporated under the laws of South Carolina in January 2007. Our deposits are insured by the FDIC up to the maximum amount permitted for all banks. We conduct a general banking business in the upstate region of South Carolina and western North Carolina. We currently have seven banking offices located in Spartanburg, Greenville, Powdersville, Easley, and Anderson, South Carolina and Asheville and Hendersonville, North Carolina, as well a loan and lease production office in Charlotte, North Carolina. We provide banking services to individuals and businesses, including accepting demand and time deposits and providing consumer loans and commercial loans and leases.

The following table sets forth selected measures of our financial position or performance for the dates or periods indicated.

	As of or for the Years Ended	
	December 31,	
	2016	2015 ⁽²⁾
Total revenue ⁽¹⁾	\$ 27,075,656	\$ 20,854,138
Net income	4,154,073	1,899,342
Total assets	642,932,989	608,290,613
Total loans and finance leases	493,091,012	473,285,065
Total deposits	527,599,212	495,822,876

⁽¹⁾ Total revenue equals net interest income plus non-interest income.

⁽²⁾ This table reflects the significant impact of merger activity for the year ended December 31, 2015, as discussed throughout this discussion and analysis of our financial condition and results of operations. For more details on these business combinations, see Note 2 of the Notes to the Consolidated Financial Statements.

Like most financial institutions, we derive the majority of our income from interest we receive on our interest-earning assets, such as loans, leases, and investments. Our primary source of funds for making these loans, leases, and investments is deposits, on which we pay interest. Consequently, one of the key measures of our success is the amount of net interest income, or the difference between the income on our average interest-earning assets and the expense on our average interest-bearing liabilities, such as deposits and borrowings. Another key measure is the spread between the yield we earn on these average interest-earning assets and the rate we pay on our average interest-bearing liabilities, which is called net interest spread.

There are risks inherent in all loans and leases, and we maintain an allowance for loan and lease losses to absorb probable losses on existing loans and leases that may become uncollectible. This allowance is maintained by charging a provision for these losses against operating earnings. A detailed discussion of this process, as well as several tables describing the allowance for loan and lease losses, is included later in this narrative.

In addition to earning interest on our loans, leases and investments, we earn income through other sources, such as fees and other charges to our banking and leasing customers, mortgage banking income, and income from providing wealth management services, as well as net gains or losses realized from the sale of assets. The various components of non-interest income, as well as non-interest expense, are described in this section.

RESULTS OF OPERATIONS

Year Ended December 31, 2016 as Compared to Year Ended December 31, 2015

Overview

Net income available to common shareholders for the year ended December 31, 2016 was \$4.1 million, or \$0.63 per diluted share, compared to \$1.8 million, or \$.35 per diluted share, for the year ended December 31, 2015. This was a \$2.3 million increase in the net income available to common shareholders and a \$.28 increase in the diluted earnings per share compared to the prior year. This increase in earnings was largely attributable to increased core earnings from the addition of earning assets from the merger with PBSC Financial Corporation and Pinnacle Bank of South Carolina (collectively, "Pinnacle") which closed in October 2015. In addition, Pinnacle's well-developed mortgage loan division generated fee income for a full year, for an increase of almost \$0.9 million over 2015. Because no loans were charged off for the year ended December 31, 2016, the provision for loan and lease losses decreased by \$0.7 million while still providing a sufficient level of allowance for loan and lease losses.

Net Interest Income

The largest component of our income is net interest income, the difference between the income earned on interest-earning assets and the interest expense on deposits and borrowings used to support such assets. Net interest margin is determined by dividing the annual net interest income by average earning assets.

For the year ended December 31, 2016, net interest income was \$22.3 million, an increase from \$18.1 million earned for the year ended December 31, 2015. The increase in 2016 was attributable principally to an increase in the volume of loans, leases and investment securities, primarily driven by organic loan growth and the addition of Pinnacle assets for a full year. This increase in volume was partially offset by decreased rates for all interest earning assets. In addition, the volume of and rates paid on our interest-bearing liabilities increased overall. Net interest margin for 2016 was 3.81% compared to 4.04% in 2015.

See further details of the changes in and components of net interest income following under the headings: "Interest Income," "Interest Expense," "Average Balances, Yields, and Rates," and "Rate/Volume Analysis."

Interest Income

Interest income totaled \$24.8 million for the year ended December 31, 2016 compared to \$19.5 million in 2015, an increase of 27%. This increase resulted from the net effect of increased outstanding balances of earning assets, which was partially offset by decreased yield. Average earning assets were \$583.8 million for the year ended December 31, 2016, with an average yield of 4.25%. For the year ended December 31, 2015, average earning assets and average yield were \$448.6 million and 4.35%, respectively.

Interest income earned on loans and finance leases for the year ended December 31, 2016 totaled \$22.7 million, compared to \$18.0 million in 2015. The average yield on loans and finance leases was 4.75% in 2016, compared to 4.84% in 2015. The increase in volume over 2015 created the most significant increase to income and is the result of an increase in loans from merger activity during 2015 combined with organic loan growth throughout 2016. Average balances of loans and finance leases increased to \$477.8 million during the year ended December 31, 2016, an increase of \$105.8 million over the average of \$372.0 million during the year ended December 31, 2015. Although yield decreased overall, it was positively impacted by the accretion of acquisition accounting fair market value adjustments on the acquired loan portfolios.

Interest earned on investment securities amounted to \$2.1 million in 2016 as compared to \$1.5 million earned in 2015, an increase of \$0.6 million. The increase resulted from an increase in the amount of investment securities held on average during 2016 partially offset by a decrease in their average yield. The average balance of investment securities was \$97.0 million in 2016, an increase of \$27.9 million from the average balance of \$69.1 million in 2015. Investment securities yielded 2.12% during the year ended December 31, 2016, compared to 2.17% during the previous year. The decline was impacted by a slight decrease in market rates throughout the year, as well as a contraction in yield premiums provided by the types of securities purchased for the portfolio.

Interest Expense

Interest expense totaled \$2.5 million for the year ended December 31, 2016 compared to \$1.4 million in 2015. This increase resulted from the net effect of a significant increase in the average outstanding balances of interest-bearing liabilities with increased average costs. Average interest-bearing liabilities were \$456.3 million with an average cost of 0.56% in 2016, compared to \$346.8 million and 0.41%, respectively, in 2015.

Interest expense on deposits totaled \$2.3 million for the year ended December 31, 2016 compared to \$1.3 million in 2015. Average interest-bearing deposits were \$422.4 million with an average cost of 0.55% in 2016, compared to \$319.5 million and 0.40%, respectively, in 2015. The increase in cost resulted from increased rates paid on most deposit products in addition to the maturity during 2016 of time deposits with lower than current market rates.

Average Balances, Yields, and Rates

The following table presents average interest earning assets and interest-bearing liabilities, net interest income and margin, and weighted average yields and rates on interest-earning assets and interest-bearing liabilities for the years ended December 31, 2016 and 2015. Yields and rates are derived by dividing income or expense by the average balance of the corresponding asset or liability.

	For the Years Ended December 31,					
	2016			2015		
	Average Balance	Income/ Expense	Yield/ Rate ⁽¹⁾	Average Balance	Income/ Expense	Yield/ Rate ⁽¹⁾
Interest Earning Assets:						
Loans and finance leases ⁽²⁾	\$ 477,751,132	\$ 22,688,552	4.75%	\$ 372,029,678	\$ 17,990,789	4.84%
Investment securities	96,955,845	2,056,200	2.12%	69,096,451	1,498,322	2.17%
Federal funds sold and other	9,085,053	55,118	0.61%	7,465,810	35,297	0.47%
Total interest earning assets	583,792,030	24,799,870	4.25%	448,591,939	19,524,408	4.35%
Non-interest Earning Assets	42,733,365			22,965,497		
Total assets	\$ 626,525,395			\$ 471,557,436		
Interest Bearing Liabilities:						
Demand, interest bearing	\$ 56,727,373	122,575	0.22%	\$ 34,778,632	57,831	0.17%
Money market and savings	227,396,430	895,670	0.39%	180,537,015	580,216	0.32%
Time deposits	138,281,482	1,300,465	0.94%	104,230,678	635,670	0.61%
Borrowed funds	33,926,445	229,210	0.68%	27,268,310	136,612	0.50%
Total interest bearing liabilities	456,331,730	2,547,920	0.56%	346,814,635	1,410,329	0.41%
Non-interest Bearing Liabilities:						
Non-interest bearing deposits	95,490,424			64,511,381		
Other liabilities	4,170,217			2,343,864		
Shareholders' Equity	70,533,024			57,887,556		
Total liabilities and shareholders' equity	\$ 626,525,395			\$ 471,557,436		
Net interest spread			3.69%			3.94%
Net interest income/margin		\$ 22,251,950	3.81%		\$ 18,114,079	4.04%
Ratio of interest earning assets to interest bearing liabilities	127.9%			129.3%		

⁽¹⁾ Average rates are calculated before the benefit of tax-exempt interest. Differences between actual yields and tax equivalent yields are not material.

⁽²⁾ Nonaccrual loans are included in average balances.

Rate/Volume Analysis

Net interest income can be analyzed in terms of the impact of changing rates and changing volume. The following table shows the effect which varying levels of interest-earning assets and interest-bearing liabilities and associated yields and rates had on net interest income for the years ended December 31, 2016 and 2015. Changes in rate/volume were allocated to both in their proportions to the absolute value of each.

	Increase (Decrease) in Net Interest Income for the Years Ended December 31,					
	2016 vs. 2015			2015 vs. 2014		
	Due to Change in		Total	Due to Change in		Total
	Volume	Rate	Change	Volume	Rate	Change
Interest Earning Assets:						
Loans and finance leases	\$ 5,014,545	\$ (316,782)	\$ 4,697,763	\$4,278,159	\$(621,743)	\$3,656,416
Investment securities	590,071	(32,193)	557,878	226,103	(42,498)	183,605
Federal funds sold and other	8,598	11,223	19,821	(18,541)	(15,175)	(33,716)
Total	<u>5,613,214</u>	<u>(337,752)</u>	<u>5,275,462</u>	<u>4,485,721</u>	<u>(679,416)</u>	<u>3,806,305</u>
Interest Bearing Liabilities:						
Demand, interest bearing	43,885	20,859	64,744	16,888	5,687	22,575
Money market and savings	168,680	146,774	315,454	100,637	5,489	106,126
Time deposits	250,028	414,767	664,795	93,713	111,733	205,446
Borrowed funds	38,146	54,452	92,598	48,932	(15,237)	33,695
Total	<u>500,739</u>	<u>636,852</u>	<u>1,137,591</u>	<u>260,170</u>	<u>107,672</u>	<u>367,842</u>
Change in net interest income	<u>\$ 5,112,475</u>	<u>\$ (974,604)</u>	<u>\$ 4,137,871</u>	<u>\$4,225,551</u>	<u>\$(787,088)</u>	<u>\$3,438,463</u>

Provision for Loan and Lease Losses

The provision for loan and lease losses is the charge to operating earnings that we believe to be necessary to maintain the allowance for loan losses at an adequate level. The amount charged to the provision is based on a review of past-due loans and delinquency trends, actual losses, classified and criticized loans, loan portfolio growth, concentrations of credit, economic conditions, historical charge-off activity and internal credit risk ratings. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revisions as more information becomes available or economic conditions change.

At the end of each quarter or more often, if necessary, we analyze the collectability of our loans and leases and adjust the allowance for loan and lease losses to an appropriate level. The allowance for loan and lease losses covers estimated credit losses on individually evaluated loans that are determined to be impaired, as well as estimated credit losses inherent in the remainder of the loan and lease portfolios.

Loan charge-offs and recoveries are charged or credited directly to the allowance as applicable. The provision for loan and lease losses was \$0.2 million and \$0.9 million for the years ended December 31, 2016 and 2015, respectively. See "Balance Sheet Review – Allowance for Loan and Lease Losses."

Non-Interest Income

Non-interest income for the year ended December 31, 2016 was \$4.8 million, an increase of \$2.1 million, or 78%, compared to \$2.7 million in 2015. Income from our ongoing operating activities improved significantly from 2015 to 2016, as 2016 reflected a full year of operations from the Pinnacle merger. The Pinnacle merger included the addition of a large number of deposit accounts as well as a fully staffed and well-seasoned mortgage division to augment our existing mortgage lenders. Mortgage brokerage income reflected the largest increase, from \$0.2 million in 2015 to \$1.1 million in 2016. The balance of the increase was spread evenly among operating lease income, service fees on deposit accounts, and other income, with each increasing approximately \$375,000 year over year. These improved non-interest categories were slightly offset by net losses on other real estate owned of \$124.3 thousand in 2016 compared to \$82.5 thousand in 2015.

Components of non-interest income are shown in the following table.

	For the Years Ended December 31,	
	2016	2015
Operating lease income	\$ 2,209,723	\$ 1,831,637
Service fees on deposit accounts	750,486	375,171
Mortgage brokerage income	1,114,943	217,441
Other income	793,482	416,916
Net gain (loss) on sale of investment securities	79,346	(18,604)
Net loss on other real estate owned	(124,274)	(82,502)
Total non-interest income	<u>\$ 4,823,706</u>	<u>\$ 2,740,059</u>

Non-Interest Expense

Non-interest expense for the year ended December 31, 2016 was \$20.7 million, compared to \$16.7 million in the prior year. The following table sets forth information related to the various components of non-interest expenses for each respective period.

	For the Years Ended December 31,	
	2016	2015
Salaries and benefits	\$11,413,587	\$ 8,607,921
Occupancy, furniture, and equipment	2,001,045	1,395,474
Operating lease expense	1,948,623	1,600,623
Data processing and computer network	2,048,716	1,295,982
Marketing	324,906	307,089
Printing, supplies, and postage	207,483	162,609
Core deposit intangible amortization	394,557	261,818
Merger-related expenses	-	1,026,332
Other operating	2,385,282	2,016,783
Total non-interest expense	<u>\$20,724,199</u>	<u>\$16,674,631</u>

The largest individual component of the \$4.0 million increase in non-interest expense was in salaries and benefits, which increased by \$2.8 million, or 33%, from \$8.6 million in 2015 to \$11.4 million in 2016. This increase was primarily due to the inclusion of a full year of compensation expense from the Pinnacle merger, which closed in October 2015.

The second largest increase after salaries and expenses was for data processing and computer network, which was \$2.0 million for 2016 compared to \$1.3 million for 2015. The Pinnacle merger added three branch locations and the associated cost of additional computer network resources. Also, the Pinnacle customer base was largely retail-oriented, and the number of our transaction account customers doubled as a result of the merger, leading to increased technology costs in support of this growth. Operating expenses increased overall as required to support both our organic growth and market expansion through our recent mergers. The costs of this growth can also be seen in the increased occupancy, furniture and equipment expense category, which increased by \$0.6 million to \$2.0 million for 2016. Partially offsetting the global non-interest expense increases was the absence of merger-related expenses in 2016, compared to \$1.0 million in 2015.

BALANCE SHEET REVIEW

December 31, 2016 as Compared to December 31, 2015

Summary

At December 31, 2016, assets totaled \$642.9 million, an increase of \$34.6 million from \$608.3 million at December 31, 2015. The increase was comprised principally of an increase in loans and finance leases, and to a lesser extent, increases in investment securities and bank-owned life insurance. Total liabilities increased by \$36.2 million to \$572.6 million at December 31, 2016 from \$536.4 million at December 31, 2015. The increase in liabilities was comprised principally of an increase in deposits and securities sold under agreements to repurchase.

Cash and Cash Equivalents

Cash and cash equivalents are comprised of cash and due from banks and Federal funds sold. These are short-term, highly liquid balances that are used to fund operations, including projected funding of loans. These balances totaled \$16.7 million at December 31, 2016 as compared to \$15.1 million at December 31, 2015.

Investment Securities

At December 31, 2016, investment securities totaled \$98.0 million and represented 16% of earning assets compared to a total of \$90.5 million, which represented 16% of earning assets at December 31, 2015. We invest primarily in U.S. Government agency and sponsored agency debt, mortgage-backed, and collateralized mortgage securities and to a lesser extent municipal securities. All of our investment securities are classified as available for sale and are carried at estimated fair value.

Contractual maturities and yields on our investment securities at December 31, 2016 are shown in the following table, at fair values. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	December 31, 2016									
	Within One Year		After One but Within Five Years		After Five but Within Ten Years		Over Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
U.S. government agency and sponsored enterprises	\$ 904,188	2.92%	\$ 3,467,922	1.66%	\$ 214,596	5.21%	\$ 7,977,192	2.59%	\$ 12,563,898	2.40%
Agency mortgage-backed securities	-	-%	381,972	3.73%	4,009,520	3.20%	31,133,482	2.68%	35,524,974	2.75%
Agency collateralized mortgage-backed securities	-	-%	12,311	4.50%	4,190,183	3.08%	16,270,074	2.17%	20,472,568	2.35%
Municipal securities	<u>1,600,602</u>	4.63%	<u>2,028,908</u>	4.46%	<u>11,817,949</u>	3.42%	<u>13,967,507</u>	4.08%	<u>29,414,966</u>	3.87%
Total	<u>\$ 2,504,790</u>	4.01%	<u>\$ 5,891,113</u>	2.76%	<u>\$ 20,232,248</u>	3.33%	<u>\$ 69,348,255</u>	2.83%	<u>\$ 97,976,406</u>	2.96%

For details on amortized costs and unrealized gains and losses within the securities portfolio, see Note 3 of the Notes to the Consolidated Financial Statements.

As a member institution, we are required to own certain stock investments in the Federal Home Loan Bank of Atlanta (“FHLB”). No ready market exists for this stock, and it has no quoted market value. However, redemption of the stock historically has been at par value; therefore, it is carried at cost. This stock generally is pledged against any borrowings from the FHLB. This investment is shown on the balance sheet as “Other investments.”

Loans and Finance Leases

Outstanding loans and finance leases represent the largest component of earning assets. At December 31, 2016, outstanding loans and finance leases, net of related allowance for loan and lease losses, fair value adjustments, and deferred fees and costs, totaled \$488.1 million, an increase of \$19.5 million, or 4%, over the \$468.6 million reported at December 31, 2015. Outstanding loans and finance leases represented 83% of total earning assets at December 31, 2016 and 83% at December 31, 2015.

The following table summarizes the composition of the loan portfolio at December 31, 2016 and 2015.

	December 31, 2016		December 31, 2015	
	Amount	% of Total	Amount	% of Total
Commercial	\$ 70,894,304	14.2%	\$ 69,764,499	14.5%
Real estate:				
Commercial	313,084,968	62.9%	298,906,653	62.3%
Residential	66,755,796	13.4%	67,606,040	14.1%
Construction	15,872,706	3.2%	14,887,518	3.1%
Consumer	5,730,997	1.2%	4,676,417	1.0%
Finance leases	<u>25,312,796</u>	<u>5.1%</u>	<u>24,062,371</u>	<u>5.0%</u>
Gross loans and finance leases	<u>497,651,567</u>	<u>100.0%</u>	479,903,498	<u>100.0%</u>
Allowance for loan and lease losses	(4,954,610)		(4,678,907)	
Fair value adjustment on acquired loans and leases	(2,545,043)		(4,823,947)	
Deferred loan fees and costs, net	<u>(2,015,512)</u>		<u>(1,794,486)</u>	
Net loans and finance leases	<u>\$488,136,402</u>		<u>\$468,606,158</u>	

A majority of our loans are to business owners of many types. We make commercial loans for real estate development and other business purposes required by our customer base.

Our credit policies determine advance rates against the different forms of collateral that can be pledged against commercial loans. Typically, the majority of loans will be limited to a percentage of their underlying collateral values such as real estate values, equipment, eligible accounts receivable, and inventory. Individual loan advance rates may be higher or lower depending upon the financial strength of the borrower and/or term of the loan. The assets financed through commercial loans are used within the business for its ongoing operation. Repayment of these kinds of loans generally comes from the cash flow of the business or the ongoing conversions of assets. Commercial mortgage loans include loans to finance commercial real estate properties. Repayment of this kind of loan is dependent upon either the ongoing cash flow of the borrowing entity or the resale or lease of the subject property. Commercial mortgage loans typically require a loan-to-value ratio of not greater than 85% and vary in terms.

Residential mortgages and home equity loans are secured by the borrower's residential real estate in either a first or second lien position. Pricing for residential mortgages and home equity loans is subject to market conditions, the applicant's qualified credit bureau score, and the collateral's loan-to-value ratio. Residential mortgages have amortization terms up to but not longer than 30 years and home equity loans generally have maturities up to 15 years.

Finance leases are secured by vehicles and equipment in a first lien position. Finance leases have terms generally ranging from 24 – 60 months at market interest rates for similar leases based on the borrower's financial strength and estimated residual collateral values.

Other consumer loans include installment loans, car loans, and overdraft lines of credit. The majority of these loans are secured.

Credit Quality

There are risks inherent in making loans and finance leases, including risks with respect to the period of time over which loans may be repaid, risks resulting from changes in economic and industry conditions, risks inherent in dealing with individual borrowers, and risks resulting from uncertainties about the future value of collateral. Our written lending policies require specified underwriting, loan documentation and credit analysis standards to be met prior to funding, with additional credit department approval for the majority of new loan and finance lease balances. In addition, to address ongoing risks, we have developed policies and procedures to evaluate the overall quality of our credit portfolio and to timely identify potential problem loans and finance leases.

The accrual of interest on loans is generally discontinued when the contractual payment of principal or interest has become 90 days past due or when we have serious doubts about further collectability of principal or interest, even though the loan is currently performing. When a loan is placed on non-accrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Interest received on non-accrual loans is typically applied against principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time, and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

Management closely monitors and explores potential options and remedial actions to recover our investment in non-performing loans. The non-performing loans identified in the following table are included in the total of our classified loans, which include loans in the grade categories special mention, substandard and doubtful. Our loan grades are described in Note 4 of the Notes to the Consolidated Financial Statements. The total of classified loans at December 31, 2016 and December 31, 2015 were \$15.4 million and \$17.5 million, respectively. The decrease is principally attributable to over \$1.8 million in loans being upgraded and no longer classified or being paid off prior to December 31, 2016.

The following table summarizes non-performing assets.

	December 31,	
	2016	2015
Non-performing loans and leases:		
Past due 90 days or more and still accruing interest	\$ -	\$ -
Non-accrual	1,937,279	3,128,461
Total non-performing loans and leases (1)	1,937,279	3,128,461
Other real estate owned	127,595	1,465,690
Total non-performing assets (2)	2,064,874	4,594,151
Performing troubled debt restructurings (TDRs) (3)	3,444,772	2,693,551
Total non-performing assets and performing TDRs	\$ 5,509,646	\$ 7,287,702
Non-performing loans and leases as a percentage of gross loans and leases	0.39%	0.65%
Non-performing assets as a percentage of total assets	0.32%	0.76%
Non-performing assets and performing TDRs as a percentage of total assets	0.86%	1.36%
Allowance to non-performing loans and leases at end of period	256%	150%
Allowance for loan losses as a percentage of total loans and leases (4)	1.00%	0.99%

- (1) Non-performing loans are comprised of (i) loans that have a non-accrual status; (ii) accruing loans that are 90 days or more past due; and (iii) non-performing TDRs.
- (2) Non-performing assets are comprised of non-performing loans, other real estate owned, and repossessed assets.
- (3) Performing TDRs are accruing loans that have been restructured in troubled debt restructurings and are in compliance with their modified terms.
- (4) There is no allowance for loan and lease losses established at the acquisition date for purchased performing loans, which instead are recorded at fair value, including a credit discount.

While not considered non-performing, our performing troubled debt restructurings are closely monitored as they consist of loans that have been modified when the borrower was experiencing financial difficulty. Troubled debt restructurings may be deemed to have a higher risk of loss than loans which have not been restructured.

Allowance for Loan and Lease Losses

We maintain an allowance for loan and lease losses, which we establish through charges in the form of a provision for loan and lease losses on our statement of income. We charge loan losses and credit recoveries directly to this allowance. We attempt to maintain the allowance at a level that we believe will be adequate to provide for potential losses in our loan portfolio. We consider a number of factors in determining the level of this allowance, including the total amount of outstanding loans, the amount of past due loans, historic loan loss experience, general economic conditions, and the assessment of risk elements in our portfolio.

Risks within the loan and lease portfolios are analyzed on a continuous basis by management, periodically analyzed by an external independent loan review function, and also are reviewed by the board's loan committee. A risk system, consisting of multiple grading categories, is utilized as an analytical tool to assess risk and appropriate allowances. In addition to the risk system, we further evaluate the risk characteristics of the loan and lease portfolios under current and anticipated economic conditions and consider such factors as the financial condition of the borrower, past and expected loss experience, and other factors which we believe deserve recognition in establishing an appropriate allowance. These estimates are reviewed at least quarterly, and, as adjustments become necessary, they are recognized in the appropriate periods.

Although we attempt to maintain the allowance at an adequate level, future additions to the allowance may be required due to the growth of the loan portfolio, changes in asset quality, changes in market conditions, and other factors. Additionally, various regulatory agencies periodically review the allowance for loan losses. These agencies may require additional provisions based upon their judgment about information available to them at the time of their examination. Although we use what we believe to be the best information available, the level of the allowance for loan and lease losses remains an estimate which is subject to significant judgment and short term change.

Deposits

Deposits are our primary source of funds for loans and investments. Total deposits were \$527.6 million at December 31, 2016, an increase of \$31.8 million from the \$495.8 million reported at December 31, 2015. This increase in deposits is primarily attributable to the retention of the deposits added with the Pinnacle merger. The following is a table of average deposits and rates by category at December 31, 2016 and 2015.

	<u>December 31, 2016</u>		<u>December 31, 2015</u>	
	<u>Amount</u>	<u>Rate</u>	<u>Amount</u>	<u>Rate</u>
Non-interest bearing deposits	\$ 95,490,424	-%	\$ 64,511,381	-%
Interest bearing deposits:				
Interest checking	56,727,373	0.22%	34,778,632	0.17%
Money market and savings	227,396,430	0.39%	180,537,015	0.32%
Time deposits	<u>138,281,482</u>	<u>0.94%</u>	<u>104,230,678</u>	0.61%
Total deposits	<u>\$517,895,709</u>	<u>0.45%</u>	<u>\$384,057,706</u>	0.33%

Core deposits, which consist primarily of local demand deposits and time deposits of less than \$250,000, provide a relatively stable funding source for our lending and investing activities. Our core deposits totaled \$403.3 million, or 76% of total deposits, at December 31, 2016. Time deposit balances over \$250,000 and deposits obtained from outside the market area are not considered core deposits because their retention can be expected to be heavily influenced by rates offered at renewal. At December 31, 2016, the total of deposits outside of our primary market totaled \$43.9 million. Due to the developed national market for certificates of deposit, we anticipate being able to either renew or replace the deposits obtained outside of the market area when they mature; however, no assurance can be given that we will be able to replace these deposits with the same terms.

Other Borrowings

We maintain Federal funds lines of credit with correspondent banks to meet short-term liquidity needs. As a member of the FHLB, we have access to borrowings through various FHLB programs. There were short-term borrowings (one year or less to maturity) from the FHLB totaling \$14.0 million at December 31, 2016 and \$22.6 million outstanding at December 31, 2015. There were also long-term borrowings (greater than one year to maturity) from the FHLB totaling \$7.5 million at December 31, 2016 and \$6.0 million at December 31, 2015. Advances from the FHLB are collateralized by our investment in the common stock of the FHLB, by a specific pledge of certain investment securities and by a blanket lien on a portion of our loan portfolio. See "Liquidity and Capital Resources" for additional details of our borrowing arrangements.

LIQUIDITY AND CAPITAL RESOURCES

Liquidity management involves monitoring our sources and uses of funds in order to meet our day-to-day cash flow requirements while maximizing profits. Liquidity represents the ability of a company to convert assets into cash or cash equivalents without significant loss and to raise additional funds by increasing liabilities. Liquidity management is made more complicated because different balance sheet components are subject to varying degrees of management control. For example, the timing of maturities of the investment portfolio is fairly predictable and subject to a high degree of control at the time investment decisions are made. However, net deposit inflows and outflows are far less predictable and are not subject to nearly the same degree of control. We must maintain adequate liquidity to respond to short-term deposit withdrawals, maturities of borrowings, loan demand, and payment of operating expenses.

At December 31, 2016, our liquid assets, consisting of cash and due from banks and Federal funds sold, net of drafts outstanding, totaled \$16.7 million. Investment securities that have not been pledged as security for deposits and other borrowings, classified as available for sale, provide a secondary source of liquidity because they can be converted to cash in a timely manner. These non-pledged securities had a market value of \$67.0 million at December 31, 2016. Our ability to raise additional deposits and to borrow funds also provides additional liquidity sources. Our regulatory capital ratios are at levels that support continued leveraging through continued expansion of our deposit base and additional borrowings. We maintain Federal funds lines of credit totaling \$43.0 million with correspondent banks. Advances under these agreements are unsecured and are limited to terms ranging from 7 to 15 days. These banks have reserved the right to withdraw these lines at their option. We have an approved credit limit of approximately \$156.6 million with the FHLB, with \$135.1 million unused at December 31, 2016. Further advances from the FHLB are limited to available collateral acceptable to the FHLB which at December 31, 2016, consisted of commercial real estate and home equity lines of credit type loans, select non-pledged investment securities, and FHLB stock.

We plan to meet our future cash needs through maturities of loans, maturities and cash flows from investment securities, expansion of our deposit base, and other borrowings.

Shareholders' equity totaled \$70.3 million and \$71.9 million at December 31, 2016 and December 31, 2015, respectively. On February 23, 2016, with regulatory approval, we redeemed all 5,000 shares of our Series A preferred stock. The decrease in shareholders' equity of \$1.6 million during the year ended December 31, 2016 resulted primarily from this stock redemption of \$5.0 million. In addition, we recorded an unrealized loss on securities available for sale of \$920 thousand and paid preferred dividends of \$7 thousand. These transactions were partially offset by net income of \$4.2 million, stock option compensation totaling \$30 thousand, and common shares issued for \$162 thousand.

We are subject to various regulatory capital requirements administered by the federal banking regulatory agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on our financial statements.

Under capital adequacy guidelines and the regulatory framework for prompt corrective action, we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. Our capital amounts and classification also are subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Effective January 1, 2015, we became subject to the new regulatory risk-based capital rules adopted by the federal banking agencies implementing Basel III. Under the new capital guidelines, our regulatory capital components consist of (1) common equity Tier 1 capital (common stock, including related surplus, and retained earnings, net of goodwill and other intangibles, deferred tax assets arising from net operating loss and tax credit carry-forwards above certain levels, and accumulated other comprehensive income items), (2) additional Tier 1 capital (qualifying non-cumulative perpetual preferred stock, including related surplus), and (3) Tier 2 capital (the allowance for loan and lease losses in an amount not exceeding 1.25% of standardized risk-based assets). Total Tier 1 capital plus Tier 2 capital constitutes total risk-based capital. The new minimum capital requirements are presented in the regulatory capital table below.

The new capital guidelines also provide that all covered banking organizations must maintain a new capital conservation buffer of common equity Tier 1 capital in an amount of greater than 2.5% of total risk-weighted assets to avoid being subject to limitations on capital distributions and discretionary bonus payments to executive officers. The capital conservation buffer requirement was phased in beginning January 1, 2016 at the 0.625% level and will be increased by that same amount on each subsequent January 1 until it reaches 2.5% on January 1, 2019. When fully phased in, the capital conservation buffer effectively will result in a required minimum common equity Tier 1 capital ratio of at least 7%, Tier 1 capital ratio of at least 8.5%, and total capital ratio of at least 10.5%.

The final regulatory capital rules also incorporate these changes in regulatory capital into the prompt corrective action framework, under which the thresholds for “adequately capitalized” banking organizations are equal to the new minimum capital requirements described above. Under this framework, in order to be considered “well capitalized,” insured depository institutions must maintain the minimum capital ratios as presented in the regulatory capital table below.

At December 31, 2016 and 2015, we were “well capitalized.” As permitted for regulated institutions that do not qualify as “advanced approach” banking organizations (those with assets greater than \$250 billion or with foreign exposures greater than \$10 billion), we made a one-time, permanent election to opt out of the requirement to include most components of accumulated other comprehensive income in regulatory capital.

The following table summarizes actual and the required capital levels to be well capitalized at December 31, 2016 and 2015.

	December 31, 2016	To be Considered “Well Capitalized”	December 31, 2015	To be Considered “Well Capitalized”
Total capital				
(To risk weighted assets)	12.6%	10.0%	13.7%	10.0%
Tier 1 capital				
(To risk weighted assets)	11.7%	8.0%	12.8%	8.0%
Common equity tier 1 capital				
(To risk weighted assets)	11.7%	6.5%	11.9%	6.5%
Tier 1 capital				
(To average assets)	10.6%	5.0%	11.2%	5.0%

On February 23, 2016, with regulatory approval, we redeemed all of the 5,000 shares of our Series A preferred stock that had been issued to the Secretary of the Treasury under the Small Business Lending Fund (“SBLF”). The aggregate redemption price of the Series A preferred stock was approximately \$5.0 million, including accrued but unpaid dividends. The preferred stock was redeemed from our existing funds. Following the redemption, we do not have any shares of our Series A preferred stock outstanding. As a result, the redemption terminated our participation in the SBLF program. We remain well capitalized after the redemption.

INTEREST RATE SENSITIVITY

Interest Rate Risk

Interest rate sensitivity is defined as the exposure to variability in net interest income resulting from changes in market-based interest rates. Asset/liability management is the process by which we monitor and control the mix, maturities and interest sensitivity of our assets and liabilities. Asset/liability management seeks to optimize net interest income over time while maintaining a balance sheet mix that is prudent with respect to liquidity, capital adequacy and interest rate risk. The absolute level and volatility of interest rates can have a significant impact on our profitability. Interest rate risk management is the process of identifying and managing the potential adverse impact of interest rate movements on our net interest income and on the fair value of our assets and liabilities.

Measurement of Sensitivity

As a part of our measurement of interest rate sensitivity, we use a “gap” analysis, which is the positive or negative dollar difference between assets and liabilities that are subject to interest rate repricing within a given time period. However, since interest rates and yields on various interest sensitive assets and liabilities do not all adjust in the same degree when there is a change in prevailing interest rates (such as prime rate), the traditional gap analysis is only a general indicator of rate sensitivity and net interest income volatility. Also, net interest income may be impacted by other significant factors in a given interest rate environment, including changes in the volume and mix of earning assets and interest-bearing liabilities. Therefore, we also contract with a third-party to assist in the preparation of a rate sensitivity model which applies rate sensitivity measures to assets and liabilities that will reprice within one year at assumed upward and downward shifts in prime rate.

Estimates of interest rate sensitivity obtained from the various measurement techniques are used as a guide by management, recognizing that model risk is always present whenever assumptions of the future must be made. Interest sensitivity is monitored and managed by our management and a committee consisting of certain members of management and of our board of directors. We believe that the current level of interest sensitivity is acceptable and manageable considering our business plan, capital level and other factors.



Independent Auditor's Report

To the Board of Directors
Carolina Alliance Bank and Subsidiary
Spartanburg, South Carolina

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Carolina Alliance Bank and its Subsidiary which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for the years then ended and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Carolina Alliance Bank and its Subsidiary as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Elliott Davis Decosimo, LLC

Greenville, South Carolina
March 28, 2017

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Consolidated Balance Sheets

December 31, 2016 and 2015

	2016	2015
Assets:		
Cash and due from banks	\$ 13,100,026	\$ 13,691,043
Federal funds sold and interest bearing bank balances	3,642,070	1,370,951
Total cash and cash equivalents	16,742,096	15,061,994
Bank term deposits	2,252,000	3,482,995
Investment securities, available for sale	97,976,406	90,475,629
Other investments	1,461,600	1,730,900
Loans held for sale	2,093,952	632,828
Loans and finance leases, net	488,136,402	468,606,158
Property and equipment, net	8,777,157	8,633,237
Leased assets, net	5,104,187	4,435,290
Bank-owned life insurance	11,358,608	3,645,463
Goodwill	4,057,337	4,309,692
Core deposit intangible	1,404,266	1,798,823
Other assets	3,568,978	5,477,604
Total assets	\$ 642,932,989	\$ 608,290,613
Liabilities and Shareholders' Equity:		
Liabilities:		
Deposits	\$ 527,599,212	\$ 495,822,876
Securities sold under agreements to repurchase	16,711,164	7,648,088
Advances from FHLB of Atlanta	21,500,000	28,600,000
Federal funds purchased	3,180,000	-
Other liabilities	3,647,169	4,343,091
Total liabilities	572,637,545	536,414,055
Commitments and contingencies (Notes 12 and 13)		
Shareholders' Equity:		
Preferred stock, \$1.00 par value, 10,000,000 shares authorized; 0 and 5,000 shares issued and outstanding at December 31, 2016 and 2015, respectively	-	5,000
Common stock, \$1.00 par value, 10,000,000 shares authorized; 6,534,833 and 6,517,436 (including 310,203 shares declared as a stock dividend on January 12, 2016, and issued on February 10, 2016) issued and outstanding at December 31, 2016 and 2015, respectively	6,534,833	6,517,436
Additional paid-in capital	59,055,109	63,850,220
Retained earnings	5,569,583	1,447,595
Accumulated other comprehensive income (loss)	(864,081)	56,307
Total shareholders' equity	70,295,444	71,876,558
Total liabilities and shareholders' equity	\$ 642,932,989	\$ 608,290,613

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

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Consolidated Statements of Income

For the Years Ended December 31, 2016 and 2015

	2016	2015
Interest Income:		
Interest and fees on loans and finance leases	\$ 22,688,552	\$ 17,990,789
Investment securities	2,056,200	1,498,322
Federal funds sold and interest bearing bank deposits	55,118	35,297
Total interest income	24,799,870	19,524,408
Interest Expense:		
Deposits	2,318,710	1,273,717
Other	229,210	136,612
Total interest expense	2,547,920	1,410,329
Net Interest Income	22,251,950	18,114,079
Provision for Loan and Lease Losses	210,000	910,210
Net Interest Income After Provision for Loan and Lease Losses	22,041,950	17,203,869
Non-Interest Income:		
Operating lease income	2,209,723	1,831,637
Service fees on deposit accounts	750,486	375,171
Mortgage brokerage income	1,114,943	217,441
Other income	793,482	416,916
Net gain (loss) on sale of securities available for sale	79,346	(18,604)
Net loss on other real estate owned	(124,274)	(82,502)
Total non-interest income	4,823,706	2,740,059
Non-Interest Expense:		
Salaries and benefits	11,413,587	8,607,921
Occupancy, furniture, and equipment	2,001,045	1,395,474
Operating lease expense	1,948,623	1,600,623
Data processing and computer network	2,048,716	1,295,982
Marketing	324,906	307,089
Printing, supplies, and postage	207,483	162,609
Core deposit intangible amortization	394,557	261,818
Merger-related expenses	-	1,026,332
Other operating	2,385,282	2,016,783
Total non-interest expense	20,724,199	16,674,631
Income Before Income Taxes	6,141,457	3,269,297
Income Tax Expense	1,987,384	1,369,955
Net Income	4,154,073	1,899,342
Dividends on Preferred Shares	7,085	50,000
Redemption of Preferred Shares	25,000	-
Net Income Available to Common Shareholders	\$ 4,121,988	\$ 1,849,342
Basic Income per Common Share	\$ 0.63	\$ 0.35
Diluted Income per Common Share	\$ 0.62	\$ 0.35
Weighted Average Common Shares Outstanding:		
Basic	6,525,814	5,218,750
Diluted	6,600,590	5,290,999

The accompanying notes are an integral part of these consolidated financial statements. Earnings per share and weighted average common shares outstanding for 2015 have been adjusted to reflect the 5 percent stock dividend in February 2016.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Consolidated Statements of Comprehensive Income

For the Years Ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Net Income	\$ 4,154,073	\$ 1,899,342
Other Comprehensive Loss:		
Unrealized losses on investment securities available for sale, pretax	\$ (1,374,423)	\$ (490,227)
Income tax effect	<u>504,261</u>	<u>203,553</u>
Reclassification of (gain) loss on sale of investment securities included in net income, pretax	(79,346)	18,604
Income tax effect	<u>29,120</u>	<u>(6,794)</u>
Total other comprehensive loss	<u>(920,388)</u>	<u>(274,864)</u>
Comprehensive Income	<u>\$ 3,233,685</u>	<u>\$ 1,624,478</u>

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

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Consolidated Statements of Changes in Shareholders' Equity

For the Years Ended December 31, 2016 and 2015

	<u>Preferred Stock</u>		<u>Common Stock</u>		<u>Additional Paid-in Capital</u>	<u>Retained Earnings</u>	<u>Accumu- lated Other Compre- hensive Income (Loss)</u>	<u>Total Share- holders' Equity</u>
	<u>Shares</u>	<u>Amount</u>	<u>Shares</u>	<u>Amount</u>				
Balance, December 31, 2014	5,000	\$ 5,000	4,560,660	\$ 4,560,660	\$44,531,081	\$ 2,841,532	\$ 331,171	\$52,269,444
Stock transactions:								
For stock-based compensation	-	-	-	-	48,342	-	-	48,342
For directors' compensation	-	-	9,963	9,963	105,722	-	-	115,685
For advisory directors' compensation	-	-	2,073	2,073	21,559	-	-	23,632
Exercise of stock options	-	-	1,000	1,000	7,409	-	-	8,409
In connection with merger transaction	-	-	1,633,537	1,633,537	16,205,797	-	-	17,839,334
Cash paid in lieu of fractional shares in connection with merger	-	-	-	-	(1,110)	-	-	(1,110)
5% common stock dividend issued February 10, 2016	-	-	310,360	310,360	2,932,919	(3,243,279)	-	-
Cash paid in lieu of fractional shares in connection with common stock dividend	-	-	(157)	(157)	(1,499)	-	-	(1,656)
Preferred stock dividends	-	-	-	-	-	(50,000)	-	(50,000)
Net income	-	-	-	-	-	1,899,342	-	1,899,342
Other comprehensive loss	-	-	-	-	-	-	(274,864)	(274,864)
Balance, December 31, 2015	5,000	5,000	6,517,436	6,517,436	63,850,220	1,447,595	56,307	71,876,558
Stock transactions:								
For stock-based compensation	-	-	-	-	30,396	-	-	30,396
For directors' compensation	-	-	11,473	11,473	98,559	-	-	110,032
For advisory directors' compensation	-	-	2,816	2,816	24,149	-	-	26,965
Exercise of stock options	-	-	3,108	3,108	21,785	-	-	24,893
Redemption of preferred stock	(5,000)	(5,000)	-	-	(4,970,000)	(25,000)	-	(5,000,000)
Preferred stock dividends	-	-	-	-	-	(7,085)	-	(7,085)
Net income	-	-	-	-	-	4,154,073	-	4,154,073
Other comprehensive loss	-	-	-	-	-	-	(920,388)	(920,388)
Balance, December 31, 2016	-	-	6,534,833	\$ 6,534,833	\$59,055,109	\$ 5,569,583	\$ (864,081)	\$70,295,444

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

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Consolidated Statements of Cash Flows

For the Years Ended December 31, 2016 and 2015

	2016	2015
Operating Activities:		
Net income	\$ 4,154,073	\$ 1,899,342
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan and lease losses	210,000	910,210
Accretion on acquired loans and deposits, net	(474,128)	(1,432,287)
Depreciation	2,674,519	2,188,385
Stock compensation	30,396	48,342
Deferred income tax expense	2,122,906	1,558,644
Amortization of premiums on investment securities, net	621,865	434,884
(Gain) loss on sale of investment securities available for sale	(79,346)	18,604
Income on bank-owned life insurance	(213,145)	(23,410)
Net losses on other real estate owned	124,274	82,502
Net increase in loans held for sale	(1,461,124)	(632,828)
Decrease in other assets	519,785	881,515
(Decrease) increase in other liabilities	(1,196,196)	174,844
Net cash provided by operating activities	7,033,879	6,108,747
Investing Activities:		
Increase in loans and finance leases, net	(18,411,133)	(26,441,847)
Purchase of investments:		
Investment securities available for sale	(33,300,588)	(48,233,818)
Bank term deposits	(249,000)	(119,000)
Bank-owned life insurance	(7,500,000)	-
Other investments	(446,300)	(636,858)
Purchase of property and equipment	(877,455)	(473,954)
Purchase of leased assets	(2,609,881)	(2,380,563)
Proceeds from investment transactions:		
Principal payments on investment securities available for sale	13,203,551	9,496,263
Maturities and calls of investment securities available for sale	5,410,000	5,619,882
Sales of investment securities available for sale	5,189,973	15,432,094
Maturity of bank term deposits	1,479,995	1,992,005
Redemption of other investments	715,600	521,558
Net cash (used in) received from merger	(13,868)	4,131,693
Proceeds from sale of other real estate owned	-	1,449,201
Net cash used for investing activities	(37,409,106)	(39,643,344)
Financing Activities:		
Net increase in deposits	31,757,448	36,025,593
Issuance of common stock and cash in lieu	161,890	147,726
Redemption of preferred stock	(5,000,000)	-
Dividends paid on preferred stock	(7,085)	(50,000)
Borrowings from FHLB of Atlanta	15,500,000	20,600,000
Repayment of borrowings from FHLB of Atlanta	(22,600,000)	(14,600,000)
Federal funds purchased	3,180,000	-
Net increase (decrease) in securities sold under agreements to repurchase	9,063,076	(948,053)
Net cash provided by financing activities	32,055,329	41,175,266
Net Increase in Cash and Cash Equivalents	1,680,102	7,640,669
Cash and Cash Equivalents, Beginning of Period	15,061,994	7,421,325
Cash and Cash Equivalents, End of Period	\$ 16,742,096	\$ 15,061,994

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

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Consolidated Statements of Cash Flows (*Continued*)

For the Years Ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Supplemental Disclosures of Cash Flow Information:		
Cash paid for interest	<u>\$ 2,532,294</u>	<u>\$ 1,369,980</u>
Income taxes refunded	<u>\$ (296,898)</u>	<u>\$ (1,142,148)</u>
Non-cash transactions:		
Loans transferred to other real estate owned	<u>\$ -</u>	<u>\$ 1,354,454</u>
Unrealized losses on investment securities	<u>\$ (1,374,423)</u>	<u>\$ (490,227)</u>
Deferred income tax effect on unrealized securities losses	<u>\$ 504,261</u>	<u>\$ 203,553</u>
Reclassification of (gain) loss on sale of investment securities included in net income	<u>\$ (79,346)</u>	<u>\$ 18,604</u>
Deferred income tax effect on securities gains reclassified	<u>\$ 29,120</u>	<u>\$ (6,794)</u>
Non-cash measurement period adjustments to assets acquired and liabilities assumed in PBSC merger:		
Loans	<u>\$ 441,538</u>	<u>\$ -</u>
Goodwill	<u>\$ (266,223)</u>	<u>\$ -</u>
Other assets	<u>\$ (173,680)</u>	<u>\$ -</u>
Other liabilities	<u>\$ (1,635)</u>	<u>\$ -</u>

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

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization - Carolina Alliance Bank (the “Bank”) was incorporated and began operations in January 2007 and provides a broad array of commercial banking services to its customers. The Bank is subject to regulation of the South Carolina State Board of Financial Institutions and the Federal Deposit Insurance Corporation.

On March 20, 2017, CAB Financial Corporation, a South Carolina corporation, was organized to serve as the holding company for the Bank (the “Holding Company”). On the same date, the Bank and the Holding Company approved the Reorganization Agreement and Plan of Share Exchange (the “Reorganization Plan”) which will be submitted for approval by shareholders of the Bank at the annual meeting of shareholders to be held on May 15, 2017. The Reorganization Plan provides for a statutory share exchange between the shareholders of the Bank and the Holding Company. At the effective date of the Reorganization, each outstanding share of common stock of the Bank will be exchanged, in a tax-free transaction, for one share of common stock of the Holding Company. After consummation of the Reorganization, the Bank will conduct its business as a wholly-owned subsidiary of the Holding Company in substantially the same manner as the Bank did before the Reorganization, and all current shareholders of the Bank will become shareholders of the Holding Company.

On October 3, 2015, PBSC Financial Corporation (“PBSC”) and PBSC’s wholly-owned subsidiary, Pinnacle Bank of South Carolina (“Pinnacle”), a South Carolina state-chartered bank with its principal office in Greenville, South Carolina, were merged with and into the Bank (the “PBSC Merger”), with the Bank as the surviving legal entity, in accordance with an Agreement and Plan of Merger dated as of March 23, 2015. See Note 2 – *BUSINESS COMBINATIONS* for complete details on this transaction.

Basis of Presentation - The consolidated financial statements include the accounts of the Bank and its wholly-owned subsidiary, NSCB 2, LLC (whose only business activity is the holding of title to certain operating real estate). Significant intercompany balances and transactions have been eliminated. The accounting policies and reporting practices conform to accounting principles generally accepted in the United States of America (“GAAP”) and to general practices in the banking industry.

Use of Estimates - The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amount of income and expenses during the reporting periods. 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 and lease losses; fair values of financial instruments, assets and liabilities acquired in business combinations, and real estate acquired in settlement of loans; the evaluation of impairment of investment securities and goodwill; and the valuation of deferred tax assets and other intangible assets.

Nature of Operations and Concentrations of Credit Risk - The Bank is engaged in the business of accepting demand and time deposits and providing loans to individuals and businesses. The Bank’s business is limited primarily to the upstate region of South Carolina and western North Carolina. The Bank has a diversified loan portfolio, and the borrowers’ ability to repay their loans is not dependent upon any specific economic sector.

Disclosure Regarding Segments - The Bank reports as one operating segment, as the chief operating decision-maker reviews the results of operations of the Bank as a single enterprise.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Business Combinations and Method of Accounting for Loans Acquired - Acquisitions are accounted for under the acquisition method of accounting. A business combination occurs when the Bank acquires net assets that constitute a business, or acquires equity interests in one or more other entities that are businesses and obtains control over those entities. Business combinations are effected through the transfer of consideration consisting of cash and/or common stock.

The assets and liabilities of the acquired entity are recorded at their respective fair values as of the acquisition date. When the fair value of the assets purchased exceeds the fair value of liabilities assumed, it results in a "bargain purchase gain." When the consideration given exceeds the fair value of the net assets received, goodwill is recognized.

Determining the fair value of assets and liabilities, especially the loan portfolio, is a complicated process involving significant judgment regarding methods and assumptions used to calculate estimated fair values. Fair values are preliminary and subject to refinement for up to one year after the acquisition date, as relevant information becomes available. The results of operations of acquired entities are included in the Bank's consolidated results from the acquisition date, and prior periods are not restated. No allowance for loan and lease losses related to the acquired loans is recorded on the acquisition date because the fair value of the loans acquired incorporates assumptions regarding future credit losses. The fair value estimates associated with the acquired loans include estimates related to expected prepayments and the amount and timing of expected principal, interest and other cash flows.

Subsequent Events - Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Non-recognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed events occurring through March 28, 2017, the date the financial statements were issued, and determined that no subsequent events have occurred requiring accrual or disclosure.

Cash and Cash Equivalents - For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, short-term interest bearing deposits and federal funds sold. Cash and cash equivalents have an original maturity of three months or less. Bank term deposits, consisting of FDIC-insured certificates of deposits with original maturities in excess of three months, are not included in cash and cash equivalents.

Investment Securities - Investments in debt and equity securities are required to be classified into one of three categories: "trading," "held to maturity," or "available for sale." During the reporting periods, the Bank held no trading or held to maturity securities. Available for sale securities are debt and equity securities which are not classified as either trading or held to maturity securities. These securities are reported at fair market value. Net unrealized gains and losses are reported as a separate component of shareholders' equity.

Gains or losses on dispositions of investment securities are determined on a trade date basis and are based on the difference between the net proceeds and the adjusted carrying amount of the securities sold, using the specific identification method. Premiums and discounts are amortized or accreted into interest income by a method that approximates a level yield.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The Bank periodically evaluates its investment securities portfolio for “other-than-temporary impairment.” If a security is considered to be other-than-temporarily impaired, the related unrealized loss is charged to income, and a new cost basis is established. Factors considered include the reasons for the impairment; the severity and duration of the impairment; changes in value subsequent to period-end; and forecasted performance of the security issuer. Impairment is considered other-than-temporary unless the Bank has both the intent and ability to hold the security for a sufficient period of time to allow the fair market value to recover, and evidence supporting the recovery outweighs evidence to the contrary.

Other Investments - Other investments consists of stock in the Federal Home Loan Bank of Atlanta (“FHLB”) which the Bank is required to own as a member institution. Transfer of the stock is restricted, no ready market exists, and it has no quoted market value. However, redemption of the stock historically has been at par value; therefore, it is stated at the Bank’s cost basis.

Loans Held For Sale – Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or fair value. The majority of loans held for sale are initially funded by the Bank with a commitment to purchase by an independent investor. Gains and losses on loan sales (sales proceeds minus carrying value) are recorded in non-interest income, and direct loan origination costs and fees are deferred at origination of the loan and are recognized in non-interest income upon sale of the loan. The estimated fair value of loans held for sale is based on independent third party commitments.

Mortgage origination income represents fees and net premiums and discounts paid by the investors and is recognized at the sale date.

Loans, Interest, and Fee Income on Loans and Leases - Loans and finance leases are stated at the principal balance outstanding and are reduced by the allowance for loan and lease losses. Loan and lease origination fees and certain direct loan origination costs are deferred and the net amount is accreted or amortized as an adjustment of the related yield over the contractual life of the loan or lease. Loan and lease origination fees and costs are netted and the net amount either reduces or increases net loans and leases outstanding. Interest income is recognized over the term of the loan or lease based on the contractual interest rate and the principal balance outstanding.

Loans generally are placed on non-accrual status when principal or interest becomes 90 days past due, or when payment in full is not anticipated. Interest payments received after a loan is placed in non-accrual status are applied as principal reductions until such time as the loan is returned to accrual status. Generally, a loan is returned to accrual status when the loan is brought current and the collectability of principal and interest is no longer in doubt.

Purchased Credit-Impaired (“PCI”) Loans - Purchased loans acquired in a business combination are recorded at estimated fair value on the date of acquisition without the carryover of the related allowance for loan and lease losses. PCI loans are accounted for under the “Receivables” topic of the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“ASC”) when the loans have evidence of credit deterioration since origination, and it is probable at the date of acquisition that the Bank will not collect all contractually required principal and interest payments. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the non-accretable difference, and is available to absorb credit losses on those loans. Subsequent decreases to the expected cash flows will generally result in a provision for loan losses. Subsequent significant increases in cash flows result in a reversal of the provision for loan losses to the extent of prior charges, or a reclassification for the non-accretable difference with a positive impact on future interest income.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Further, an excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretible yield and is recognized into interest income over the remaining life of the loan when there is a reasonable expectation about the amount and timing of such cash flows.

Purchased Performing Loans - The Bank accounts for performing loans acquired in business combinations using the contractual cash flows method of recognizing discount accretion based on the acquired loans' contractual cash flows. Purchased performing loans are recorded at fair value, including a credit discount and a rate discount. The fair value discount is accreted as an adjustment to yield over the estimated lives of the loans. There is no allowance for loan and lease losses established at the acquisition date for purchased performing loans. A provision for loan and lease losses is recorded as the fair value discount is accreted over time and for any further deterioration in these loans subsequent to the acquisition.

Allowance for Loan and Lease Losses - The Bank provides for loan and lease losses using the allowance method. Provisions for loan and lease losses are added to the allowance through charges to operating expenses. Loans and leases which are determined to be uncollectible are charged against the allowance and recoveries on loans and leases previously charged off are added to the allowance. The provision for loan and lease losses charged to operations is an amount sufficient to bring the allowance to an estimated balance considered adequate to absorb losses inherent in the portfolio.

Management's determination of the adequacy of the allowance is based on an evaluation of the portfolio, current economic conditions, historical loan and lease loss experience, and other risk factors. During 2015, management modified the methodology used for the determination of the allowance for loan losses to include the Bank's historical loss experience over a 20-quarter look-back period, as compared to a look-back period of 32 quarters, which had been used previously. This change did not have a material impact on the estimated allowance at December 31, 2015. While management uses the best information available to make evaluations, future adjustments may be necessary if economic and other conditions differ substantially from the assumptions used. The allowance for loan and lease losses is subject to periodic evaluation by various regulatory authorities and may be subject to adjustment upon their examination.

A loan is considered to be impaired when full payment according to the terms of the loan agreement is not probable or when the terms of a loan are modified in a troubled debt restructuring ("TDR"). The fair value of impaired loans may be determined based upon the present value of expected cash flows discounted at the loan's effective interest rate, the market price of the loan, if available, or, if the loan is collateral-dependent, the estimated fair value of the underlying collateral, less estimated selling costs.

The treatment of the loan impairment is based on the status of the borrower and the underlying collateral. In general, the amount by which the loan principal outstanding exceeds the fair value of the loan is charged-off for consumer loans and collateral-dependent loans, whereas for all other loans, a portion of the allowance for loan and lease losses is allocated specifically to cover this shortfall. When the ultimate collectability of an impaired loan's principal is in doubt, wholly or partially, all cash receipts are applied to principal. Once payments equal to the outstanding principal balance have been received, further cash receipts are applied to interest income, to the extent that any interest has been foregone.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Property and Equipment - Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets. Building and fixtures have estimated useful lives of 10 to 40 years and furniture and equipment have estimated useful lives of 3 to 15 years. Maintenance and repairs are charged to operations, while major improvements are capitalized. Upon retirement, sale, or other disposition of property and equipment, the cost and accumulated depreciation are eliminated from the accounts and the gain or loss is included in income from operations.

Leased Assets - The Bank has purchased construction, office, and athletic equipment that it leases to customers under operating lease agreements with varying terms. The value of the leased asset is recorded at cost and depreciated on the straight-line basis over the estimated useful life (3 to 5 years), after the date the equipment is put in service, and depreciated down to its estimated residual value. The Bank periodically reviews the residual values of leased assets for impairment using various factors, including the practices and benchmarks of the larger competitors in the particular industry.

Costs incurred on leased equipment subsequent to initial acquisition are capitalized when it is probable that future economic benefits in excess of the originally assessed performance will result; otherwise, they are expensed as incurred.

Other Real Estate Owned and Repossessed Assets - Other real estate owned is comprised of real property acquired through a foreclosure proceeding or acceptance of a deed-in-lieu of foreclosure. Repossessed assets include personal property acquired through conveyance in satisfaction of debts. Other real estate owned and repossessed assets are recorded at the lower of the recorded investment in the loan at the time of acquisition or the estimated fair value of the underlying property collateral, less selling costs. Any write-down in the carrying value of a property at the time of repossession is charged to the allowance for loan and lease losses. Any subsequent write-downs to reflect current fair market value, as well as gains and losses on disposition and revenues and expenses incurred in maintaining such properties, are treated as period costs. Other real estate owned and repossessed assets are included in "Other assets" in the balance sheet and balances are summarized in Note 4.

Goodwill and Other Intangible Assets - Intangible assets consist of goodwill and core deposit intangibles, which resulted from the mergers with Forest Commercial and PBSC. Goodwill represents the cost in excess of the fair value of net assets acquired (including identifiable intangibles) in transactions accounted for as business combinations. Goodwill has an indefinite useful life and is evaluated for impairment annually, or more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value.

An initial qualitative evaluation is made to assess the likelihood of impairment and to determine whether further quantitative testing to calculate the fair value is necessary. When the qualitative evaluation indicates that impairment is more likely than not, quantitative testing is required whereby the fair value of each reporting unit is calculated and compared to the recorded book value. If the calculated fair value of the reporting unit exceeds its carrying value, goodwill is not considered impaired and no further testing is considered necessary. If the carrying value of a reporting unit exceeds its calculated fair value, the impairment test continues by comparing the carrying value of the reporting unit's goodwill to the implied fair value of goodwill. The implied fair value is computed by adjusting all assets and liabilities of the reporting unit to current fair value with the offset adjustment to goodwill.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Core deposit intangibles represent the value of long-term deposit relationships acquired in a business combination. The core deposit intangibles are being amortized over seven years using the 150% declining balance method. This amortization method is used to match the recognition of the cost of the asset to the estimated lives of the underlying deposit relationships. These estimated useful lives are periodically reviewed for reasonableness.

Bank-Owned Life Insurance - The Bank owns life insurance policies on certain current and past officers where the insurance policy benefits and ownership are retained by the employer. These policies are recorded at their cash surrender value. Income from these policies and changes in the net cash surrender value are recorded in non-interest income. The cash value accumulation is permanently tax deferred if the policy is held to the insured person's death and certain other conditions are met.

Derivative Instruments - Financial derivatives are reported at fair value in other assets or other liabilities. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as part of a hedging relationship, the gain or loss is recognized in current earnings.

Beginning in 2015, the Bank entered into interest-rate swap contracts in connection with its commercial lending activities. These swaps allow qualified commercial banking customers to convert a floating-rate loan payment to fixed-rate loan payment while the Bank simultaneously enters into an equal and opposite interest rate swap with an independent counterparty. These swap transactions do not meet hedge accounting requirements and therefore changes in the fair value of both the customer swaps and the counterparty swaps, which have an offsetting inverse relationship, are recognized directly in earnings.

See Note 11 *DERIVATIVE INSTRUMENTS* for more information about the Bank's derivatives.

Advertising - Advertising, promotional, and other business development costs generally are expensed as incurred. External costs incurred in producing media advertising are expensed the first time the advertising takes place. External costs relating to direct mailing costs are expensed in the period in which the direct mailings are sent.

Stock-Based Compensation - Compensation cost is recognized for stock options issued to employees and directors. Compensation cost is measured as the fair value of these awards on the date of grant. The fair value of the stock options issued under the plan is expensed over the vesting period of each option grant. Further information about the plan and the methodology to determine the fair value of stock options is detailed in Note 16.

Merger-Related Expenses - all expenses associated with mergers (described in Note 2) are included in the Consolidated Statements of Income under like caption.

Income Taxes - The asset and liability approach is utilized to account for income taxes, which requires recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the financial statement carrying values and the tax bases of assets and liabilities, as well as net operating loss carry forwards. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be realized or settled. A current tax asset or liability is recognized for taxes that are presently receivable or payable and is included in "Other assets" or "Other liabilities" in the balance sheet.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The Bank has analyzed its filing positions in the federal and state jurisdictions where it is required to file income tax returns, as well as all open tax years in these jurisdictions. The Bank believes that income tax filing positions taken or expected to be taken in its tax returns will more likely than not be sustained upon audit by the taxing authorities and does not anticipate any adjustments that will result in a material adverse impact on the Bank's financial condition, results of operations, or cash flows. Therefore, no reserves for uncertain income tax positions have been recorded.

Earnings Per Share - Basic earnings per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed by dividing net income available to common shareholders by the weighted average number of common shares and potential common shares outstanding during the period. Potential common shares consist solely of dilutive stock options determined by the treasury stock method using the average market price of the shares during the period. Earnings per share amounts for the year ended December 31, 2015 have been adjusted to reflect the five percent stock dividend issued in February 2016.

Sales of Loans - Gains and losses on the sales of loans are accounted for as the difference between the proceeds received and the carrying value of the loans. Such gains or losses are recognized in the financial statements at the time of the sale.

Comprehensive Income - Comprehensive income consists of net income and net unrealized gains and losses on investment securities available for sale, net of related tax effects, and is presented in the Consolidated Statements of Changes in Shareholders' Equity and in the separate Consolidated Statements of Comprehensive Income.

Stock Dividend - On January 11, 2016 the board of directors declared a five percent stock dividend of the Bank's common shares, distributed on February 10, 2016. All references to share and per share amounts in the statements of operations and accompanying notes to the financial statements have been retroactively adjusted to reflect the five percent stock dividend.

Fair Value Measurements - Fair value is the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

Fair values are determined under a hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs in the measurement process. There are three levels of inputs that may be used to measure fair value:

Level 1: These inputs principally consist of quoted prices in active markets for identical assets or liabilities. (The Bank has no assets or liabilities measured by the use of Level 1 inputs.)

Level 2: Observable inputs such as quoted prices for similar assets or liabilities or other inputs that are observable or can be corroborated by observable market data are the primary types of measurements that comprise Level 2.

Level 3: Unobservable inputs that are supported by little or no market activity or that may involve using pricing models, discounted cash flow methodologies, or similar techniques are included in this level. The determination of values also may require significant management judgment or estimation.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Reclassifications - Certain amounts previously reported have been reclassified to conform to the current presentation of these consolidated financial statements. These reclassifications had no effect on previously reported net income or shareholders' equity.

Recently Issued Accounting Standards - In June 2016, the FASB issued guidance to change the accounting for credit losses and modify the impairment model for certain debt securities. The amendments will be effective for the Bank for fiscal years beginning after December 15, 2019 and interim periods within those fiscal years. Early adoption is permitted for all organizations for periods beginning after December 15, 2018. The Bank is currently evaluating the effect that implementation of the new standard will have on its financial position, results of operations, and cash flows.

In March 2016, the Stock Compensation topic of the ASC was amended to simplify several aspects of the accounting for share-based payment award transactions including the income tax consequences, the classification of awards as either equity or liabilities, and the classification on the statement of cash flows. The amendments will be effective for the Bank for fiscal years beginning after December 15, 2016 and interim periods within those fiscal years. Early adoption is permitted. The Bank does not expect these amendments to have a material effect on its financial statements.

In February 2016, the FASB amended the Leases topic of the ASC which will require lessees to recognize an asset on the balance sheet for the right to use the leased asset and a liability for the corresponding lease obligation for leases with terms of more than 12 months. The new guidance also requires additional disclosures by lessees and contains targeted changes to accounting by lessors. This guidance is effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years. The Bank is currently evaluating this guidance to determine the impact on its consolidated financial statements.

In January 2016, the Financial Instruments topic of the ASC was amended to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The amendments will be effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years, with early adoption of certain provisions permitted. The Bank will apply the guidance by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The Bank does not expect these amendments to have a material effect on its consolidated financial statements.

In November 2015, the FASB amended the Income Taxes topic of the ASC to simplify the presentation of deferred income taxes by requiring that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. The amendments will be effective for fiscal years beginning after December 15, 2017 and interim periods with annual periods beginning after December 15, 2018, with early adoption permitted. The Bank will apply the guidance retrospectively. The Bank does not expect these amendments to have a material effect on its consolidated financial statements.

In September 2015, the Business Combinations topic of the ASC was amended to eliminate the requirement that an acquirer in a business combination account for measurement-period adjustments retrospectively. Instead, an acquirer now recognizes measurement-period adjustments during the period in which it determines the amount of the adjustment. The amendment was effective on January 1, 2016 and was applied prospectively to adjustments that occurred after the effective date. Adoption of the amendment did not have a material effect on the Bank's consolidated financial statements.

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

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 2 - BUSINESS COMBINATIONS

On October 3, 2015, the Bank completed the PBSC Merger. Under terms of the Agreement and Plan of Merger dated March 23, 2015, PBSC shareholders could elect to receive 1.0909 shares of the Bank's voting common stock for each share of PBSC common stock or cash in the amount of \$12.00 per share, subject to allocation and pro-rata procedures to ensure that approximately 80% of PBSC common shares were converted into the right to receive the Bank's voting common stock, while the remaining 20% were converted into the right to receive cash.

Pinnacle operated three full-service offices located in Greenville and Easley, South Carolina. The merger with Pinnacle gave the Bank an entry into the Greenville market area, which is an important market in furtherance of the Bank's objective to serve the entire Upstate area of South Carolina.

The assets acquired and liabilities assumed were initially presented at their estimated fair values based on a preliminary allocation of the purchase price. In many cases, the determination of these fair values required management to make estimates about discount rates, future expected cash flows, market conditions and other future events that were highly subjective and subject to change. The fair value estimates were considered preliminary and subject to change for up to one year after the closing date of the merger as additional information became available. Based on a preliminary purchase price allocation, the Bank recorded \$4,309,692 million in goodwill. During the period January 1, 2016 to October 3, 2016, the Bank recorded adjustments to the estimated fair values of loans, other assets, and other liabilities, which resulted in a \$252,356 decrease in goodwill. The adjusted amount of goodwill of \$4,057,337 reflects the excess purchase price over the estimated fair value of the net assets acquired.

The following table presents the consideration paid by the Bank in the acquisition of PBSC and the assets acquired and liabilities assumed as of October 3, 2015, as initially reported at December 31, 2015 and as adjusted to final values at December 31, 2016:

	As Recorded by PBSC	Initial Fair Value Adjust- ments	Initial Fair Values Reported by the Bank	Subsequent Fair Value Adjust- ments	Final Fair Values Reported by the Bank
Consideration paid:					
1,633,620 common shares issued			\$ 17,838,224		\$ 17,838,224
Cash			4,493,490		4,493,490
Total consideration			<u>22,331,714</u>		<u>22,331,714</u>
Assets:					
Cash and cash equivalents	\$ 9,250,184	\$ -	9,250,184	\$ -	9,250,184
Investment securities, available for sale	12,988,690	(50,103)	12,938,587	-	12,938,587
Other investments	353,100	-	353,100	-	353,100
Loans, net	117,535,838	(1,479,481)	116,056,357	439,954	116,496,311
Property and equipment, net	1,478,438	110,000	1,588,438	-	1,588,438
Accrued interest	327,271	-	327,271	-	327,271
Core deposit intangibles	-	1,112,937	1,112,937	-	1,112,937
Other assets	4,671,890	1,547,439	6,219,329	(159,179)	6,060,150
Total assets acquired	<u>\$146,605,411</u>	<u>\$ 1,240,792</u>	<u>\$147,846,203</u>	<u>\$ 280,775</u>	<u>\$148,126,978</u>

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 2 - BUSINESS COMBINATIONS (Continued)

	<u>As Recorded by PBSC</u>	<u>Initial Fair Value Adjust- ments</u>	<u>Initial Fair Values Reported by the Bank</u>	<u>Subsequent Fair Value Adjust- ments</u>	<u>Final Fair Values Reported by the Bank</u>
Liabilities:					
Deposits	\$121,624,045	\$ (24,039)	\$121,600,006	\$ -	\$121,600,006
Other borrowings	5,604,056	-	5,604,056	-	5,604,056
Other liabilities	2,620,119	-	2,620,119	28,420	2,648,539
Total liabilities assumed	<u>129,848,220</u>	<u>(24,039)</u>	<u>129,824,181</u>	<u>28,420</u>	<u>129,852,601</u>
Net identifiable assets acquired over liabilities assumed					
	<u>\$ 16,757,191</u>	<u>\$ 1,264,831</u>	<u>18,022,022</u>	<u>252,355</u>	<u>18,274,377</u>
Goodwill			<u>\$ 4,309,692</u>	<u>\$ (252,355)</u>	<u>\$ 4,057,337</u>

Fair value and other merger related adjustments include a decrease in the market value of investment securities of \$50,103, decreases in the historical cost of loans for current market interest rates in excess of contractual rates in the amount of \$265,743 and a net adjustment for potential loan and lease losses in excess of the recorded allowance for loan and lease losses in the amount of \$773,784.

An intangible asset in the amount of \$1,112,937 for the fair value of long-term deposit relationships was recorded and a decrease in the stated value of certificates of deposits in the amount of \$24,039 was recorded to reflect contractual rates in excess of current market interest rates. An increase in property and equipment of \$110,000 was recorded to reflect the appraised value of branch office real estate. A deferred tax asset of \$1,676,599 was recorded to reflect the tax effect of the foregoing adjustments and to account for certain tax basis adjustments made to PBSC assets and liabilities in order to conform to the Bank's tax accounting methods.

The pro forma results below combine the historical results of the Bank with PBSC for the year ended December 31, 2015 as if the merger had taken place on January 1, 2015. While certain adjustments were made for the estimated impact of certain fair value adjustments and other merger-related activity, they are not indicative of what would have occurred.

Net interest income plus other income	<u>\$ 26,166,655</u>
Net income	<u>\$ 3,541,989</u>

It is not practicable to present the revenue and earnings of PBSC during the period October 3, 2015 through December 31, 2015 because PBSC has not been maintained as a separate accounting entity.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 3 - INVESTMENT SECURITIES

The amortized cost and fair value of investment securities available for sale at December 31, 2016 and 2015 are as follows:

	2016			Fair Value
	Amortized Cost	Gross Unrealized		
		Gains	Losses	
U.S. government agency and sponsored enterprises	\$ 12,727,758	\$ 60,024	\$ (223,884)	\$ 12,563,898
Agency mortgage-backed securities	35,776,785	162,175	(413,986)	35,524,974
Agency collateralized mortgage obligations	20,703,528	42,857	(273,817)	20,472,568
Municipal securities	30,133,402	66,390	(784,826)	29,414,966
Total available for sale	<u>\$ 99,341,473</u>	<u>\$ 331,446</u>	<u>\$ (1,696,513)</u>	<u>\$ 97,976,406</u>

	2015			Fair Value
	Amortized Cost	Gross Unrealized		
		Gains	Losses	
U.S. government agency and sponsored enterprises	\$ 13,641,397	\$ 104,032	\$ (128,999)	\$ 13,616,430
Agency mortgage-backed securities	34,091,002	253,093	(238,606)	34,105,489
Agency collateralized mortgage obligations	19,465,176	66,953	(204,434)	19,327,695
Municipal securities	23,189,352	269,911	(33,248)	23,426,015
Total available for sale	<u>\$ 90,386,927</u>	<u>\$ 693,989</u>	<u>\$ (605,287)</u>	<u>\$ 90,475,629</u>

In the year ended December 31, 2016, there were 12 sales of investment securities available for sale at a gain; there was one sale at a loss. The gross proceeds of \$5,189,973 and net gain are reflected in the Consolidated Statements of Cash Flows. In the year ended December 31, 2015, there were 21 sales of investment securities available for sale at a gain; there were 18 sales at a loss. The gross proceeds of \$15,432,094 and net loss are reflected in the Consolidated Statements of Cash Flows.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 3 - INVESTMENT SECURITIES (Continued)

For investment securities which had been in an unrealized loss position for less than 12 months, the number of securities, the fair value, and the gross unrealized losses for each investment security category at December 31, 2016 and 2015 are as follows:

	2016			2015		
	#	Fair Value	Unrealized Losses	#	Fair Value	Unrealized Losses
U.S. government agency and sponsored enterprises	21	\$ 8,818,043	\$ (203,433)	8	\$ 4,135,067	\$ (21,106)
Agency mortgage-backed securities	38	25,573,495	(397,540)	27	22,849,008	(233,013)
Agency collateralized mortgage obligations	24	15,939,400	(263,684)	19	12,631,247	(164,432)
Municipal securities	43	23,586,739	(784,826)	9	4,391,160	(31,913)
Total temporarily impaired securities	<u>126</u>	<u>\$73,917,677</u>	<u>\$(1,649,483)</u>	<u>63</u>	<u>\$ 44,006,482</u>	<u>\$ (450,464)</u>

There were seven investment securities which had been in an unrealized loss position for greater than 12 months at December 31, 2016 and 20 at December 31, 2015. The number of securities, the fair value, and the gross unrealized losses for each investment security category at December 31, 2016 and 2015 are as follows:

	2016			2015		
	#	Fair Value	Unrealized Losses	#	Fair Value	Unrealized Losses
U.S. government agency and sponsored enterprises	1	\$ 522,735	\$ (20,451)	13	\$ 4,798,300	\$ (107,893)
Agency mortgage-backed securities	5	1,000,882	(16,446)	3	234,029	(5,593)
Agency collateralized mortgage obligations	1	306,494	(10,133)	3	1,603,963	(40,002)
Municipal securities	-	-	-	1	288,100	(1,335)
Total temporarily impaired securities	<u>7</u>	<u>\$ 1,830,111</u>	<u>\$ (47,030)</u>	<u>20</u>	<u>\$ 6,924,392</u>	<u>\$ (154,823)</u>

Based on its other-than-temporary impairment analysis at December 31, 2016, management concluded that the unrealized losses reflected in the preceding summaries were not other-than-temporary as of that date. Management believes the decline in value to be solely the result of changes in interest rates and not from deterioration in the securities' quality. The Bank has the intention and ability to hold these securities for a period of time sufficient to allow for their recovery in value or maturity.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 3 - INVESTMENT SECURITIES (Continued)

Investment securities at December 31, 2016 and 2015 were pledged as collateral for the following purposes (at fair value):

	2016	2015
Customer repurchase agreements	\$ 17,111,893	\$ 8,942,278
Public entity deposits	9,438,648	8,865,905
Total	<u>\$ 26,550,541</u>	<u>\$ 17,808,183</u>

Amortized cost and fair value of securities available for sale at December 31, 2016, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Mortgage-backed securities and collateralized mortgage obligations are shown separately since they are not due at a single maturity date.

	Amortized Cost	Fair Value
Due within one year or less	\$ 2,516,699	\$ 2,504,790
Due after one through five years	5,565,984	5,496,830
Due after five through ten years	12,176,546	12,032,545
Due after ten years	22,601,931	21,944,699
No contractual maturity	56,480,313	55,997,542
Total investment securities	<u>\$ 99,341,473</u>	<u>\$ 97,976,406</u>

NOTE 4 - LOANS AND FINANCE LEASES

Loans and finance leases receivable at December 31, 2016 and 2015 consisted of the following:

	2016	2015
Commercial	\$ 70,894,304	\$ 69,764,499
Real estate:		
Commercial	313,084,968	298,906,653
Residential	66,755,796	67,606,040
Construction	15,872,706	14,887,518
Consumer	5,730,997	4,676,417
Gross loans	472,338,771	455,841,127
Finance leases	25,312,796	24,062,371
Gross loans and finance leases	497,651,567	479,903,498
Allowance for loan and lease losses	(4,954,610)	(4,678,907)
Fair value adjustments on acquired loans and leases	(2,545,043)	(4,823,947)
Deferred fees and costs, net	(2,015,512)	(1,794,486)
Net loans and finance leases	<u>\$ 488,136,402</u>	<u>\$ 468,606,158</u>

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 4 - LOANS AND FINANCE LEASES (Continued)

At December 31, 2016, substantially all of the Bank's commercial real estate loans and home equity lines of credit were pledged as collateral for advances from the FHLB under the borrowing facility described in Note 9.

A summary of changes in the allowance for loan and lease losses is as follows for the years ended December 31, 2016 and 2015:

	2016	2015
Balance, beginning of year	\$ 4,678,907	\$ 3,946,405
Provision for loan and lease losses	210,000	910,210
Loans charged off	-	(266,545)
Loan recoveries	65,703	88,837
Balance, end of year	\$ 4,954,610	\$ 4,678,907

The Bank makes loans to individuals and small- to mid-sized businesses for various personal and commercial purposes primarily in the upstate region of South Carolina and western North Carolina. Credit concentrations can exist in relation to individual or groups of borrowers, industry segments, geographic regions and collateral characteristics. Credit risk associated with these concentrations could arise when a significant amount of loans sharing similar characteristics are simultaneously impacted by economic or other conditions which adversely affect their collectability. The Bank regularly monitors its credit concentrations. The Bank's loan portfolio is not concentrated in loans to any single borrower or a relatively small number of borrowers. The largest component of the loan portfolio is loans secured by real estate mortgages which were comprised of the following at December 31, 2016 (construction loans have been allocated to commercial and residential categories as appropriate):

	Amount	% of Real Estate Loans
Commercial real estate :		
Owner-occupied	\$ 127,291,042	32.2%
Other	193,158,453	48.8%
Total commercial real estate	320,449,495	81.0%
Residential real estate	75,263,975	19.0%
Total real estate loans	\$ 395,713,470	100.0%
% of gross loans	83.8%	

In addition to monitoring potential concentrations described above, management monitors exposure to credit risk that could arise from potential concentrations of lending products and practices, such as loans that subject borrowers to substantial payment increases (e.g. principal deferral periods, loans with initial interest-only periods, etc.) and loans with high loan-to-value ratios. At December 31, 2016, approximately \$16.1 million, or 3.4% of gross loans, were identified as having high loan-to-value ratios. The largest component comprising these loans was commercial real estate loans of approximately \$10.5 million which was below the aggregate supervisory loan-to-value limit of 30% of capital for this type of loan by approximately \$10.6 million.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 4 - LOANS AND FINANCE LEASES (Continued)

The remainder of the balance of high loan-to-value loans, \$5.6 million, was also well below supervisory limits. Additionally, there are industry practices that could subject the Bank to increased credit risk should economic conditions change over the course of a loan's life. For example, the Bank makes variable rate loans and fixed rate principal-amortizing loans with maturities prior to the loan being fully paid (i.e. balloon payment loans). These loans are underwritten and monitored to manage the associated risks. Management has determined that there is no concentration of credit risk associated with its lending policies or practices.

Credit quality of individual residential loans and consumer loans is monitored principally through review of delinquency measures and non-accrual levels on a portfolio-level basis. The Bank uses an internal loan grading system to classify and monitor the credit quality of all commercial loans. Loan risk grades are based on a graduated scale representing increasing likelihood of loss. The originating loan officers are responsible for the assignment of risk grades to commercial loans, subject to verification by an approving officer or the Management Loan Committee. In addition, the Credit Policy Officer is responsible for confirming loan grades and, along with the Management Loan Committee, has final authority over loan grading. Loan gradings also are reviewed on a regular basis by an independent third-party loan review firm. Individual loan officers also are responsible for ensuring that loan grades are updated as needed over the life of the loan. Loan grade descriptions and a summary of the grading of the Bank's loan portfolio by segment are as follows:

Grade 1 - Loans in this category are virtually risk-free and are well-collateralized by cash-equivalent instruments. The repayment program is well-defined and achievable. Repayment sources are numerous. No material documentation deficiencies or exceptions exist.

Grade 2 - This grade is reserved for loans secured by readily marketable collateral, or loans within guidelines to borrowers with liquid financial statements. A liquid financial statement is a financial statement with substantial liquid assets relative to debts. These loans have excellent sources of repayment, with no significant identifiable risk of collection, and conform in all respects to Bank policy, guidelines, underwriting standards, and Federal and State regulations (no exceptions of any kind).

Grade 3 - This grade is reserved for the Bank's top quality loans. These loans have excellent sources of repayment, with no significant identifiable risk of collection. Generally, loans assigned this risk grade will demonstrate the following characteristics:

- No exceptions of any kind.
- Documented historical cash flow that meets or exceeds required minimum Bank guidelines, or that can be supplemented with verifiable cash flow from other sources.
- Adequate secondary sources to liquidate the debt.

Grade 4 - This grade is given to acceptable loans. These loans have adequate sources of repayment, with little identifiable risk of collection. Loans assigned this risk grade will demonstrate the following characteristics:

- Limited exceptions - any exceptions that are identified during the underwriting and approval process have been adequately mitigated by other factors.
- Documented historical cash flow that meets or exceeds required minimum Bank guidelines, or that can be supplemented with verifiable cash flow from other sources.
- Adequate secondary sources to liquidate the debt.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 4 - LOANS AND FINANCE LEASES (Continued)

Grade 5 - This grade is given to acceptable loans that show signs of weakness in either adequate sources of repayment or collateral, but have demonstrated mitigating factors that minimize the risk of delinquency or loss. Loans assigned this grade may demonstrate some or all of the following characteristics:

- Additional exceptions to the Bank's policy requirements, product guidelines, or underwriting standards that present a higher degree of risk to the Bank. Although the combination and/or severity of identified exceptions is greater, all exceptions have been properly mitigated by other factors.
- Unproven, insufficient, or marginal primary sources of repayment that appear sufficient to service the debt at this time.
- Marginal or unproven secondary sources to liquidate the debt.

Grade 6 - This grade is given to Watch List or **Special Mention** loans which include the following characteristics:

- Loans with underwriting guideline tolerances and/or exceptions and with no mitigating factors.
- Extending loans that are currently performing satisfactorily but with potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Bank's position at some future date.
- Loans where adverse economic conditions that develop subsequent to the loan origination that don't jeopardize liquidation of the debt but do substantially increase the level of risk may also warrant this rating.

Grade 7 - A **Substandard** loan is inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as substandard must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt; they are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. Loans consistently not meeting the repayment schedule should be downgraded to substandard. Loans in this category are characterized by deterioration in quality exhibited by any number of well-defined weaknesses requiring corrective action. Such loans are no longer considered to be adequately protected due to the borrower's declining net worth, lack of earnings capacity, declining collateral margins and/or unperfected collateral positions. A possibility of loss of a portion of the loan balance cannot be ruled out. The repayment ability of the borrower is marginal or weak and the loan may have exhibited excessive overdue status or extensions and/or renewals.

Grade 8 - Loans classified **Doubtful** have all the weaknesses inherent in loans classified Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. However, these loans are not yet rated as loss because certain events may occur which would salvage the debt. The ability of the borrower to service the debt is extremely weak, overdue status is constant, the debt has been placed on non-accrual status, and no definite repayment schedule exists. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off.

Grade 9 - Loans classified **Loss** are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this worthless loan even though partial recovery may be effected in the future.

Not Graded - Primarily consists of individual residential or consumer loans not assigned a risk grade, in accordance with the Bank's credit policy. Also, not graded may be commercial loans for which a grade is pending because the loan is under review.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 4 - LOANS AND FINANCE LEASES (Continued)

The composition of the loan portfolio by segment and grade at December 31, 2016 is as follows:

	<u>Real Estate</u>					<u>Total</u>
	<u>Commercial</u>	<u>Commercial</u>	<u>Residential</u>	<u>Construction</u>	<u>Consumer</u>	
Grade 1	\$ 2,206,092	\$ -	\$ -	\$ -	\$ 67,935	\$ 2,274,027
Grade 2	535,680	2,324,797	-	-	-	2,860,477
Grade 3	15,230,803	94,748,175	10,180,525	1,514,733	584,404	122,258,640
Grade 4	41,652,704	154,825,089	204,538	8,501,988	-	205,184,319
Grade 5	10,052,125	46,707,823	159,043	342,500	2,874	57,264,365
Grade 6	81,102	1,965,861	1,015,761	-	-	3,062,724
Grade 7	98,821	9,859,780	425,470	-	972	10,385,043
Grade 8	446,785	1,507,780	-	-	-	1,954,565
Not graded	590,192	1,145,663	54,770,459	5,513,485	5,074,812	67,094,611
Gross loans	<u>\$70,894,304</u>	<u>\$313,084,968</u>	<u>\$66,755,796</u>	<u>\$ 15,872,706</u>	<u>\$ 5,730,997</u>	<u>\$472,338,771</u>

The composition of the loan portfolio by segment and grade at December 31, 2015 is as follows:

	<u>Real Estate</u>					<u>Total</u>
	<u>Commercial</u>	<u>Commercial</u>	<u>Residential</u>	<u>Construction</u>	<u>Consumer</u>	
Grade 1	\$ 4,177,392	\$ -	\$ -	\$ -	\$ 191,935	\$ 4,369,327
Grade 2	4,005,143	2,649,786	-	-	-	6,654,929
Grade 3	17,410,646	125,077,060	14,477,204	5,598,998	1,092,361	163,656,269
Grade 4	33,950,881	114,423,975	183,538	6,777,319	-	155,335,713
Grade 5	9,106,205	39,805,459	487,634	725,438	10,814	50,135,550
Grade 6	152,054	1,552,786	1,001,137	-	-	2,705,977
Grade 7	119,677	10,908,058	171,261	-	8,013	11,207,009
Grade 8	834,165	2,732,812	-	-	4,653	3,571,630
Not graded	8,336	1,756,717	51,285,266	1,785,763	3,368,641	58,204,723
Gross loans	<u>\$69,764,499</u>	<u>\$298,906,653</u>	<u>\$67,606,040</u>	<u>\$ 14,887,518</u>	<u>\$ 4,676,417</u>	<u>\$455,841,127</u>

The composition of non-performing assets at December 31, 2016 and 2015 is as follows:

	<u>2016</u>	<u>2015</u>
Non-accrual loans:		
Commercial	\$ 94,900	\$ 248,230
Real estate:		
Commercial	1,842,379	2,880,231
Residential	-	-
Total non-accrual loans	<u>1,937,279</u>	<u>3,128,461</u>
Other real estate owned	<u>127,595</u>	<u>1,465,690</u>
Non-performing assets	<u>\$ 2,064,874</u>	<u>\$ 4,594,151</u>
Loans past due 90 days or more still accruing interest	<u>\$ -</u>	<u>\$ -</u>

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 4 - LOANS AND FINANCE LEASES (Continued)

The composition of past due loans by portfolio segment at December 31, 2016 is as follows:

	Days Past Due			Total Past Due	Current	Total Loans
	30-59	60-89	90 or More ⁽¹⁾			
Commercial	\$ -	\$ -	\$ 94,900	\$ 94,900	\$ 70,799,404	\$ 70,894,304
Real estate:						
Commercial	-	2,693,110	1,842,379	4,535,489	308,549,479	313,084,968
Residential	257	-	-	257	66,755,539	66,755,796
Construction	-	-	-	-	15,872,706	15,872,706
Consumer	-	-	-	-	5,730,997	5,730,997
Gross loans	<u>\$ 257</u>	<u>\$ 2,693,110</u>	<u>\$ 1,937,279</u>	<u>\$ 4,630,646</u>	<u>\$ 467,708,125</u>	<u>\$ 472,338,771</u>

The composition of past due loans by portfolio segment at December 31, 2015 is as follows:

	Days Past Due			Total Past Due	Current	Total Loans
	30-59	60-89	90 or More ⁽¹⁾			
Commercial	\$ -	\$ -	\$ 248,230	\$ 248,230	\$ 69,516,269	\$ 69,764,499
Real estate:						
Commercial	-	-	2,880,231	2,880,231	296,026,422	298,906,653
Residential	442,064	-	-	442,064	67,163,976	67,606,040
Construction	-	-	-	-	14,887,518	14,887,518
Consumer	-	-	-	-	4,676,417	4,676,417
Gross loans	<u>\$ 442,064</u>	<u>\$ -</u>	<u>\$ 3,128,461</u>	<u>\$ 3,570,525</u>	<u>\$ 452,270,602</u>	<u>\$ 455,841,127</u>

⁽¹⁾ All loans past due 90 or more days are in non-accrual status.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 4 - LOANS AND FINANCE LEASES (Continued)

The Company acquired certain loans in the PBSC Merger which had experienced credit deterioration since origination (purchased credit impaired (“PCI”) loans). Accretion on PCI loans is based on estimated future cash flows, regardless of contractual maturity. There were no PCI loans acquired during the year ended December 31, 2016.

The following table summarizes the outstanding balance and related carrying amount of the PBSC PCI loans as of the acquisition date of October 3, 2015:

Outstanding balance	\$ 7,294,792
Nonaccretable difference	(1,557,116)
Accretable yield	<u>(105,332)</u>
Carrying amount	<u>\$ 5,632,344</u>

The changes in accretable yield during the years ended December 31, 2016 and 2015 in regard to loans transferred at acquisition for which it was probable that all contractually required payments would not be collected are presented in the table below.

	<u>2016</u>	<u>2015</u>
Balance, beginning of year	\$ 92,441	\$ -
Additions	-	105,332
Accretion	(75,844)	(12,891)
Other changes, net	<u>876</u>	<u>-</u>
Balance, end of year	<u>\$ 17,473</u>	<u>\$ 92,441</u>

The carrying amounts of acquired PCI loans included in the consolidated balance sheet and the related outstanding balances at December 31, 2016 and 2015, were as follows:

	<u>2016</u>	<u>2015</u>
Outstanding balance	\$ 4,193,432	\$ 6,233,820
Carrying amount	3,275,884	4,571,372

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 4 - LOANS AND FINANCE LEASES (Continued)

The following tables summarize information relative to impaired loans by portfolio segment.

	December 31, 2016				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial	\$ 1,973	\$ 1,973	\$ -	\$ 2,813	\$ 223
Real estate:					
Commercial	743,143	1,241,131	-	1,448,794	58,252
Residential	179,244	179,244	-	177,262	8,106
Construction	-	-	-	-	-
Consumer	972	972	-	938	169
	925,332	1,423,320	-	1,629,807	66,750
With a related allowance:					
Commercial	47,798	47,798	630	52,536	3,189
Real estate:					
Commercial	3,472,895	3,472,895	229,619	3,520,077	170,560
Residential	246,226	246,226	114,414	252,683	10,800
Construction	-	-	-	-	-
Consumer	2,874	2,874	411	4,452	536
	3,769,793	3,769,793	345,074	3,829,748	185,085
Total impaired loans:					
Commercial	49,771	49,771	630	55,349	3,412
Real estate:					
Commercial	4,216,038	4,714,026	229,619	4,968,871	228,812
Residential	425,470	425,470	114,414	429,945	18,906
Construction	-	-	-	-	-
Consumer	3,846	3,846	411	5,390	705
	\$ 4,695,125	\$ 5,193,113	\$ 345,074	\$ 5,459,555	\$ 251,835
Troubled debt restructurings included in impaired loans:					
Accruing	\$ 3,444,772	\$ 3,444,772	\$ 303,659	\$ 3,494,840	\$ 168,060
Non-accrual	487,692	985,680	-	1,186,634	-
	\$ 3,932,464	\$ 4,430,452	\$ 303,659	\$ 4,681,474	\$ 168,060

Not included in the impaired loan table above are \$4,193,432 of purchased credit-impaired loans with discounts of \$819,021 and \$98,527 for credit and yield, respectively, for a reported net book value of \$3,275,884.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 4 - LOANS AND FINANCE LEASES (Continued)

	December 31, 2015				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial	\$ 47,617	\$ 47,617	\$ -	\$ 55,941	\$ 2,459
Real estate:					
Commercial	1,672,711	2,274,762	-	2,436,334	40,978
Residential	-	-	-	-	-
Construction	-	-	-	-	-
Consumer	372	372	-	805	145
	<u>1,720,700</u>	<u>2,322,751</u>	<u>-</u>	<u>2,493,080</u>	<u>43,582</u>
With a related allowance:					
Commercial	-	-	-	-	-
Real estate:					
Commercial	1,607,728	1,607,728	100,692	1,624,130	95,385
Residential	263,263	263,263	47,590	268,288	11,498
Construction	-	-	-	-	-
Consumer	5,783	5,783	1,319	6,134	736
	<u>1,876,774</u>	<u>1,876,774</u>	<u>149,601</u>	<u>1,898,552</u>	<u>107,619</u>
Total impaired loans:					
Commercial	47,617	47,617	-	55,941	2,459
Real estate:					
Commercial	3,280,439	3,882,490	100,692	4,060,464	136,363
Residential	263,263	263,263	47,590	268,288	11,498
Construction	-	-	-	-	-
Consumer	6,155	6,155	1,319	6,939	881
	<u>\$ 3,597,474</u>	<u>\$ 4,199,525</u>	<u>\$ 149,601</u>	<u>\$ 4,391,632</u>	<u>\$ 151,201</u>
Troubled debt restructurings included in impaired loans:					
Accruing	\$ 2,693,551	\$ 2,693,551	\$ 149,601	\$ 2,752,482	\$ 151,056
Non-accrual	747,850	1,245,838	-	1,380,076	-
	<u>\$ 3,441,401</u>	<u>\$ 3,939,389</u>	<u>\$ 149,601</u>	<u>\$ 4,132,558</u>	<u>\$ 151,056</u>

Not included in the impaired loan table above are \$6,233,820 of purchased credit-impaired loans with discounts of \$1,489,498 and \$172,950 for credit and yield, respectively, for a reported net book value of \$4,571,372.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 4 - LOANS AND FINANCE LEASES (Continued)

At December 31, 2016, the outstanding recorded investment in loans which had been determined in prior years to be impaired under ASC 310-10-35 was \$3,921,172, and there was \$303,659 in related allowance for loan and lease losses associated with those loans. Following is a summary of loans determined to be TDRs during the years ended December 31, 2016 and 2015:

	2016			2015		
	Number of Loans	Pre- Modification Amount	Post- Modification Amount	Number of Loans	Pre- Modification Amount	Post- Modification Amount
Commercial	1	\$ 11,293	\$ 11,293	2	\$ 44,135	\$ 44,135
Real estate:						
Commercial	2	559,265	559,265	2	149,783	149,783
Residential	-	-	-	-	-	-
Construction	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
	3	\$ 570,558	\$ 570,558	4	\$ 193,918	\$ 193,918

Of the loans that were identified as TDRs during the year ended December 31, 2016, all three involved financial difficulty with renewal terms that did not mitigate the increased potential risk. During the year ended December 31, 2016, there were no loans that had been previously restructured removed from this classification (except by pay-offs). During the year ended December 31, 2016, five loans that had been previously restructured defaulted. The aggregate recorded investment at the loans' default was approximately \$262,000. During the year ended December 31, 2015, there were three loans that had been previously restructured removed from this classification. Two were paid off by the borrower, and the third was restructured during 2015 in the absence of financial difficulty and under terms that did not represent a concession by the bank.

The following table summarizes activity related to the allowance for loan and lease losses by portfolio segment and finance leases for the year ended December 31, 2016:

	Balance Beginning of Year	Provision for Losses	Loan Charge Offs	Loan Recoveries	Balance End of Year
Commercial	\$ 660,265	\$ (33,866)	\$ -	\$ 38,731	\$ 665,130
Real estate:					
Commercial	2,929,603	211,338	-	23,258	3,164,199
Residential	687,427	48,983	-	3,714	740,124
Construction	142,217	6,971	-	-	149,188
Consumer	44,259	9,458	-	-	53,717
Finance leases	215,136	(32,884)	-	-	182,252
Total	\$4,678,907	\$ 210,000	\$ -	\$ 65,703	\$4,954,610

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 4 - LOANS AND FINANCE LEASES (Continued)

The following table summarizes activity related to the allowance for loan and lease losses for the year ended December 31, 2015 by portfolio segment:

	Balance Beginning of Year	Provision for Losses	Loan Charge Offs	Loan Recoveries	Balance End of Year
Commercial	\$ 555,622	\$ 50,340	\$ (12,733)	\$ 67,036	\$ 660,265
Real estate:					
Commercial	1,884,877	1,268,748	(224,262)	240	2,929,603
Residential	575,355	120,061	(29,550)	21,561	687,427
Construction	641,372	(499,155)	-	-	142,217
Consumer	202,967	(158,708)	-	-	44,259
Finance Leases	86,212	128,924	-	-	215,136
Total	\$3,946,405	\$ 910,210	\$ (266,545)	\$ 88,837	\$4,678,907

The following tables present the basis upon which loans in each portfolio segment and finance leases were reviewed for impairment, with the related allowance for loan and lease losses broken out on the same basis, at December 31, 2016 and 2015:

	2016					
	Gross Loan and Leases			Allowance for Loan and Lease Losses		
	Basis of Review		Total	Basis of Review		Total
	Individual	Collective	Total	Individual	Collective	Total
Commercial	\$ 49,771	\$ 70,844,533	\$ 70,894,304	\$ 630	\$ 664,500	\$ 665,130
Real estate:						
Commercial	4,216,038	308,868,930	313,084,968	229,619	2,934,580	3,164,199
Residential	425,470	66,330,326	66,755,796	114,414	625,710	740,124
Construction	-	15,872,706	15,872,706	-	149,188	149,188
Consumer	3,846	5,727,151	5,730,997	411	53,306	53,717
Finance leases	-	25,312,796	25,312,796	-	182,252	182,252
Total	\$4,695,125	\$492,956,442	\$497,651,567	\$ 345,074	\$4,609,536	\$4,954,610

Included in the "Collective" and "Total" columns of the impaired loan table above are \$4,193,432 of purchased credit-impaired loans with discounts of \$819,021 and \$98,527 for credit and yield, respectively, for a reported net book value of \$3,275,884.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 4 - LOANS AND FINANCE LEASES (Continued)

	2015					
	Gross Loans			Allowance for Loan Losses		
	Basis of Review			Basis of Review		
	Individual	Collective	Total	Individual	Collective	Total
Commercial	\$ 47,617	\$ 69,716,882	\$ 69,764,499	\$ -	\$ 660,265	\$ 660,265
Real estate:						
Commercial	3,280,439	295,626,214	298,906,653	100,692	2,828,911	2,929,603
Residential	263,263	67,342,777	67,606,040	47,590	639,837	687,427
Construction	-	14,887,518	14,887,518	-	142,217	142,217
Consumer	6,155	4,670,262	4,676,417	1,319	42,940	44,259
Finance leases	-	24,062,371	24,062,371	-	215,136	215,136
Total	<u>\$3,597,474</u>	<u>\$476,306,024</u>	<u>\$479,903,498</u>	<u>\$ 149,601</u>	<u>\$4,529,306</u>	<u>\$4,678,907</u>

Included in the “Collective” and “Total” columns in the table above are \$7,134,674 of purchased credit-impaired loans with discounts of \$1,489,498 and \$172,950 for credit and yield, respectively, for a reported net book value of \$5,472,226.

Performing loans and finance leases totaling approximately \$112.3 million and \$130.0 million were acquired during 2015 and 2014, respectively. These loans and finance leases totaled approximately \$101.3 million and \$159.8 million, with related fair value adjustments of approximately \$1.6 and \$3.2 million at December 31, 2016 and 2015, respectively.

NOTE 5 - PROPERTY AND EQUIPMENT

Property and equipment at December 31, 2016 and 2015 are summarized as follows:

	2016	2015
Land	\$ 1,559,924	\$ 1,559,924
Building	6,194,929	6,084,929
Furniture and equipment	3,610,447	3,584,052
Leasehold improvements	480,845	497,104
	11,846,145	11,726,009
Less accumulated depreciation	3,068,988	3,092,772
Property and equipment, net	<u>\$ 8,777,157</u>	<u>\$ 8,633,237</u>

Depreciation expense for the years ended December 31, 2016 and 2015 was \$733,535 and \$594,916, respectively. During the year ended December 31, 2016, fully depreciated computer equipment and fully amortized leasehold improvements and software with total original book value of \$757,319 were retired.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 6 - LEASED ASSETS

Leased assets at December 31, 2016 and 2015 are summarized as follows:

	<u>2016</u>	<u>2015</u>
Equipment	\$ 8,651,118	\$ 7,059,755
Less accumulated depreciation	<u>3,546,931</u>	<u>2,624,465</u>
Leased assets, net	<u>\$ 5,104,187</u>	<u>\$ 4,435,290</u>

Depreciation expense on leased assets for the years ended December 31, 2016 and 2015 was \$1,940,984 and \$1,593,469, respectively. The estimated residual at the end of the lease term is \$1,571,717 at December 31, 2016. Minimum future lease receipts under these leases are as follows at December 31, 2016:

2017	\$ 1,828,283
2018	1,325,658
2019	584,207
2020	184,905
2021	<u>53,519</u>
Total	<u>\$ 3,976,572</u>

NOTE 7 - CORE DEPOSIT INTANGIBLE

At December 31, 2016, core deposit intangible assets, net of accumulated amortization, amounted to \$1,404,266. The amount of core deposit premium recorded as a result of the merger with Pinnacle was \$1,112,937, and the amount of core deposit premium recorded as a result of the merger with Forest Commercial was \$1,125,940. The core deposit intangible assets are amortized over the estimated life of the assets. Amortization expense related to the core deposit premiums was \$394,557 and \$261,818 for the years ended December 31, 2016 and 2015, respectively. Amortization of the core deposit intangible asset is computed using the 150% declining balance method over an amortization period of seven years. Estimated future amortization expense is as follows at December 31, 2016:

2017	\$ 340,998
2018	319,840
2019	319,840
2020	251,408
2021	132,144
2022	<u>40,036</u>
Total	<u>\$ 1,404,266</u>

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 8 - DEPOSITS

Deposit accounts at December 31, 2016 and 2015 are summarized as follows:

	<u>2016</u>	<u>2015</u>
Non-interest bearing deposits	\$ 101,185,722	\$ 88,691,297
Interest bearing deposits:		
Interest checking	68,309,702	53,194,035
Money market	139,160,239	168,917,419
Savings	74,715,527	57,377,716
Time deposits	144,228,022	127,642,409
Total deposits	<u>\$ 527,599,212</u>	<u>\$ 495,822,876</u>

At December 31, 2016 and 2015 there were deposits amounting to approximately \$43.9 million and \$31.1 million, respectively, obtained from outside the Bank's market area through the internet and deposit brokers. At December 31, 2016 and 2015, time deposits greater than \$250,000 totaled \$40,328,313 and \$36,272,574, respectively. Overdraft deposits reclassified to loans were \$1,438,106 and \$12,028 at December 31, 2016 and 2015, respectively.

At December 31, 2016 the scheduled maturities of time deposits were as follows:

2017	\$ 67,349,105
2018	50,222,699
2019	14,421,642
2020	54,452
2021	12,180,124
Total time deposits	<u>\$ 144,228,022</u>

NOTE 9 - OTHER BORROWINGS

Repurchase Agreements - All of the Bank's repurchase agreements are with its commercial deposit customers. At December 31, 2016 and 2015, respectively, balances of \$16,711,164 and \$7,648,088 were outstanding at rates of 0.30% to 0.65% for December 31, 2016 and 0.30% to 0.45% for December 31, 2015.

Federal Funds Purchased - The Bank maintains federal funds lines of credit with correspondent banks to meet short-term liquidity needs. Advances under these agreements are unsecured and are limited to terms ranging from 7 to 15 days. These banks have reserved the right to withdraw these lines at their option. At December 31, 2016, the Bank had credit availability of \$43.0 million under these lines with \$3,180,000 outstanding.

FHLB Line of Credit - The Bank has an approved credit line with the FHLB of approximately \$156.6 million, subject to the Bank's ability to pledge qualifying collateral. Advances totaled \$21.5 million and \$28.6 million at December 31, 2016 and 2015, respectively. The advances are at fixed rates with interest paid monthly and principal paid at maturity.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 9 - OTHER BORROWINGS (Continued)

The following table summarizes the FHLB borrowings at December 31, 2016:

<u>Maturity Date</u>	<u>Balance</u>	<u>Interest Rate</u>
January 19, 2017	\$ 5,000,000	0.63%
March 28, 2017	4,500,000	0.64%
May 23, 2017	1,500,000	1.23%
November 9, 2017	3,000,000	1.07%
May 23, 2018	1,500,000	1.49%
October 18, 2018	3,000,000	0.99%
December 6, 2018	3,000,000	1.38%
	<u>\$21,500,000</u>	

Federal Reserve Bank Credit Facility - The Bank is eligible to borrow through the Federal Reserve Bank's ("FRB") "Discount Window" program. Any borrowings under this program must be secured by eligible collateral and are limited to very short terms, typically overnight. The FRB has indicated that though institutions are not required to seek funding elsewhere before requesting credit, they expect that institutions will use the Discount Window as a backup rather than a regular source of funding. The Bank maintains it as a part of its contingency funding plan. The Bank estimates that credit availability under this program was approximately \$100.0 million at December 31, 2016.

NOTE 10 - INCOME TAXES

The income tax effects of temporary differences between financial statement carrying values and the tax bases of assets and liabilities at December 31, 2016 and 2015 are as follows:

	<u>2016</u>	<u>2015</u>
Deferred tax assets:		
Allowance for loan and lease losses	\$ 1,373,617	\$ 1,254,688
Unrealized losses on securities available for sale	500,987	-
Acquisition accounting adjustments	408,020	1,071,705
Organization and start-up costs	309,184	370,387
Non-qualified stock options	335,759	339,589
Deferred compensation	40,038	328,299
Other	438,693	284,067
Total deferred tax assets	<u>3,406,298</u>	<u>3,648,735</u>
Deferred tax liabilities:		
Leased assets	3,092,470	1,754,384
Property and equipment	610,823	585,838
Loan origination costs	149,705	129,131
Unrealized gains on securities available for sale	-	32,394
Other	51,939	56,102
Total deferred tax liabilities	<u>3,904,937</u>	<u>2,557,849</u>
Net deferred tax (liability) asset	<u>\$ (498,639)</u>	<u>\$ 1,090,886</u>

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 10 - INCOME TAXES (Continued)

Deferred tax assets represent the future tax benefit of deductible differences and, if it is more likely than not that a tax asset will not be realized, a valuation allowance is required to reduce the recorded deferred tax assets to net realizable value. At December 31, 2016, management determined that no valuation allowance was necessary.

The components of the change in the net deferred tax assets are as follows:

	2016
Total change in net deferred tax assets	\$ (1,589,525)
Less change in unrealized gains on securities available for sale	533,381
Change in operating deferred tax assets	<u>\$ (2,122,906)</u>

The Bank has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions.

The Bank's federal and state income tax returns are open and subject to examination from the 2013 tax return year and forward.

The income tax expense for the years ended December 31, 2016 and 2015 is summarized as follows:

	2016	2015
Current income tax (benefit) expense	\$ 4,110,290	\$ (188,689)
Net deferred income tax expense (benefit)	(2,122,906)	1,558,644
Income tax expense	<u>\$ 1,987,384</u>	<u>\$ 1,369,955</u>

The income tax expense for the years ended December 31, 2016 and 2015 is reconciled to the amount of income tax computed at the federal statutory rate of 34% on income before income taxes as follows:

	2016	2015
Tax expense at statutory rate	\$ 2,088,095	\$ 1,111,561
Increase (decrease) in taxes resulting from:		
State income taxes, net of federal benefit	118,193	60,437
Non-deductible merger costs	-	158,609
Stock option compensation	10,477	13,372
Tax- exempt interest income	(159,252)	(82,675)
Other, net	(70,129)	108,651
Income tax expense	<u>\$ 1,987,384</u>	<u>\$ 1,369,955</u>

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 11 - DERIVATIVE INSTRUMENTS

The Bank had no derivative contracts to assist in managing its own interest-rate sensitivity. Following is a summary of interest-rate swap contracts with commercial banking customers to convert floating-rate loan payments to fixed-rate loan payments and the equal and opposite interest rate swap contracts with an independent counterparty:

	<u>Notional Amount</u>	<u>Estimated Fair Value</u>		<u>Gains (Losses)</u>
		<u>Other Assets</u>	<u>Other Liabilities</u>	<u>Non-interest Income</u>
December 31, 2016:				
Pay fixed/receive variable	\$23,349,670	\$ 711,778	\$ -	\$ 575,351
Pay variable/receive fixed	<u>23,349,670</u>	<u>-</u>	<u>711,778</u>	<u>(575,351)</u>
Total interest rate agreements	<u>\$46,699,340</u>	<u>\$ 711,778</u>	<u>\$ 711,778</u>	<u>\$ -</u>
	<u>Notional Amount</u>	<u>Estimated Fair Value</u>		<u>Gains (Losses)</u>
		<u>Other Assets</u>	<u>Other Liabilities</u>	<u>Non-interest Income</u>
December 31, 2015:				
Pay fixed/receive variable	\$ 9,414,950	\$ 136,427	\$ -	\$ 45,038
Pay variable/receive fixed	<u>9,414,950</u>	<u>-</u>	<u>136,427</u>	<u>(45,038)</u>
Total interest rate agreements	<u>\$18,829,900</u>	<u>\$ 136,427</u>	<u>\$ 136,427</u>	<u>\$ -</u>

All changes in fair value are measured on a monthly basis. The net interest differential is recognized as an adjustment to interest income. In the event of early termination, the net proceeds received or paid on the interest rate swap agreements are recognized immediately in non-interest income and the future net interest differential, if any, is recognized prospectively in interest income.

NOTE 12 - COMMITMENTS AND CONTINGENCIES

The Bank leases several office facilities and various equipment under operating leases. The office leases typically require that the Bank pay taxes, insurance, and maintenance on the facilities. Lease expense for the years ended December 31, 2016 and 2015 was \$684,720 and \$450,238, respectively. The amount expensed for related party rents was \$270,077 and \$270,077 for the years ended December 31, 2016 and 2015, respectively.

In April 2016, the Bank entered into a three-year lease for additional administrative office space in Spartanburg. The lease may be renewed for two successive three-year terms. In connection with the moving of certain personnel from the Bank's main office to this new leased office, the Spartanburg leasing department moved from its leased office in February 2017 and the lease expired on February 28, 2017.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 12 - COMMITMENTS AND CONTINGENCIES (Continued)

The Asheville office lease commenced on August 1, 2010, includes a ten-year term and a renewal option to extend the term of the lease for two separate and successive five-year periods. The lease is in an agreement with a board member (related party) of the Bank. The Hendersonville office lease commenced on October 1, 2011, includes a five-year term and a renewal option to extend the term of the lease for one separate and successive five-year period. The Charlotte office lease commenced on January 1, 2015 for a four-year term.

In addition, the Bank is in its final one-year renewal option period for its Seneca branch, which will expire May 20, 2017, and its second one-year renewal option for its Anderson branch, which will expire September 7, 2017.

As part of the merger with Pinnacle, the Bank acquired leases for the Greenville and Easley branches. The Greenville lease had an original term of five years and was amended and extended during 2009 for a ten-year term. The Easley lease commenced in January 2015, has a ten-year term and includes a renewal option to extend the term of the lease for two separate and successive five-year periods.

Minimum future rentals under these leases are as follows:

2017	\$ 689,684
2018	685,333
2019	642,065
2020	507,325
2021	99,920
2022 and beyond	<u>227,247</u>
Total	<u>\$ 2,851,574</u>

The Bank has a contract for data processing services with a remaining term of 66 months at December 31, 2016 which had an average monthly payment of approximately \$106,000 in the year ended December 31, 2016.

The Bank has entered into employment agreements with certain senior officers. These agreements include provisions regarding term, compensation, benefits, incentive programs, stock option plans, severance, and non-compete provisions. The agreements have terms ranging from two to three years and annually are extended automatically for successive one-year terms, provided that the Bank or officer may at any time give notice that the term is to be fixed at the term remaining at the last extension. The agreements also may be terminated if the officer's employment is terminated under various provisions of the agreements.

Management is not aware of any legal proceedings which would have a material adverse effect on the financial position or operating results of the Bank.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 13 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

In the ordinary course of business, and to meet the financing needs of its customers, the Bank is a party to various financial instruments with off-balance sheet risk. These financial instruments, which include commitments to extend credit and standby letters of credit, involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheet. The contract amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments.

The Bank's exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amounts of those instruments. The same credit policies used for on-balance sheet instruments are used in making commitments and conditional obligations.

The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the borrower. Collateral varies but may include accounts receivable, inventory, property, plant and equipment, and commercial and residential real estate. Since many of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any material condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require the payment of a fee. At December 31, 2016, the Bank's commitments to extend additional credit totaled approximately \$132.6 million, the majority of which are at variable rates of interest with varying maturities. Included in the Bank's total commitments are standby letters of credit. Letters of credit are commitments issued by the Bank to guarantee the performance of a customer to a third party and totaled approximately \$3.0 million at December 31, 2016.

The derivative financial instruments discussed in Note 11 expose the Bank to credit risk. Credit risk is the risk of failure by the counterparty to perform under the terms of a derivative contract. When the fair value of a derivative contract is positive, the counterparty owes the Bank, which creates credit risk for the Bank. When the fair value of a derivative is negative, the Bank owes the counterparty and, therefore, it does not possess credit risk. The credit risk in derivative instruments is mitigated by a highly-rated counterparty that management believes to be creditworthy. As the swaps are subject to master netting agreements, the Bank had limited exposure relating to interest rate swaps with its institutional counterparty at December 31, 2016.

NOTE 14 - PREFERRED STOCK

On August 23, 2011, the Bank completed the sale of \$5 million of Series A preferred stock to the Secretary of the Treasury under the Small Business Lending Fund ("SBLF"). The fund was established under the Small Business Jobs Act of 2010 that was created to encourage lending to small businesses by providing capital to qualified community banks with assets less than \$10 billion.

Under the terms of the stock purchase agreement, the Treasury received 5,000 shares of \$1.00 par value, non-cumulative perpetual preferred stock with a liquidation value of \$1,000 per share in exchange for \$5 million.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 14 - PREFERRED STOCK (Continued)

The Series A preferred stock qualified as Tier 1 capital. Beginning with the initial dividend period, which ended September 30, 2011, and for each dividend period since, the Bank's dividend rate was one percent (1%). The Bank paid dividends of \$50,000 for the year ended December 31, 2015 and \$7,085 for the period from January 1, 2016 to February 23, 2016.

On February 23, 2016, with regulatory approval, the Bank redeemed all of the 5,000 shares of its Series A preferred stock. The aggregate redemption price of the Series A preferred stock was approximately \$5.0 million, including accrued but unpaid dividends. The preferred stock was redeemed from the Bank's existing funds. Following the redemption, the Bank does not have any shares of its Series A preferred stock outstanding. As a result, the redemption terminated the Bank's participation in the SBLF program.

NOTE 15 - DIVIDENDS

On January 11, 2016, the Bank's board of directors approved a five percent stock dividend to the Bank's shareholders. The record date was January 26, 2016, and the distribution date was February 10, 2016. Earnings per share and average shares outstanding have been retroactively adjusted to reflect the stock dividend in our Consolidated Statements of Income and certain other share and per share disclosures.

Currently, the Bank has no plans to initiate payment of cash dividends on its common shares. It is anticipated that any future dividends paid by the Bank to common shareholders would be dependent on earnings, capital requirements, and financial condition.

NOTE 16 - STOCK COMPENSATION

Stock Dividend - All share and per share amounts in this note have been adjusted for the 5% stock dividend in 2016.

Stock Option Plans - The Bank has three stock option plans (the "Plans") for the benefit of the Bank's officers, employees, and directors. Under terms of the Plans, the Board may grant options to purchase common stock ("options") of the Bank aggregating up to 21% of outstanding shares, which amounted to 1,372,315 and 1,368,695 at December 31, 2016 and 2015, respectively.

Options issued under the Plans have an exercise price equal to the stock's fair market value (based on the most recent stock trades) on the grant date. The life of options granted cannot exceed 10 years.

In connection with the Forest Commercial merger, the Bank assumed a total of 298,349 options outstanding under the Forest Commercial Bank 2008 Incentive Stock Option Plan and the Forest Commercial Bank 2008 Nonstatutory Stock Option Plan (the "FCB Plans"). Total options available for grant under the FCB Plans were frozen at the amount of options outstanding as of the merger date and the availability of options under the Carolina Alliance plan was reduced by the amount of option availability under these plans, such that options available for grant under the three plans combined totaled 1,005,626 shares. All options outstanding under the FCB Plans were fully vested when assumed by the Bank and had a weighted average remaining life of 3.5 years. All had an exercise price of \$10.51 and a negligible fair value.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 16 - STOCK COMPENSATION (Continued)

Equity Incentive Plan - On February 23, 2017 the Bank's Board of Directors approved the adoption of the Carolina Alliance Bank 2017 Equity Incentive Plan (the "Equity Plan"), which will be submitted to the Bank's shareholders for approval at the annual meeting of shareholders to be held on May 15, 2017. The Equity Plan is a compensation plan that will provide the Bank with the ability to grant several forms of equity, including stock options, restricted stock, restricted stock units, and stock with no restrictions, to its officers, employees, directors, advisors (including members of an advisory board), and consultants to reward performance, attract highly qualified personnel, and provide incentives to such individuals to increase shareholder value.

Upon shareholder approval of the Equity Plan, the current Plans will be frozen and no further grants will be made. The Equity Plan permits the Bank to issue up to 600,000 shares through equity awards. Based on scheduled grant expirations in the current Plans on May 21, 2017 and the Bank's approximately 6.5 million outstanding shares, the maximum shares that will be issuable under the Equity Plan, in combination with the remaining outstanding stock options under the current Plans, is projected to represent approximately 17% of the Bank's outstanding shares. The following is a summary of activity in the Plans for the years ended December 31, 2016 and 2015:

	2016			2015		
	Shares	Weighted Average Exercise Price	Weighted Average Fair Value	Shares	Weighted Average Exercise Price	Weighted Average Fair Value
Outstanding, beginning of year	789,693	\$ 9.44	\$ 2.21	786,337	\$ 9.43	\$ 2.16
Granted	11,000	9.76	3.89	12,600	10.55	4.43
Exercised	(3,108)	8.01	2.84	(1,050)	8.01	2.84
Forfeited	(14,741)	8.08	2.76	(8,194)	10.51	-
Outstanding, end of year	782,844	9.48	2.22	789,693	9.44	2.21
Options exercisable	750,214	9.48	2.15	749,835	9.47	2.15
Non-vested options, end of year	32,630	9.41	3.76	39,858	8.85	3.43
Options vesting during year	10,831	8.65	3.36	47,817	8.28	3.30
Shares available for grant	589,471			579,002		

All options outstanding have a 10-year life and all non-vested options have a five-year vesting period. Stock options outstanding and vested at December 31, 2016 have an average remaining life of 1.5 years. Exercise prices per share of outstanding stock options range from \$7.95 to \$14.29. At December 31, 2016, 744,439 options had an intrinsic value of approximately \$2,054,000. At December 31, 2015, 454,598 options had an intrinsic value of approximately \$757,000.

The Bank utilizes the Black-Scholes valuation model to determine the compensation recognized under the fair value method described in Note 1. This fair value is then amortized on a straight-line basis over the vesting period of the option.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 16 - STOCK COMPENSATION (Continued)

The following assumptions were utilized in the application of the Black-Scholes model for the years ended December 31, 2016 and 2015:

Weighted Average Risk-Free Interest Rate - The risk-free interest rate used to value option grants is based on the U.S. Treasury yield curve on the date of grant.

Expected Volatility - Expectations for volatility are based on the historical volatility of the Company's common stock at the date of grant.

Dividend Yield - Due to dividend restrictions early in the life of the Bank and the anticipated need for capital to fund growth, management assumes that no dividends will be paid over the expected life of options granted.

Expected Life - The expected life is assumed to be 75% of the contractual life of the option. This is based on a review of average life assumptions used by seasoned community banks that base their average life assumptions on actual historical exercise statistics.

The following table summarizes the weighted average assumptions used by the Black-Scholes option-pricing model stock and other information concerning stock option awards granted by the Bank as of and for the years ended December 31, 2016 and 2015.

	2016	2015
Weighted average risk-free interest rate	1.51%	1.88%
Expected volatility	35%	36%
Expected life (years)	7.5 years	7.5 years
Dividend yield	None	None
Compensation charged against pretax income	\$ 30,396	\$ 48,342
Approximate future compensation of options outstanding	\$ 106,804	\$ 116,168
Weighted average years remaining to recognize future compensation	3.5 years	3.3 years

Director Compensation Program - The Bank has compensation plans for its 15 independent directors and 19 advisory board members which represent its different markets. Monthly fees earned by the directors are determined based on a combination of fixed amounts for board and committee membership, and variable amounts based on the number of meetings attended. The advisory board members earn quarterly fees that are based on meeting attendance. Total director fee expense was approximately \$159,000 and \$179,000 in the years ended December 31, 2016 and 2015, respectively. Total advisory board member fee expense was approximately \$31,000 and \$71,000 in the years ended December 31, 2016 and 2015, respectively.

Directors and advisory board members may elect payment of fees in the form of cash or in Bank stock. Fees earned and payable in cash are paid quarterly, and fees payable in Bank stock are accrued monthly based on the market price of the stock on the last day of each respective month. The accrued compensation is settled from authorized but unissued shares semi-annually. Stock-settled fees earned, paid, and payable as of and for the years ended December 31, 2016 and 2015 are shown in the following table (2015 share amounts have been adjusted to reflect the stock dividend issued in February 2016).

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 16 - STOCK COMPENSATION (Continued)

	Advisory Directors		Directors		Combined	
	Shares	Market Value	Shares	Market Value	Shares	Market Value
December 31, 2016:						
Due at beginning of year	1,343	\$ 12,530	5,083	\$ 47,428	6,426	\$ 59,958
Fees earned	2,184	22,971	12,346	134,091	14,530	157,062
Shares issued	<u>(2,816)</u>	<u>(26,965)</u>	<u>(11,473)</u>	<u>(110,032)</u>	<u>(14,289)</u>	<u>(136,997)</u>
Due at end of year	<u>711</u>	<u>\$ 8,536</u>	<u>5,956</u>	<u>\$ 71,487</u>	<u>6,667</u>	<u>\$ 80,023</u>
December 31, 2015:						
Due at beginning of year	2,175	\$ 23,609	5,570	\$ 60,476	7,745	\$ 84,085
Fees earned	1,241	12,553	9,476	102,637	10,717	115,190
Shares issued	<u>(2,073)</u>	<u>(23,632)</u>	<u>(9,963)</u>	<u>(115,685)</u>	<u>(12,036)</u>	<u>(139,317)</u>
Due at end of year	<u>1,343</u>	<u>\$ 12,530</u>	<u>5,083</u>	<u>\$ 47,428</u>	<u>6,426</u>	<u>\$ 59,958</u>

NOTE 17 - REGULATORY MATTERS

The Bank is subject to various regulatory capital requirements administered by the federal banking regulatory agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements.

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

Effective January 1, 2015, the Bank is subject to the new regulatory risk-based capital rules adopted by the federal banking agencies implementing Basel III. Under the new capital guidelines, the Bank's regulatory capital components consist of (1) common equity Tier 1 capital (common stock, including related surplus, and retained earnings, net of goodwill and other intangibles, deferred tax assets arising from net operating loss and tax credit carry-forwards above certain levels, and accumulated other comprehensive income items), (2) additional Tier 1 capital (qualifying non-cumulative perpetual preferred stock, including related surplus), and (3) Tier 2 capital (the allowance for loan and lease losses in an amount not exceeding 1.25% of standardized risk-based assets). Total Tier 1 capital plus Tier 2 capital constitutes total risk-based capital.

The new capital guidelines also provide that all covered banking organizations must maintain a new capital conservation buffer of common equity Tier 1 capital in an amount of greater than 2.5% of total risk-weighted assets to avoid being subject to limitations on capital distributions and discretionary bonus payments to executive officers. The capital conservation buffer requirement was phased in beginning January 1, 2016 at the 0.625% level and will be increased by that same amount on each subsequent January 1 until it reaches 2.5% on January 1, 2019. When fully phased in, the capital conservation buffer effectively will result in a required minimum common equity Tier 1 capital ratio of at least 7%, Tier 1 capital ratio of at least 8.5%, and total capital ratio of at least 10.5%.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 17 - REGULATORY MATTERS (Continued)

The final regulatory capital rules also incorporate these changes in regulatory capital into the prompt corrective action framework, under which the thresholds for “adequately capitalized” banking organizations are equal to the new minimum capital requirements described above. Under this framework, in order to be considered “well capitalized,” insured depository institutions must maintain the minimum capital ratios as presented as of December 31, 2016 in the regulatory capital table below.

At December 31, 2016 and 2015, the Bank was “well capitalized.” As permitted for regulated institutions that do not qualify as “advanced approach” banking organizations (those with assets greater than \$250 billion or with foreign exposures greater than \$10 billion), the Bank made a one-time, permanent election to opt out of the requirement to include most components of accumulated other comprehensive income in regulatory capital.

The following table summarizes actual and required capital levels at December 31, 2016.

	<u>Actual</u>		<u>Basel III Minimum Phase-in Requirement</u>		<u>Well Capitalized Requirement</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
	(Amounts in \$000)					
As of December 31, 2016:						
Total capital (To risk weighted assets)	\$ 71,525	12.6%	\$ 48,903	8.6%	\$ 56,699	10.0%
Tier 1 capital (To risk weighted assets)	66,545	11.7	37,563	6.6	45,359	8.0
Common equity Tier 1 (To risk weighted assets)	66,545	11.7	29,058	5.1	36,854	6.5
Tier 1 capital (To average assets)	66,545	10.6	25,144	4.0	31,429	5.0

The following table summarizes actual and required capital levels at December 31, 2015.

	<u>Actual</u>		<u>For Capital Adequacy Purposes Minimum</u>		<u>Well Capitalized Minimum</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
	(Amounts in \$000)					
As of December 31, 2015:						
Total capital (To risk weighted assets)	\$ 71,733	13.7%	\$ 41,883	8.0%	\$ 52,354	10.0%
Tier 1 capital (To risk weighted assets)	67,029	12.8	31,412	6.0	41,883	8.0
Common equity Tier 1 (To risk weighted assets)	62,054	11.9	23,559	4.5	34,030	6.5
Tier 1 capital (To average assets)	67,029	11.2	23,955	4.0	29,944	5.0

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 18 - RELATED PARTY TRANSACTIONS

Certain directors, executive officers and companies with which they are affiliated (collectively referred to as “insiders”) are customers of and have banking transactions with the Bank in the ordinary course of business. Loans to insiders are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable arms-length transactions. At December 31, 2016 and 2015, respectively, loans to insiders approximated \$6.8 million and \$8.7 million, and deposits from insiders approximated \$9.2 million and \$11.3 million. For both years ended December 31, 2016 and 2015, rents totaling \$270,077 were paid to a related party for the lease of the Bank’s Asheville branch office.

NOTE 19 - EMPLOYEE BENEFIT PLANS

The Bank has a 401(k) plan which covers all eligible employees. For the years ended December 31, 2016 and December 31, 2015, participants could contribute up to \$18,000 per year, and the Bank matched contributions equal to 100% of employee contributions up to four percent (4%) plus 50% of employee contributions up to the next two percent (2%) of eligible compensation. Contributions to the plan were approximately \$402,209 and \$311,000 in the years ended December 31, 2016 and 2015, respectively.

NOTE 20 - FAIR VALUE OF FINANCIAL INSTRUMENTS

Financial instruments include cash and due from banks, federal funds sold, investment securities, other investments, loans, deposit accounts, other borrowings, and accrued interest. The following methods and assumptions were used by the Bank in estimating fair values of financial instruments recorded or disclosed in the financial statements:

Cash and Due from Banks - For these short-term instruments, the carrying amounts approximate their fair values.

Federal Funds Sold and Interest Bearing Bank Balances - The carrying amounts of federal funds sold and interest bearing bank balances approximate their fair value due to their short maturities (daily).

Bank Term Deposits - Fair values for fixed-rate certificates of deposit are estimated utilizing a discounted cash flow calculation that applies current market interest rates of certificates of deposits with similar remaining maturities to the portfolio of certificates of deposits.

Investment Securities - Fair value for investment securities equals quoted market price if such information is available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities. The Bank utilizes a third party pricing service to provide valuations on its securities portfolio. Most of these securities are U.S. government agency debt obligations or agency mortgage-backed securities traded in active markets. The third party valuations are determined based on the characteristics of each security (such as maturity, duration, rating, etc.) and in reference to similar or comparable securities. Due to the nature and methodology of these valuations, the Bank considers these fair value measurements as Level 2.

Other Investments - No ready market exists for the FHLB stock, and it has no quoted market value. However, redemption of the stock historically has been at par value; therefore, it is stated at the Bank’s cost basis.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 20 - FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Loans Held for Sale - Due to their short term nature, the carrying amount of loans held for sale approximates fair value.

Loans and Finance Leases - For variable rate loans that reprice based on each change in a reference rate (e.g. prime rate), fair values are based on carrying values. Fair values for all other loans and leases are estimated using discounted cash flow analyses, with interest rates currently being offered for loans and leases with similar terms to borrowers of similar credit quality. Fair values for impaired loans are estimated using discounted cash flow analyses or the net estimated realizable fair value of underlying collateral values, where applicable.

Accrued Interest Receivable and Payable - The carrying amounts for these items approximate their fair values due to the short period to settlement (three months or less).

Deposits - The fair values disclosed for demand deposits are, by definition, equal to their carrying amounts. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated monthly maturities.

Securities Sold under Agreements to Repurchase - The carrying value of these retail repurchase agreements approximates fair value since these obligations mature daily.

Advances from FHLB of Atlanta - The valuation methodology utilizes a discounted cash flow calculation that applies current offered interest rates for fixed rate advances with similar remaining maturities.

Derivative Instruments - Derivative instruments, including interest rate swaps and swap fair value hedges, are recorded at fair value on a recurring basis as determined by the third party provider.

Off-Balance Sheet Instruments - Fair values of off-balance sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The total fair value of such instruments is not material.

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Bank's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Bank's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and, therefore, cannot be determined with precision. Changes in assumptions could affect these estimates significantly.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 20 - FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The estimated fair values of the Bank's financial instruments were as follows at December 31, 2016 and 2015:

	2016		2015	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets:				
Cash and due from banks	\$ 13,100,026	\$ 13,100,026	\$ 13,691,043	\$ 13,691,043
Federal funds sold and interest bearing bank balances	3,642,070	3,642,070	1,370,951	1,370,951
Bank term deposits	2,252,000	2,250,727	3,482,995	3,476,277
Investment securities, available for sale	97,976,406	97,976,406	90,475,629	90,475,629
Other investments	1,461,600	1,461,600	1,730,900	1,730,900
Loans held for sale	2,093,952	2,093,952	632,828	632,828
Loans and finance leases, net	488,136,402	490,681,000	468,606,158	471,485,000
Bank-owned life insurance	11,358,608	11,358,608	3,645,463	3,645,463
Accrued interest receivable	1,567,568	1,567,568	1,559,163	1,559,163
Interest rate derivatives	711,778	711,778	136,427	136,427
Financial Liabilities:				
Deposits	\$527,599,212	\$503,320,000	\$495,822,876	\$480,288,000
Securities sold under agreements to repurchase	16,711,164	16,711,164	7,648,088	7,648,088
Advances from FHLB of Atlanta	21,500,000	21,553,000	28,600,000	28,659,000
Federal funds purchased	3,180,000	3,180,000	28,600,000	28,659,000
Accrued interest payable	115,025	115,025	99,399	99,399
Interest rate derivatives	711,778	711,778	136,427	136,427

The Bank reports fair value on a recurring basis for certain financial instruments, most notably available for sale investment securities. The following table presents the balances of assets and liabilities measured at fair value on a recurring basis:

	Total	Level 1	Level 2	Level 3
December 31, 2016:				
Financial Assets:				
Investment securities, available for sale:				
U.S. government agency and sponsored enterprises	\$ 12,563,898	\$ -	\$ 12,563,898	\$ -
Agency mortgage-backed securities	35,524,974	-	35,524,974	-
Agency collateralized mortgage obligations	20,472,568	-	20,472,568	-
Municipal securities	29,414,966	-	29,414,966	-
Interest rate derivatives	711,778	-	711,778	-
Total	<u>\$ 98,688,184</u>	<u>\$ -</u>	<u>\$ 98,688,184</u>	<u>\$ -</u>
Financial Liabilities:				
Interest rate derivatives	<u>\$ 711,778</u>	<u>\$ -</u>	<u>\$ 711,778</u>	<u>\$ -</u>

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 20 - FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
December 31, 2015:				
Financial Assets:				
Investment securities, available for sale:				
U.S. government agency and sponsored enterprises	\$ 13,616,430	\$ -	\$ 13,616,430	\$ -
Agency mortgage-backed securities	34,105,489	-	34,105,489	-
Agency collateralized mortgage obligations	19,327,695	-	19,327,695	-
Municipal securities	23,426,015	-	23,426,015	-
Interest rate derivatives	<u>136,427</u>	<u>-</u>	<u>136,427</u>	<u>-</u>
Total	<u>\$ 90,612,056</u>	<u>\$ -</u>	<u>\$ 90,612,056</u>	<u>\$ -</u>
Financial Liabilities:				
Interest rate derivatives	<u>\$ 136,427</u>	<u>\$ -</u>	<u>\$ 136,427</u>	<u>\$ -</u>

The Bank may be required, from time to time, to measure certain assets at fair value on a non-recurring basis. These include assets that are measured at the lower of cost or market that were recognized at fair value which was below cost at the end of the period. Assets subject to non-recurring use of fair value measurements include impaired loans, PCI loans, and foreclosed assets. Due to the use of both observable and unobservable inputs and the significant amount of judgment required in the determination of fair values, both of these categories of assets are considered to be valued under Level 3 inputs.

The fair value of impaired and PCI loans is determined based upon the present value of expected cash flows discounted at the loan's effective interest rate or the estimated net realizable fair value of the collateral if the loan is collateral-dependent. The fair value of collateral is determined by obtaining an observable market price or obtaining an appraised value from an independent licensed or certified appraiser, using observable market data.

This data includes information such as selling price of similar properties and capitalization rates of similar properties sold within the market, adjusted for differences in the properties, expected future cash flows, or earnings of the subject property based on current market expectations and other relevant factors. In addition, management may apply selling and other discounts to the underlying collateral value to determine the fair value.

Other real estate owned is valued by use of appraisals and management's judgment as described for valuation of collateral underlying collateral-dependent impaired loans.

CAROLINA ALLIANCE BANK AND SUBSIDIARY

Notes to the Consolidated Financial Statements

NOTE 20 - FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

The following tables present the fair value measurement of assets measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fall at December 31, 2016 and 2015:

	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
December 31, 2016:				
Impaired loans	\$ 4,350,051	\$ -	\$ -	\$ 4,350,051
Purchased credit-impaired loans	3,275,884	-	-	3,275,884
Other real estate owned	127,595	-	-	127,595
Total	<u>\$ 7,753,530</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 7,753,530</u>
December 31, 2015:				
Impaired loans	\$ 3,447,873	\$ -	\$ -	\$ 3,447,873
Purchased credit-impaired loans	5,472,226	-	-	5,472,226
Other real estate owned	1,465,690	-	-	1,465,690
Total	<u>\$10,385,789</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$10,385,789</u>

For Level 3 assets and liabilities measured at fair value on a non-recurring basis as of December 31, 2016, the significant unobservable inputs used in the fair value measurements were as follows:

	<u>Fair Value</u>	<u>Valuation Technique</u>	<u>Significant Unobservable Inputs</u>	<u>Discount Range</u>
Impaired loans	\$ 4,350,051	Appraised Value, Discounted Cash Flows and Market Value of the Underlying Collateral	Discount Factors Applied to Valuations for: Shorter Marketing Period (Liquidation Approach), Sales Commissions, and Selling Costs	0% - 14%
Purchased credit-impaired loans	3,275,884	Discounted Expected Cash Flows and Market Value of the Underlying Collateral	Estimates of Probability and Timing of Default and Payment Patterns	0% - 60%
Other real estate owned	127,595	Appraised Value and Estimates from Independent Sources	Discount Factors Applied to Valuations for: Shorter Marketing Period (Liquidation Approach), Sales Commissions, and Selling Costs	0% - 14%
Total	<u>\$ 7,753,530</u>			



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John Kimberly, *President and Chief Executive Officer*
Lamar Simpson, *Chief Financial Officer and Chief Operating Officer*
David Barnett, *Executive Vice President, SC Western Region President*
Jack Buice, *Executive Vice President, Commercial Banking Officer*
Tim Camp, *Executive Vice President, Commercial Banking Executive*
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Tracy Woodruff, *Vice President, Branch Manager*
Dave McBride, *Leasing Executive*
Charles M. Shepherd, *Leasing Executive*

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John Kimberly, *President*
Lamar Simpson, *Chief Financial Officer*

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Caleb C. Fort
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Easley
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The common stock of Carolina Alliance Bank is traded over the counter through
OTC Markets Group, Inc. (OTCQX: CRLN)

