



# **COMMUNITY National Bank**

Where You Belong!

2009 Annual Report



April 30, 2010

To Our Shareholders:

No one could argue that 2009 was one of the most challenging years in the history of the banking industry, and certainly in the brief history of Community National Bank of the Lakeway Area. We stated in last year's annual report that we thought we were well positioned for the recession. Little did we know that events in 2009 would test that statement, but they did just that. The much publicized recession, which started in 2008, has had an effect on most, if not all, of us. It has affected both small and large businesses, families and individuals across our land and around the world. The high unemployment rate, currently at 12% locally, down from a peak in the 15% range, has taken a toll on everyone. Lower collateral values and increased loan losses are standards across the banking industry, and we have not been immune to these events. The good news is that we were and are still well positioned, and are seeing signs that the worst of the storm has passed and brighter days are on the horizon. Despite this awful year, your bank still has a Tier 1 Capital Ratio of 9% and a Total Capital Ratio of 16%. The best thing we can say about the past year is goodbye and good riddance—and look forward to a brighter future.

The Bank reported a loss of \$(2.38) million or \$(1.26) per share for the twelve months ended December 31, 2009. This compares to a loss of \$(1.66) million or \$(0.88) per share for the twelve months ended December 31, 2008. The loss for 2009 was attributable to a large provision for loan losses of \$1.1 million, the write down of several foreclosed properties of \$397 thousand and a \$1.3 million impairment charge related to the Bank's equity investment in Silverton Financial Services, Inc. (Silverton Bank), which was placed in receivership on May 1, 2009. We do not have any equity investments in other correspondent banks. You can read the expanded results for 2009 in the pages that follow.

The banking industry as a whole is in a state of flux. New financial regulations seem to fall from Washington, D.C. like rain. Some of the new regulations are needed, but the sins of Wall Street are resulting in crippling regulations for Main Street as well as for smaller community banks, like us, that have never engaged in subprime lending, collateralized debt obligations, or the other actions of Wall Street. So far, Congress has realized that Main Street did not cause the problem, and should not be included in the punishment. However, we expect a much higher regulatory burden for community banks, and the management team is hard at work making the necessary adjustments to survive in the new environment in which we find ourselves.

Some of the steps your team have taken, are in the process of taking, or are considering are:

- Reducing personnel, mostly by attrition
- Frozen all salaries until the Bank is profitable again
- Suspended company contributions to our 401(k)
- Suspended all board of director and director committee fees (none paid in 2009)
- Reviewing all vendor contracts, renegotiating where possible and changing vendors in other cases
- Outsourcing tasks when appropriate
- Reviewing pricing of all products and services and adjusting upward where possible
- Studying ways to earn more fee income
- Asking stockholders to approve a "going private" transaction which will reduce future regulatory burdens and cut legal, accounting, and auditing costs

These items, and others still on the drawing board, will either enhance our revenues or reduce our overhead. **The first quarter of 2010 was slightly profitable, which is evidence our strategies are beginning to work.** All banks will need to be leaner to survive the future, and your bank is no exception. The management team pledges to make that happen. We welcome a visit from you any time. Hopefully, all of you will bring more business to us and help us make the turn to profitability. We thank you for your loyal support!

Sincerely,

A handwritten signature in black ink that reads "Sam F. Grigsby, Jr." in a cursive style.

Sam F. Grigsby, Jr.  
Chairman & CEO

A handwritten signature in black ink that reads "Charles A. Hughes" in a cursive style.

Charles A. Hughes  
President

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

*The following presents management's discussion and analysis of our financial condition and results of operations. You should read this discussion in conjunction with our financial statements and related notes that are included elsewhere in this Annual Report. This discussion contains forward-looking statements that involve risks and uncertainties. Our actual results could differ significantly from those described in the forward-looking statements as a result of various factors, including those discussed under the caption "Risk Factors" continued in our Annual Report on Form 10-K and "Special Note Regarding Forward-Looking Statements" in this Annual Report. This discussion is intended to assist in understanding our financial condition and results of operations. The data presented for the periods ended December 31, 2009 and 2008 are derived from our audited financial statements and include, in the opinion of management, all adjustments necessary to present fairly the data for such periods.*

### **Forward-Looking Statements**

This Annual Report contains statements that constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements are based on many assumptions and estimates and are not guarantees of future performance. Our actual results may differ materially from those projected in any forward-looking statements, as they will depend on many factors about which we are unsure, including many factors which are beyond our control. The words "may," "would," "will," "expect," "anticipate," "believe," "intend," "plan," and "estimate," as well as similar expressions, are meant to identify such forward-looking statements. Potential risks and uncertainties include, but are not limited to:

- Significant increases in competitive pressure in the banking and financial services industries;
- Changes in the interest rate environment that could reduce anticipated or actual margins;
- Changes in political conditions or the legislative or regulatory environment;
- General economic conditions, either nationally or regionally and especially in our primary service area, becoming less favorable than expected resulting in, among other things, a deterioration in credit quality;
- Changes occurring in business conditions and inflation;
- Changes in technology;
- Changes in monetary and tax policies;
- The level of allowance for loan loss;
- The rate of delinquencies and amounts of charge-offs;
- The rates of loan growth;
- Adverse changes in asset quality and resulting credit risk-related losses and expenses;
- Changes in the securities markets; and
- Other risks and uncertainties detailed from time to time in our filings with the Office of the Comptroller of the Currency.

## Critical Accounting Policies and Estimates

The accounting and reporting policies of the Bank are in accordance with accounting principles generally accepted in the United States of America and conform to general practices within the banking industry. Our significant accounting policies are discussed in detail in Note 1 in the “Notes to Financial Statements.” Critical accounting policies include the initial adoption of an accounting policy that has a material impact on the financial presentation and accounting estimates reflected in the financial statements that require the Bank to make assumptions about matters that were highly uncertain at the time of estimation. Disclosure about critical estimates is required if different estimates that the Bank reasonably could have used in the current period would have a material impact on the presentation of the Bank’s financial condition, changes in financial condition or results of operations.

The Bank’s calculation related to the allowance for loan losses represents a critical accounting estimate. The allowance for loan losses is established and maintained at levels management deems adequate to cover probable losses inherent in the portfolio as of the balance sheet date. The level is based on past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower’s ability to repay, underlying estimated values of collateral securing loans, current economic conditions, regulatory requirements and other factors. Should any of these factors change, the estimate of credit losses in the loan portfolio and the related allowance would also change. For further discussion regarding our methodology for the allowance for loan and lease losses, see the “Allowance and Provisions for Loan Losses” section of this management’s discussion and analysis.

## Results of Operations for the Years Ended December 31, 2009 and 2008

**Overview.** The Bank reported a loss of \$(2.38) million or \$(1.26) per share for the year ended December 31, 2009. This compares to a loss of \$(1.66) million or \$(0.88) per share for the year ended December 31, 2008. The loss for 2009 was attributable to a large provision for loan losses during the year of \$1.1 million; and the write down of other real estate owned by the Bank of \$397 thousand. In addition to the large loan loss provision and the write down of foreclosed properties incurred during the second quarter, the Bank incurred a loss of \$1.3 million due to the impairment charge related to the Bank’s equity investment in Silverton Financial Services, Inc. (Silverton Bank), which was placed into receivership on May 1, 2009, and losses associated with trust preferred securities issued by Silverton Bank classified as available for sale securities by the Bank. The Bank does not have any equity investments in other correspondent banks.

**Net Interest Income.** For the years ended December 31, 2009 and December 31, 2008, net interest income totaled \$3.7 million (including loan fees). The largest component of interest income is interest income from loans, including loan fees, which totaled \$5.3 million, representing a yield of 6.66% for 2009, and \$5.4 million, representing a yield of 6.96% for 2008. Interest expense for the year ended December 31, 2009 totaled \$2.6 million. For the year ended December 31, 2008 interest expense totaled \$2.9 million. The net interest margin realized on earning assets and the interest rate spread were 3.35% and 3.05% respectively, for the year ended December 31, 2009 as compared to 3.48% and 2.88%, respectively, for the year ended December 31, 2008. Net interest income declined approximately \$46 thousand during 2009.

While the net change in interest income for the year was minimal, there were several fluctuations in the individual components making up net interest income. Interest income on loans was down for the year approximately \$92 thousand primarily because of declining demand. Interest received on investment securities also declined \$263 thousand from \$1.2 million for the year ended December 31, 2008 to \$916 thousand for the year ended December 31, 2009. The decline in investment interest is rate driven as the Bank has had excess liquidity and chose to invest primarily in short-term agency securities. The actual balance in investment securities available for sale was up significantly for the year. The third component of interest income was interest on Federal Funds Sold. Again, balances were up for 2009 versus 2008, but income was down \$70 thousand, from \$124 thousand in 2008 to \$54 thousand in 2009. During the year ended December 31, 2009, daily overnight rates have averaged around 0.25%.

Like interest income, the components of interest expense also had several fluctuations from 2008 to 2009. Deposit interest declined from \$2.4 million for the year ended December 31, 2008 to \$2.2 million for the same period in 2009. Deposit balances increased during the year; however, overall rates declined significantly. Time deposit yields declined from 4.07% for the year ended December 31, 2008 to 3.16% for the year ended December 31, 2009. Likewise, savings and money market deposits declined from 2.10% to 1.25%, FHLB Advances from 4.07% to 3.57% and other deposits from 1.84% to 0.25% for the same period. The yield on interest-bearing demand accounts increased from 0.43% for the year ended December 31, 2008 to 2.68% for the year ended December 31, 2009. This was a result of the introduction of a new Community Rewards Checking product during the year.

***Provision for Loan Losses.*** The provision for loan losses is the charge to operating earnings that management estimates is necessary to maintain the allowance for loan losses at an adequate level. The provision charged to expense was \$1.1 million for the year ended December 31, 2009 as compared to \$1.9 million for the year ended December 31, 2008. The provision is a result of management's efforts to increase the allowance to match the risk in the loan portfolio. The provision for 2009 was primarily due to increased charge offs of several purchased participations, which the Bank had partially prepared for with a large loss provision in 2008. Due to the uncertain economic environment, management increased the amount of allowance on classified credits in an effort to adequately reserve for potential/existing problem credits. The allowance for loan losses was 1.86% of gross loans at December 31, 2009 as compared to 3.01% at December 31, 2008.

There are risks inherent in making all loans, 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, in the case of a collateralized loan, risks resulting from uncertainties about the future value of the collateral. We anticipate maintaining an allowance for loan losses based on, among other things, historical experience, an evaluation of economic conditions, and regular reviews of delinquencies and loan portfolio quality. Our judgment about the adequacy of the allowance is based upon a number of assumptions about future events, which we believe to be reasonable, but which may not prove to be accurate. Thus, there is a risk that charge-offs in future periods could exceed the allowance for loan losses or that substantial additional increases in the allowance for loan losses could be required. Additions to the allowance for loan losses resulted in a decrease in our net income and our capital. The Bank had net charge-offs for 2009 of \$2.2 million as compared to \$125.0 thousand for 2008. Of the \$2.2 million charged off, \$1.9 million related to purchased participation loans while \$277 thousand related to Bank originated loans. There were no loans over ninety days past due and still accruing interest at December 31, 2009. The Bank had one loan totaling \$174 thousand ninety days or more past due and still accruing interest at December 31, 2008. The Bank also had foreclosed real estate at December 31, 2009 with a carrying value of \$1.8 million compared to \$322 thousand at December 31, 2008.

***Noninterest Income.*** The Bank's noninterest income is composed of several components, some of which may vary significantly between quarterly and annual periods. Service charges on deposit accounts and other noninterest income generally will reflect the growth of the Bank while other areas, such as secondary market loan origination fees, will depend on market conditions.

The following is the makeup of our noninterest income for the years ended December 31, 2009 and 2008:

	<b>Years Ended December 31,</b>		<b>2009-2008 Percent Increase (Decrease)</b>
	<b>2009</b>	<b>2008</b>	
<b>Noninterest income:</b>	(Dollars in thousands)		
Service charges on deposit accounts	\$ 344	\$ 300	14.7%
Commissions on loans originated for others	30	35	(14.3)%
Net gain on sales of securities available for sale and equity investments	0	52	(100.0)%
Other noninterest income:			
Merchant credit card fees	1	3	(66.7)%
Credit insurance fees	6	10	(40.0)%
Network interchange fees	94	63	49.2%
Safe deposit box rental fees	7	7	0.0%
Rental income	9	8	12.5%
Other noninterest income	20	17	17.6%
Total noninterest income	<u>\$ 511</u>	<u>\$ 495</u>	<u>3.2%</u>

Noninterest income increased \$16 thousand, or 3.2% for the year ended December 31, 2009 compared to \$92 thousand, or 22.8% for the year ended December 31, 2008. The increase was primarily attributable to increases in service charges on deposit accounts which increased \$44 thousand or 14.7% over 2008. Network interchange fees also increased for the year by \$31 thousand or 49.2%. The major component of the service charges on deposit accounts is insufficient funds fees, which totaled \$297 thousand or 58.1% of total noninterest income.

Through the associations with various mortgage-lending companies, the Bank originates and sells, on the secondary market, fixed and variable rate residential and commercial long-term mortgages, earning fees for the loans originated. Fees on secondary market loans sold were down \$5 thousand or 14.3% from the \$35 thousand reported in 2008. While rates have remained low for fixed rate mortgage products, the demand in the local market continued to be weak for 2009.

During 2009, the Bank had a net loss on the sale of securities available for sale and held to maturity of \$91 thousand compared to \$52 thousand in gains for the year ended December 31, 2008. The Bank recorded an impairment loss relating to an equity investment in Silverton Bank of \$1.1 million during 2009. These losses are discussed in the noninterest expense section below. Management sold the majority of the mortgage backed securities portfolio comprised of FNMA and FHLMC securities and replaced them with GNMA securities that carry a lower capital risk weighting.

**Noninterest Expenses.** Noninterest expense consists of salaries and employee benefits, equipment and occupancy expenses, and other operating expenses. The following is the makeup of our noninterest expense for the years ended December 31, 2009 and 2008:

	<b>Years Ended December 31,</b>		<b>2009-2008 Percent Increase (Decrease)</b>
	<b>2009</b>	<b>2008</b>	
<b>Noninterest expense:</b>	(Dollars in thousands)		
Salaries and employee benefits			
Salaries	\$ 1,483	\$ 1,527	(2.9)%
Payroll taxes	124	125	(0.8)%
Group insurance	150	169	(11.2)%
Other employee benefits	44	71	(38.0)%
Total salaries and employee benefits	<u>1,801</u>	<u>1,892</u>	<u>(4.8)%</u>
Occupancy expense	778	759	2.5%
Data processing	302	259	16.6%
Office supplies and postage	93	128	(27.3)%
Advertising and promotion	99	318	(68.9)%
Legal and other professional	352	309	13.9%
Net loss on the sales of securities available for sale and held to maturity	91	0	100.0%
Loss on impaired equity investments	1,129	0	100.0%
Loss on the sale of foreclosed assets	73	14	80.8%
Other noninterest expense:			
Directors' fees	0	101	(100.0)%
Loan related expenses	171	127	34.6%
Foreclosed assets valuation allowance	397	48	727.1%
Insurance, including FDIC assessments	243	125	94.4%
Other noninterest expense	234	196	11.4%
Total other noninterest expense	<u>1,045</u>	<u>597</u>	<u>71.0%</u>
Total noninterest expense	<u>\$ 5,763</u>	<u>\$ 4,276</u>	<u>34.8%</u>

Total noninterest expense increased from \$4.3 million in 2008 to \$5.8 million in 2009. The largest dollar increase in noninterest expense was in the loss on impaired equity investments. This line item was \$1.1 million for 2009 and related to the Bank's impaired equity investment in Silverton Bank. Another significant increase during the year was in the foreclosed assets valuation allowance which increased from \$48 thousand in 2008 to \$397 thousand in 2009. This expense was incurred as a result of lowering carrying values on certain Bank owned properties. Insurance, including FDIC assessments, also increased from \$125 thousand for the year ended December 31, 2008 to \$243 thousand for 2009. This increase was primarily the result of a special assessment to help recapitalize the insurance fund due to bank closures during the year.

Management has and continues to work on reducing controllable expenses. Salaries have declined slightly and should continue to do so in 2010 through attrition. Also, directors' fees have been eliminated for the foreseeable future. Advertising declined from \$318 thousand in 2008 to \$99 thousand for the year ended December 31, 2009.

Occupancy costs increased approximately \$19 thousand from \$759 thousand in 2008 to \$778 thousand in 2009. The largest increase in occupancy expense was in depreciation expense associated with the new West Morristown branch. Depreciation increased \$31 thousand, from \$241 thousand in 2008 to \$273 thousand in 2009. Maintenance contract expense also increased \$12 thousand from \$91 thousand in

2008 to \$103 thousand in 2009. Several components of occupancy expense declined during the year; the largest decline being in rent expense as a result of the completion of the new branch which eliminated the rental of a temporary facility.

Legal and Professional fees also increased \$43 thousand during the year, from \$309 thousand in 2008 to \$352 thousand in 2009. The majority of the increase in this category was in legal fees, which increased \$71 thousand during 2009. The increase in legal fees stemmed primarily from increased expenses relating to our nonperforming assets and from expense relating to the Board's consideration of several strategic alternatives over the past year. The \$43 thousand increase in legal fees was partially offset by a decline in outside service fees of \$24 thousand. The decline in outside service fees was primarily due to the contract cancellation on a loan pricing system.

Advertising and promotional expense declined \$219 thousand for the year ended December 31, 2009 to \$99 thousand from \$318 thousand for the year ended December 31, 2008. Every component of the marketing budget was cut for 2009, including advertising by \$187 thousand, promotions by \$23 thousand, charitable contributions by \$4 thousand, and entertainment by \$5 thousand.

The Bank incurred approximately \$397 thousand in expense as a result of establishing a valuation allowance which lowered the carrying values of other real estate owned (OREO) based on current contractual or market information. This compares to \$48 thousand for 2008. Other noninterest expense increased \$97 thousand during the year from \$551 thousand in 2008 to \$648 thousand in 2009. There were several components that had significant increases during the year. The expense of maintaining the OREO increased from \$20 thousand in 2008 to \$82 thousand in 2009. Other large increases were in the FDIC insurance assessment which increased \$114 thousand from \$64 thousand in 2008 to \$178 thousand in 2009. This increase was a result of higher insurance rates for 2009 and a special assessment to help restore the insurance fund totaling \$49 thousand paid September 30, 2009.

Several items declined to help offset the increases in noninterest expense listed above. Directors' fees were suspended, resulting in a savings of \$101 thousand dollars for the year. Supplies and postage declined \$35 thousand for year from \$128 thousand in 2008 to \$93 thousand in 2009.

One area of concern for 2010 and beyond is the costs associated with compliance, especially with Sarbanes-Oxley (SOX) legislation. While SEC non-accelerated filers such as the Bank have been granted additional time to comply with the regulations, the Bank had to provide management's assessment of the effectiveness of internal controls over financial reporting as of December 31, 2007, and the Bank's external audit firm will have to provide its opinion of management's assertion regarding the effectiveness of internal controls over financial reporting when SOX section 404(b) becomes effective for non-accelerated filers. On December 2, 2009, the SEC amended temporary rules related to the effective date for non-accelerated filers to comply with SOX Section 404(b), making this section effective for the year ending December 31, 2010, unless the SEC provides further extensions. The Bank has been able to keep the costs of compliance to a relatively low level to date, but this could increase significantly going forward.

Barring any special assessments, noninterest expense should decline in 2010. Management continues to look at all operating costs to determine where cuts can be made.

***Provision for Income Taxes.*** During the year ended December 31, 2009 the Bank recorded a deferred tax benefit of \$331 thousand as compared to \$345 thousand during 2008. The Bank had state and federal net operating loss carryforwards of \$7.6 million and \$6.5 million, respectively at December 31, 2009. These carryforwards resulted from start-up expenses of the Bank and net operating losses in the first few years of operation as well as the years ended December 31, 2008 and 2009. The decision to record the deferred tax benefit is based on management's belief that the Bank will have future taxable income sufficient to utilize the tax benefit within the carryforward period under federal and state laws. Management maintained a 56% valuation allowance of \$1.7 million, related to the net deferred tax asset, at the end of 2009, and will continue to maintain a valuation allowance until it is more likely than not that future earnings will be sufficient to use the tax benefit in the required time frame. At December 31, 2008,

management maintained a 50% valuation allowance or \$976 thousand. For a further explanation of the deferred tax benefit see note 8 in the financial statements.

### **Discussion of Financial Condition at December 31, 2009 and 2008**

Community National Bank of the Lakeway Area's total assets at December 31, 2009 were \$124.8 million, an increase of \$6.7 million or 5.7% from December 31, 2008. The majority of the asset growth was in the Bank's investment portfolio.

Total securities at December 31, 2009 were \$33.6 million as compared to \$26.4 million at December 31, 2008. The portfolio is classified as either available for sale or held to maturity. At December 31, 2009 the Bank did not have any investments classified as held to maturity. The held to maturity portfolio at December 31, 2008 was reported at amortized cost and consisted of \$3.7 million of mortgage-backed securities. The available for sale portfolio at December 31, 2009 was \$33.6 million compared to \$22.7 million for 2008. The \$33.6 million is comprised of 53.8% U.S. Government Agency securities and 46.2% GNMA asset-backed securities. The portfolio increased during the year as a result of increased funding from the deposit portfolio and unexpected early payments in the loan portfolio. The Bank began a restructuring of the investment portfolio during the fourth quarter of 2008 which was completed during the first quarter of 2009. This restructuring removed the mortgage-backed security portfolio comprised of FNMA and FHLMC securities, and replaced them with GNMA securities with lower capital risk weightings. Investment securities are an important tool used to manage the interest rate sensitivity and liquidity of the Bank.

Net loans for the period ended December 31, 2009 decreased \$5.5 million to \$75.8 million as compared to \$81.3 million at December 31, 2008. This represents a decline during the period of approximately 6.8%. Gross loans for the period decreased 7.9% to \$77.2 million from \$83.8 million at December 31, 2008. Lower demand, coupled with the movement of a portion of the portfolio into OREO, accounted for the decline. Much of the decline in gross loans was reallocated into other assets, including our available for sale securities.

The allowance for loan losses at December 31, 2009 was \$1.4 million or 1.86% of gross loans. This compares to \$2.5 million or 3.01% of gross loans at December 31, 2008. The decline in both dollar and percentage of gross loans was a result of the Bank preparing in 2008 for the charge-off of several purchased participations that occurred in 2009. Also, nonaccrual loans declined from \$4.0 million as of December 31, 2008 to \$2.0 million as of December 31, 2009. Actual net charge-offs for the year were \$2.2 million, up significantly from the \$125 thousand reported in 2008. Of the \$2.2 million in net charge-offs during 2009, \$1.9 million was related to purchased participations while \$277 thousand was attributable to the locally generated portfolio. Management analyzes the loan portfolio to determine the adequacy of the allowance for loan losses. Provisions are made to the allowance in order to maintain a level adequate to absorb anticipated loan losses.

The \$2.0 million of nonaccrual loans at December 31, 2009 was comprised of \$1.1 million in Bank originated loans and \$888 thousand in purchased participations that are real estate secured and located in the market area. With declines in the local, regional, and national economies, it will most likely take an extensive period of time to work out the nonaccrual loans. Management continues to receive monthly updates from the lead banks on the purchased participations and adjusts the allowance for loan losses accordingly as collateral values and conditions change.

Interest receivable, deferred tax benefit, foreclosed assets, prepaid banking agency assessments and other assets increased during the period from \$2.0 million at December 31, 2008 to \$4.5 million at December 31, 2009. The increase is primarily due to the recording of the net deferred tax benefit of \$353 thousand related to the current year's loss, an increase in foreclosed properties of \$1.5 million primarily related to the foreclosure of purchased participations, and an increase in prepaid banking agency assessments of \$586 thousand comprised of the new prepaid FDIC assessment. Equity investments for the period declined from \$2.0 million to \$830 thousand primarily due to the \$1.1 million loss recorded as a result of the write-off of the Silverton Bank stock.

Premises and equipment declined during the year from \$3.3 million to \$3.0 million. The nearly \$300 thousand decrease is primarily the result of depreciation expense of \$273 thousand during the year.

At December 31, 2009, deposits totaled \$98.9 million, an increase of \$6.5 million from the \$92.4 million reported in 2008. Noninterest-bearing demand deposits were \$9.0 million or 9.1% of total deposits and interest-bearing deposits were \$89.9 million or 90.9% of total deposits. The deposit mix changed during the year as a result of the introduction of a new Community Rewards Checking product. Interest-bearing checking accounts increased during the year from \$6.1 million in 2008 to \$22.9 million in 2009. Time deposits greater than \$100 thousand declined \$9.0 million due to brokered certificates of deposit maturing but not being renewed.

The Community Rewards Checking product was introduced during the fourth quarter of 2008. The Bank was the first in the local market to introduce the new Community Rewards Checking product. This checking product paid a rate of 4.51% on balances up to \$25,000 initially. The customer is rewarded with the higher rate for taking advantage of various electronic banking elements that afford the Bank significant savings in operating costs. The product has been very popular and has become the main source of deposit growth for the Bank. The Bank informed customers that the rate would be reduced beginning in January 2010 to 3.76%. Since the end of 2008, similar products have been introduced by competitors.

Stockholders' equity totaled \$12.4 million at December 31, 2009, a decline of \$2.5 million from the \$14.9 million reported at December 31, 2008. The Bank recorded a net loss of \$(2.4) million for the year ended December 31, 2009 and other comprehensive loss, net of tax, of \$(94) thousand. This compares to a net loss for the year ended December 31, 2008 of \$(1.7) million and other comprehensive income, net of tax, of \$307 thousand.

### **Net Interest Income**

Like most financial institutions, the primary component of earnings for the Bank is net interest income. Net interest income is the difference between interest income, principally from loan and investment securities portfolios, and interest expense, principally on customer deposits and borrowings. Changes in net interest income result from changes in volume, spread and margin. For this purpose, volume refers to the average dollar level of interest-earning assets and interest-bearing liabilities, spread refers to the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities, and margin refers to net interest income divided by average interest-earning assets and is influenced by the level and relative mix of interest-earning assets and interest-bearing liabilities, as well as levels of noninterest-bearing liabilities and capital.

**Average Balances and Average Rates Earned and Paid.** The following table sets forth, for the periods indicated, information with regard to average balances of assets and liabilities, as well as the total dollar amounts of interest income from interest-earning assets and interest expense on interest-bearing liabilities, resultant yields or costs, net interest income, net interest spread, net interest margin and ratio of average interest-earning assets to average interest-bearing liabilities. Nonaccrual loans have been included in determining average loans.

	2009			2008		
	Average Balance	Interest	Yield/ Cost	Average Balance	Interest	Yield/ Cost
Assets:						
Interest-earning assets:						
Loans	\$ 79,063,129	\$ 5,267,460	6.66%	\$ 77,055,437	\$ 5,359,415	6.96%
Investment securities	25,620,161	916,270	3.58%	24,629,903	1,179,646	4.79%
Federal funds sold	3,030,178	6,991	0.23%	2,777,551	56,672	2.04%
Other	1,909,005	47,188	2.47%	2,429,588	67,091	2.76%
Total interest earning assets	\$ 109,622,473	\$ 6,237,909	5.69%	\$ 106,892,479	\$ 6,662,824	6.23%
Other noninterest earning assets	9,682,356			6,342,177		
Total assets	\$ <u>119,304,829</u>			\$ <u>113,234,656</u>		
Liabilities and stockholders' equity:						
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand	\$ 13,553,792	\$ 362,799	2.68%	\$ 4,666,660	\$ 20,123	0.43%
Savings and money market	19,427,925	242,349	1.25%	18,616,327	391,505	2.10%
Time	51,648,190	1,629,725	3.16%	49,901,328	2,030,717	4.07%
Advances	8,876,712	316,896	3.57%	10,346,995	420,807	4.07%
Other	3,329,424	8,465	0.25%	4,134,391	75,891	1.84%
Total interest-bearing liabilities	\$ <u>96,836,043</u>	\$ <u>2,560,233</u>	2.64%	\$ <u>87,665,701</u>	\$ <u>2,939,043</u>	3.35%
Other noninterest-bearing liabilities	8,738,112			9,462,494		
Stockholders' equity	<u>13,730,674</u>			<u>16,106,461</u>		
Total liabilities and stockholders' equity	\$ <u>119,304,829</u>			\$ <u>113,234,656</u>		
Excess of interest-earning assets over interest-bearing liabilities	\$ <u>12,786,430</u>			\$ <u>19,226,778</u>		
Ratio of interest-earning assets over interest-bearing liabilities	113%			122%		
Net interest income		\$ <u>3,677,676</u>			\$ <u>3,723,781</u>	
Net interest spread			3.05%			2.88%
Net interest margin			3.35%			3.48%

### Rate/Volume Analysis

The following table analyzes the dollar amount of changes in interest income and interest expense for major components of interest-earning assets and interest-bearing liabilities. The table distinguishes between (i) changes attributable to volume (changes in volume multiplied by the prior period's rate), (ii) changes attributable to rate (changes in rate multiplied by the prior period's volume), and (iii) net change (the sum of the previous columns). The change attributable to both rate and volume (changes in rate multiplied by changes in volume) has been allocated equally to both the changes attributable to volume and the changes attributable to rate:

	<b>Year Ended 2009 Versus 2008 Increase (Decrease) Due to</b>		
	<b>Volume</b>	<b>Rate</b>	<b>Net</b>
	(Dollars in thousands)		
Interest Income:			
Loans	\$ 28	\$ (120)	\$ (92)
Investment securities	(35)	(228)	(263)
Federal funds sold and other	363	(433)	(70)
Total interest-earning assets	<u>356</u>	<u>(781)</u>	<u>(425)</u>
Interest Expense:			
Deposits	152	(359)	(207)
Borrowings and Other	(52)	(120)	(172)
Total interest-bearing liabilities	<u>100</u>	<u>(479)</u>	<u>(379)</u>
Net change in interest income	<u>\$ 256</u>	<u>\$ (302)</u>	<u>\$ (46)</u>

### Interest Rate Sensitivity

Interest rate sensitivity measures the timing and magnitude of the repricing of assets compared with the repricing of liabilities and is an important part of asset/liability management of a financial institution. The objective of interest rate sensitivity management is to generate stable growth in net interest income, and to control the risks associated with interest rate movements. Management frequently reviews interest rate risk exposure and the expected interest rate environment so that adjustments in interest rate sensitivity can be made in a timely fashion. Since the assets and liabilities of a bank are primarily monetary in nature (payable in fixed, determinable amounts), the performance of a bank is affected more by changes in interest rates than by inflation. Interest rates generally increase as the rate of inflation increases, but the magnitude of the change in rates may not be the same.

Net interest income is the primary component of net income for financial institutions. Net interest income is affected by the timing and magnitude of repricing of as well as the mix of interest sensitive and noninterest sensitive assets and liabilities. "Gap" is a static measurement of the difference between the contractual maturities or repricing dates of interest sensitive assets and interest sensitive liabilities within the following twelve months. Gap is an attempt to predict the behavior of the Bank's net interest income in general terms during periods of movement in interest rates. In general, if the Bank is asset sensitive, more of its interest sensitive assets are expected to reprice within twelve months than its interest sensitive liabilities over the same period. In a rising interest rate environment, assets repricing more quickly is expected to enhance net interest income. Alternatively, decreasing interest rates would be expected to have the opposite effect on net interest income since assets would theoretically be repricing at lower interest rates more quickly than interest sensitive liabilities. Although it can be used as a general predictor, Gap as a predictor of movements in net interest income has limitations due to the static nature of its definition and due to its inherent assumption that all assets will reprice immediately and fully at the contractually designated time. At December 31, 2009, the Bank, as measured by Gap, was in a liability sensitive position. Management has several tools available to evaluate and control interest rate risk, including deposit pricing policies and changes in the mix of various types of assets and liabilities.

The following table summarizes the amounts of interest-earning assets and interest-bearing liabilities outstanding at December 31, 2009 that are expected to mature, prepay, or reprice in each of the future time periods shown. Except as stated below, the amount of assets or liabilities that mature or reprice during a particular period were determined in accordance with the contractual terms of the assets or liabilities. Adjustable rate loans are included in the period in which interest rates are next scheduled to adjust rather than in the period in which they are due, and fixed rate loans and mortgage-backed securities are included in the periods in which they are anticipated to be repaid based on scheduled maturities. The Bank's savings accounts and interest-bearing demand accounts (NOW and money market deposit accounts), are subject to immediate withdrawal; however, historical experience has proven these deposits to be more

stable over the course of a year. For the purposes of the gap analysis below, approximately twenty-five percent of the savings and interest-bearing demand deposits are shown repricing in one year or less with the remainder repricing in the one to five year category.

**AT DECEMBER 31, 2009**  
**MATURING OR REPRICING IN**

	3 MONTHS OR LESS	4 MONTHS TO 12 MONTHS	1 TO 5 YEARS	OVER 5 YEARS	TOTAL
(Dollars in Thousands)					
Interest-earning assets:					
Federal funds sold	\$ 4,590	\$ 0	\$ 0	\$ 0	\$ 4,590
Debt securities	0	0	15,769	17,788	33,557
Loans, Gross (excluding nonaccrual loans)	15,934	5,608	41,628	12,039	75,209
Other interest earning assets	981	500	0	0	1,481
Total interest-earning assets	<u>21,505</u>	<u>6,108</u>	<u>57,397</u>	<u>29,827</u>	<u>114,837</u>
Interest-bearing liabilities:					
Deposits:					
Interest Bearing Savings, MMA and Demand	2,423	7,266	29,097	423	39,209
Time deposits	9,554	36,600	4,517	0	50,671
Advances	0	2,000	8,500	0	10,500
Repurchase Agreements	2,584	0	0	0	2,584
Total interest-bearing liabilities	<u>14,561</u>	<u>45,866</u>	<u>42,114</u>	<u>423</u>	<u>102,964</u>
Interest sensitivity difference per period	<u>\$ 6,944</u>	<u>\$ (39,758)</u>	<u>\$ 15,283</u>	<u>\$ 29,404</u>	<u>\$ 11,873</u>
Cumulative interest sensitivity difference	<u>\$ 6,944</u>	<u>\$ (32,814)</u>	<u>\$ (17,531)</u>	<u>\$ 11,873</u>	
Cumulative difference to total interest-earning assets	<u>6.05%</u>	<u>(28.57)%</u>	<u>(15.27)%</u>	<u>10.34%</u>	

At December 31, 2009, the difference between the Bank's liabilities and assets repricing or maturing within one year was \$32.8 million. Due to an excess of liabilities repricing or maturing within one year, an increase in interest rates could cause the Bank's net interest income to decrease.

Certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or periods of repricing, they may reflect changes in market interest rates differently. Additionally, certain assets, such as adjustable-rate mortgages, have features that restrict changes in interest rates, both on a short-term basis and over the life of the asset. Other factors that may affect the assumptions made in the table include changes in interest rates, pre-payment rates, early withdrawal levels, and the ability of borrowers to service their debt.

**Capital Resources**

Future growth and expansion of the Bank is dictated by the ability to create capital, which is generated principally by earnings. Adequacy of the Bank's capital is also monitored to ensure compliance with regulatory requirements. One of management's primary objectives is to maintain a strong capital position in order to warrant confidence from customers, investors, bank regulators and stockholders. A measure of capital position is capital adequacy, defined as the amount of capital needed to maintain future asset growth and absorb unforeseen losses. Regulators consider a variety of factors in determining an institution's capital adequacy, including quality and stability of earnings, asset quality, guidance and expertise and liquidity. Regulatory guidelines place an emphasis on stockholders' equity in relation to total assets adjusted for risk. As of December 31, 2009, the Bank's tier 1 capital to risk-weighted assets ratio was 14.9%, its total capital to risk-weighted assets ratio was 16.2% and its leverage ratio was 9.0%.

Management considers the Bank to be well-capitalized and expects to be able to meet future needs caused by growth and expansion, as well as current and future capital requirements implemented by the regulatory agencies.

Management is not aware of any current recommendations by the regulatory authorities, which, if implemented, would have a material effect on liquidity, capital resources or operations.

The following table summarizes the Bank's risk-based capital ratios at December 31, 2009 and 2008 respectively:

	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
Total capital (to risk-weighted assets)	16.2%	19.6%
Tier 1 capital (to risk-weighted assets)	14.9%	18.3%
Tier 1 capital (to average assets)	9.0%	12.5%

The Bank was considered to be well-capitalized at December 31, 2009 by regulatory standards.

### **Liquidity**

The Bank's liquidity is a measure of its ability to fund loans, withdrawals and maturities of deposits, and other cash outflows in a cost effective manner. The Bank's principal sources of liquidity are deposits, scheduled payments and prepayments of loan principal, maturities of investment securities, access to liquid assets, and funds provided by operations. While scheduled loan payments and maturing investments are relatively predictable sources of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. Liquid assets, which consist of cash and due from banks, federal funds sold and investment securities classified as available for sale, comprised 32.6% and 21.8% of total assets at December 31, 2009 and December 31, 2008, respectively.

The increase in liquid assets is a result of an increase in investment securities available for sale and federal funds sold. The increase in deposits and FHLB Advances during 2009, coupled with a decline in the loan portfolio, provided the funds for the increased liquidity. During 2009, the Bank sold and purchased federal funds depending on liquidity needs. At December 31, 2009, the Bank had \$4.6 million in federal funds sold compared to \$604 thousand at December 31, 2008. Should the need arise, the Bank would have the capability to sell securities classified as available for sale or to borrow funds as necessary. The Bank has established credit lines with three correspondent banks to borrow up to \$8.5 million secured. There were no borrowings outstanding against these credit lines at December 31, 2009 and December 31, 2008, respectively. The Bank also had the capacity to borrow from the Federal Home Loan Bank of Cincinnati. At December 31, 2009, the Bank had an application in process with the Federal Reserve Bank of Atlanta to gain access to the discount window.

Total deposits were \$98.9 million and \$92.4 million, respectively for the periods ended December 31, 2009 and 2008. Time deposits, which are the only deposit accounts that have stated maturity dates, are generally considered to be rate sensitive. Time deposits represented 51.3% and 61.7% of total deposits at December 31, 2009 and 2008, respectively. Time deposits of \$100 thousand or more represented 25.5% and 37.0% of the Bank's total deposits at December 31, 2009 and 2008, respectively. At December 31, 2009 and 2008, the Bank had brokered time and savings deposits totaling \$836 thousand and \$10.8 million, respectively. Management accepts time deposits from outside the Bank's local market area when such funding sources are necessary to fund growth if the rates paid are comparable to rates offered to retail customers or lower. Management believes most of the Bank's time deposits are relationship-oriented. While the Bank will need to pay competitive rates to retain these local deposits at their maturities, there are other subjective factors that will determine their continued retention. Based upon prior experience, the Bank anticipates that a substantial portion of outstanding certificates of deposit will renew upon maturity.

In 2009, operating activities of the Bank provided \$70 thousand of cash flows, reflecting a net loss of \$(2.4) million and deducting non-cash operating expenses including provision for loan losses of \$1.1 million and depreciation of \$272.5 thousand.

Investing activities, including lending, utilized \$5.3 million of the Bank's cash flow in 2009. This represents a decrease of \$10.1 million from the \$15.4 million used in 2008. The primary uses of cash were the excess of purchases of investment securities over payments, maturities, sales and calls, totaling \$7.7 million. This was somewhat offset by the net decrease in loans of \$1.8 million, and the proceeds from the sale of foreclosed assets of \$653 thousand.

Net additional cash flows of \$9.3 million were provided by financing activities, a decrease of \$3.8 million from the \$13.1 million reported in 2008. Cash flow provided from the net change in deposits was \$6.5 million, while cash provided by advances was \$3.5 million. These increases were partially offset by a decline in repurchase agreements of \$681 thousand.

### Loan Portfolio

The Bank's primary source of revenue is interest and fee income from its lending activities. These lending activities consist principally of originating commercial operating and working capital loans, residential mortgage loans, home equity lines of credit, other consumer loans and loans secured by commercial real estate. The Bank's current lending strategy is to establish greater market share throughout Hamblen, Jefferson and Grainger Counties in east Tennessee. Through other banks and investment groups, the Bank also purchases participations in loans outside its primary lending area. These loans are underwritten using the same care and standards used for originated loans. The Bank has a diversified loan portfolio with no significant concentrations to any one borrower or industry.

The following table sets forth, at the dates indicated, our loan portfolio composition by type of loan.

	<u>At December 31,</u>	
	<u>2009</u>	<u>2008</u>
	<b>(Dollars in thousands)</b>	
Loans secured by real estate:		
Commercial properties	\$ 23,373	\$ 20,440
Construction and land development	2,998	11,635
Residential and other properties	34,277	31,215
Total loans secured by real estate	<u>60,648</u>	<u>63,290</u>
Commercial and industrial loans	10,106	12,660
Consumer loans and other	3,986	4,830
Government agency guaranteed	2,365	2,939
Total gross loans	<u>77,105</u>	<u>83,719</u>
Plus: Unamortized premiums on purchased loans	94	131
Less: Allowance for loan losses	<u>(1,439)</u>	<u>(2,522)</u>
Total loans receivable, net	<u>\$ 75,760</u>	<u>\$ 81,328</u>

## Maturities and Sensitivities of Loans to Changes in Interest Rates

As of December 31, 2009, maturities of gross loans in the indicated classifications were as follows (amounts are presented in thousands):

	<u>Within 1 Year</u>	<u>1 to 5 Years</u>	<u>Over 5 Years</u>
Commercial properties & construction and land development	\$ 10,736	\$ 10,319	\$ 5,316
Residential and other properties	9,753	17,483	7,040
Commercial and industrial loans	5,908	3,820	378
Consumer loans and other	1,141	2,768	77
Purchased government guaranteed loans	0	450	2,009
Totals	\$ <u>27,538</u>	\$ <u>34,840</u>	\$ <u>14,820</u>

As of December 31, 2009, the interest terms of loans in the indicated classification for the indicated maturity ranges are as follows (amounts are presented in thousands):

	<u>Fixed Interest Rates</u>	<u>Variable Interest Rates</u>	<u>Total</u>
Commercial properties and construction & land development	\$ 17,439	\$ 8,932	\$ 26,371
Residential and other	13,336	20,940	34,276
Commercial and industrial	7,832	2,274	10,106
Consumer loans and other	3,770	216	3,986
Government agency guaranteed	1,903	556	2,459
Totals	\$ <u>44,280</u>	\$ <u>32,918</u>	\$ <u>77,198</u>

As of December 31, 2009, the Bank had non-accrual loans totaling \$1.99 million compared to \$3.98 million at December 31, 2008. In addition, the Bank had \$174 thousand in loans 90 or more days past due and still accruing interest as of December 31, 2008. There were no loans over 90 days past due and still accruing interest at December 31, 2009.

## Allowance and Provision for Loan Losses

The allowance for loan losses represents management's estimate of an amount adequate to provide for potential losses inherent in the loan portfolio. Management determines the allowance for loan losses based on a number of factors, including a review and evaluation of the Bank's loan portfolio, historical losses, and current and projected economic conditions locally and nationally. The allowance is monitored and analyzed in conjunction with the Bank's loan analysis and grading program, and provisions for loan losses are made to maintain an adequate allowance for loan losses. The allowance for loan losses is created by direct charges to operations. Losses on loans are charged against the allowance for loan losses in the accounting period in which they are determined by management to be necessary and are established based on the amount that management has determined to be adequate to provide for potential losses inherent in the loan portfolio. The Bank made provisions for loan losses of \$1.1 million for the year ended December 31, 2009 as compared to \$1.9 million for the year ended December 31, 2008. The provision for loan losses did decline in 2009 from the 2008 level, but was still a significant amount when compared to earlier years' provisions. The Bank had increased the provision for loan losses in 2008 to reserve for several purchased participations that were classified at December 31, 2008. The participations were charged off during 2009 and are being carried in OREO.

Management realizes that general economic trends greatly affect loan losses, and no assurances can be made that future charges to the loan loss allowance may not be significant in relation to the amount provided during a particular period, or that future evaluations of the loan portfolio based on conditions then prevailing will not require sizable additions to the allowance, thus necessitating similarly sizable charges to income. Based on its best judgment, evaluation, and analysis of the loan portfolio, management considers the allowance for loan losses to be adequate for the reporting periods.

Management believes that the loans classified for regulatory purposes as loss, doubtful, substandard, or special mention, and the loans classified as troubled debt restructurings, are the only loans in the portfolio that represent material credits about which management is aware of any information that causes management to have serious doubts as to the ability of such borrowers to comply with the loan repayment terms; however, in the current economy, there could be additional classified loans.

Interest accrual on loans is discontinued when management believes, after consideration of economic and business conditions and collection efforts, that collection of interest is doubtful. Additionally, all loans contractually past due 90 days or more and not in the process of collection or adequately secured are placed on nonaccrual status.

**Nonperforming Assets.** The following table sets forth information with respect to the Bank's nonaccrual loans, restructured loans, total nonperforming loans (nonaccrual plus restructured loans), and total nonperforming assets.

	<u>At December 31,</u>	
	<u>2009</u>	<u>2008</u>
	(Dollars in thousands)	
Nonaccrual loans	\$ 1,990	\$ 3,978
Restructured loans	1,112	0
Total nonperforming loans	<u>3,102</u>	<u>3,978</u>
Real estate owned	1,827	322
Total nonperforming assets	<u>\$ 4,929</u>	<u>\$ 4,300</u>
Accruing loans past due 90 days or more	\$ 0	\$ 174
Allowance for loan loss	\$ 1,439	\$ 2,522
Nonperforming loans to period end loans	4.02%	4.74%
Allowance for loan losses to period end loans	1.86%	3.01%
Allowance for loan losses to nonperforming loans	46.39%	63.40%
Nonperforming assets to total assets	3.95%	3.64%

**Allowance for Loan Losses.** The following table shows the allocation of our allowance for loan losses at the dates indicated. The allocation is based on an evaluation of defined loan problems, historical ratios of loan losses and other factors that may affect future loan losses in the categories of loans shown.

	<b>At December 31,</b>			
	<b>2009</b>		<b>2008</b>	
	<b>Amount</b>	<b>% of Total Loans (1)</b>	<b>Amount</b>	<b>% of Total Loans (1)</b>
	<b>(Dollars in thousands)</b>			
Balance applicable to:				
Commercial real estate	\$ 440	30.3%	\$ 516	24.4%
Construction	190	3.9%	1,280	13.9%
Residential and other	396	44.4%	247	37.2%
Commercial and industrial	339	13.1%	404	15.1%
Consumer	74	5.1%	75	5.8%
Government guaranteed	0	3.2%	0	3.6%
		100.0%		100.0%
Unallocated	0		0	
Total	<u>\$ 1,439</u>		<u>\$ 2,522</u>	

(1) Represents total of all outstanding loans in each category as a percent of total loans outstanding.

The following table presents activity in the allowance for loan losses for the periods indicated:

	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
	<b>(Dollars in thousands)</b>	
Balance at beginning of period	\$ 2,522	\$ 702
Charge-offs:		
Consumer and other	(94)	(78)
Construction and land development	(1,128)	0
Commercial and industrial	(416)	(17)
Commercial real estate	(532)	0
1-4 family residential	(32)	
Home equity lines of credit	(26)	(58)
Total charge-offs	<u>(2,228)</u>	<u>(153)</u>
Recoveries:		
Consumer and other	6	27
Commercial real estate	0	0
Residential 1-4 family	0	1
Total recoveries	<u>6</u>	<u>28</u>
Net charge-offs	(2,222)	(125)
Provision for loan losses charged to operations	<u>1,139</u>	<u>1,945</u>
Balance at end of period	<u>\$ 1,439</u>	<u>\$ 2,522</u>
Ratio of net loan charge-offs to average loans outstanding	2.81%	0.16%
Ratio of allowance for loan losses to loans outstanding at period-end	1.86%	3.01%

## Investment Securities

The investment portfolio of the Bank can be classified as either available for sale or held to maturity. At December 31, 2009 the Bank did not have any securities in the held to maturity portfolio. The fair value of investment securities available for sale totaled \$33.6 million at December 31, 2009 compared to \$22.7 million at December 31, 2008. This is an increase of \$10.9 million or 48.0%, due primarily to the use of excess liquidity resulting from a significant increase in deposits and a decline in the loan portfolio during the year. The available for sale portfolio consists of approximately 53.8% Obligations of U.S. Government Agencies and 46.2% Mortgage-backed securities. The mix has changed from 42.3% Obligations of U.S. Government Agencies, 57.1% Mortgage-backed securities, and 0.6% Corporate securities at December 31, 2008. The change in mix during the year resulted in the Bank achieving a lower portfolio yield. As a result of restructuring the portfolio by selling FNMA and FHLMC mortgage-backed securities and replacing them with U.S. Government guaranteed GNMA securities, the average life of the portfolio increased.

The held to maturity portfolio had a carrying value of \$3.7 million at December 31, 2008. The securities in this classification were purchased as part of a leveraged transaction on September 1, 2005 and were comprised 100% of mortgaged-backed securities. As part of the overall restructuring of the investment portfolio, the held to maturity portfolio was sold during the fourth quarter of 2008 and the first quarter of 2009 and replaced with higher quality GNMA securities.

The combined portfolios have an average life of 8.26 years and a weighted average yield at December 31, 2008 of 3.39%. This compares to an average life of 7.0 years and weighted average yield of 5.04% at December 31, 2008. The Bank had \$6.6 million of the portfolio pledged to secure federal funds lines of credit, the state collateral pool and repurchase agreements.

The following tables present the maturities of investment securities classified as available for sale at their carrying values and the weighted average yields for each range of maturities presented. The actual maturities of mortgage-backed securities may differ from the contractual maturities presented in the table below due to prepayments.

<b>Maturities at December 31, 2009</b>	<b>Within One Year</b>	<b>After One through Five Years</b>	<b>After Five through Ten Years</b>	<b>After Ten Years</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>				
Obligations of U.S. Government Agencies	\$ 0	\$ 6,030	\$ 5,012	\$ 7,221	\$ 18,263
Mortgage-Backed Securities	0	9,557	1,027	4,705	15,289
Subtotal	0	15,587	6,039	11,926	33,552
Market value adjustment on Available for sale securities	0	182	(6)	(170)	6
Total	\$ 0	\$ 15,769	\$ 6,033	\$ 11,756	\$ 33,558
Weighted Average Yield	0	3.32%	3.09%	3.64%	3.39%

Maturities at December 31, 2008	Within	After One	After Five	After	Total
	One Year	through Five Years	through Ten Years	Ten Years	
(Dollars in thousands)					
Obligations of U.S. Government					
Agencies	\$ 0	\$ 0	\$ 7,499	\$ 1,999	\$ 9,498
Corporate Securities	0	0	0	175	175
Mortgage-Backed Securities	98	0	800	11,992	12,890
Subtotal	98	0	8,299	14,166	22,563
Market value adjustment on Available for sale securities	0	0	116	7	123
Total	\$ 98	\$ 0	\$ 8,415	\$ 14,173	\$ 22,686
Weighted Average Yield	3.39%	0.00%	4.86%	5.21%	5.07%

The following tables present the maturities of investment securities classified as held to maturity at their carrying values and the weighted average yields for each range of maturities presented. The actual maturities of mortgage-backed securities may differ from the contractual maturities presented in the table below due to prepayments.

Maturities at December 31, 2008	Obligations of U.S.		Mortgage- Backed Securities	Weighted- Average Yield
	Government Corporations and Agencies	Weighted- Average Yield		
Five to ten years	\$ 0	0	\$ 2,117,841	4.78%
After ten years	0	0	1,568,083	4.98%
Totals	\$ 0	0	\$ 3,685,924	4.87%

There were no held to maturity securities at December 31, 2009.

## Deposits

The Bank relies on deposits generated in its market area to provide the majority of funds needed to support lending activities and for investment in liquid assets. The Bank's balance sheet growth is largely determined by the availability of deposits in its market area, the cost of attracting the deposits, and prospects of profitably utilizing the available deposits by increasing the loan or investment portfolios. The Bank continuously monitors market pricing, competition, rates and internal interest rate spreads to work toward growth and profitability. Because deposits are the principal source of funds for continued growth, the Bank attempts to structure rates so as to promote deposit and asset growth, while at the same time increasing the overall profitability of the Bank.

The daily average amounts of deposits and the average rates paid for each major category of deposits for the periods indicated are summarized below:

	<b>For the Year Ended December 31,</b>			
	<b>2009</b>		<b>2008</b>	
	<b>Amount</b>	<b>Rate</b>	<b>Amount</b>	<b>Rate</b>
	<b>(Dollars in thousands)</b>			
Savings, NOW, and money market	\$ 32,982	1.83%	\$ 23,283	1.77%
Time deposits over \$100,000	26,605	3.21%	27,464	4.04%
Other time deposits	25,043	3.10%	22,437	4.11%
 Total interest-bearing deposits	 84,630	 2.64%	 73,184	 3.34%
Non-interest bearing deposits	8,164		8,879	
 Total deposits	 \$ 92,794	 2.41%	 \$ 82,063	 2.98%

The following table sets forth the amounts and maturities of our certificates of deposit.

	<b>At December 31, 2009</b>				
	<b>3 Months Or Less</b>	<b>Over 3 to 12 Months</b>	<b>Over 1 to 3 Years</b>	<b>Over 3 Years</b>	<b>Total</b>
	<b>(Dollars in thousands)</b>				
Certificates of deposit:					
Less than \$100,000	\$ 4,599	\$ 18,582	\$ 1,891	\$ 399	\$ 25,471
\$100,000 or more	3,660	19,469	1,961	110	25,200
 Total	 \$ 8,259	 \$ 38,051	 \$ 3,852	 \$ 509	 \$ 50,671

#### **Off-Balance Sheet Arrangements**

In order to meet the financing needs of our customers in the normal course of business, the Bank is a party to financial instruments with off-balance sheet risks. These financial instruments consist of commitments to extend credit and standby letters of credit. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Standby letters of credit are written conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. Most letters of credit extend for one year or less. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending any other type of loan to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. A commitment involves, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheets. The Bank's exposure to credit loss in the event of nonperformance by the other party to the instrument is represented by the contractual notional amount of the instrument.

Since certain commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank uses the same credit policies in making commitments to extend credit as it does for on-balance sheet instruments. Collateral held for commitments to extend credit varies but may include unimproved and improved real estate, certificates of deposit or personal property.

The following table summarizes our off-balance sheet financial instruments whose contract amounts represent credit risk:

	<b>December 31, 2009</b>	<b>December 31, 2008</b>
	<b>(Dollars in thousands)</b>	
Commitments to extend credit	\$ 7,909	\$ 10,622
Stand-by letters of credit	\$ 49	\$ 451

### **Effect of Governmental Policies**

We are affected by the policies of regulatory authorities, including the Federal Reserve Board, and the OCC. An important function of the Federal Reserve Board is to regulate the national money supply. Among the instruments of monetary policy used by the Federal Reserve Board are: purchases and sales of U.S. Government securities in the marketplace; changes in the discount rate, which is the rate any depository institution must pay to borrow from the Federal Reserve; and changes in the reserve requirements of depository institutions. These instruments are effective in influencing economic and monetary growth, interest rate levels and inflation.

The monetary policies of the Federal Reserve Board and other governmental policies have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future. Because of changing conditions in the national and international economy and in the money markets, as well as the result of actions by monetary and fiscal authorities, it is not possible to predict with certainty future changes in interest rates, deposit levels or loan demand or whether the changing economic conditions will have a positive or negative effect on operations and earnings.

Legislation from time to time is introduced in the United States Congress and the Tennessee General Assembly and other state legislatures, and regulations are proposed by the regulatory agencies that could affect our business. It cannot be predicted whether or in what form any of these proposals will be adopted or the extent to which our business may be affected thereby.

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

AUDITED FINANCIAL STATEMENTS

Years Ended December 31, 2009 and 2008

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

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CERTIFIED PUBLIC ACCOUNTANTS

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of  
Community National Bank of the Lakeway Area:

We have audited the accompanying balance sheets of Community National Bank of the Lakeway Area (the Bank) as of December 31, 2009 and 2008 and the related statements of operations, comprehensive loss, changes in stockholders' equity, and cash flows for each of the years then ended. The Bank's management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Bank is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Bank's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Community National Bank of the Lakeway Area as of December 31, 2009 and 2008, and the results of its operations and its cash flows for each of the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Pershing Yoakley & Associates, P.C.*

Knoxville, Tennessee  
March 29, 2010

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

**BALANCE SHEETS**

	As of December 31,	2009	2008
<b>ASSETS</b>			
Cash and Cash Equivalents:			
Cash and Due From Banks	\$	2,596,412	\$ 2,475,510
Federal Funds Sold		4,590,000	604,000
Total Cash and Cash Equivalents		<u>7,186,412</u>	<u>3,079,510</u>
Securities:			
Available for Sale, at Fair Value		33,557,505	22,685,722
Held to Maturity, at Amortized Cost		0	3,685,924
Total Securities		<u>33,557,505</u>	<u>26,371,646</u>
Equity Investments, at Cost		829,900	2,027,342
Loans, Net of Estimated Allowance for Loan Losses of \$1,438,566 in 2009 and \$2,521,744 in 2008		75,759,650	81,328,038
Premises and Equipment, Net		3,048,394	3,303,461
Interest Receivable		542,335	559,845
Foreclosed Assets		1,827,445	322,200
Deferred Tax Benefit		1,329,484	976,387
Prepaid Banking Agency Assessments		585,998	0
Other Assets		179,168	98,098
<b>TOTAL ASSETS</b>	<b>\$</b>	<b><u>124,846,291</u></b>	<b><u>\$ 118,066,527</u></b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>			
<b>LIABILITIES:</b>			
Deposits:			
Noninterest-bearing	\$	8,974,590	\$ 9,479,658
Interest-bearing		89,879,819	82,904,756
Total Deposits		<u>98,854,409</u>	<u>92,384,414</u>
Securities Sold Under Agreements to Repurchase		2,583,891	3,264,788
Advances from Federal Home Loan Bank		10,500,000	7,000,000
Interest Payable		346,071	409,779
Other Liabilities		125,240	93,699
Total Liabilities		<u>112,409,611</u>	<u>103,152,680</u>
<b>STOCKHOLDERS' EQUITY</b>			
Common Stock, Par Value \$1, Authorized 4,000,000 Shares; Issued and Outstanding 1,891,426 Shares at December 31, 2009 and 2008		1,891,426	1,891,426
Capital in Excess of Par Value		17,041,955	17,041,955
Retained Deficit		(6,501,606)	(4,118,706)
Accumulated Other Comprehensive Income		4,905	99,172
Total Stockholders' Equity		<u>12,436,680</u>	<u>14,913,847</u>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$</b>	<b><u>124,846,291</u></b>	<b><u>\$ 118,066,527</u></b>

The accompanying footnotes are an integral part of these financial statements.

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

**STATEMENTS OF OPERATIONS**

	For the Years Ended December 31,	2009	2008
		<u>                    </u>	<u>                    </u>
<b>INTEREST INCOME</b>			
Loans, Including Fees		\$ 5,267,460	\$ 5,359,415
Securities		916,270	1,179,646
Federal Funds Sold and Other		54,179	123,763
Total Interest Income		<u>6,237,909</u>	<u>6,662,824</u>
<b>INTEREST EXPENSE</b>			
Deposits		2,234,872	2,442,345
Advances		316,896	420,807
Other		8,465	75,891
Total Interest Expense		<u>2,560,233</u>	<u>2,939,043</u>
<b>NET INTEREST INCOME</b>		3,677,676	3,723,781
<b>PROVISION FOR ESTIMATED LOAN LOSSES</b>		<u>1,138,937</u>	<u>1,944,626</u>
<b>NET INTEREST INCOME AFTER PROVISION FOR ESTIMATED LOAN LOSSES</b>		<u>2,538,739</u>	<u>1,779,155</u>
<b>NONINTEREST INCOME</b>			
Service Charges on Deposit Accounts		344,052	299,773
Net Gain on Sales of Securities		0	51,830
Commissions on Loans Originated for Others		30,233	35,488
Other		136,361	107,588
Total Noninterest Income		<u>510,646</u>	<u>494,679</u>
<b>NONINTEREST EXPENSE</b>			
Salaries and Employee Benefits		1,801,138	1,891,617
Occupancy Costs		778,237	758,567
Data Processing		302,309	259,084
Office Supplies and Postage		92,870	127,742
Advertising and Promotion		98,608	317,613
Legal and Other Professional		352,374	308,831
Net Loss on the Sale of Foreclosed Assets		72,802	13,621
Loss on Impaired Equity Investments		1,128,642	0
Net Loss on Sales of Securities		90,990	0
Foreclosed Assets Valuation Expense		396,734	47,800
Other		648,357	550,926
Total Noninterest Expense		<u>5,763,061</u>	<u>4,275,801</u>
<b>NET LOSS BEFORE INCOME TAXES</b>		(2,713,676)	(2,001,967)
<b>INCOME TAX BENEFIT (Note 8)</b>		<u>(330,776)</u>	<u>(344,799)</u>
<b>NET LOSS</b>		<u>\$ (2,382,900)</u>	<u>\$ (1,657,168)</u>

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

**STATEMENTS OF OPERATIONS (Continued)**

	For the Years Ended December 31,	<u>2009</u>	<u>2008</u>
LOSS PER SHARE			
Basic		<u>\$ (1.26)</u>	<u>\$ (0.88)</u>
Diluted		<u>\$ (1.26)</u>	<u>\$ (0.88)</u>

The accompany footnotes are an integral part of these financial statements.

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

**STATEMENTS OF COMPREHENSIVE LOSS**

	For the Years Ended December 31,	<u>2009</u>	<u>2008</u>
NET LOSS		<u>\$ (2,382,900)</u>	<u>\$ (1,657,168)</u>
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX EFFECTS			
Net Unrealized Gains (Losses) on Securities Available for Sale Arising During the Year		(258,003)	308,826
Reclassification Adjustment for Net Realized (Gains) Losses Included in Net Loss		141,415	(41,716)
Deferred Income Tax Expense Related to Net Unrealized Gains (Losses) on Securities Available for Sale, Net of Valuation Allowance		22,321	39,533
Other Comprehensive Income (Loss), Net of Tax Effects		<u>(94,267)</u>	<u>306,643</u>
COMPREHENSIVE LOSS		<u><u>\$ (2,477,167)</u></u>	<u><u>\$ (1,350,525)</u></u>

The accompany footnotes are an integral part of these financial statements.

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

	Common Stock	Capital in Excess of Par Value	Retained Deficit	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
BALANCES, JANUARY 1, 2008	\$ 1,891,426	\$ 17,041,955	\$ (2,461,538)	\$ (207,471)	\$ 16,264,372
Net Loss	0	0	(1,657,168)	0	(1,657,168)
Other Comprehensive Income	0	0	0	306,643	306,643
	<u>1,891,426</u>	<u>17,041,955</u>	<u>(4,118,706)</u>	<u>99,172</u>	<u>14,913,847</u>
BALANCES, DECEMBER 31, 2008	1,891,426	17,041,955	(4,118,706)	99,172	14,913,847
Net Loss	0	0	(2,382,900)	0	(2,382,900)
Other Comprehensive Loss	0	0	0	(94,267)	(94,267)
	<u>0</u>	<u>0</u>	<u>0</u>	<u>(94,267)</u>	<u>(94,267)</u>
BALANCES, DECEMBER 31, 2009	<u>\$ 1,891,426</u>	<u>\$ 17,041,955</u>	<u>\$ (6,501,606)</u>	<u>\$ 4,905</u>	<u>\$ 12,436,680</u>

The accompany footnotes are an integral part of these financial statements.

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

**STATEMENTS OF CASH FLOWS**

	For the Year Ended December 31,	<u>2009</u>	<u>2008</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net Loss	\$	(2,382,900)	\$ (1,657,168)
Adjustments to Reconcile Net Loss to Net Cash Provided by Operating Activities:			
Provision for Estimated Loan Losses		1,138,937	1,944,626
Provision for Foreclosed Assets Valuation		396,734	47,800
Depreciation		272,536	241,278
Federal Home Loan Bank Stock Dividends		0	(16,000)
Net Amortization of Premiums on Securities		327,690	22,932
Net Amortization of Premiums on Purchased Loans		37,122	9,967
Net Loss (Gain) on Sales of Securities Available for Sale		141,415	(41,716)
Net Gain on Sales of Securities Held to Maturity		(50,425)	(10,114)
Net Loss on the Sale of Foreclosed Assets		72,802	13,621
Loss on Impairment of Equity Investments		1,128,642	0
Decrease (Increase) in Accrued Interest Receivable		17,510	(52,137)
Increase in Deferred Tax Benefit		(330,776)	(344,799)
(Increase) Decrease in Prepaid Expenses and Other Assets		(667,068)	58,423
Decrease in Accrued Interest Payable		(63,708)	(141,414)
Increase in Other Liabilities		31,541	49,625
Total adjustments		<u>2,452,952</u>	<u>1,782,092</u>
<b>Net Cash Provided by Operating Activities</b>		<u>70,052</u>	<u>124,924</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Securities Available for Sale:			
Sales and Calls		21,766,661	9,889,007
Purchases		(39,671,993)	(21,566,081)
Maturities		0	500,000
Principal Repayments Received		6,448,187	2,453,544
Securities Held to Maturity:			
Sales and Calls		3,693,580	757,398
Principal Repayments Received		42,438	771,876
Purchases of Equity Investments		(18,100)	(284,686)
Sales of Equity Investments		86,900	312,741
Proceeds from the Sale of Foreclosed Assets		652,926	5,450
Net (Increase) Decrease in Loans		1,764,622	(7,124,651)
Purchases of Premises and Equipment		(17,469)	(1,133,592)
<b>Net Cash Used in Investing Activities</b>		<u>(5,252,248)</u>	<u>(15,418,994)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Net (Decrease) Increase in Non-Interest-Bearing Deposits		(505,068)	738,039
Net Increase in Interest-Bearing Deposits (Excluding Time Deposits)		13,318,802	627,451
Net (Decrease) Increase in Time Deposits		(6,343,739)	17,893,467
Proceeds from (Payments on) Advances from Federal Home Loan Bank		3,500,000	(5,000,000)
Net Decrease in Securities Sold Under Agreements to Repurchase		(680,897)	(1,205,877)
<b>Net Cash Provided by Financing Activities</b>		<u>9,289,098</u>	<u>13,053,080</u>

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

**STATEMENTS OF CASH FLOWS (Continued)**

For the Year Ended December 31,	<u>2009</u>	<u>2008</u>
<b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>	4,106,902	(2,240,990)
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR</b>	<u>3,079,510</u>	<u>5,320,500</u>
<b>CASH AND CASH EQUIVALENTS AT END OF YEAR</b>	<u><u>\$ 7,186,412</u></u>	<u><u>\$ 3,079,510</u></u>
<b>Supplementary Disclosures of Cash Flow Information:</b>		
Cash Paid During the Year for:		
Interest	\$ 2,623,941	\$ 3,080,457
Income Taxes	\$ -	\$ -
<b>Supplementary Disclosures for Noncash Investing Activities:</b>		
Change in Net Unrealized Gains/Losses on Securities Available for Sale	\$ 116,588	\$ 267,110
Change in Deferred Income Tax Tax Benefit Associated with Unrealized Gains/ Losses on Investment Securities Available for Sale	\$ 22,321	\$ 39,533
Change in Net Unrealized Gains/Losses on Securities Available for Sale, Net of Tax Effects	\$ 94,267	\$ 306,643
Loans Moved to Foreclosed Assets	\$ 2,267,707	\$ 191,362

The accompany footnotes are an integral part of these financial statements.

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ended December 31, 2009 and 2008

NOTE 1 – NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations – Community National Bank of the Lakeway Area (the Bank) commenced banking operations on April 9, 2003. The Bank provides a variety of banking services to individuals and businesses primarily in the counties of Hamblen and Jefferson through its main office and branch in Morristown and branch office in Jefferson City, Tennessee. Its primary deposit products are demand deposits and certificates of deposit, and its primary lending products are commercial business, real estate mortgage, and consumer installment loans.

Use of Estimates - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect certain reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, valuation of foreclosed assets, the fair value of financial instruments, and the valuation of deferred tax assets, and the related allowance.

Comprehensive Income - Comprehensive income consists of net income/losses and other comprehensive income/losses. Other comprehensive income includes net unrealized gains and losses on securities available for sale, net of any related tax effects, which is also recognized as a separate component of stockholders' equity.

Cash and Cash Equivalents - For purposes of the statements of cash flows, cash and cash equivalents include cash and balances due from banks and federal funds sold, all of which mature within 90 days.

Cash and Due From Banks - Cash and due from banks includes balances on deposit with correspondent commercial banks located in the Southern United States. The Bank also maintains cash deposits with the Federal Home Loan Bank ("FHLB") of Cincinnati and the Federal Reserve Bank of Nashville. The balances in the accounts at the correspondent commercial banks were not in excess of FDIC insurance limits as of December 31, 2009 and December 31, 2008.

Federal Funds Sold - Federal funds sold consists of an unsecured loan to a correspondent commercial bank located in the Southern United States. This loan, plus interest, is required to be repaid on the next business day.

Securities – Debt securities are classified as held to maturity when management has the positive intent and ability to hold the securities to maturity. Securities held to maturity are recorded at amortized cost. The amortization of premiums and accretion of discounts are recognized in interest income using a method approximating the interest method over the terms of these securities.

Securities available for sale are carried at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Realized gains and losses on securities available for sale are included in noninterest income and noninterest expense, respectively, and when applicable, are reported as a reclassification adjustment, net of tax, in other comprehensive income. Realized gains and losses on sale of securities are recorded on the trade date and determined using the specific identification method. The amortization of premiums and accretion of discounts are recognized in interest income using the interest method over the terms of the securities.

Prior to a change in accounting guidance on April 1, 2009, in determining whether other-than-temporary impairment existed, management considered (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Declines in the fair value of individual securities below their cost that are deemed to be other-than-temporary were reflected in earnings as realized losses, if applicable.

Effective April 1, 2009, the Bank adopted new accounting guidance related to other-than-temporary impairment of securities. The new guidance amended the criteria for recognizing other-than-temporary impairments of debt securities and expanded the

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 1 – NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

disclosure requirements for impairment losses on debt and equity securities. The new guidance specifies that if (1) a company does not have the intent to sell a debt security prior to recovery and (2) it is more likely than not that it will not have to sell the debt security prior to recovery; the security would not be considered other-than-temporarily impaired unless there is a credit loss. The credit loss component is the amount of principal cash flows not expected to be received over the remaining term of the security based on cash flow projections. For debt securities that management has no intent to sell and believes that it more likely than not will not be required to sell prior to recovery, only the credit loss component of the impairment is recognized in earnings, while the non-credit loss is included in accumulated other comprehensive income.

Equity Investments - The Bank maintains certain investments with regulatory and other entities with which it has an ongoing business relationship. At December 31, 2009 and December 31, 2008, approximately \$25,000 represents the cash reserve balance required to be on hand by the Federal Reserve Bank of Atlanta. The Bank's equity investments in the FHLB of Cincinnati and the Federal Reserve Bank of Atlanta are carried at cost which approximates fair value based on the stock redemption provisions of each of the entities. The investment in FHLB stock is in part based on the Bank's amount of advances from the FHLB.

Loans - Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs, the estimated allowance for loan losses, and any deferred fees (if material) or costs on originated loans. Interest income is accrued on the unpaid principal balance.

The accrual of interest is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual status or charged-off at an earlier date if collection of principal or interest is considered doubtful.

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

Estimated Allowance for Loan Losses - The estimated allowance for loan losses is maintained at a level which, in management's judgment, is adequate to absorb credit losses inherent in the loan portfolio. The amount of the estimated allowance is based on management's evaluation of the collectability of the loan portfolio, including the nature of the portfolio, credit concentrations, trends in historical loss experience, specific impaired loans, and economic conditions. Estimated allowances for impaired loans are generally determined based on collateral values or the present value of estimated future cash flows. Because of uncertainties associated with local, regional, and national economic conditions, collateral values, and future cash flows on impaired loans, it is reasonably possible that management's estimate of credit losses inherent in the loan portfolio, and the related estimated allowance, may change materially in the near term. The estimated allowance is increased by a provision for loan losses, which is charged to expense and reduced by charge-offs, net of recoveries. Changes in the estimated allowance relating to impaired loans are charged or credited to the provision for loan losses.

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

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 1 – NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local, regional, and national economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated allowance for loan losses. Such agencies may require the Bank to recognize additional losses based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible due to regulatory adjustments cannot be estimated.

The estimated allowance for loan losses consists of specific and general components. The specific component relates to loans that are classified as doubtful, substandard, and special mention (as defined by the Bank consistent with the definitions given by regulatory agencies). For those loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and classified loans that are collectively evaluated for impairment. The general component is based on historical loss experience adjusted for qualitative factors.

Loan Fees, Discounts, and Premiums - Loan fees on long-term real estate loans, net of initial direct costs related to initiating and closing the loans, will be deferred, if material, and amortized into interest income over the remaining lives of the loans as an adjustment of yield using the interest method. Any discounts and premiums originated in conjunction with the purchase of loans are accreted or amortized into income, principally by the level yield method, over the remaining lives of the loans purchased.

Premises and Equipment - Land is stated at cost. Premises and equipment are stated at cost, less accumulated depreciation. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized. Gains and losses on dispositions are included in current operations. Depreciation is computed using the straight-line method over the following estimated useful lives:

	<u>Years</u>
Buildings	40
Furniture, Fixtures, and Equipment	2-15
Leasehold Improvements	5-30

Advertising and Promotion - Advertising and promotion costs are expensed as incurred.

Foreclosed Assets - Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less estimated cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in other noninterest expense. There was a valuation allowance at December 31, 2009 of \$392,234 and December 31, 2008 of \$47,800.

Income Taxes – The income tax accounting guidance results in two components of income tax expense – current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to taxable income or loss. The Bank determines deferred income taxes using the liability method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities. The Bank's deferred taxes relate primarily to differences between the basis of the allowance for loan losses and accumulated depreciation. Deferred tax assets and liabilities are reflected at income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 1 – NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

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

The Bank has estimated a 56% valuation allowance at December 31, 2009 to offset the net deferred tax asset resulting from timing differences. See Note 8 for additional information.

Stock Options - The Bank recognizes compensation cost relating to share-based payment transactions based on the fair value of the equity or liability instruments issued. Compensation cost is measured using the fair value of the stock option award on the grant date and is recognized over the employee service period. The Company uses a stock option pricing model to determine the fair value of the award on the grant date.

Income (Loss) Per Share - Basic income (loss) per share represents earnings attributable to stockholders divided by the weighted-average number of shares outstanding during the period. Diluted earnings (losses) per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to net income (loss) that would result from the assumed issuance. Potential common shares that may be issued by the Bank relate solely to outstanding stock options and are determined using the treasury stock method.

	Years Ended December 31,	
	2009	2008
Per Share Information:		
Basic, as Reported	\$ (1.26)	\$ (0.88)
Diluted, as Reported	\$ (1.26)	\$ (0.88)

Loss per share is based on the following for the years ended December 31:

	2009	2008
Weighted Average Number of Shares Outstanding Used for Basic Calculation	1,891,426	1,891,426
Weighted Average Number of Shares Outstanding Used for Diluted Calculation	1,891,426	1,891,426

Accounting Standards Codification - In June 2009, the Financial Accounting Standard Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 168, The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles (GAAP) - a Replacement of FASB Statement No. 162 (the "Codification"). The Codification became the single source of authoritative GAAP to be applied by nongovernmental entities, with the exception of guidance issued by the Securities and Exchange Commission (SEC) and its staff. All guidance contained in the Codification carries an equal level of authority. FASB ASC 105-10, Generally Accepted Accounting Principles, became applicable during fiscal year 2009. All accounting references have been updated, and therefore SFAS references have been replaced with, or accompanied by, ASC references.

On August 18, 2009, the SEC issued Interpretive Release No. 33 – 9062A titled Commission Guidance Regarding the Financial Accounting Standards Board's Accounting Standards of Codification. In this release, the SEC stated that as of September 15, 2009, references in the SEC's rules and SEC staff guidance to specific standards under U.S. generally accepted accounting principles should be understood to mean the corresponding reference in the Codification. The SEC also stated that the Codification does not supersede any SEC rules or regulations, is not the authoritative source for SEC rules or SEC staff

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 1 – NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

guidance, and the inclusion of any SEC rules or SEC staff guidance in the Codification will not affect how such items may be updated in the future by the SEC.

Newly Adopted Accounting Pronouncements - In April 2009, FASB issued FSP No. FAS 157-4, Determining Fair Value When the Volume and Level of Activity for the Asset or Liability have Significantly Decreased and Identifying Transactions that Are Not Orderly (FSP 157-4) (superceded by ASC 820, Fair Value Measurements and Disclosures). FSP 157-4 indicates that if an entity determines that either the volume and/or level of activity for an asset or liability has significantly decreased (from normal conditions for that asset or liability) or price quotations or observable inputs are not associated with orderly transactions, increased analysis and management judgment will be required to estimate fair value. FSP 157-4 is effective for interim and annual periods ended after June 15, 2009, with early adoption permitted. FSP 157-4 must be applied prospectively. The provisions of FSP 157-4 became effective for the Bank's interim period ended on June 30, 2009, and its adoption did not have a significant impact on the Bank's financial statements.

In April 2009, the FASB issued FSP No. 107-1 and APB 28-1, Interim Disclosures about Fair Value of Financial Instruments (FSP 107-1 and APB 28-1) (superceded by FASB ASC 825, Financial Instruments, and FASB ASC 270, Interim Reporting). This FSP requires disclosures about fair value of financial instruments in interim reporting periods of publicly traded companies that were previously only required to be disclosed in annual financial statements. The FSP was effective for interim reporting periods ending after June 15, 2009. As this FSP only amends the disclosure requirements about fair value of financial instruments to require those disclosures in interim periods, the adoption of this FSP had no impact on the Bank's annual financial statements.

In April 2009, the FASB issued FSP No. FAS 115-2 and FAS 124-2, Recognition and Presentation of Other-Than-Temporary Impairments (FSP 115-2 and 124-2) (superceded by FASB ASC 320, Investments - Debt and Equity Securities). FSP 115-2 and 124-2 clarifies the interaction of the factors that should be considered when determining whether a debt security is other-than-temporarily impaired. For debt securities, management must assess whether (a) it has the intent to sell the security and (b) it is more likely than not that it will be required to sell the security prior to its anticipated recovery. These assessments are made before assessing whether the entity will recover the cost basis of the investment. This change does not affect the need to forecast recovery of the value of the security through either cash flows or market price. In instances when a determination is made that an other-than-temporary impairment exists but the investor does not intend to sell the debt security and it is not more likely than not that it will be required to sell the debt security prior to its anticipated recovery, FSP 115-2 and 124-2 changes the presentation and amount of the other-than-temporary impairment recognized in the income statement. The other-than-temporary impairment is separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income. FSP 115-2 and 124-2 also requires additional disclosures. The provisions of FSP 115-2 and 124-2 became effective for interim periods ending after June 15, 2009. Adoption of the FSP did not have a material impact on the Bank's financial statements.

In May 2009, the FASB issued SFAS No. 165, Subsequent Events (SFAS 165) (superceded by FASB ASC 855, Subsequent Events). Under FASB ASC 855, companies are required to evaluate events and transactions that occur after the balance sheet date but before the date the financial statements are issued, or available to be issued in the case of non-public entities. FASB ASC 855 requires entities to recognize in the financial statements the effect of all events or transactions that provide additional evidence of conditions that existed at the balance sheet date, including the estimates inherent in the financial preparation process. Entities shall not recognize the impact of events or transactions that provide evidence about conditions that did not exist at the balance sheet date but arose after that date. FASB ASC 855 is effective for interim and annual reporting periods ending after June 15, 2009. The Bank adopted the provisions of FASB ASC 855 during the quarter ended June 30, 2009. The Bank evaluated all events and transactions that occurred after December 31, 2009 through March 29, 2010, the issuance date of

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 1 – NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

the financial statements. During this period management did not note any material recognizable subsequent events that required recognition or disclosure in the December 31, 2009 financial statements.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109 (superceded by FASB ASC 740, *Income Taxes*). FASB ASC 740 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements. FASB ASC 740 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FASB ASC 740 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FASB ASC 740 is effective for fiscal years beginning after December 15, 2008. Adoption of FASB ASC 740 did not have a material impact on the financial statements of the Bank. The Bank has not taken any material uncertain income tax positions in its previously filed income tax returns or in income tax returns expected to be filed.

In August 2009, the FASB issued Accounting Standards Update No. 2009-05 ("ASU 2009-05"), *Fair Value Measurements and Disclosures* (ASC Topic 820, *Measuring Liabilities at Fair Value*). ASU 2009-05 amends subtopic 820-10, *Fair Value Measurements and Disclosures – Overall*, and provides clarification for the fair value measurement of liabilities. ASU 2009-05 is effective for the first reporting period including interim periods beginning after issuance. The Bank adopted this standard for the year ended December 31, 2009 and its adoption did not have a material impact on its financial statements.

NOTE 2 - FEDERAL HOME LOAN BANK STOCK

As a member of the Federal Home Loan Bank, the Bank is required to maintain stock in an amount equal to .15% of total assets. Federal Home Loan Bank stock is carried at cost and is maintained by the Bank at par value of one hundred dollars per share. The Bank's carrying cost of FHLB stock was \$433,900 and \$415,800 for the years ended December 31, 2009 and 2008, respectively.

NOTE 3 - SECURITIES

The amortized cost and estimated fair value of securities classified as available for sale are as follows:

	Securities Available for Sale			
	Amortized	Gross	Gross	Estimated
	Cost	Unrealized	Unrealized	Fair
		Losses	Value	
As of December 31, 2009:				
Debt Securities:				
Obligations of U.S. Government Agencies	\$ 18,262,237	\$ 38,476	\$ (229,890)	\$ 18,070,823
Mortgage-Backed and Related Securities	15,289,202	214,693	(17,213)	15,486,682
Total Securities Available for Sale	<u>\$ 33,551,439</u>	<u>\$ 253,169</u>	<u>\$ (247,103)</u>	<u>\$ 33,557,505</u>

	Securities Available for Sale			
	Amortized	Gross	Gross	Estimated
	Cost	Unrealized	Unrealized	Fair
		Losses	Value	
As of December 31, 2008:				
Debt Securities:				
Obligations of U.S. Government Agencies	\$ 9,498,103	\$ 111,122	\$ 0	\$ 9,609,225
Mortgage-Backed and Related Securities	12,889,965	95,310	(23,630)	12,961,645
Corporate Securities	175,000	0	(60,148)	114,852
Total Securities Available for Sale	<u>\$ 22,563,068</u>	<u>\$ 206,432</u>	<u>\$ (83,778)</u>	<u>\$ 22,685,722</u>

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 3 – SECURITIES (Continued)

The amortized cost and estimated fair value of securities classified as held to maturity are as follows:

	Securities Held to Maturity			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
As of December 31, 2008:				
Mortgage-Backed Securities	\$ 3,685,924	\$ 92,935	\$ 0	\$ 3,778,859
Total Securities Held to Maturity	<u>\$ 3,685,924</u>	<u>\$ 92,935</u>	<u>\$ 0</u>	<u>\$ 3,778,859</u>

The amortized cost and estimated fair value of debt securities as of December 31, 2009, by contractual maturity, are as follows:

	Available for Sale	
	Amortized Cost	Estimated Fair Value
Due in One to Five Years	\$ 6,030,154	\$ 6,024,289
Due in Five to Fifteen Years	11,184,036	11,038,097
Due Over Fifteen Years	1,048,047	1,008,437
	<u>18,262,237</u>	<u>18,070,823</u>
Mortgage-Backed Securities	15,289,202	15,486,682
Total Securities	<u>\$ 33,551,439</u>	<u>\$ 33,557,505</u>

The expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers may have the right to call or repay obligations without call or prepayment penalties. Therefore, the mortgage-backed securities are presented separately in the above table.

Proceeds from sales of securities classified as available for sale totaled \$9,266,661 during the year ended December 31, 2009 (\$7,889,007 in 2008). There were gross gains of \$86,528 realized during the year ended December 31, 2009 (\$49,810 in 2008). Gross losses of \$227,943 (\$8,094 in 2008) were realized by the Bank during the year ended December 31, 2009. Additionally, the Bank sold three securities from the held to maturity portfolio, due to deterioration in the issuer's credit worthiness, and as part of a restructuring of the investment portfolio to zero percent risk weighted investments. The proceeds from the sales from the held to maturity portfolio totaled \$3,693,580 (\$757,398 in 2008), which includes a gain of \$50,425 (\$10,114 in 2008) being recognized for the year ended December 31, 2009.

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 3 – SECURITIES (Continued)

The following table shows the Bank's gross unrealized losses and fair value, aggregated by the security category and the length of time that individual securities have been in a continuous loss position.

	Less Than 12 Months		12 Months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2009						
Obligations of U.S. Government						
Agencies	\$ 11,022,698	\$ (229,890)	\$ 0	\$ 0	\$ 11,022,698	\$ (229,890)
Mortgage-Backed Securities	5,469,602	(17,213)	0	0	5,469,602	(17,213)
Total	<u>\$ 16,492,300</u>	<u>\$ (247,103)</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 16,492,300</u>	<u>\$ (247,103)</u>
December 31, 2008						
Mortgage-Backed Securities	\$ 6,312,708	\$ (23,497)	\$ 97,769	\$ (133)	\$ 6,410,477	\$ (23,630)
Corporate Securities	114,852	(60,148)	0	0	114,852	(60,148)
Total	<u>\$ 6,427,560</u>	<u>\$ (83,645)</u>	<u>\$ 97,769</u>	<u>\$ (133)</u>	<u>\$ 6,525,329</u>	<u>\$ (83,778)</u>

Management performs periodic reviews for impairment in accordance with FASB ASC 320.

At December 31, 2009, the 14 securities with unrealized losses have decreased in value 1.48 percent from the Bank's amortized cost basis. At December 31, 2008, the six securities with unrealized losses have decreased in value 1.27 percent from the Bank's amortized cost basis. Most of these securities are guaranteed by either U.S. government agencies or had investment grade ratings upon purchase. Furthermore, the issuers of these securities have not established any cause for default. The unrealized losses associated with these investment securities are primarily driven by changes in interest rates and are not due to the credit quality of the securities. These securities will continue to be monitored as a part of the Bank's ongoing impairment analysis, but are expected to perform even if the rating agencies reduce the credit rating of the bond insurers.

FASB ASC 320 requires management to assess whether the Bank has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. Management does not intend to sell these securities and it is more likely than not that management will not be required to sell the securities before the recovery of its amortized cost bases.

In making this determination, management has considered its cash flow and liquidity requirements, capital requirements, economic factors, and contractual or regulatory obligations for indication that these securities will be required to be sold before a forecasted recovery occurs. In management's opinion, all securities that are in an unrealized loss position as of December 31, 2009, are not other-than-temporarily impaired. Therefore, no impairment expense should be recorded as of December 31, 2009.

Debt securities with a total estimated fair value (which approximates book value) of approximately \$6,584,000 as of December 31, 2009 (\$19,458,000 in 2008) were pledged primarily to secure deposits of public funds, repurchase agreements, and federal funds lines of credit.

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 4 - LOANS AND ESTIMATED ALLOWANCE FOR LOAN LOSSES

A summary of loans as of December 31, 2009 and 2008 is as follows:

	2009	2008
Loans Secured by Real Estate:		
Commercial Properties	\$ 23,373,394	\$ 20,439,540
Construction and Land Development	2,997,566	11,634,805
Residential and Other Properties	34,276,731	31,215,301
Total Loans Secured by Real Estate	<u>60,647,691</u>	<u>63,289,646</u>
Commercial and Industrial	10,105,982	12,659,657
Consumer and Other	3,985,766	4,830,462
Government Agency Guaranteed	2,364,744	2,938,862
	<u>77,104,183</u>	<u>83,718,627</u>
Plus: Unamortized Premiums on Purchased Loans	94,033	131,155
Less: Estimated Allowance for Loan Losses	<u>(1,438,566)</u>	<u>(2,521,744)</u>
Loans, net	<u>\$ 75,759,650</u>	<u>\$ 81,328,038</u>

Included in Consumer and Other Loans shown above are deposit account balances totaling \$13,803 which were in overdraft status as of December 31, 2009 (\$13,655 in 2008).

In the ordinary course of business, the Bank has entered into off-balance-sheet financial instruments consisting of commitments to extend credit, commercial letters of credit, and standby letters of credit. These financial instruments are recorded in the financial statements when they are funded. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual or notional amount of those instruments. The Bank uses the same credit policies in making such commitments as it does for instruments that are included in the balance sheet. Outstanding letters of credit were approximately \$49,000 as of December 31, 2009 (\$451,000 at December 31, 2008). Unadvanced lines of credit and commitments to extend credit were approximately \$7,909,000 as of December 31, 2009 (\$10,622,000 at December 31, 2008). Of the total outstanding letters of credit and unadvanced lines and commitments as of December 31, 2009 approximately \$6,518,000 (\$8,779,000 at December 31, 2008) were secured, primarily by real estate. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties.

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

From time to time, the Bank provides credit to its executive officers, directors, and their affiliates. In management's opinion, such transactions are made on the same terms as those prevailing for comparable transactions with other borrowers and do not represent more than a normal risk of collection. The balance in this category changes based upon disbursements and repayments of loans and changes in directors or executive officers. Loans to executive officers, directors, and their affiliates are as follows:

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 4 - LOANS AND ESTIMATED ALLOWANCE FOR LOAN LOSSES (Continued)

	2009	2008
Balance at Beginning of Year	\$ 742,571	\$ 944,505
Net Disbursements and Other Additions	1,723,933	791,399
Net Repayments and Other Reductions	(419,464)	(993,333)
Balance at End of Year	<u>\$ 2,047,040</u>	<u>\$ 742,571</u>

Activity in the estimated allowance for loan losses is as follows:

	2009	2008
Balance at Beginning of Year	\$ 2,521,744	\$ 702,074
Charge-Offs	(2,228,420)	(153,451)
Recoveries	6,305	28,495
Provision Charged to Expense	1,138,937	1,944,626
Balance at End of Year	<u>\$ 1,438,566</u>	<u>\$ 2,521,744</u>

The following is a summary of information pertaining to impaired and non-accrual loans:

	2009	2008
Impaired Loans without a Specific Valuation Allowance	\$ 6,975,293	\$ 3,099,917
Impaired Loans with a Specific Valuation Allowance	0	3,925,062
Total Impaired Loans	<u>\$ 6,975,293</u>	<u>\$ 7,024,979</u>
Specific Valuation Allowance Related to Impaired Loans	\$ 0	\$ 1,764,961
Past-due Loans Ninety Days or More and Still Accruing Interest	\$ 0	\$ 174,250
Total Non-Accrual Loans	\$ 1,989,687	\$ 3,978,127
Average Investment in Specifically Evaluated Impaired Loans	\$ 2,210,487	\$ 2,475,904
Interest Income Recognized on Impaired Loans	\$ 0	\$ 0
Interest Income Recognized on a Cash Basis on Impaired Loans	\$ 0	\$ 0

Loan impairment and any related valuation allowance is determined under the provisions established by FASB ASC 310. For all periods presented above, impaired loans without a valuation allowance represent loans for which management believes that the estimated collateral value of the property securing the loan is higher than the carrying value of that loan.

Interest income that would have accrued on non-accrual loans if they were on a current basis was \$25,913 and \$176,615 for the years ended December 31, 2009 and 2008, respectively.

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 4 - LOANS AND ESTIMATED ALLOWANCE FOR LOAN LOSSES (Continued)

The Bank has four loans at December 31, 2009 with outstanding balances of approximately \$1,112,000 that met the regulatory definition for Troubled Debt Restructurings. All four loans were moved to interest only payments, thus providing the borrower with a concession that would normally not be given. All four loans were reviewed for impairment as of December 31, 2009. One of the loans was not performing in accordance with the modified terms and has been classified as substandard.

Current instabilities in both the local and national economy are contributing to notable deteriorations in real estate values. Such instabilities in the local economy have the potential to impact the underlying value of real estate collateral securing a sizable portion of the Bank's loan portfolio. In addition, unemployment levels remain elevated, both nationally and locally, and established businesses throughout the United States are being forced to lay off employees and/or cease operations due to declining financial performance. Due to these instabilities and uncertainties, current estimates relating to the Bank's allowance for loan losses could change significantly in the near term.

NOTE 5 - PREMISES AND EQUIPMENT

A summary of premises and equipment is as follows as of December 31:

	2009	2008
Land	\$ 448,929	\$ 448,929
Building	742,341	742,341
Leasehold Improvements	1,649,800	1,649,800
Furniture, Fixtures, and Equipment	1,806,642	1,789,173
	<u>4,647,712</u>	<u>4,630,243</u>
Less Accumulated Depreciation	(1,599,318)	(1,326,782)
	<u>\$ 3,048,394</u>	<u>\$ 3,303,461</u>

NOTE 6 - DEPOSITS

A summary of deposits is as follows as of December 31:

	2009	2008
Noninterest-Bearing Demand Accounts	\$ 8,974,590	\$ 9,479,658
Interest-Bearing Accounts		
Checking Accounts	22,912,639	6,134,219
Money Market Accounts	9,104,142	11,468,915
Savings Accounts	7,191,564	8,286,409
Time Deposits:		
Less Than \$100,000	25,471,952	22,831,277
\$100,000 or More	25,199,522	34,183,936
Total Interest-Bearing Accounts	<u>89,879,819</u>	<u>82,904,756</u>
Total Deposits	<u>\$ 98,854,409</u>	<u>\$ 92,384,414</u>

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 6 – DEPOSITS (Continued)

There were no brokered certificate of deposit pools included in time deposits greater than \$100,000 at December 31, 2009 compared to approximately \$10,806,000 at December 31, 2008.

As of December 31, 2009, the scheduled maturities of time deposits above are as follows:

2010	\$	46,310,714
2011		982,592
2012		2,869,879
2013		283,215
2014		225,074
	\$	<u>50,671,474</u>

The Bank's executive officers, directors, and their affiliates maintain certain deposit accounts with the Bank which are, in management's opinion, offered on the same terms and rates as all other depositors.

NOTE 7 - SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

The Bank has sold certain securities under agreements to repurchase, primarily on an overnight basis, to certain commercial depositors. The total of these securities was \$2,583,892 and \$3,264,788 as of December 31, 2009 and 2008, respectively.

Securities sold under agreements to repurchase averaged approximately \$3,312,000 during 2009 (\$4,118,000 during 2008). The maximum amount outstanding at any month-end during 2009 was approximately \$6,089,000 (\$4,898,000 during 2008).

NOTE 8 - INCOME TAXES

The Bank accounts for income taxes in accordance with income tax accounting guidance in FASB ASC 740.

The provision for income taxes charged to income for the years ended December 31, 2009 and 2008 consists of the following:

	2009	2008
Deferred Tax Benefit	\$ (330,776)	\$ (344,799)
Total Tax Benefit	<u>\$ (330,776)</u>	<u>\$ (344,799)</u>

Income taxes as shown in the statements of operations differ from the amounts computed using the statutory federal income tax rate for the following reasons:

	2009		2008	
	Amount	Percent of Pretax Loss	Amount	Percent of Pretax Loss
Federal income tax benefit at statutory rate	\$ (922,650)	(34.0) %	\$ (680,668)	(34.0) %
Change in deferred tax valuation allowance	737,997	27.2	188,932	9.4
Non-deductible items	838	0.0	1,665	0.1
State income (benefit) expense and other, net	(146,961)	(5.4)	145,272	7.3
Total Tax Benefit	<u>\$ (330,776)</u>	<u>(12.2) %</u>	<u>\$ (344,799)</u>	<u>(17.2) %</u>

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 8 – INCOME TAXES (Continued)

Net deferred tax assets consist of the following components as of December 31, 2009 and December 31, 2008:

	2009	2008
Deferred Tax Assets:		
Net Operating Loss Carryforward	\$ 2,551,387	\$ 1,420,468
Capital Loss Carryforward	383,738	0
Allowance for Loan Losses	338,119	904,065
Contribution Carryover	8,208	11,685
Total Deferred Tax Assets	<u>3,281,452</u>	<u>2,336,218</u>
Valuation Allowance	<u>(1,714,384)</u>	<u>(976,387)</u>
	<u>1,567,068</u>	<u>1,359,831</u>
Deferred Tax Liabilities:		
Depreciation	219,726	318,707
Accretion - Investment Securities	156	1,232
Unrealized Holding Gains on Securities Available for Sale	1,161	46,964
FHLB Stock Dividends	16,541	16,541
Total Deferred Tax Liabilities	<u>237,584</u>	<u>383,444</u>
Net Deferred Tax Asset	<u>\$ 1,329,484</u>	<u>\$ 976,387</u>

As of December 31, 2009 and 2008, the Company recorded a valuation allowance of \$1,714,384 and \$976,387, respectively, on the deferred tax assets to reduce the total to an amount that management believes will ultimately be realized. This represents a 56% and 50% valuation allowance on net deferred tax assets as of December 31, 2009 and 2008, respectively. Realization of the deferred tax asset is dependent upon sufficient future taxable income available within the carryforward or reversal period under the federal and state laws. During the year ended December 31, 2009, the Bank increased the valuation allowance by \$737,997. The effect of this increase was recorded as a decrease in the deferred tax benefit included in the accompanying statements of operations. A valuation allowance for the balance of the deferred tax benefit will be maintained until management determines it is more likely than not that future earnings will be sufficient to use the tax benefit in the required time frame.

The Bank has state and federal net operating loss carryforwards totaling approximately \$7,591,872 and \$6,546,165, respectively, at December 31, 2009. These carryforwards are available to offset tax liabilities on future income through 2029 for federal income taxes and 2024 for state income taxes.

As of December 31, 2009, the Bank has accrued no interest and no penalties related to uncertain tax positions. It is the Bank's policy to recognize interest and/or penalties related to income tax matters in income tax expense.

NOTE 9 - FEDERAL HOME LOAN BANK ADVANCES AND OTHER BORROWINGS

The Bank has four advances from the FHLB of Cincinnati at December 31, 2009 (two in 2008). The four advances are for \$5 million, \$2 million, \$3 million and \$500 thousand and mature in 2015, 2010, 2012, and 2013, respectively. The weighted average interest rate on these advances is 3.40%. The FHLB has a one time option to convert the \$5 million advance to a variable rate. If the FHLB exercises its option and increases the interest rate on this advance, the Bank has the option to pay the advance in full without penalty.

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 9 - FEDERAL HOME LOAN BANK ADVANCES AND OTHER BORROWINGS (Continued)

Pursuant to a collateral agreement with the FHLB, advances are secured by the Bank's FHLB stock and qualifying first mortgage loans.

The Bank also maintains a federal funds accommodation line of credit through three of its correspondent commercial banks (one in 2008). The accommodation line allows secured borrowings up to a maximum amount of \$8,450,000. Advances must be repaid on the next business day with interest. No borrowings were outstanding on these lines at December 31, 2009 or 2008.

NOTE 10 - REGULATORY MATTERS

As a national bank, the Bank is subject to the dividend restrictions set forth by the Comptroller of the Currency. Under such restrictions, the Bank may not, without the prior approval of the Comptroller of the Currency, declare dividends in any one year in excess of the sum of the Bank's current year earnings plus undistributed Bank earnings from the prior two years. The Bank has not paid any dividends to its stockholders to date.

The Bank is subject to various regulatory capital requirements administered by the federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the 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 are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of Total and Tier I capital (as defined in the regulations) to Risk-Weighted Assets (as defined), and of Tier I capital (as defined) to Average Assets (as defined). Management believes, as of December 31, 2009 and 2008, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2009 and 2008, the Bank is categorized as *well capitalized* under the regulatory framework for prompt corrective action. To be categorized as *well capitalized*, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table. There are no conditions or events since that date that management believes have changed the institution's category.

The Bank's actual capital amounts and ratios are also presented in the table. All amounts are in thousands of dollars.

	Actual		To Comply With Minimum Capital Requirements		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2009						
Total Capital (to Risk-Weighted Assets)	\$ 12,186	16.2%	\$ 6,023	8.0%	\$ 7,528	10.0%
Tier I Capital (to Risk-Weighted Assets)	\$ 11,239	14.9%	\$ 3,011	4.0%	\$ 4,517	6.0%
Tier I Capital (to Average Assets)	\$ 11,239	9.0%	\$ 4,969	4.0%	\$ 6,212	5.0%
As of December 31, 2008						
Total Capital (to Risk-Weighted Assets)	\$ 15,846	19.6%	\$ 6,482	8.0%	\$ 8,103	10.0%
Tier I Capital (to Risk-Weighted Assets)	\$ 14,814	18.3%	\$ 3,241	4.0%	\$ 4,862	6.0%
Tier I Capital (to Average Assets)	\$ 14,814	12.5%	\$ 4,722	4.0%	\$ 5,902	5.0%

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 11 - RETIREMENT PLAN

The Bank has established a 401(k) retirement plan which allows eligible officers and employees to contribute up to the maximum allowable amount under the IRS Code. The Bank has the option, at the discretion of the board of directors, to make contributions to the plan. During the year ended December 31, 2009 the Bank did not contribute to the plan. For the year ended December 31, 2008 the Bank contributed \$25,286.

NOTE 12 - STOCK OPTIONS

Effective with the organization of the Bank, the Bank's board of directors approved a stock option plan, which was ratified by the Bank's stockholders on April 4, 2003. The plan reserved 141,000 shares of the Bank's common stock for issuance pursuant to the options to be granted. In December 2005, the board of directors awarded a total of 123,250 options related to these shares, by individual agreements to employees of the Bank. These options have an exercise price of \$13.50 per share, which was estimated to be greater than the fair value of the stock on the date the options were granted. The options became fully vested on the grant date and expire in five years. The Bank intends to issue new common shares when options are exercised. No options were exercised under this plan in 2009 and 2008, respectively.

A summary of the status of the Bank's stock options outstanding is presented below:

	2009		2008	
	Shares Under Option	Weighted Average Exercise Price	Shares Under Option	Weighted Average Exercise Price
Outstanding at Beginning of Year	123,250	\$ 13.50	123,250	\$ 13.50
Granted by Individual Agreements	0	0	0	0
Exercised	0	0	0	0
Forfeited	0	0	0	0
Outstanding at End of Year	<u>123,250</u>	<u>\$ 13.50</u>	<u>123,250</u>	<u>\$ 13.50</u>
Options Exercisable at Year-End	<u>123,250</u>		<u>123,250</u>	
Weighted-Average Fair Value of Options Granted During the Year	\$ <u>N/A</u>		\$ <u>N/A</u>	

Information pertaining to options outstanding at December 31, 2009 is as follows:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$ 13.50	123,250	1.00	\$ 13.50	123,250	\$ 13.50

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 13 - LEASE COMMITMENTS

The Bank has entered into an operating lease agreement and a sublease agreement to rent space that serves as the Bank's main office. The initial term of the lease and sublease was for five years commencing in November and October 2002, respectively. The lease and sublease were renewed for an additional five years commencing on November 1, 2007 and expiring October 31, 2012. The Bank has the option at that time to renew for an additional five years. The total monthly rental payment under the lease and sublease is \$13,630.

The Bank entered into an operating lease during 2007 for the rental of office space in Dandridge, Tennessee for the purpose of establishing a loan production office. This lease has an initial term of five years with two five year renewal options. The total monthly rental under this lease is \$1,308. During 2008, the Bank ceased operations at this loan production office. The Bank currently has the space sublet for \$800 per month, increasing to \$1,000 per month in January 2010 until the existing lease expires.

The Bank entered into a twenty year ground lease in west Morristown where the Bank built a full service branch. The payments on this lease commenced in January of 2008 at \$2,500 per month.

The Bank also leases certain office equipment for \$864 per month. These leases will expire in 2011.

Rent expense for all lease commitments for the year ended December 31, 2009 was \$223,601 (\$207,336 during 2008).

Future minimum rental payments under all noncancellable operating leases as of December 31, 2009 are as follows:

2010	\$	219,624
2011		219,624
2012		167,613
2013		30,000
2014		30,000
Thereafter		390,000
	\$	<u>1,056,861</u>

NOTE 14 - SIGNIFICANT GROUP CONCENTRATIONS OF CREDIT RISK

The Bank's primary business activity is with customers located within East Tennessee. As of December 31, 2009 and 2008, the Bank had a concentration in loans which are secured by real estate, as shown in Note 4. The usual risk associated with such a concentration is generally mitigated by being spread over several hundred unrelated borrowers and by adequate loan-to-collateral value ratios. Note 3 describes the types and amounts of securities the Bank has invested in as of December 31, 2009 and 2008. The Bank does not have any significant concentrations with any one industry or customer.

NOTE 15 - DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS

The Bank uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with FASB ASC 820, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in certain instances, there are no quoted market prices for the Bank's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 15 - DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The recent fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

*Valuation Hierarchy:*

In accordance with this guidance, the Bank groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

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

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

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

Following is a description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy.

**Assets:**

Securities – Where quoted prices are available in an active market, the Bank classifies the securities within level 1 of the valuation hierarchy. Securities are defined as both long and short positions. Level 1 securities include highly liquid government bonds and exchange-traded equities.

If quoted market prices are not available, the Bank estimates fair values using pricing models and discounted cash flows that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, and credit spreads. Examples of such instruments, which would generally be classified within level 2 of the valuation hierarchy, include government-sponsored enterprise obligations, corporate bonds, and other securities. Mortgage-backed securities are included in level 2 if observable inputs are available. In certain cases where there is limited activity or less transparency around inputs to the valuation, the Bank classifies those securities in level 3.

Impaired loans - The Bank does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with FASB ASC 310. The fair value of

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 15 - DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

impaired loans is estimated using several methods including collateral value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At December 31, 2009, substantially all of the total impaired loans were evaluated based on the fair value of collateral. In accordance with FASB ASC 310, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on the observable market price or a current, independent appraised value, the Bank records the impaired loan as nonrecurring Level 2. The Bank records the impaired loan as nonrecurring Level 3 when management has become aware of events that have significantly impacted the condition or marketability of the collateral since the most recent appraisal. In this case, management will reduce the appraisal value based on factors determined by their judgment and collective knowledge of the collateral and market conditions.

Foreclosed Assets - Foreclosed assets consisting of properties obtained through foreclosure or in satisfaction of loans is initially recorded at fair value, determined on the basis of current appraisals, comparable sales, and other estimates of value obtained principally from independent sources, adjusted for estimated selling costs. At the time of foreclosure, any excess of the loan balance over the fair value of the real estate held as collateral is treated as a charge against the allowance for loan losses. Gains or losses on sale and any subsequent adjustments to the fair value are recorded as a component of foreclosed real estate expense. Other real estate is included in Level 3 of the valuation hierarchy.

Liabilities:

At December 31, 2009, the Bank had no liabilities meeting the criteria for disclosure.

The following tables present the financial instruments carried at fair value as of December 31, 2009, in the balance sheets:

Assets measured at fair value on a recurring basis as of December 31, 2009:

	Total	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Securities Available for Sale:				
Obligations of U.S. Government Agencies	\$ 18,070,823	\$ 18,070,823	\$ 0	\$ 0
Mortgage-Backed and Related Securities	15,486,682	0	15,486,682	0
Securities Available-for-Sale	\$ 33,557,505	\$ 18,070,823	\$ 15,486,682	\$ 0

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 15 - DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Assets measured at fair value on a nonrecurring basis as of December 31, 2009:

	Total	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired Loans	\$ 6,975,293	\$ 0	\$ 0	\$ 6,975,293
Foreclosed Assets	1,827,445	0	0	1,827,445
	<u>\$ 8,802,738</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 8,802,738</u>

The Bank has an established process for determining fair values. Fair value is based upon quoted market prices, where available. If listed prices or quotes are not available, fair value is based upon internally developed models or processes that use primarily market-based or independently-sourced market data, including interest rate yield curves, option volatilities and third party information. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. Furthermore, while the Bank believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies, or assumptions, to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

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

Cash and Cash Equivalents - Cash and cash equivalents include cash and due from banks, cash on hand, and federal funds sold. The carrying amounts reported in the balance sheets approximate fair value.

Equity Investments - The carrying value of these equity investments with regulatory and other entities in which the Bank has an ongoing business relationship approximates fair value, based on the stock redemption provisions of entities.

Interest Receivable – The carrying amounts of interest receivable approximate fair value.

Deposits - The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits and NOW, money market, and savings accounts, is equal to the amount payable on demand at the reporting date. The fair value of time deposits is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

Securities Sold Under Agreements to Repurchase - The estimated fair value of these liabilities, which are short term, approximates their carrying value.

Advances From Federal Home Loan Bank - Rates currently available to the Bank for debt with similar terms and remaining maturities are used to estimate the fair value of existing debt.

Interest Payable – The carrying amounts of interest payable approximate fair value.

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 15 - DISCLOSURES ABOUT FAIR VALUE OF FINANCIAL INSTRUMENTS (Continued)

Commitments to Extend Credit - The fair value of loan commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. Fixed-rate commitments to extend credit are not material to the Bank as of December 31, 2009 and 2008.

The carrying amount and estimated fair value of the Bank's financial instruments at December 31, are as follows:

	2009		2008	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>FINANCIAL ASSETS:</b>				
Cash and Cash Equivalents	\$ 7,186,512	\$ 7,186,512	\$ 3,079,510	\$ 3,079,510
Securities	\$ 33,557,505	\$ 33,557,505	\$ 26,371,646	\$ 26,464,581
Equity Investments	\$ 829,900	\$ 829,900	\$ 2,027,342	\$ 2,027,342
Net Loans	\$ 75,759,650	\$ 75,220,822	\$ 81,328,038	\$ 80,866,092
Interest Receivable	\$ 542,335	\$ 542,335	\$ 559,845	\$ 559,845
<b>FINANCIAL LIABILITIES:</b>				
Deposits	\$ 98,854,409	\$ 99,333,634	\$ 92,384,414	\$ 92,950,743
Securities Sold Under Agreements to Repurchase	\$ 2,583,891	\$ 2,583,891	\$ 3,264,788	\$ 3,264,788
Advances From Federal Home Loan Bank	\$ 10,500,000	\$ 10,834,639	\$ 7,000,000	\$ 7,655,262
Interest Payable	\$ 346,071	\$ 346,071	\$ 409,779	\$ 409,779

NOTE 16 - EMPLOYMENT AGREEMENTS

The Bank has entered into employment agreements with five of its officers for a minimum annual salary and other related benefits. The agreements also contain certain non-compete restrictions.

NOTE 17 - COMMITMENTS AND CONTINGENT LIABILITIES

The Bank is subject to claims and lawsuits which arise primarily in the ordinary course of business. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits will not have a material adverse effect on the financial position of the Bank.

NOTE 18 - IMPAIRED EQUITY INVESTMENTS

Included in the Bank's December 31, 2009 statement of operations as loss on impaired equity investments is a \$1,128,642 impairment charge related to the Bank's investments in Silverton Financial Services, Inc., which was a leading correspondent bank with over 1,400 bank clients, and was taken into receivership on May 1, 2009. In accordance with generally accepted

COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

NOTES TO FINANCIAL STATEMENTS

Years Ending December 31, 2009 and 2008

NOTE 18 - IMPAIRED EQUITY INVESTMENTS (Continued)

accounting principles, the Bank recognized this loss in the first quarter of 2009. The Bank does not have any equity investments in other correspondent banks.

## Market for Our Common Equity and Related Matters

From August 16, 2006 to December 18, 2008, the Bank's common stock was traded on the Nasdaq National Market ("Nasdaq") under the symbol CNLA. On December 9, 2008, we voluntarily delisted the common stock from Nasdaq, effective the open of trading on December 19, 2008. Since our voluntary delisting, our shares have been quoted on the Nasdaq Over-the-Counter Bulletin Board under the symbol CNLA.OB, and on the Pink Sheets under the symbol CNLA. We took this action to reduce and more effectively manage our regulatory and administrative costs, and to enable our management to better focus on the growth and development of our business.

As of March 15, 2010, there were approximately 744 shareholders of record of the Bank's common stock and 1,891,426 shares outstanding. The development of an active secondary market requires the existence of an adequate number of willing buyers and sellers. Historically, the reported trading volume would indicate a lack of activity in the secondary market for our common stock. The lack of activity in the secondary market for our common stock may materially impact a shareholder's ability to promptly sell common stock at a price acceptable to the selling shareholder, and contributes to the volatility of our common stock's price. The high and low prices per share as reported on a quarterly basis in 2009 and 2008 are as follows:

<u>Quarter</u>	<u>High</u>	<u>Low</u>	<u>Dividend</u>
<b>2009</b>			
4 <sup>th</sup> Quarter	\$3.00	\$ 1.70	\$ –
3 <sup>rd</sup> Quarter	4.25	1.55	–
2 <sup>nd</sup> Quarter	4.30	2.60	–
1 <sup>st</sup> Quarter	4.25	2.10	–
<b>2008</b>			
4 <sup>th</sup> Quarter	\$6.55	\$ 3.71	\$ –
3 <sup>rd</sup> Quarter	8.00	6.25	–
2 <sup>nd</sup> Quarter	9.00	5.50	–
1 <sup>st</sup> Quarter	11.00	6.60	–

The Bank has not paid and does not anticipate paying dividends on its common stock in the immediate future. The Bank is required by federal law to obtain prior approval of the Office of the Comptroller of the Currency (OCC) for payments of dividends if the total of all dividends declared by our Board of Directors in any year will exceed (1) the total of the Bank's net profits for that year, plus (2) the Bank's retained net profits of the preceding two years, less any required transfers to surplus. Under applicable OCC regulations, no dividends may be paid by a national bank until it is cumulatively profitable; as a consequence, the Bank is currently prohibited from paying dividends. No assurance can be given that dividends will be declared by the Bank, or if declared, what the amount of the dividends will be or whether such dividends, once declared, would continue.

Shareholders may obtain, without charge, a copy of Community National Bank of the Lakeway Area's 2009 Annual Report to the Office of the Comptroller of the Currency on Form 10-K. Written requests should be addressed to:

Darwin K. Kilday  
Chief Financial Officer and Corporate Secretary of the Bank  
Community National Bank of the Lakeway Area  
PO Box 1919  
Morristown, TN 37816-1919

A copy of the Annual Report on Form 10-K is also available on our website [www.cnbla.com](http://www.cnbla.com).

# COMMUNITY NATIONAL BANK OF THE LAKEWAY AREA

## *Board of Directors*

**Steven J. Adams**

*Independent Business Consultant*

**Ronald D. Ailey**

*Co-Owner, Burke-Ailey Construction*

**Jerry C. Cranford**

*Retired*

**Uriel Edde, Jr.**

*President, Edde Chevrolet, Inc*

**Samuel F. Grigsby, Jr.**

*Chairman/CEO, Community National Bank*

**Charles A. Hughes**

*President/CLO Community National Bank*

**Darwin K. Kilday**

*Executive VP/CFO, Community National Bank*

**Claude Leroy Royston**

*President, Royston Chrysler, Dodge, Jeep*

**Thomas D. Rush, Jr.**

*Executive Vice President., Community National Bank*

**M. Edward Stiner, Jr.**

*Regional President, Community National Bank*

**Eric N. Ward**

*Agency Manager, TN Farmers Mutual Insurance Co*

**Donald Watson**

*Retired*

## *Officers*

**Samuel F. Grigsby, Jr.**

**Charles A. Hughes**

**Darwin K. Kilday**

**M. Edward Stiner**

**Thomas D. Rush, Jr.**

**Carlos E. Wolfe**

**Debbie K. Estes**

**Donna D. Hubbard**

**Annette Smith**

**Jay C. Setser**

**Patricia A. Bowman**

**Brandon S. Stubblefield**

**Gregory E. Harrell**

**Dan Redding**

**Chairman/CEO**

**President/CLO**

**Executive Vice President/CFO**

**Regional President**

**Executive Vice President**

**Senior Vice President**

**Vice President**

**Vice President**

**Vice President**

**Assistant Vice President**

**Auditor**

**Controller & Operations Manager**

**Information Technology Officer**

**Mortgage/Commercial Loan Officer**