



TRI CITY BANKSHARES CORPORATION

Dear Shareholder,

We are certain 2013 will be remembered as the year Tri City Bankshares Corporation turned the page. After four years of hard work resolving problem loans acquired from the FDIC as well as credit issues which developed in our legacy loan portfolio due to the economic downturn, we are proud to report that past due and non-accrual loans are at their lowest level since December 31, 2008.

As our major loan clean-up effort began to subside in 2013, we have focused on several important initiatives. We view loan growth as the key to enhanced profitability in future years. Reduced loan demand during a soft economy resulted in excess funds recovered from loan collections being deployed to investment securities. In today's interest rate environment, low investment yields compress our net interest margin. As we grow the loan portfolio our net interest margin will increase as will our profitability.

In support of our focus on loan growth, the most significant strategic initiative in 2013 was a re-organization of our commercial lending operation. To maximize our strengths in area markets, senior commercial lenders now manage commercial loan hubs consisting of multiple Tri City offices. The hub structure will provide efficiencies in each of the markets we serve, lead to more consistent loan underwriting and serve as a good training ground for our younger lenders as they work in a team environment. We believe this structural change, plus the addition of experienced marketers hired in 2013, will lead to the desired loan growth.

In addition to the commercial lending changes, we enhanced our retail lending operation during the year. We installed a fully automated mortgage origination system that will enhance the customer experience and streamline the application process and loan underwriting. The new mortgage origination system has online access as a feature of our website. In fact, the entire website is new and improved as a result of the first major "facelift" for this popular bank delivery channel.

Other important improvements were made this year in how we go to market. In addition to our branch footprint, online banking and enhanced website, we rolled out mobile banking in 2013 as another vehicle to serve our customers. In just six months the mobile application has attracted more than 12,000 users.

The Board of Directors also made the strategic decision to sell our Cedarburg and Grafton facilities in the 4th quarter of 2013, along with \$21.6 million of Ozaukee County deposits associated with those offices. The sale resulted in a pre-tax gain of \$2.1 million and will allow management to focus on our core markets in Milwaukee county and Racine/Kenosha as well.

The Board of Directors continues to monitor capital levels following the prepayment of 2013 and 2014 dividends in December of 2012. During 2013, bank regulators finalized new capital standards which will require all banks to hold more capital. The enhanced capital requirements begin to take effect in 2015 and are phased in over several years. Your Board has always voted to maintain high levels of equity to allow the Corporation and the banking subsidiary to operate from a position of strength, and we are positioned well within the new regulatory expectations. The Bank's Capital Policy as amended in January 2014 will ensure that position continues.

With a strong capital base as our foundation, we believe the 2013 initiatives will allow us to serve our customers better, grow the loan portfolio and lead to enhanced profitability in the years to come.

Very truly yours,

TRI CITY BANKSHARES CORPORATION

A handwritten signature in black ink, appearing to read "Ronald K. Puetz". The signature is fluid and cursive, with a prominent loop at the end.

Ronald K. Puetz
Chairman of the Board
Chief Executive Officer

Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion provides management's analysis of the audited consolidated financial statements of Tri City Bankshares Corporation (the "Corporation") and should be read in conjunction with those financial statements. This discussion focuses on significant factors that affected the Corporation's financial performance in 2013, with comparisons to 2012 and to 2011 where applicable. For all periods presented, the operations of Tri City National Bank (the "Bank") contributed substantially all of the Corporation's revenues and expenses. Included in the operations of the Bank are the activities of its wholly-owned subsidiaries, Tri City Capital Corporation and Title Service of Southeast Wisconsin, Inc.

This report contains statements that may constitute forward-looking statements that speak of the Corporation's plans, goals, beliefs or expectations, refer to estimates or use similar terms. Forward-looking statements are subject to significant risks and uncertainties. The Corporation's actual results may differ materially from the results discussed in such forward-looking statements.

On August 8, 2012 the Corporation's shareholders were notified that recently-enacted legislation allowed the Corporation and other banking companies with fewer than 1,200 shareholders to remove their stock from registration under the Securities Exchange Act of 1934 and thereby terminate their obligation to file financial and other reports with the Securities and Exchange Commission ("SEC"). The Board of Directors approved the filing of Form 15 with the SEC to voluntarily deregister, which officially ended the Corporation's SEC-reporting obligations as of November 6th, 2012. As a result, there are two audit opinions provided by Baker Tilly Virchow Krause included in the audited financial statements. The first opinion states that the audits as of December 31, 2013 and December 31, 2012 were done in accordance with auditing standards generally accepted in the United States of America. The second opinion indicates that the audit completed for the period ended December 31, 2011 was conducted in accordance with the standards of the Public Company Accounting Oversight Board as required by the SEC.

Performance Summary

The Corporation posted net income of \$8.9 million during 2013, an increase of \$0.8 million, or 9.3%, compared to 2012. Earnings per share increased to \$1.00 for the full year ending on December 31, 2013 compared to \$0.92 for the same period in 2012. The increase in earnings was due to a \$0.7 million decrease in the provision for loan losses, a \$2.3 million increase in non-interest income and a \$2.1 million decrease in non-interest expense which was offset by a \$3.9 million decrease in net interest income and a \$0.4 million increase in income tax expense.

The decrease in the provision for loan losses was due to a decrease in non-performing loans during 2013 compared to 2012. The increase in non-interest income was largely due to a \$2.2 million gain on the sale of the Bank's Cedarburg and Grafton locations during the 4th quarter of 2013. The decrease in non-interest expense was primarily due to a decrease in data processing costs and a one-time expense incurred during 2012. The decrease in net interest income was due to a reduction of interest income on both loans and investments which was partially offset by a decrease in interest paid on deposits.

The Corporation's total assets decreased \$51 million, or 4.1%, from \$1,232 million at December 31, 2012 to \$1,181 million at December 31, 2013. The decrease in total assets was primarily due to a decrease in investments, federal funds sold and loans which was offset by an increase in other money market instruments which represent excess funds invested at the Federal Reserve Bank of Chicago as an alternative to federal funds sold. In addition, total deposits decreased \$60.4 million as of December 31, 2013 compared to December 31, 2012 due to both the sale of our Cedarburg and Grafton branches and a decline in municipal deposits.

There were no dividends paid to shareholders during 2013. However, in December of 2012, the Board of Directors of the Corporation approved a special dividend of \$1.70 per share. This dividend was approved at that time due to the likelihood of less favorable tax treatment of dividend income in 2013 and beyond. In effect, the Corporation "prepaid" at least two years' dividends in consideration of the potential advantage to our shareholders under the previous dividend tax structure.

The Corporation has a long history of maintaining capital ratios in excess of the levels required to be considered well capitalized. This philosophy is unchanged. The Board of Directors is confident that shareholders will appreciate this decision and are equally confident that shareholders will understand the elimination of dividends until the prepaid amount is realized as future earnings. The Board of Directors currently plans to resume quarterly dividend payments in 2015. However, the Board of Directors cannot predict the economy, and as a result cannot predict earnings for the Corporation that far in advance. The Board of Directors will continue to review earnings, regulatory requirements and other factors on a quarterly basis when considering the appropriate level of dividends.

On October 23, 2009, the Bank was the successful bidder for the Bank of Elmwood ("Acquired Bank") through an FDIC-assisted purchase (the "Acquisition"). The Acquisition was the result of a competitive bidding process facilitated by the FDIC. The Bank bid negative \$110.9 million and the FDIC estimated the net cost of the transaction to be \$101.1 million and the "least costly" resolution for the FDIC. The Acquisition has positively impacted the earnings of the Bank.

INCOME STATEMENT ANALYSIS

Table 1 provides average balances of interest-earning assets and interest-bearing liabilities, the interest income and expense resulting from each, and the calculated interest rates earned and paid. The table further shows net interest income, interest rate spread, and the net interest margin on a tax-equivalent basis for the years ended December 31, 2013, 2012 and 2011.

Table 1

AVERAGE BALANCES AND INTEREST RATES (Interest rates on a tax-equivalent basis) (Dollars in Thousands)

	2013			2012			2011		
	Average Balance	Interest	Yield or Cost	Average Balance	Interest	Yield or Cost	Average Balance	Interest	Yield or Cost
ASSETS									
Interest-earning assets:									
Loans ⁽¹⁾	\$ 687,577	\$ 36,024	5.24%	\$ 695,408	\$ 40,870	5.88%	\$ 722,719	\$ 46,958	6.50 %
Taxable investment securities ⁽²⁾	290,758	2,946	1.01%	307,775	3,250	1.06%	256,707	4,824	1.88 %
Nontaxable investment securities	44,093	1,674	3.80%	47,922	1,983	4.14%	47,050	2,102	4.47 %
Other money market instruments	71,138	177	0.25%	-	-	-%	-	-	- %
Fed funds sold	9,412	8	0.09%	48,593	43	0.09%	25,268	28	0.11 %
Total interest-earning assets	1,102,978	40,829	3.70%	1,099,698	46,146	4.20%	1,051,744	53,912	5.13 %
Noninterest-earning assets:									
Other assets	80,374			77,681			66,907		
TOTAL ASSETS	\$ 1,183,352			\$ 1,177,379			\$ 1,118,651		
LIABILITIES AND EQUITY									
Interest-bearing liabilities:									
Transaction accounts	\$ 292,877	217	0.07%	\$ 276,010	371	0.13%	\$ 256,241	485	0.19 %
Money market	224,625	429	0.19%	214,817	721	0.34%	199,816	1,011	0.51 %
Savings deposits	206,389	89	0.04%	198,957	283	0.14%	182,093	379	0.21 %
Other time deposits	154,347	1,180	0.76%	179,323	1,829	1.02%	193,147	2,696	1.40 %
Short-term borrowing	15	-	0.00%	1,256	10	0.80%	3,027	13	0.43 %
Total interest bearing liabilities	878,253	1,915	0.22%	870,363	3,214	0.37%	834,324	4,584	0.55 %
Noninterest-bearing liabilities:									
Demand deposits	184,613			171,994			161,355		
Other	8,962			10,674			5,523		
Stockholders' equity	111,524			124,348			117,449		
Total liabilities and stockholders' equity	\$ 1,183,352			\$ 1,177,379			\$ 1,118,651		
Net interest earnings and interest rate spread ⁽³⁾									
		\$ 38,914	3.48%	\$ 42,932	3.83%		\$ 49,328	4.58 %	
Net interest margin ⁽⁴⁾									
			3.53%		3.90%			4.69 %	

1. The average loan balances and rates include non-accrual loans.
2. The interest income on tax exempt securities is computed on a tax-equivalent basis using a tax rate of 34% for all periods presented.
3. Interest rate spread represents the difference between the average yield earned on average interest-earning assets for the period and the average rate accrued on average interest-bearing liabilities for the period and is represented on a tax-equivalent basis.
4. Net interest margin represents net interest income for a period divided by average interest-earning assets for the period and is represented on a tax-equivalent basis.

The following table sets forth, for the periods indicated, a summary of the changes in interest earned on a fully tax-equivalent basis and interest paid resulting from changes in volume and rates:

Table 2

NET INTEREST INCOME AND EXPENSE VOLUME AND RATE CHANGE
(Dollars in Thousands)

	2013 Compared to 2012 Increase (Decrease) Due to			2012 Compared to 2011 Increase (Decrease) Due to		
	Volume	Rate(1)	Net	Volume	Rate(1)	Net
Interest earned on:						
Loans	\$ (460)	\$ (4,386)	\$ (4,846)	\$ (1,775)	\$ (4,313)	\$ (6,088)
Taxable investment securities	(180)	(124)	(304)	960	(2,534)	(1,574)
Non-taxable investment	(158)	(151)	(309)	39	(158)	(119)
Other money market instruments	177	-	177	-	-	-
Fed funds sold	(35)	-	(35)	26	(11)	15
Total interest-earning assets	\$ (656)	\$ (4,661)	\$ (5,317)	\$ (750)	\$ (7,016)	\$ (7,766)
Interest paid on:						
Transaction accounts	\$ 23	\$ (177)	\$ (154)	\$ 37	\$ (151)	\$ (114)
Money market	33	(325)	(292)	76	(366)	(290)
Savings deposits	11	(205)	(194)	35	(131)	(96)
Time deposits	(255)	(394)	(649)	(193)	(674)	(867)
Short-term borrowings	(10)	-	(10)	(8)	5	(3)
Total interest-bearing liabilities	\$ (198)	\$ (1,101)	\$ (1,299)	\$ (53)	\$ (1,317)	\$ (1,370)
Increase (decrease) in net interest income			\$ (4,018)			\$ (6,396)

1. The change in interest due to both rate and volume has been allocated to rate changes.

Net Interest Income

Total interest income on loans decreased \$4.8 million, or 11.9%, during 2013 compared to the same period in 2012. The decrease was due to both a reduction in loan volume and the low interest rate environment. Average loans decreased \$7.8 million, or 1.1%, during 2013 due primarily to the run-off of acquired loans. In addition to a decrease in loan volume, loan yields decreased 64 basis points to 5.24% during 2013 compared to 5.88% in 2012, as new and renewed loans were booked at lower interest rates than the existing portfolio. The decrease in interest income on loans was also due to a \$1.6 million decrease in purchase accounting income related to the Acquisition from \$4.1 million during 2012 to \$2.5 million during 2013. Loan discount accretion is realized as the Acquired Bank's loan portfolio continues to amortize, mature, renew or pay off. Interest income on loans during 2013, excluding loan discount accretion, decreased by \$3.2 million compared to same period in 2012.

Interest income on investment securities on a tax-equivalent basis decreased \$0.5 million, or 8.9%, during 2013 compared to the same period in 2012. This change reflects both a decrease in volume and a decrease in yield. Total average investment securities decreased \$20.8 million to \$334.9 million as of December 31, 2013 due to an increase in short-term money market investments. The average tax equivalent yield on the investment securities decreased 9 basis points to 1.38% during 2013 compared to 1.47% for the same period in 2012. The decrease in the average tax equivalent yield was primarily due to the high level of mortgage refinance activity which caused prepayment speeds on our investments in collateralized mortgage obligations ("CMO") and mortgage-backed securities ("MBS") to increase and resulted in a decrease in interest income due to accelerated levels of premium amortization.

Interest expense during 2013 decreased \$1.3 million or 40.4%, compared to the same period in 2012. The average yield on interest-bearing liabilities decreased 15 basis points to 0.22% during 2013 compared to 0.37% in 2012. The decrease in average yields was partially offset by an increase in average interest-bearing liabilities of \$7.9 million to \$878.3 million for 2013 from \$870.4 million during 2012, due to an increase in core deposits despite the sale of \$21.6 million in deposits associated with the Cedarburg/Grafton transaction.

Net interest income in the consolidated statements of income (which excludes the tax-equivalent adjustment) was \$38.3 million during 2013, compared to \$42.2 million for the same period in 2012. The tax equivalent adjustments (adjustments needed to bring tax-exempt interest to a level that would yield the same after-tax income had that income been subject to taxation using a 34% tax rate) of \$0.6 million for 2013 and \$0.7 million for 2012 resulted in a tax-equivalent net interest income of \$38.9 million and \$42.9 million, respectively. The tax-equivalent net interest margin for 2013 was 3.53% compared to 3.90% during 2012.

Total interest income on loans decreased \$6.1 million, or 13.0%, during 2012 compared to the same period in 2011. The decrease was due to both a reduction in loan volume and the continued low interest rate environment. The decrease in interest income on loans was also due to a \$1.7 million decrease in purchase accounting income related to the Acquisition from \$5.8 million during 2011 to \$4.1 million during 2012. Interest income on investment securities on a tax-equivalent basis decreased \$1.7 million, or 24.4%, during 2012 compared to the same period in 2011. This change reflects an increase in volume which was partially offset by a decrease in yield. Interest expense during 2012 decreased \$1.4 million or 29.9%, compared to the same period in 2011. The decrease was due to a decrease in yield which was partially offset by an increase in volume. Net interest income on a tax-equivalent basis was of \$42.9 million in 2012 and \$49.3 million in 2011. The tax-equivalent net interest margin for 2012 was 3.90% compared to 4.69% during 2011.

Provision for Loan Losses

The provision for loans losses (“PLL”) results from the assessment of qualitative and quantitative factors to determine the required allowance for loan losses (“ALL”). Factors considered are the size of the portfolio, levels of nonperforming loans, historical losses, risk inherent in certain categories of loans, concentrations of loans to certain borrowers or certain industry segments, economic trends, collateral pledged, and other factors that could affect loan losses as discussed in the paragraphs following Table 8.

The PLL represents the amount periodically added to the Bank’s ALL and charged to earnings in the relevant period. The PLL for 2013 was \$6.5 million, a decrease from \$7.2 million in 2012 and \$8.4 million in 2011. The fluctuations in the PLL reflect the charge-off activity, net of recoveries on loans previously charged off as well as the level of non-performing loans. Net charge-offs were \$6.3 million in 2013, \$6.0 million in 2012 and \$6.9 million in 2011. Charge-offs, and the corresponding PLL, are expected to decline over time as the level of net charge-offs and problem loans decline as the economy improves.

Non-interest Income

A summary of non-interest income for the years ended December 31, 2013, 2012 and 2011 appear in Table 3 below:

Table 3

NON-INTEREST INCOME (Dollars in Thousands)

	For the Year Ended December 31,		
	2013	2012	2011
Service charges on deposits	\$ 9,777	\$ 10,108	\$ 9,987
Loan servicing income	357	133	318
Net gain on sale of loans	1,558	2,569	1,249
Increase in cash surrender value of life insurance	1,010	837	467
Gain on sale of branches	2,153	-	-
Non-accretable loan discount	3,680	1,974	2,247
Other income	950	1,571	522
Total non-interest income	\$ 19,485	\$ 17,192	\$ 14,790

Total non-interest income was \$19.5 million for 2013, an increase of \$2.3 million or, 13.3% from \$17.2 million in 2012. The increase was primarily due the one-time gain of \$2.1 million on the sale of the Cedarburg and Grafton branches and an increase in non-accretable loan discount income of \$1.7 million. The non-accretable loan discount income is related to the purchase accounting on the loans acquired in the Acquisition that were specifically identified as credit impaired which were paid or charged off during the year. In future years, non-accretable income will be dependent on the difference between future contractual payments expected to be received and the carrying amount of the loans specifically impaired. In addition to the one-time gain on the branch sale and the non-accretable loan discount income, loan servicing income increased by \$0.2 million and the cash surrender value of life insurance increased \$0.2 million. The increases were offset by a decrease in the net gain on sale of loans of \$1.0 million, a decrease in other income of \$0.6 million and a decrease in service charge income on deposits of \$0.3 million. The decrease in the net gain on sale of loans was due to an increase in mortgage rates during the year that resulted in a reduction in refinance activity in the secondary mortgage market. The decrease in other income was primarily due to a decrease in the gain on the sale of other real estate owned (“OREO”), net of carrying costs, of \$0.6 million in 2013 compared to 2012.

Total non-interest income was \$17.2 million for 2012, an increase of \$2.4 million or 16.2% from \$14.8 million in 2011. The increase was primarily due to three factors. Interest rates on mortgage loans continued to decline to record low levels in 2012 resulting in a record year in mortgage loan origination. The net gain on sale of loans increased \$1.3 million during 2012 compared to 2011 due to strong refinance activity in the secondary mortgage market. In addition, the Bank purchased an additional \$15.0 million of bank owned life insurance during 2012 which resulted in a \$0.4 million increase in the cash surrender value of life insurance. Finally, there was a \$1.0 million increase in other non-interest income that was driven by two factors. There was an increase in the gain on the sale of OREO, net of

carrying costs, of \$0.7 million in 2012 compared to 2011. In addition, there was one-time income of \$0.3 million on the sale of excess land at one of the Bank's branches. Loan servicing income decreased \$0.2 million due to an acceleration of the Bank's mortgage serving rights amortization due to an increased level of refinancing activity. Non-accretable income, which is part of the Acquisition related purchase accounting, decreased \$0.3 million in 2012 compared to 2011. This is income related to loans acquired in the Acquisition that were specifically identified as credit impaired which were paid or charged off during the year. In future years, non-accretable income will be dependent on the difference between future contractual payments expected to be received and the carrying amount of the loans specifically impaired.

Non-interest Expense

A summary of non-interest expense for the years ended December 31, 2013, 2012 and 2011 appear in Table 4 below:

Table 4

NON-INTEREST EXPENSE (Dollars in Thousands)

	For the Year Ended December 31,		
	2013	2012	2011
Salaries and employee benefits	\$ 21,406	\$ 21,407	\$ 22,037
Occupancy	4,093	3,733	4,067
Furniture and equipment	1,740	1,966	1,887
Computer services	2,979	4,075	3,679
Advertising and promotional	730	953	1,033
Regulatory agency assessments	1,273	1,286	1,317
Office supplies	765	833	790
Core deposit intangible amortization	230	310	418
Other expenses	4,777	5,518	5,597
Total non-interest expense	\$ 37,993	\$ 40,081	\$ 40,825

Total non-interest expense for 2013 was \$38.0 million, a decrease of \$2.1 million or 5.2% over 2012 as management continues to make expense control a priority. Salaries and employee benefits remained stable at \$21.4 million in both 2012 and 2013. Occupancy expense increased \$0.3 million in 2013 compared to 2012 due to an increase in maintenance and repair expenses, utilities and property taxes. Furniture and equipment decreased by \$0.2 million in 2012 while computer services decreased by \$1.1 million. The decrease in computer services was due to renegotiated telecommunications and data processing contracts. Advertising expense decreased \$0.2 million to \$0.7 million in 2013 as the Bank focused on larger, higher exposure advertising opportunities and discontinued several outlets that produced lower returns. Both office supply expense and core deposit amortization expense decreased \$0.1 million in 2013 compared to 2012. The core deposit amortization expense will decrease annually until it is fully amortized in 2017. Other non-interest expense decreased by \$0.7 million due to a reduction in loan collection and the aforementioned renegotiated telecommunications contracts.

Total non-interest expense for 2012 was \$40.1 million, a decrease of \$0.7 million or 1.8% over 2011. Salaries and employee benefits decreased \$0.6 million due to retirements, regular attrition and the closure of one in-store branch location while total benefit costs remained stable. Occupancy expense decreased \$0.3 million in 2012 compared to 2011 due to a decrease in maintenance and repair expenses, a decrease in rent expense and an increase in rental income. Furniture and equipment decreased slightly by \$0.1 million in 2012 while computer services increased by \$0.4 million. The increase in computer services was due to one-time charges related to a change in our telephone and data communications provider. This increase was partially offset by a decrease in data processing costs due to the negotiation of a new contract with our current provider. Advertising expense decreased \$0.1 million to \$0.9 million in 2012 as the Bank focused on larger, higher exposure advertising opportunities and discontinued several outlets that produced lower returns. Office supply expense remained stable while the Bank incurred core deposit amortization expense of \$0.3 million in 2012 compared to \$0.4 million in 2011. Other non-interest expense remained stable at \$5.5 million in 2012.

Income Taxes

Income tax expense was \$4.4 million in 2013 compared to \$4.0 million in 2012 and \$4.7 million in 2011. The Corporation's effective tax rate (income tax expense divided by income before income taxes) was 33.3% in 2013 compared to 33.0% in both 2012 and 2011.

BALANCE SHEET ANALYSIS

Investment Securities Portfolio

The investment securities portfolio is intended to provide the Bank with liquidity, a source of stable income, and is structured to minimize the Corporation's credit exposure.

Table 5

INVESTMENT SECURITIES PORTFOLIO (Dollars in Thousands)

	For the Year Ended December 31,					
	2013		2012		2011	
	Carrying Value	Percentage of Total	Carrying Value	Percentage of Total	Carrying Value	Percentage of Total
Obligations of:						
States and political subdivisions (tax exempt)	\$ 42,693	12.89%	\$ 44,008	12.5%	\$ 51,028	14.2%
States and political subdivisions (taxable)	12,589	3.80%	16,510	4.7%	12,118	3.4%
U.S. government sponsored entities	150,200	45.35%	151,781	43.2%	261,602	72.6%
Collateralized mortgage obligations	41,340	12.48%	43,812	12.5%	17,069	4.7%
Mortgage-backed securities	84,355	25.48%	95,413	27.1%	18,699	5.1%
Other	-	0.00%	-	0.00%	50	0.00%
Total investment securities	<u>\$ 331,177</u>	<u>100.00%</u>	<u>\$ 351,524</u>	<u>100.00%</u>	<u>\$ 360,566</u>	<u>100.00%</u>
Designated as:						
Available for sale	\$ 32,272	9.75%	\$ -	0.00%	\$ -	0.00%
Held to maturity	298,905	90.25%	351,524	100.00%	360,566	100.00%
Total investment securities	<u>\$ 331,177</u>	<u>100.00%</u>	<u>\$ 351,524</u>	<u>100.00%</u>	<u>\$ 360,566</u>	<u>100.00%</u>

The total investment securities portfolio decreased \$20.3 million or 5.8% to \$331.2 million at December 31, 2013 compared to \$351.5 million at December 31, 2012. At December 31, 2013, the total carrying value of investment securities represented 28.1% of total assets, compared to 29.3% at December 31, 2012. The decrease in the investment securities portfolio was due to called securities and high prepayment speeds on mortgage-backed securities which was partially offset by investment purchases.

States and political subdivisions (tax-exempt) investment securities decreased \$1.3 million, or 3.0% to \$42.7 million at December 31, 2013 compared to \$44.0 million at December 31, 2012. States and political subdivisions (taxable) investment securities decreased \$3.9 million or 23.6% to \$12.6 million at December 31, 2013 compared to \$16.5 million at year end 2012. Management mitigates credit quality concerns by limiting purchases to rated investments of high quality or, on a limited basis, to well-known local non-rated issues. Diversity in the municipal portfolio is maintained by limiting the amount of investment to any single debtor in the municipal category. At December 31, 2013, the Bank's securities portfolio did not contain any obligations of any single issuer that were payable by the same source of revenue or taxing authority where the aggregate carrying value of such securities exceeded 1.6% of stockholders' equity.

Investments in U.S. government sponsored entity ("GSE") securities decreased \$1.6 million to \$150.2 million at December 31, 2013 compared to \$151.8 million at year end 2012. Investments include three GSEs; the Federal Home Loan Bank, the Federal National Mortgage Association ("Fannie Mae"), and the Federal Home Loan Mortgage Corporation ("Freddie Mac"). Many of the GSE securities contain step-up features in which the yields are scheduled to increase in future periods. Step-up features provide the Bank the advantage of increasing yields in a rising rate environment in return for the optionality of a call feature favoring the issuer. GSEs such as Fannie Mae and Freddie Mac are not explicitly guaranteed by the U.S. government. The U.S. government has, however, provided unlimited support to both entities since 2009. The Federal Home Loan Bank and the Federal Farm Credit Bank to date have not required support from the U.S. Government.

Investments in CMO and MBS securities decreased \$13.5 million from \$139.2 million at December 31, 2012 to \$125.7 million at December 31, 2013. The decline in the investments in CMO and MBS securities was due to prepayments of \$45.8 million which was partially offset by \$32.3 million in purchases. Low interest rates through the first five months of 2013 resulted in elevated prepayment speeds as the underlying mortgages continued to be refinanced. As longer term interest rates began to rise in June of 2013, the mortgage refinancing boom largely ended resulting in slower prepayment speeds and slower premium amortization which had a positive effect on the investment yields. The mortgages underlying these securities are guaranteed by Fannie Mae, Freddie Mac and the Government National Mortgage Association ("Ginnie Mae").

In 2013 the Board of Directors amended the Bank's Investment Policy and voted to create an Asset/Liability and Investment Committee ("ALICO") to manage the balance sheet and oversee liquidity, contingency funding, investment strategy and monitor the Board approved limits tested by Asset/Liability modeling. The Committee consists of the CEO and CFO of the Bank and three outside members of the Board. The Committee reports to the Board on a quarterly basis.

Since the 2009 Acquisition, the investment portfolio has increased to represent 28.0% of the Bank's assets compared to 13.5% prior to the Acquisition. The investment in loan alternatives is the result of a decreasing loan portfolio. This trend will diminish as the loan portfolio increases, but investment securities performance in 2014 and 2015 will have a very significant impact on the balance sheet and the income statement.

The amended Investment Policy authorizes the use of a Registered Investment Advisor to manage a portion of the investment portfolio. The Board action was taken partially to address succession planning and partially due to the challenges in today's historically low rate environment. With the investment portfolio's increased impact on performance, the inclusion of a professional Registered Investment Advisor was deemed appropriate at this time.

Historically all of the investments securities have been classified as held to maturity. Beginning in the 4th quarter of 2013, management classified new purchases as available for sale. Securities classified as available for sale are those securities which the Bank has determined might be sold to meet potential liquidity needs, reposition holdings to increase returns or modify durations, or in response to changes in interest rates or other economic factors. They may or may not be held until maturity. Securities available for sale are carried at fair value.

Loans

Total loans were \$683.0 million at December 31, 2013, a decrease of \$21.6 million, or 3.0%, from \$704.6 million at December 31, 2012. The decrease in the loan portfolio during 2013 was attributable to portfolio amortization, payoffs and the continued reduction of the Acquired Bank's loan portfolio exceeding new loan production. Management is focused on portfolio growth and believes several factors will positively impact the effort in 2014. The increase of \$21.7 million in commercial real estate lending in 2013 is the result of a reorganization of the Bank's commercial loan group and hiring of several new marketing officers in 2013. Management will continue this effort with more marketing hires in 2014. This aggressive step is necessary because loan demand remains sluggish even with the economy slightly improved, and every competitor is seeking to expand its loan portfolio as well.

Loans originated by the Bank are generally loans to small businesses and individuals in the communities served in the Southeastern Wisconsin market. Although the legal lending limit of the Bank was \$19.2 million per borrower as of December 31, 2013, most of the Bank's larger customers are borrowers with credit needs of \$10 million and less and, in fact, most borrowers' credit relationships total less than \$1 million. At December 31, 2013, there were five relationships in excess of \$10 million with aggregate exposure totaling \$63.9 million, twelve relationships between \$5.0 and \$10 million with aggregate exposure totaling \$82.3 million and twenty six relationships between \$2.0 and \$5.0 million with aggregate exposure totaling \$89.7 million. Of these forty three relationships with \$235.9 million committed, the balance outstanding at December 31, 2013 was \$210.5 million. The remaining \$25.4 million represented unfunded liability on lines of credit to eighteen of the borrowers.

As of October 23, 2009 (the "Acquisition Date"), the Acquired Bank's loan portfolio of \$279.2 million was discounted \$85.1 million to reflect the estimated fair value of the acquired loans. Between the Acquisition Date and December 31, 2013, both the Acquired Bank's loan portfolio and the associated discount have been significantly reduced as a result of activity in the Acquired Bank's loan portfolio including renewals, amortization, pay-offs and charge-offs. Thus, as of December 31, 2013 the remaining Acquired Bank's loan portfolio was \$71.0 million with a discount of \$18.0 million reflecting the difference between cash flows expected to be received and contractually required payments on the acquired loans. In addition, \$48.7 million of the Acquired Bank's loan portfolio has been restructured or renewed into the Bank's portfolio and does not have any remaining discount. Management continues to pursue improvement in the credit quality of the acquired loans as they are renewed and integrated into the Bank's portfolio. Management believes the remaining discount will be sufficient to cover the remaining credit losses related to the acquired loans that have not yet been paid off, renewed or restructured since the Acquisition. The following table presents information concerning the composition of the loans held for investment by the Bank at the dates indicated.

Table 6

LOAN PORTFOLIO COMPOSITION
(Dollars in Thousands)

	For the Year Ended December 31,					
	2013		2012		2011	
	Amount	% of Total	Amount	% of Total	Amount	% of Total
Commercial	\$ 20,577	3.01%	\$ 20,286	2.89%	\$ 19,956	2.82%
Real estate						
Construction	29,493	4.32%	40,790	5.79%	46,600	6.58%
Commercial	346,972	50.80%	325,335	46.17%	298,043	42.11%
Residential	229,565	33.61%	258,548	36.69%	288,609	40.78%
Multifamily	45,610	6.68%	47,526	6.74%	39,799	5.62%
Installment and other	10,793	1.58%	12,151	1.72%	14,790	2.09%
Total loans	<u>\$ 683,010</u>	100.00%	<u>\$ 704,636</u>	100.00%	<u>\$ 707,797</u>	100.00%

As Table 6 indicates, commercial loans were \$20.6 million at December 31, 2013, an increase of \$0.3 million, or 1.4% from December 31, 2012 and comprised 3.0% of the total loan portfolio compared to \$20.3 million comprising 2.9% of the loan portfolio at December 31, 2012. Historically, commercial lending has been a small part of the Bank's portfolio which continues to be the case in 2013. Commercial loans are collateralized by general business assets such as accounts receivable, inventory and equipment and have no real estate component.

Real estate construction loans decreased \$11.3 million, or 27.7% to \$29.5 million, representing 4.3% of the total loan portfolio at December 31, 2013, compared to \$40.8 million or 5.8% of the total loan portfolio at December 31, 2012. The decrease from 2012 to 2013 was due primarily to continued repayment of the Bank's construction loan portfolio. Construction financing by definition is classified as such only during the development phase. When the project is complete, the outstanding balance is paid in one of several ways. In the case of residential real estate development, the sale of the spec home or lot results in payment. In the case of a commercial project, the completed building is refinanced to term debt for the developer or in some cases a new buyer. Historically, real estate construction loans have been made to developers who are well known to the Bank, have prior successful project experience and are well capitalized. Loans are made to customers in the Bank's Southeastern Wisconsin market with experience and knowledge of the local economy. As evidenced by the decreasing portfolio balances from 2011 to 2013, this segment of the market has not rebounded. Lot inventory remains available from projects completed or begun at the peak of the market. The Bank has seen an increase in new home starts by several builders, but the aggregate construction volume of individual home loans is not adequate to replace the developer pay down of the larger subdivision loans.

Commercial real estate loans increased \$21.7 million, or 6.7% to \$347.0 million at December 31, 2013, compared to \$325.3 million at December 31, 2012. This increase marks back-to-back years of growth in commercial real estate loans. Commercial real estate loans also increased \$27.3 million to \$325.3 million at December 31, 2012. The increase is due to new business exceeding the portfolio amortization, pay-offs and elimination of nonperforming commercial real estate loans from the Acquisition. This category of loans made up the largest component of the total loan portfolio at 50.8% at December 31 2013 and 46.2% at December 31, 2012. The increase is attributable to new relationships as well as new projects with current customers which outpaced run-off from the Acquired loan portfolio. The Bank's commercial real estate lending efforts are focused on owner occupied, improved property such as office buildings, warehouses, small manufacturing operations and retail facilities. The most significant risk factor is occupancy. The fact that the Bank prefers owner occupied commercial real estate reduces that risk, provided of course, the owner's business survives. The Bank's \$19.2 million per-borrower legal lending limit would permit it to compete for activity in the middle market, but management prefers to seek small businesses as its target borrowers. Loans to such businesses are approved based on the creditworthiness, economic feasibility and cash flow abilities of the borrower. The commercial real estate portfolio increases in each of the last two years also indicates a shift in the Bank's portfolio as management emphasizes commercial over residential real estate.

The shift away from residential real estate portfolio loans was made necessary due to the marketplace. Residential real estate loans in the portfolio have historically been originated with maturities of one, two or three years. Amortization periods offered to balloon customers had been 20-25 years depending on equity and loan-to-value ratios. In 2013, fixed rate financing at historically low rates caused many of our portfolio loan customers to seek long term financing in the secondary market. The Bank retained the customer and profited from the transaction in the secondary market, but the refinancing of in-house loans decreased the portfolio as a result. Residential real estate loans which include single family, 2-4 family dwellings and home equity lines of credit or "HELOCs" secured by real estate decreased \$29.0 million, or 11.2% to \$229.5 million comprising 33.6% of the Bank's total loan portfolio at December 31, 2013 compared to \$258.5 million comprising 36.7% of the Bank's total loan portfolio at December 31, 2012. In addition to the portfolio decrease caused by the low rate scenario in 2013, changes in 2014 mandated by the Consumer Financial Protection Bureau ("CFPB") further limit the Bank's traditional residential real estate products with "QM" or Qualified Mortgage rules all but eliminating balloon notes. Management will continue to offer consumer real estate loans with Adjustable Rate Mortgage or ARM loan products, but as stated, the shift to commercial real estate was a necessary strategic decision.

Mortgage customers seeking long term rate locks choose the secondary market products offered by the Bank where rates can be fixed for 15, 20 or 30 years. These loans are then sold and as a result, do not impact the portfolio yields nor are they a factor in interest rate risk. Loans from the Acquisition are either one-, two- or three-year balloons or Adjustable Rate Mortgages (“ARMs”). While ARMs were not the Bank’s vehicle of choice for rate management prior to the creation of the CFPB, they serve the purpose of providing annual rate adjustments after an initial fixed rate period of three to five years. ARM loans from the Acquired Bank residential real estate loan portfolio have been repriced since they were acquired at the margin (2.625%) prescribed by Freddie Mac over their assigned indices. A typical ARM index is the one year U.S. Treasury note rate, which continued near historic lows during 2013. This rate hovered between 0.10% and 0.20% for most of the year, resulting in adjusted rates below 3.0% for ARM mortgage customers. Of the variable rate mortgage loans repricable, total ARM portfolio yields decreased 32 basis points to 4.04% at December 31, 2013 from 4.36% at December 31, 2012 as a result of these rate decreases.

Multifamily real estate loans decreased \$1.9 million, or 4.0%, to \$45.6 million, representing 6.7% of the total loan portfolio at December 31, 2013 compared to \$47.5 million comprising 6.7% of the total loan portfolio at December 31, 2012. The loans in this category are collateralized by properties with more than four family dwelling units. The Bank has always been conservative in requiring borrowers to be well qualified and to provide their personal guarantees, as well as insisting on proper debt service coverage ratios and equity sufficient to sustain reasonable debt service in the event of interest rate pressure. Loans in this category typically have maturities of 3, 4 or 5 years and are amortized over 15 to 20 years. While any loan presents risk to the Bank, loans in this segment are performing quite well in the downturn because of the Bank’s underwriting criteria and with significant foreclosure activity in the market, many former homeowners are back in the rental market.

Installment loans decreased \$1.4 million, or 11.2%, to \$10.8 million at December 31, 2013 compared to \$12.2 million at December 31, 2012 due to the elimination of acquired loans outpacing new business. These loans consist of auto loans, mobile home loans and unsecured consumer loans which have been decreasing at the Bank for several years. Auto loan volume decreased despite improved new car sales in 2013 because dealer incentive financing makes this non-competitive. The Bank has historically limited its exposure to mobile home loans and unsecured consumer loans. However, the Bank acquired a number of such consumer loans in the Acquisition, many of which continue to perform, despite not meeting the Bank’s historical underwriting standards.

To ensure credit quality, overall credit management of portfolio loans in the Bank requires sound loan underwriting and administration, systematic monitoring of existing loans, effective loan review, early identification of problem loans, an adequate ALL and valid non-accrual and charge-off policies. As the economy weakened, loan underwriting was strengthened at the Bank by reducing delegated authority for lenders in the branch locations to ensure that appropriate standards would be met on every credit request. These precautions were extended through 2013 and deemed necessary as management believed many loan requests were the result of marginally qualified borrowers, both commercial and consumer, attempting to leave their existing bank due to rate pressure and new requirements such as additional collateral or other restrictive terms.

Other Real Estate Owned

Real estate acquired by foreclosure or by deed in lieu of foreclosure is held for sale and is initially recorded at the lesser of carrying value or fair value at the date of foreclosure less estimated selling expenses, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed and any excess of carrying value over fair value is recorded as a valuation allowance. At the date of foreclosure any write down to fair value less estimated selling costs is charged to the ALL. Costs relating to the development and improvement of the property may be capitalized; holding period costs and subsequent changes to the valuation allowance are charged to expense. A summary of the activity in OREO is as follows:

Table 7

OTHER REAL ESTATE OWNED (Dollars in Thousands)

	For the Year Ended December 31,					
	2013		2012		2011	
	Dollar Balance	Number of Properties	Dollar Balance	Number of Properties	Dollar Balance	Number of Properties
Beginning Balance	\$ 8,545	31	\$ 7,351	67	\$ 5,407	49
Additions	10,007	108	10,167	79	10,256	118
Sales	(12,843)	(117)	(8,973)	(115)	(8,313)	(100)
Ending Balance	<u>\$ 5,709</u>	<u>22</u>	<u>\$ 8,545</u>	<u>31</u>	<u>\$ 7,350</u>	<u>67</u>

Both the number of properties and the total balance of OREO declined in 2013 compared to 2012. As of December 31, 2013, the Bank had 22 properties in OREO with a total balance of \$5.7 million compared to 31 properties with a total balance of \$8.5 million as of December 31, 2012. Management expects a decrease in OREO activity during 2014 as the foreclosure pipeline, a precursor to OREO, continues to decline.

The collection practices for the Bank are centralized in order to efficiently handle the increased levels of past due loans, foreclosures and repossessions from both legacy loans and acquired loans. The Bank has three collection divisions reporting to an executive vice president: commercial loan workouts, retail loan collection and collection of the secondary market real estate loan portfolio serviced by the Bank. The Bank's goal is to minimize the delay in liquidation. The Bank has used its own officers as the best source for identifying buyers for OREO as they know which of the Bank's existing customers are in the market for real estate. This strategy has proven successful as Bank officers have been responsible for identifying the buyers for 150 of the 332 properties sold over the last three years.

Allowance for Loan Losses

The loan portfolio is the primary asset subject to credit risk. Credit risk is controlled and monitored through the use of lending standards, management's strict underwriting of potential borrowers and ongoing review of loan payment performance. Managing credit risk and minimizing loan losses is a high priority for management. Active asset quality administration, including early problem loan identification and timely resolution, aids in the management of credit risk and minimization of loan losses.

Table 8 summarizes the ALL balances at the beginning and end of each year from 2011 through 2013, changes in the ALL arising from loans charged-off and recoveries on loans previously charged-off, additions to the allowance that have been charged to expense and selected performance ratios.

Table 8

SUMMARY OF ALLOWANCE FOR LOAN LOSSES (Dollars in Thousands)

	For the Year Ended December 31,		
	2013	2012	2011
Balance of allowance for loan losses at beginning of period	\$ 12,197	\$ 11,012	\$ 9,527
Total loans charged-off	(7,015)	(6,715)	(7,128)
Total recoveries	707	700	243
Net loans charged-off	(6,308)	(6,015)	(6,885)
Additions to allowance charged to expense	6,482	7,200	8,370
Balance of allowance for loan losses at end of period	\$ <u>12,371</u>	\$ <u>12,197</u>	\$ <u>11,012</u>
Total loans	\$ 683,010	\$ 704,636	\$ 707,798
Total nonperforming loans ⁽¹⁾	\$ 19,065	\$ 22,374	\$ 22,405
Ratio of allowance for loan losses to total nonperforming loans	64.89%	54.51%	49.15%
Ratio of nonperforming loans to total loans	2.79%	3.18%	3.17%
Ratio of nonperforming assets to total assets	2.10%	2.51%	2.49%
Ratio of net loans charged-off during the period to average loans outstanding	0.92%	0.86%	0.95%
Ratio of allowance at end of year to total loans	1.81%	1.73%	1.56%

⁽¹⁾This amount excludes purchased credit-impaired loans. Purchased credit-impaired loans have evidence of pre-Acquisition deterioration in credit quality. Fair value of these loans as of the Acquisition Date includes estimates of credit losses.

The ALL represents management's estimate of an amount adequate to provide for probable and inherent credit losses in the loan portfolio. To assess the adequacy of the ALL, management uses significant judgment focusing on specific reserves applied to loans that are identified for evaluation on an individual loan basis. In addition, loans are analyzed on a group basis using risk characteristics that are common to groups of similar loans. The factors that are considered include changes in the size and character of the loan portfolio, changes in the levels of impaired and nonperforming loans, historical losses in each category, the risk inherent in specific loans, concentrations of loans to specific borrowers or industries, existing economic conditions, and the fair value of underlying collateral as well as changes to the fair value of underlying collateral.

At December 31, 2013, the ALL was \$12.4 million, compared to \$12.2 million at December 31, 2012. As of December 31, 2013, the ratio of the ALL to total loans was 1.81% and covered 64.9% of nonperforming loans, compared to a ratio of 1.73% covering 54.5% of nonperforming loans at December 31, 2012. The increase in the ratio of ALL to total loans during 2013 was due to both a decrease in loans and an increase in the ALL. Nonperforming loans, not including the acquired credit impaired nonperforming loans were \$19.1 million, or 2.8% of total loans as of December 31, 2013 compared to \$22.4 million, or 3.18% of total loans at December 31, 2012. Net charge-offs were \$6.3 million and \$6.0 million for 2013 and 2012, respectively. Loans charged-off are subject to continuous review and specific efforts are taken to achieve maximum recovery of principal, accrued interest and related expenses.

Potential Problem Loans

Management uses an internal asset classification system as a means of reporting problem and potential problem assets. At the quarterly meetings, the Board of Directors of the Bank reviews trends for loans classified as “Special Mention,” “Substandard” and “Doubtful” for the previous thirteen months both as a total dollar volume in each classified category and as the percent of capital each classified category represents. A Special Mention loan has potential weaknesses that deserves management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan at some future date. An asset is classified Substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets include those characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Assets classified as Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of current existing facts, conditions and values, highly questionable and improbable. Assets classified as Loss are those considered uncollectible and viewed as non-bankable assets, worthy of charge-off. Assets that do not currently expose the Bank to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses that may or may not be within the control of the customer are deemed to be Watch.

The determination as to the classification of assets and the amount of valuation allowance is subject to review by the Bank’s regulator, the Office of the Comptroller of the Currency (the “OCC”), which can order the establishment of additional general or specific loss allowances. There can be no assurance that regulators, in reviewing the Bank’s loan portfolio, will not request the Bank to materially adjust its allowance for loan losses. The OCC, in conjunction with the other federal banking agencies, has adopted an interagency policy statement on the ALL. The policy statement provides guidance for financial institutions on both the responsibilities of management for the assessment and establishment of adequate allowances and guidance for banking agency examiners to use in determining the adequacy of general valuation guidelines. Generally, the policy statement recommends that (1) institutions have effective systems and controls to identify, monitor and address asset quality problems; (2) management has analyzed all significant factors that affect the collectability of the portfolio in a reasonable manner; and (3) management has established acceptable allowance evaluation processes that meet the objectives set forth in the policy statement. Management believes it has established an adequate ALL. The Bank analyzes its process regularly, with modifications made if needed, and reports those results four times per year at meetings of the Board of Directors. Although management believes that adequate specific and general loan loss allowances have been established, actual losses are dependent upon future events and, as such, further additions to the level of specific and general loan loss allowances may become necessary.

Deposits

Deposits are the Bank's largest source of funds. The Bank competes in Southeastern Wisconsin with other financial institutions such as banks, thrifts and credit unions, as well as non-bank institutions, for retail and commercial deposits. The Bank continues to market its checking accounts and had continued success in 2013 with completely free checking (noninterest-bearing), several options for interest-bearing checking and for Investor Checking, a tiered product. The interest-bearing checking options offered are desirable to the Bank as low cost core deposit growth. Depositors earn interest, but the yields paid on these products are low compared to other funding costs. The following table presents the average daily balance of deposits and average rate paid on deposits for the years ended December 31, 2013, 2012 and 2011.

Table 9

**AVERAGE DAILY BALANCE OF DEPOSITS AND AVERAGE RATE PAID ON DEPOSITS
(Dollars in Thousands)**

	2013		2012		2011	
	Amount	Rate	Amount	Rate	Amount	Rate
Noninterest-bearing demand deposits	\$ 184,613	-%	\$ 171,994	-%	\$ 161,355	-%
Transaction Accounts	292,877	0.07%	276,010	0.13%	256,241	0.19%
Money Market Accounts	224,625	0.19%	214,817	0.34%	199,816	0.51%
Savings	206,389	0.04%	198,957	0.14%	182,093	0.21%
Time deposits (excluding time certificates of deposit of \$100,000 or more)	99,326	0.71%	103,806	0.96%	120,793	1.41%
Time deposits (\$100,000 or more)	55,021	0.87%	75,517	1.10%	72,354	1.38%
	<u>\$ 1,062,851</u>		<u>\$ 1,041,101</u>		<u>\$ 992,652</u>	

For the year ended December 31, 2013, average daily deposits were \$1,063 million, an increase of \$22 million or 2.1% over \$1,041 million at December 31, 2012. The Bank continued to have organic deposit growth across most of the branches due to a strong product line, convenient hours and locations, and successful marketing campaigns. Average deposits increased during 2013 despite the sale of our Cedarburg and Grafton branch locations on November 1, 2013 which included the sale of the fixed assets as well as \$21.6 million in deposits.

Average non-interest-bearing demand deposits increased \$12.6 million, or 7.3%, to \$184.6 million at December 31, 2013 compared to \$172.0 million at December 31, 2012 which mirrors the overall growth of our deposit base. These core deposits are very valuable to the Bank given their noninterest-bearing status.

Transaction accounts consist of interest-bearing checking held by individuals, municipalities, non-profit organizations and sole proprietorships. Average transaction accounts increased \$16.9 million, or 6.1%, to \$292.9 million at December 31, 2013 compared to \$276.0 million on December 31, 2012. The blended yield for all transaction accounts in 2013 was 0.07%, a decrease of 6 bp from 0.13% in 2012.

The daily average balance of money market deposit accounts increased \$9.8 million, or 4.6%, to \$224.6 million for 2013 compared to \$214.8 million in 2012. The increase in money market accounts during 2013 is due to the relatively attractive interest rates paid on this product compared to certain transaction accounts and longer term certificates of deposits. The yield on money market deposits decreased 15 bp to 0.19% for 2013 from 0.34% in 2012.

The daily average balance of savings accounts increased \$7.4 million, or 3.7%, to \$206.4 million for the year ended December 31, 2013 from \$199.0 million at December 31, 2012. The yield on basic savings was 0.04% in 2013 and 0.14% in 2012. Savings include savings sweep accounts for businesses in the amount of \$10.2 million with rates that are tied to the Fed funds rate and vary as that index moves.

The daily average balance of time deposits decreased by \$25.0 million, or 13.9%, to \$154.3 million at December 31, 2013, from \$179.3 million at December 31, 2012. The decline was primarily due to deposits moving from fixed rate products with longer terms into floating interest rate products, such as money market accounts given the very low rates available in 2013. Within that total, time deposits less than \$100,000 decreased \$4.5 million, or 4.3%, to \$99.3 million at year-end 2013 from \$103.8 million at December 31, 2012. The yield on time deposits less than \$100,000 was 0.71% in 2013, down from 0.96% in 2012. Time deposits \$100,000 or more decreased by \$20.5 million, or 27.1%, to \$55.0 million at year-end 2013 from \$75.5 million at December 31, 2012. The yield on time deposits \$100,000 or more was 0.87% in 2013, down from 1.10% in 2012.

Capital

The adequacy of the Corporation's capital is regularly reviewed to ensure that sufficient capital is available for current and future needs and is in compliance with regulatory guidelines. The assessment of overall capital adequacy depends on a variety of factors, including asset quality, liquidity, earnings stability, changing competitive forces, economic condition in markets served, and strength of management. Table 10 presents the capital levels for the years ended December 31, 2013, 2012 and 2011.

Table 10

CAPITAL
(Dollars and Share Numbers in Thousands)

	For the Years Ended December 31,		
	2013	2012	2011
Total stockholders' equity	\$ 118,216	\$ 109,384	\$ 121,980
Tier 1 capital	117,831	108,689	120,816
Total capital	\$ 127,107	\$ 118,312	\$ 130,371
Book value per common share	\$ 13.28	\$ 12.28	\$ 13.70
Cash dividends declared per common share	\$ -	\$ 2.33	\$ 0.21
Tier 1 leverage ratio	9.98%	9.10%	10.63%
Tier 1 risk-based capital ratio	15.93%	14.16%	15.84%
Total risk-based capital ratio	17.18%	15.41%	17.08%
Shares outstanding (period end)	8,905	8,905	8,905
Basic shares outstanding (average)	8,905	8,905	8,905
Diluted shares outstanding (average)	8,905	8,905	8,905

Total stockholders' equity at December 31, 2013 increased \$8.8 million to \$118.2 million, or \$13.28 book value per common share compared with \$109.4 million, or \$12.28 book value per common share at December 31, 2012. The increase in stockholders' equity during 2013 was due \$8.9 million in net income which was reduced by an accumulated other comprehensive loss of \$0.1 million.

No dividends were paid in 2013 compared to three regular quarterly dividends of \$0.21 per share being declared in April, July and October of 2012. In addition, the Corporation paid a special dividend of \$1.70 per share in December of 2012. The dividend was intended to be a prepayment of future dividends in anticipation of potential changes in the tax code related to dividend income. Management and the Board are committed to rebuilding the Corporation's capital to offset this prepayment and therefore do not anticipate making additional dividend payments until at least 2015.

As of December 31, 2013, the Corporation's Tier 1 leverage ratio was 9.98% compared to 9.10% at December 31, 2012. Tier 1 risk-based capital ratios were 15.93% and 14.16% at December 31, 2013 and 2012, respectively, and total risk-based capital ratios were 17.18% and 15.41% at December 31, 2013 and 2012, respectively. All of the Corporation's ratios remain significantly in excess of minimum regulatory requirements. A bank is "well capitalized" if it maintains a minimum Tier 1 leverage ratio of 5.0% and a minimum Tier 1 risk based capital ratio of 6.0%. Earnings continue to be stable and provide sufficient capital retention for anticipated growth. Management actively reviews capital strategies for the Corporation and each of its subsidiaries in light of perceived business risks, future growth opportunities, industry standards and regulatory requirements including the implementation of BASIL III capital rules beginning on January 1, 2015.

Interest Rate Risk

Financial institutions derive their income primarily from the excess of interest collected over interest paid. The rates of interest an institution earns on its assets and pays on its liabilities generally are established contractually for a period of time. Since market interest rates change over time, an institution is exposed to changes in profit margins (or losses) if it cannot adapt to interest rate changes. Interest Rate Risk ("IRR") is the exposure of an organization's financial condition to adverse movements in interest rates. Accepting this risk can be an important source of profitability and stockholder value. However, excessive levels of IRR could pose a significant threat to the Bank's earnings and capital base. Accordingly, effective risk management that maintains IRR at prudent levels is essential to the Bank's safety and soundness.

When assessing IRR, the Bank seeks to ensure that appropriate policies, procedures, management information systems and internal controls are in place to maintain IRR at prudent levels with consistency and continuity. Evaluating the quantitative level of IRR exposure requires the Bank to assess the existing and potential future effects of changes in interest rates on its consolidated financial condition, including capital adequacy, earnings, liquidity and, where appropriate, asset quality.

Financial institutions are also subject to prepayment risk in falling rate environments. For example, mortgage loans and other financial assets may be prepaid by a debtor so that the debtor may refinance its obligations at new, lower rates. Prepayments of assets carrying higher rates reduce the Bank's interest income and overall asset yields. Certain portions of an institution's liabilities may be short-term or due on demand, while most of its assets may be invested in long-term loans or investments. Accordingly, the Bank seeks to have in place sources of cash to meet short-term demands. These funds can be obtained by increasing deposits, borrowing or selling assets. Also, short-term borrowings provide additional sources of liquidity for the Bank.

Several ways an institution can manage IRR include selling existing assets or repaying certain liabilities and matching repricing periods for new assets and liabilities by shortening terms of new loans or investments. The Bank has employed all these strategies in varying degrees. An institution might also invest in more complex financial instruments intended to hedge or otherwise mitigate IRR. Interest rate swaps, futures contracts, options on futures and other such derivative financial instruments are often used for this purpose. The Bank has never purchased any of these types of derivative financial instruments.

In order to measure earnings sensitivity to changing rates, the Bank uses two different measurement tools: static gap analysis and simulation of earnings. The static gap analysis starts with contractual repricing information for assets and liabilities. These items are then combined with repricing estimations for administered rate (interest-bearing demand deposits, savings, and money market accounts) and non-rate related products (demand deposit accounts, other assets and other liabilities) to create a baseline repricing balance sheet.

As table 11 below illustrates, the Bank's balance sheet was asset sensitive to interest rate movements for principal amounts maturing in one year at December 31, 2013. Asset sensitive means that interest-bearing assets will reprice faster than interest-bearing liabilities. In a rising rate environment, an asset sensitive bank will generally be beneficial. Liability sensitive means interest-bearing deposits will reprice faster than interest-bearing assets. In a rising rate environment a liability sensitive bank will generally not be beneficial.

Table 11

STATIC GAP ANALYSIS
December 31, 2013
(Dollars in Thousands)

	Principal Amount Maturing in:							Total
	Immediate	2014	2015	2016	2017	Thereafter		
Rate-sensitive assets:								
I/B Due From Banks	\$ 65,827	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	65,827
Fed Funds Sold	2,986	-	-	-	-	-	-	2,986
U. S. Agencies	-	30,000	64,000	10,050	-	46,150	-	150,200
Mortgage-Backed Securities	-	26,927	16,713	10,590	7,061	64,404	-	125,695
Municipal Securities	-	8,327	8,274	4,150	4,508	29,876	-	55,135
FRB Stock	322	-	-	-	-	-	-	322
Commercial	11,233	37,517	10,304	4,354	3,966	1,854	-	69,228
Real Estate	32,203	231,328	121,676	136,498	39,142	35,049	-	595,896
Consumer	572	1,532	1,012	1,176	194	230	-	4716
Other Loans	44	565	515	531	480	2,843	-	4978
Total RS Assets	\$ 113,187	\$ 336,196	\$ 222,494	\$ 167,349	\$ 55,351	\$ 180,406	\$ -	\$ 1,074,983
Rate-sensitive liabilities:								
NOW Accounts	\$ -	\$ 47,332	\$ 47,333	\$ 47,333	\$ 47,333	\$ 126,221	\$ -	\$ 315,552
Money Market Accounts	-	108,676	108,676	-	-	-	-	217,352
Savings	-	19,576	19,578	19,578	19,578	117,468	-	195,778
Time Deposits	-	89,189	26,614	8,577	7,467	3,626	-	135,473
Total RS Liabilities	\$ -	\$ 264,773	\$ 202,201	\$ 75,488	\$ 74,378	\$ 247,315	\$ -	\$ 864,155

The Corporation's funding acquisition and deployment strategy, management reporting and board approved limits target a cumulative ratio of 1.0 for Rate Sensitive Assets vs. Rate Sensitive Liabilities ("RSA/RSL") at one year (where a cumulative ratio of 1.0 is balanced and neither asset nor liability sensitive after one year). The Bank RSA/RSL ratio was 1.70 at December 31, 2013. The asset sensitive difference of 0.70 means that \$184.6 million more interest-earning assets will be rate adjusted than interest bearing liabilities over the next 12 months. The ratio and analysis includes assumptions that closely follow the Bank's techniques for managing risk: lagged interest rate adjustments, administered rate products, rate adjustment of cash flow from amortization and prepayment of loans through reinvestment, and the reinvestment of maturing assets and liabilities. In this case, management has positioned the Bank to benefit from rising interest rates as the Bank has more assets that will reprice in the next 12 months than liabilities which would positively impact net interest income.

Along with the static gap analysis, determining the sensitivity of short-term future earnings to a hypothetical plus or minus 100 bp and 200 bp parallel rate shock can be accomplished through the use of simulation modeling. In addition to the assumptions used to create the static gap, simulation of earnings includes the modeling of the balance sheet as an ongoing entity. The model projects net interest income based on a hypothetical change in interest rates. The resulting net interest income for the next 12 month period is compared to the net interest income amount calculated using flat rates. Table 12 below represents the Corporation's earnings sensitivity to a plus or minus 100 and 200 bp parallel rate shock.

Table 12

NET INTEREST INCOME OVER ONE YEAR HORIZON
December 31, 2013
(Dollars in Thousands)

	Amount	Dollar Change	Percentage Change
+200 bps	\$ 39,480	\$ 1,732	4.59 %
+100 bps	38,639	891	2.36 %
Base	37,748	-	- %
-100 bps	36,482	(1,266)	(3.35) %
-200 bps	34,313	(3,435)	(9.10) %

These results are based solely on the modeled changes in market rates, and do not reflect the earnings sensitivity that may arise from other factors such as the shape of the yield curve and changes in spread between key market rates. These actions also do not include any action management may take to mitigate potential income variances. Actual results will differ from simulated results due to the timing, magnitude and frequency of interest rate changes as well as changes in market conditions and management strategies.

Liquidity

The ability to provide the necessary funds for the Bank's day-to-day operations depends on a sound liquidity position. Management monitors the Bank's liquidity by reviewing the maturity distribution between interest-earning assets and interest-bearing liabilities. Fluctuations in interest rates can be the primary cause for the flow of funds into or out of a financial institution. The Bank continues to offer products that are competitive and encourages depositors to invest their funds in these products. Management believes that these efforts will help the Bank to not only retain these deposits, but to encourage continued deposit growth. As of December 31, 2013, the Bank has the ability to borrow up to \$70.0 million in federal funds purchased and \$27.6 million available for short-term liquidity through the Federal Reserve Bank Discount window.

During the year, the Bank manages its overall liquidity, taking into consideration funded and unfunded commitments as a percentage of its liquidity sources. The Bank's liquidity sources have been and are expected to continue to be sufficient to meet the cash requirements of its lending activities.

Off-Balance Sheet Arrangements

The Bank uses certain derivative financial instruments to meet the ongoing credit needs of its customers and to manage the market exposure of its residential loans held for sale and its commitments to extend credit for residential loans. Derivative financial instruments include commitments to extend credit and forward loan sale commitments. The Bank does not use interest rate contracts (e.g. swaps, caps or floors) or other derivatives to manage interest rate risk and has none of these instruments outstanding at December 31, 2013 or 2012. The Bank, through its normal operations, does have loan commitments and standby letters of credit outstanding as of December 31, 2013 and December 31, 2012 in the amounts of \$98.0 million and \$101.5 million, respectively. These items are further explained in Note 18 of Notes to Consolidated Financial Statements.

Tri City Bankshares Corporation
Selected Financial Data

	2013	2012	2011	2010	2009
<u>Results of Operations:</u>					
Total interest income	\$ 40,260,922	\$ 45,472,669	\$ 53,196,793	\$ 61,928,649	\$ 44,386,514
Total interest expense	1,914,793	3,213,143	4,583,358	5,712,618	6,953,466
Net interest income	38,346,129	42,259,526	48,613,435	56,216,031	37,433,048
Provision for loan losses	6,482,000	7,200,000	8,370,000	6,930,000	3,705,555
Net interest income after PLL	31,864,129	35,059,526	40,243,435	49,286,031	33,727,493
Non-interest income	17,332,360	17,191,751	14,790,163	16,476,536	14,597,386
Non-interest expense	37,993,007	40,081,136	40,824,792	43,078,525	34,086,548
Gain on sale of bank branches	2,152,957	-	-	-	-
Acquisition-related gain	-	-	-	-	21,474,123
Provision for income tax	4,443,584	4,018,157	4,692,601	8,374,000	13,635,000
Net income	<u>\$ 8,912,855</u>	<u>\$ 8,151,984</u>	<u>\$ 9,516,205</u>	<u>\$ 14,310,042</u>	<u>\$ 22,077,454</u>

Per Share Data:

Basic earnings per share	\$ 1.00	\$ 0.92	\$ 1.07	\$ 1.61	\$ 2.48
Cash dividends declared per share	\$ -	\$ 2.33	\$ 0.21	\$ 2.40	\$ 1.08

Selected Financial Condition Data (at December 31):

(Dollars in Thousands)

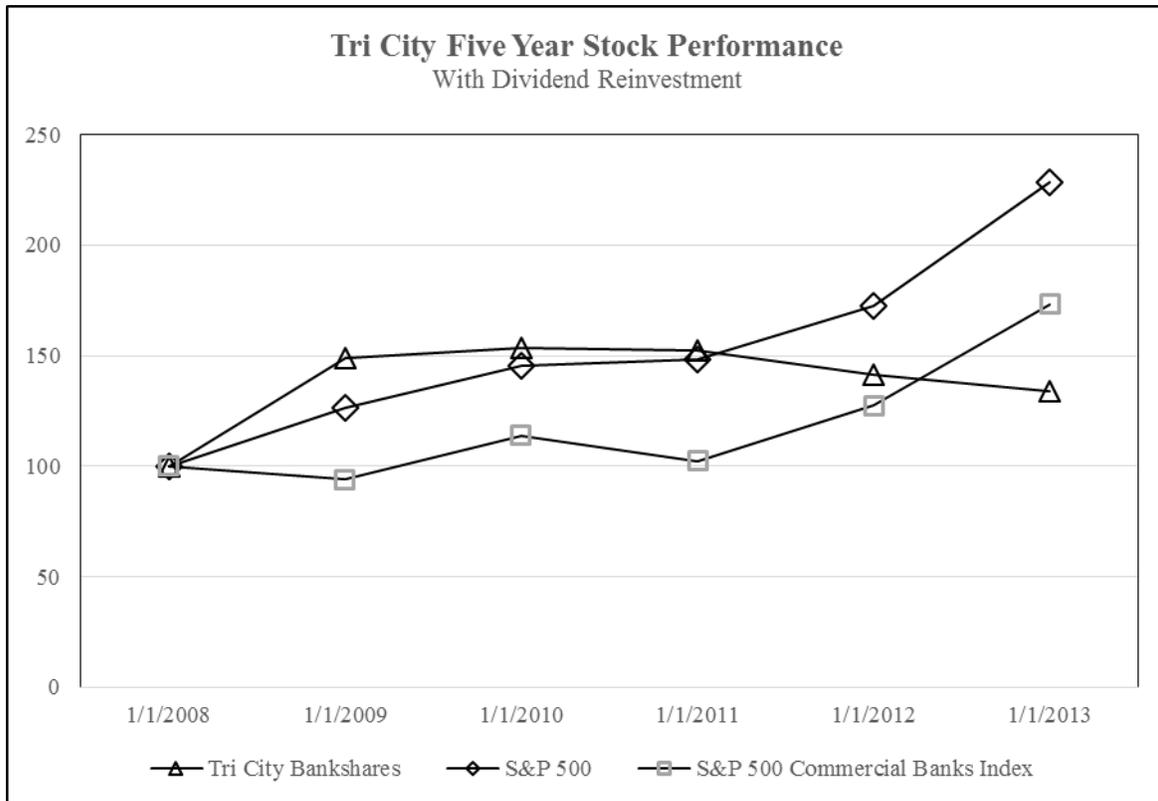
Total assets	\$ 1,180,647	\$ 1,231,752	\$ 1,215,143	\$ 1,141,687	\$ 1,125,709
Total net loans	670,639	692,440	696,786	737,302	781,846
Total investment securities	331,177	351,523	360,566	227,804	189,789
Total deposits	1,058,776	1,119,207	1,070,480	1,018,447	987,984
Total stockholders' equity	118,216	109,384	121,981	114,335	121,396

Market for Corporation's Common Stock

The Corporation's stock is quoted over-the-counter on the OTCQB bulletin board under the trading symbol "TRCY" and on the Pink Sheets under the trading symbol "TRCY.PK." Over-the-counter quotations do not reflect retail mark-up, mark-down or commission and may not necessarily reflect actual transactions.

STOCK PERFORMANCE GRAPH

The following graph shows the cumulative total stockholder return on the Corporation's common stock over the last five fiscal years compared to the returns of the Standard & Poor's 500 Stock Index and S&P 500 Commercial Banks Index compiled by Standard & Poor's and consisting of 13 regional banks, assuming that \$100 is invested on December 31, 2008 with dividends reinvested.



PERIOD (FISCAL YEAR COVERED)	S&P 500	S&P 500 COMMERCIAL BANKS	TRI CITY BANKSHARES
2008	\$ 100.00	\$ 100.00	\$ 100.00
2009	\$ 126.46	\$ 94.00	\$ 148.95
2010	\$ 145.51	\$ 113.87	\$ 153.54
2011	\$ 148.59	\$ 102.32	\$ 152.49
2012	\$ 172.37	\$ 127.45	\$ 141.48
2013	\$ 228.19	\$ 173.26	\$ 133.90

INDEPENDENT AUDITORS' REPORT

Board of Directors and Shareholders
Tri City Bankshares Corporation
Oak Creek, Wisconsin

We have audited the accompanying consolidated financial statements of Tri City Bankshares Corporation and its subsidiaries, which comprise the consolidated balance sheet as of December 31, 2013, and the related consolidated statement of income, comprehensive income, stockholders' equity, and cash flow for the year then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America.

Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Tri City Bankshares Corporation and its subsidiaries as of December 31, 2013, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Baker Tilly Vuchow Krause, LLP

Milwaukee, Wisconsin
March 25, 2014



Baker Tilly Virchow Krause, LLP
777 E Wisconsin Ave, 32nd Floor
Milwaukee, WI 53202-5313
tel 414 777 5500
fax 414 777 5555
bakertilly.com

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders
Tri City Bankshares Corporation

We have audited the accompanying consolidated balance sheets of Tri City Bankshares Corporation and subsidiaries (the "Corporation") as of December 31, 2011, and the related consolidated statements of income, stockholders' equity and cash flows for each of the two years in the period ended December 31, 2011. These consolidated financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Tri City Bankshares Corporation and subsidiaries as of December 31, 2011 and the results of their operations and cash flows for each of the two years ended December 31, 2011, in conformity with accounting principles generally accepted in the United States of America.

Baker Tilly Virchow Krause, LLP

Milwaukee, Wisconsin
March 6, 2013

TRI CITY BANKSHARES CORPORATION

CONSOLIDATED BALANCE SHEETS

As of December 31, 2013 and 2012

ASSETS

	<u>2013</u>	<u>2012</u>
Cash and due from banks	\$ 114,523,575	\$ 59,719,085
Federal funds sold	2,986,359	63,060,224
Cash and cash equivalents	<u>117,509,934</u>	<u>122,779,309</u>
Held to maturity securities, fair value of \$294,615,354 and \$355,987,948 as of 2013 and 2012, respectively	298,904,927	351,523,150
Securities available for sale	32,272,071	-
Loans held for investment, less allowance for loan losses of \$12,370,590 and \$12,197,012 as of 2013 and 2012, respectively	670,639,122	692,439,668
Premises and equipment – net	15,895,213	18,005,267
Cash surrender value of life insurance	29,339,423	28,328,926
Mortgage servicing rights – net	1,751,649	1,685,893
Core deposit intangible	464,541	694,922
Other real estate owned	5,709,401	8,544,665
Accrued interest receivable and other assets	8,160,899	7,750,512
TOTAL ASSETS	<u>\$ 1,180,647,180</u>	<u>\$ 1,231,752,312</u>

LIABILITIES AND STOCKHOLDERS' EQUITY

LIABILITIES

Deposits		
Demand	\$ 194,943,002	\$ 199,261,784
Savings and NOW	728,358,155	750,122,506
Other time	135,474,838	169,822,847
Total Deposits	<u>1,058,775,995</u>	<u>1,119,207,137</u>
Other Liabilities	3,655,601	3,160,910
Total Liabilities	<u>1,062,431,596</u>	<u>1,122,368,047</u>

STOCKHOLDERS' EQUITY

Cumulative preferred stock, \$1 par value 200,000 shares authorized, no shares issued	-	-
Common stock, \$1 par value, 15,000,000 shares authorized, 8,904,915 shares issued and outstanding in 2013 and 2012	8,904,915	8,904,915
Additional paid-in capital	26,543,470	26,543,470
Accumulated other comprehensive loss	(81,536)	-
Retained earnings	82,848,735	73,935,880
Total Stockholders' Equity	<u>118,215,584</u>	<u>109,384,265</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$ 1,180,647,180</u>	<u>\$ 1,231,752,312</u>

See accompanying notes to consolidated financial statements.

TRI CITY BANKSHARES CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
For the Years Ended December 31, 2013, 2012 and 2011

	<u>2013</u>	<u>2012</u>	<u>2011</u>
INTEREST INCOME			
Loans	\$ 36,024,369	\$ 40,870,501	\$ 46,957,702
Investment securities			
Taxable	2,926,997	3,230,957	4,804,949
Tax exempt	1,104,994	1,309,326	1,386,998
Federal funds sold and due from banks	185,236	42,559	27,818
Other	<u>19,326</u>	<u>19,326</u>	<u>19,326</u>
Total Interest Income	<u>40,260,922</u>	<u>45,472,669</u>	<u>53,196,793</u>
INTEREST EXPENSE			
Deposits	1,914,736	3,203,426	4,570,769
Other borrowings	<u>57</u>	<u>9,717</u>	<u>12,589</u>
Total Interest Expense	<u>1,914,793</u>	<u>3,213,143</u>	<u>4,583,358</u>
Net Interest Income before Provision for Loan Losses	38,346,129	42,259,526	48,613,435
Provision for loan losses	<u>6,482,000</u>	<u>7,200,000</u>	<u>8,370,000</u>
Net Interest Income after Provision for Loan Losses	<u>31,864,129</u>	<u>35,059,526</u>	<u>40,243,435</u>
NONINTEREST INCOME			
Service charges on deposits	9,777,598	10,108,357	9,986,812
Loan servicing income	356,779	132,600	317,687
Net gain on sale of loans	1,557,687	2,568,443	1,248,797
Gain on sale of bank branches	2,152,957	-	-
Increase in cash surrender value of life insurance	1,010,498	837,204	467,458
Non-accretable loan discount	3,680,013	1,974,071	2,247,167
Other income	<u>949,785</u>	<u>1,571,076</u>	<u>522,242</u>
Total Noninterest Income	<u>19,485,317</u>	<u>17,191,751</u>	<u>14,790,163</u>
NONINTEREST EXPENSES			
Salaries and employee benefits	21,405,721	21,407,022	22,037,202
Net occupancy costs	4,092,791	3,732,617	4,067,094
Furniture and equipment expenses	1,740,409	1,965,881	1,886,925
Computer services	2,978,800	4,075,449	3,678,813
Advertising and promotional	729,900	952,789	1,033,215
FDIC and other regulatory assessments	1,273,385	1,286,408	1,316,754
Office supplies	765,107	832,921	790,283
Core deposit intangible amortization	230,381	310,212	418,219
Other expenses	<u>4,776,513</u>	<u>5,517,837</u>	<u>5,596,287</u>
Total Noninterest Expenses	<u>37,993,007</u>	<u>40,081,136</u>	<u>40,824,792</u>
Total Income before Taxes	13,356,439	12,170,141	14,208,806
Less: Income tax expense	<u>4,443,584</u>	<u>4,018,157</u>	<u>4,692,601</u>
NET INCOME	<u>\$ 8,912,855</u>	<u>\$ 8,151,984</u>	<u>\$ 9,516,205</u>
Basic earnings per share	<u>\$ 1.00</u>	<u>\$ 0.92</u>	<u>\$ 1.07</u>
Dividends per share	<u>\$ 0.00</u>	<u>\$ 2.33</u>	<u>\$ 0.21</u>
Weighted average shares outstanding	<u>8,904,915</u>	<u>8,904,915</u>	<u>8,904,915</u>

See accompanying notes to consolidated financial statements.

TRI CITY BANKSHARES CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the Years Ended December 31, 2013, 2012 and 2011

	<u>2013</u>	<u>2012</u>	<u>2011</u>
NET INCOME	\$ 8,912,855	\$ 8,151,984	\$ 9,516,205
Other Comprehensive loss, net of tax:			
Unrealized losses on securities:			
Net unrealized holding losses arising during the period	(136,200)	-	-
Tax effect	<u>54,664</u>	<u>-</u>	<u>-</u>
Total other comprehensive loss, net of tax:	<u>(81,536)</u>	<u>-</u>	<u>-</u>
COMPREHENSIVE INCOME	<u>\$ 8,831,319</u>	<u>\$ 8,151,984</u>	<u>\$ 9,516,205</u>

See accompanying notes to consolidated financial statements.

TRI CITY BANKSHARES CORPORATION
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
For the Years Ended December 31, 2013, 2012 and 2011

	<u>Common Stock</u>	<u>Additional Paid-in Capital</u>	<u>Accumulated Other Comprehensive Loss</u>	<u>Retained Earnings</u>	<u>Total</u>
BALANCES – January 1, 2011	\$ 8,904,915	\$ 26,543,470	\$ -	\$ 78,886,168	\$ 114,334,553
Net income	-	-	-	9,516,205	9,516,205
Cash dividends - \$0.21 per share	-	-	-	(1,870,029)	(1,870,029)
BALANCES – January 1, 2012	8,904,915	26,543,470	-	86,532,344	121,980,729
Net income	-	-	-	8,151,984	8,151,984
Cash dividends - \$2.33 per share	-	-	-	(20,748,448)	(20,748,448)
BALANCES – December 31, 2012	8,904,915	26,543,470	-	73,935,880	109,384,265
Net income	-	-	-	8,912,855	8,912,855
Net changes in unrealized loss on on securities available for sale	-	-	(136,200)	-	(136,200)
Tax effect	-	-	54,664	-	54,664
Total Comprehensive income	-	-	-	-	8,831,319
BALANCES – December 31, 2013	<u>\$ 8,904,915</u>	<u>\$ 26,543,470</u>	<u>\$ (81,536)</u>	<u>\$ 82,848,735</u>	<u>\$ 118,215,584</u>

See accompanying notes to consolidated financial statements.

TRI CITY BANKSHARES CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2013, 2012 and 2011

	2013	2012	2011
CASH FLOWS FROM OPERATING ACTIVITIES			
Net Income	\$ 8,912,855	\$ 8,151,984	\$ 9,516,205
Adjustments to reconcile net income to net cash flows provided by operating activities:			
Depreciation	1,905,020	2,059,240	2,149,444
(Accretion) amortization of servicing rights, premiums and discounts	(376,752)	1,564,957	(6,696,585)
Gain on sale of loans	(1,557,687)	(2,568,443)	(1,248,797)
Amortization of other intangibles	230,381	310,212	418,219
Provision for loan losses	6,482,000	7,200,000	8,370,000
Benefit for deferred income taxes	(733,998)	(1,560,287)	(1,170,614)
Proceeds from sales of loans held for sale	60,894,249	97,997,995	56,224,575
Originations of loans held for sale	(59,794,904)	(96,155,402)	(55,365,375)
Increase in cash surrender value of life insurance	(1,010,498)	(837,204)	(467,458)
Gain on other real estate owned	(803,891)	(623,936)	(700,534)
Gain on sale of bank branches	(2,152,957)	-	-
Gain on disposal of premises and equipment	(6,923)	(256,057)	(26,250)
Net change in:			
Accrued interest receivable and other assets	(410,387)	384,114	(503,139)
Payable for investments purchased	-	(17,165,797)	17,165,797
Accrued interest payable and other liabilities	1,283,353	(795,274)	727,108
	<u>12,859,861</u>	<u>(2,293,898)</u>	<u>28,393,210</u>
CASH FLOWS FROM INVESTING ACTIVITIES			
Activity in held to maturity securities:			
Maturities, prepayments and calls	138,080,907	391,116,342	246,482,676
Purchases	(90,825,232)	(389,080,745)	(380,118,180)
Activity in available for sale securities:			
Purchases	(32,416,354)	-	-
Net decrease (increase) in loans	11,450,735	(6,939,472)	29,953,612
Purchase of life insurance	-	(15,000,000)	-
Purchases of premises and equipment – net	(742,254)	(1,081,214)	(987,490)
Proceeds from sale of other real estate owned	13,646,937	9,596,668	9,013,104
Proceeds from sales of premises and equipment	3,107,167	419,633	38,900
	<u>42,301,906</u>	<u>(10,968,788)</u>	<u>(95,617,378)</u>
CASH FLOWS FROM FINANCING ACTIVITIES			
Net (decrease) increase in deposits	(60,431,142)	48,727,235	52,032,610
Net change in other borrowings	-	-	(4,815,964)
Dividends paid	-	(20,748,448)	-
	<u>(60,431,142)</u>	<u>27,978,787</u>	<u>47,216,646</u>
Net Change in Cash and Cash Equivalents	(5,269,375)	14,716,101	(20,007,522)
CASH AND CASH EQUIVALENTS – BEGINNING OF YEAR	<u>122,779,309</u>	<u>108,063,208</u>	<u>128,070,730</u>
CASH AND CASH EQUIVALENTS – END OF YEAR	<u>\$ 117,509,934</u>	<u>\$ 122,779,309</u>	<u>\$ 108,063,208</u>

See accompanying notes to consolidated financial statements.

TRI CITY BANKSHARES CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Years Ended December 31, 2013, 2012 and 2011
(continued)

	<u>2013</u>		<u>2012</u>		<u>2011</u>
SUPPLEMENTAL CASH FLOW DISCLOSURES					
Cash paid for interest	\$ 1,977,489	\$	3,285,817	\$	4,692,288
Cash paid for income taxes	4,980,000		5,410,000		5,480,000
Loans receivable transferred to other real estate owned	10,007,782		10,166,719		10,256,043
Mortgage servicing rights resulting from sales of loans	458,342		725,850		389,597
Dividends accrued not paid	-		-		1,870,029

See accompanying notes to consolidated financial statements.

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2013, 2012 and 2011

NOTE 1 - Summary of Significant Accounting Policies

The consolidated financial statements of Tri City Bankshares Corporation (the "Corporation") include the accounts of its wholly owned subsidiary, Tri City National Bank (the "Bank"). The Bank includes the accounts of its wholly owned subsidiaries, Tri City Capital Corporation, a Nevada investment subsidiary, and Title Service of Southeast Wisconsin, Inc., a title company subsidiary. The consolidated financial statements have been prepared in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP") and conform to general practices within the banking industry. All significant intercompany accounts and transactions have been eliminated in the consolidated financial statements. The Corporation has evaluated the consolidated financial statements for subsequent events through the report issue date.

The consolidated income of the Corporation is principally from the income of its wholly owned subsidiary. The Bank grants commercial, residential and consumer loans and accepts deposits primarily in Southeastern Wisconsin. The Corporation and the Bank are subject to competition from other financial institutions and nonfinancial institutions providing financial products. Additionally, the Corporation and the Bank are subject to the regulations of certain regulatory agencies and undergo periodic examination by those regulatory agencies.

On June 3, 2013, the Bank entered into a branch sale agreement to sell the Bank's branch operations in Cedarburg and Grafton Wisconsin. On November 1, 2013, the transaction, which included total deposits of \$21.6 million was consummated, resulting in a gain on sale of \$2.2 million.

Use of Estimates

In preparing consolidated financial statements in conformity with U.S. GAAP, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, valuation of other real estate owned and deferred taxes.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash and balances due from banks and federal funds sold, all of which mature within ninety days. The Bank maintains amounts due from banks which, at times, may exceed federally insured limits. The Bank has not experienced any losses in such accounts.

Securities

Securities classified as held to maturity are those securities the Bank has both the intent and ability to hold to maturity regardless of changes in market conditions, liquidity needs or changes in general economic conditions. Interest and dividends are included in interest income from the related securities as earned. Securities are accounted for on a trade date basis and carried at cost, adjusted for amortization of premium and accretion of discount, computed by the effective interest method over their contractual lives. The sale of a security within three months of its maturity date or after collection of at least 85 percent of the principal outstanding at the time the security was acquired is considered a maturity for purposes of classification and disclosure.

Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are accounted for on a trade date basis and carried at fair value, with unrealized holding gains and losses deemed other-than-temporarily impaired due to non-credit issues reported in other comprehensive income, net of tax. Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

Declines in the fair value of securities below their cost that are other-than-temporary due to credit issues are reflected as "Other than temporary impairment of securities" in the consolidated statement of income. In estimating other-than-temporary losses, management considers: (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the Corporation's ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value. The difference between the present values of the cash flows expected to be collected and the amortized cost basis is the credit loss. The credit loss is the portion of the other-than-temporary impairment that is recognized in earnings and is a reduction to the cost basis of the security. The portion of other-than-temporary impairment related to all other factors is included in other comprehensive income (loss).

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2013, 2012 and 2011

NOTE 1 - Summary of Significant Accounting Policies (cont.)

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the amount of unpaid principal, reduced by an allowance for loan losses and any deferred fees or costs in originating loans. Interest income is accrued and credited to income on a daily basis based on the unpaid principal balance. Loan origination fees, net of certain direct loan origination costs, are deferred and recognized as an adjustment of the loan yield using an effective interest method. The accrual of interest income on impaired loans is discontinued when, in the opinion of management, there is reasonable doubt as to the borrower's ability to meet payment of interest or principal when they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Cash collections on impaired loans are credited to the loan receivable balance and no interest income is recognized on those loans until the principal balance is current. Loans are returned to accrual status when the principal and interest amounts contractually due are brought current and future payments are reasonably assured. A troubled debt restructuring ("TDR") includes a loan modification where a borrower is experiencing financial difficulty and the Bank grants a concession to that borrower that the Bank would not otherwise consider except for the borrower's financial difficulties. All TDRs are classified as impaired loans. TDRs may be on accrual or non-accrual status based upon the performance of the borrower and management's assessment of collectability. Loans deemed non-accrual may return to accrued status based on performance in accordance with terms of the restructuring, generally 6 months.

Consistent with regulatory guidance, charge-offs are taken when specific loans, or portions thereof, are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. The Bank's policy is to promptly charge these loans off in the period the uncollectible loss amount is reasonably determined. The Bank promptly charges-off commercial and real estate loans, or portions thereof, when available information confirms that specific loans are uncollectible based on information that includes, but is not limited to, (1) the deteriorating financial condition of the borrower, (2) declining collateral values, and/or (3) legal action, including bankruptcy, that impairs the borrower's ability to adequately meet its obligations. All consumer loans 120 days past due and all other loans with principal and interest 180 days or more past due will be reviewed for potential charge-off at least quarterly.

Loans Acquired Through Purchase

Loans acquired through the completion of a purchase, including loans that have evidence of deterioration of credit quality since origination and for which it is probable, at acquisition, that the Bank will be unable to collect all contractually-required payments receivable, are initially recorded at fair value with no valuation allowance. Loans are evaluated individually at the date of acquisition to determine if there is evidence of deterioration of credit quality since origination. Loans where there is evidence of deterioration of credit quality since origination may be aggregated and accounted for as a pool of loans if the loans being aggregated have common risk characteristics. Contractually-required payments for interest and principal that exceed the undiscounted cash flows expected at acquisition, or the "nonaccretable difference," are not recognized as a yield adjustment, a loss accrual or a valuation allowance. Subsequent decreases to the expected cash flows will generally result in a provision for loan losses. Subsequent increases in cash flows result in a reversal of the provision for loan losses to the extent of prior charges or a reclassification of the difference from non-accretable discount to accretable discount with a positive impact on interest income. The difference between the undiscounted cash flows expected at acquisition and the investment in the loan, or the "accretable yield," is recognized as interest income on a level-yield method over the life of the loan. Increases in expected cash flows subsequent to the initial investment are recognized prospectively through adjustment of the yield on the loan over its remaining life. Decreases in expected cash flows are recognized as provision for loan losses. If the Bank does not have the information necessary to reasonably estimate expected cash flows, it may use the cost recovery method or cash basis method of income recognition. Valuation allowances on these impaired loans reflect only losses incurred after the acquisition (meaning the present value of all cash flows expected at acquisition that ultimately are not to be received).

Loans Held for Sale

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated market value in the aggregate. Net unrealized gains or losses are recognized through a valuation allowance by charges to income. All sales are made without recourse.

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2013, 2012 and 2011

NOTE 1 - Summary of Significant Accounting Policies (cont.)

Allowance for Loan Losses

The allowance for loan losses is a valuation allowance for probable and inherent losses incurred in the loan portfolio. Management maintains allowances for loan losses at levels deemed adequate to absorb estimated probable credit losses inherent in the loan portfolio. The adequacy of the allowances is determined based on periodic evaluations of the loan portfolios and other relevant factors. The allowance is comprised of both a specific component and a general component. Even though the entire allowance is available to cover losses on any loan, specific allowances are provided on impaired loans pursuant to accounting standards. The general allowance is based on historical loss experience, adjusted for qualitative and environmental factors. Management reviews the assumptions and methodology related to the general allowance in an effort to update and refine the estimate on a quarterly basis.

In determining the general allowance management has segregated the loan portfolio by loan class. For each class of loan, a historical loss factor is computed. In determining the appropriate period of activity to use in computing the historical loss factor management reviews trends in net charge-off ratios. It is management's intention to utilize a period of activity that is most reflective of current experience. Changes in the historical period are made when there is a distinct change in the trend of net charge-off experience. Management adjusts the historical loss factors for the impact of the following qualitative factors: asset quality, changes in volume and terms, policy changes, ability of management, economic trends, industry conditions, changes in credit concentrations and competitive/legal factors. In determining the impact, if any, of an individual qualitative factor, management compares the current underlying facts and circumstances surrounding a particular factor with those in the historical periods, adjusting the historical loss factor in a directionally consistent manner with changes in the qualitative factor. Management separately evaluates both the Bank's historical portfolio as well as acquired loans that have renewed and are eligible to be considered as part of the general allowance. Management will continue to analyze the qualitative factors on a quarterly basis, adjusting the historical loss factor both up and down, to a factor deemed appropriate for the probable and inherent risk of loss in its portfolio.

Specific allowances are determined as a result of the impairment process. When a loan is identified as impaired it is evaluated for loss using either the fair value of collateral method or the present value of cash flows method. If the present value of expected cash flows or the fair value of collateral exceeds the Bank's carrying value of the loan, no loss is anticipated and no specific reserve is established. However, if the Bank's carrying value of the loan is greater than the present value of expected cash flows or fair value of collateral, a specific reserve is established. In either situation, loans identified as impaired are excluded from the calculation of the general reserve.

The allowance for loan losses is increased by provisions charged to earnings and reduced by charge-offs, net of recoveries. The adequacy of the allowance for loan losses is reviewed and approved by the Bank's Board of Directors on a quarterly basis. The allowance for loan losses reflects management's best estimate of the probable and inherent losses on loans and is based on a risk model developed and implemented by management and approved by the Bank's Board of Directors.

In addition, various regulatory agencies periodically review the allowance for loan losses. These agencies may suggest additions to the allowance for loan losses based on their judgments of collectability based on information available to them at the time of their examination.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Bank, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Mortgage Servicing Rights

The Bank records a mortgage servicing right ("MSR") asset when it continues to service borrower payments and perform maintenance activities on loans in which the loan has been sold to secondary market investors. The servicing rights are initially capitalized at fair value on an individual loan level basis. In the period in which the loan is sold to the secondary market investors, the gain on sale of the loan is increased by the value of the initial MSR. Amortization of MSRs is calculated based on actual payment activity on a per loan basis.

Quarterly impairment testing is performed by the Bank to determine that MSRs are recorded at the lower of fair value or amortized cost. Annually the Bank engages a third party specialist to calculate the fair value using significant inputs/assumptions such as prepayment speed, default rates, cost to service and discount rates. A valuation allowance is recorded when the fair value of the MSRs is less than its amortized cost.

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2013, 2012 and 2011

NOTE 1 - Summary of Significant Accounting Policies (cont.)

Premises and Equipment

Depreciable assets are stated at cost less accumulated depreciation. Provisions for depreciation are computed on straight-line methods over the estimated useful lives of the assets, which range from 3 to 10 years for furniture and equipment and 15 to 40 years for buildings and lease-hold improvements. Repairs and maintenance costs are expensed as incurred.

Other Real Estate Owned

Other real estate owned (“OREO”) comprises real estate acquired in partial or full satisfaction of loans. OREO is recorded at estimated fair value less estimated selling costs at the date of transfer, establishing a new cost basis, with any excess of the related loan balance over the fair value less expected selling costs charged to the allowance for loan losses. Subsequently, properties are evaluated and any additional declines in value are recorded in current period earnings. The amount the Bank ultimately recovers on repossessed assets may differ substantially from the net carrying value of these assets because of future market factors beyond the Bank’s control.

Intangible Assets

The Bank’s intangible assets include the value of ongoing customer relationships (core deposit intangible) arising from the purchase of certain assets and the assumption of certain liabilities from unrelated entities. Core deposit intangibles are amortized over an eight year period. Any impairment in the intangibles would be recorded against income in the period of impairment. No impairment was recorded during the years ended December 31, 2013, 2012 and 2011.

Federal Reserve Bank Stock

The Bank’s investment in Federal Reserve Bank (“FRB”) stock meets the minimum amount required by current regulations and is carried at cost, which approximates fair value.

Off-Balance Sheet Financial Instruments

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. Such financial instruments are recorded in the consolidated financial statements when they are funded or related fees are incurred or received.

Derivative Financial Instruments

The Bank utilizes derivative financial instruments to meet the ongoing credit needs of its customers and in order to manage the market exposure of its residential loans held for sale and its commitments to extend credit for residential loans. Derivative financial instruments include commitments to extend credit. The Bank does not use interest rate contracts (e.g. swaps, caps, floors) or other derivatives to manage interest rate risk and has none of these instruments outstanding at December 31, 2013 or 2012.

Advertising Costs

All advertising costs incurred by the Bank are expensed in the period in which they are incurred.

Income Taxes

The Corporation files a consolidated federal income tax return and combined state income tax returns. Income tax expense is recorded based on the liability method. Deferred income tax assets and liabilities are computed annually for differences between the financial statement and tax bases of assets and liabilities that will result in taxable or deductible amounts in the future based on enacted tax laws and rates applicable to the periods in which the differences are expected to affect taxable income. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. The differences relate principally to the allowance for loan losses, mortgage servicing rights, deferred loan fees, and premises and equipment. Valuation allowances are established when necessary to reduce deferred income tax assets to the amount expected to be realized. The Corporation also accounts for the uncertainty in income taxes related to the recognition and measurement of a tax position taken or expected to be taken in an income tax return. The Corporation follows the applicable accounting guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition related to the uncertainty in these income tax positions. It is the Corporation’s policy to include interest and penalties in tax expense.

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 1 - Summary of Significant Accounting Policies (cont.)

Earnings Per Share

Basic earnings per share is computed based upon the weighted average number of common shares outstanding during each year. The Corporation had no potentially dilutive shares outstanding during any of the three years in the period ended December 31, 2013.

Segment Reporting

The Corporation has determined that it has one reportable segment - community banking. The Bank offers a range of financial products and services to external customers, including: accepting deposits and originating residential, consumer and commercial loans. Revenues for each of these products and services are disclosed in the consolidated statements of income.

Employee Benefit Plan

The Bank has established a defined contribution 401(k) profit-sharing plan for qualified employees. The Bank's policy is to fund contributions as accrued.

Reclassifications

Certain 2012 and 2011 amounts have been reclassified to conform to the 2013 presentation. The reclassifications have no effect on previously reported consolidated net income, basic earnings per share, and consolidated stockholders' equity.

Recent Accounting Pronouncements

In January 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-04, Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40) Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loan upon Foreclosure. The amendments in the ASU clarify when an in substance repossession or foreclosure occurs – that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The new ASU requires a creditor to reclassify a collateralized consumer mortgage loan to real estate property upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. The ASU is effective for the Corporation beginning January 1, 2015. The provisions of this ASU are not anticipated to have a significant impact on our consolidated financial condition, results of operations or liquidity.

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2013, 2012 and 2011

NOTE 2 - Fair Value of Financial Instruments

The accounting guidance for fair value measurements and disclosures establishes a three-level valuation hierarchy for disclosure of fair value measurements. The valuation hierarchy favors the transparency of inputs to the valuation of an asset or liability as of the measurement date and thereby favors use of Level 1 if appropriate information is available, and otherwise Level 2 and finally Level 3 if a Level 2 input is not available. The three levels are defined as follows.

- Level 1 — Fair value is based upon quoted prices (unadjusted) for identical assets or liabilities in active markets in which the Corporation can participate.
- Level 2 — Fair value is based upon quoted prices for similar (i.e., not identical) assets and liabilities in active markets, and other inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3 — Fair value is based upon financial models using primarily unobservable inputs.

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

The Corporation has an established process for determining fair value of assets on both a recurring and nonrecurring basis. 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 that use primarily market-based or independently-sourced market parameters, including interest rate yield curves and option volatilities. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments include amounts to reflect counterparty credit quality, creditworthiness, liquidity and unobservable parameters that are applied consistently over time. Any changes to the valuation methodology are reviewed by management to determine appropriateness of the changes.

Securities available for sale - The fair value of securities available for sale is determined by obtaining market price quotes from independent third parties wherever such quotes are available. Where such quotes are not available, management utilizes independent third party valuation analysis to support these estimates and judgments in determining fair value. The following table presents, for the periods noted the Corporation's fair value of securities available for sale in accordance with the fair value hierarchy described above.

Loans held for investment - The Bank does not record loans held for investment at fair value on a recurring basis. However, from time to time, a particular loan may be considered impaired and an allowance for loan losses 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 relevant accounting guidance. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value or discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceeds the recorded investments in such loans. At December 31, 2013 and 2012, substantially all of the impaired loans were evaluated based on the fair value of the collateral. In accordance with relevant accounting guidance, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price or a current appraised value, the Bank records the impaired loan as a nonrecurring Level 2 valuation. Valuations based on management estimates are recorded as nonrecurring Level 3. Mortgage loans available for sale and held for investment are valued using fair values attributable to similar mortgage loans. The fair value of the other loans is based on the fair value of obligations with similar credit characteristics.

Other real estate owned - Loans on which the underlying collateral has been repossessed are recorded at fair value less estimated costs to sell upon transfer to OREO establishing a new cost basis. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Bank records the OREO as a nonrecurring Level 2 valuation. Valuations based on management estimates are recorded as nonrecurring Level 3.

The methods described above may produce a fair value estimate that may not be indicative of net realizable value or reflective of future fair values. Further, while the Corporation 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 different estimates of fair values of the same financial instruments at the reporting date.

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2013, 2012 and 2011

NOTE 2 - Fair Value of Financial Instruments (cont.)

Assets measured at fair value on a recurring basis for 2013 are summarized below. As of December 31, 2012 the Bank did not carry any assets that were measured at fair value on a recurring basis.

Assets measured on a recurring basis

	Balance at 12/31/13	Level 1	Level 2	Level 3
Securities available for sale:				
Collateralized mortgage obligations	\$ 5,277,348	\$ -	\$ 5,277,348	\$ -
Mortgage-backed securities	26,994,723	-	26,994,723	-
Total securities available for sale	\$ 32,272,071	\$ -	\$ 32,272,071	\$ -

Assets measured at fair value on a non-recurring basis for 2012 and 2013 are summarized below:

Assets measured on a nonrecurring basis

	Balance at 12/31/13	Level 1	Level 2	Level 3
Loans held for investment	\$ 16,865,798	\$ -	\$ -	\$ 16,865,798
Other real estate owned	5,709,401	-	-	5,709,401
Totals	\$ 22,575,199	\$ -	\$ -	\$ 22,575,199

	Balance at 12/31/12	Level 1	Level 2	Level 3
Loans held for investment	\$ 18,189,649	\$ -	\$ -	\$ 18,189,649
Other real estate owned	8,544,665	-	-	8,544,665
Totals	\$ 26,734,314	\$ -	\$ -	\$ 26,734,314

Disclosure of fair value information about financial instruments, for which it is practicable to estimate that value, is required whether or not recognized in the consolidated balance sheets. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Certain financial instruments with a fair value that is not practicable to estimate and all non-financial instruments are excluded from the disclosure requirements. Accordingly, the aggregate fair value amounts presented do not necessarily represent the underlying value of the Corporation.

The following is a description of the valuation methodologies used by the Corporation to estimate fair value, as well as the general classification of financial instruments pursuant to the valuation hierarchy:

Cash and due from banks – Due to their short-term nature, the carrying amount of cash and due from banks approximates fair value.

Fed funds sold – Due to their short-term nature, the carrying amount of Fed funds sold approximates fair value.

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 2 - Fair Value of Financial Instruments and Available for Sale (cont.)

Held to maturity and available for sale securities – The fair value is estimated using quoted market prices.

Federal Reserve Bank Stock – It is not practical to determine the fair value of FRB Stock due to restrictions placed on its transferability. No secondary market exists for FRB stock. The stock is bought and sold at par by the FRB. Management believes the recorded value is the fair value.

Loans held for investment – The fair value of loans held for investment is estimated using the rates currently offered for loans held for investment segregated by loan purpose and term.

Cash surrender value of life insurance – Fair value is based on the cash surrender value of the individual policies as provided by the insurance agency.

Mortgage servicing rights - The fair value of MSRs is estimated using third-party information for selected asset price tables for servicing cost and servicing fees applied to the Bank's portfolio of serviced loans.

Deposits - The fair value of demand deposits and savings accounts approximates the carrying amount. The fair value of fixed maturity certificates of deposit is estimated using the rates currently offered for certificates of deposit with similar remaining maturities.

The estimated fair values of financial instruments at December 31, 2013 and 2012 are as follows:

	December 31, 2013		December 31, 2012	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
FINANCIAL ASSETS				
Cash and due from banks	\$ 114,523,575	\$ 114,523,575	\$ 59,179,085	\$ 59,179,085
Federal funds sold	2,986,359	2,986,359	63,060,224	63,060,224
Held to maturity securities	298,904,927	294,615,354	351,523,150	355,987,948
Available for sale securities	32,272,071	32,272,071	-	-
Federal reserve stock	322,100	322,100	322,100	322,100
Loans held for investment, net	670,639,122	675,172,328	692,439,668	700,335,974
Cash surrender value of life insurance	29,339,423	29,339,423	28,328,926	28,328,926
Mortgage servicing rights	1,751,649	2,608,349	1,685,893	1,750,724
Accrued interest receivable	3,262,918	3,262,918	4,164,716	4,164,716
FINANCIAL LIABILITIES				
Deposits	\$ 1,058,775,995	\$ 1,058,222,293	\$ 1,119,207,137	\$ 1,118,005,211
Accrued interest payable	115,873	115,873	178,569	178,569

The estimated fair value of fee income on letters of credit outstanding at December 31, 2013 and December 31, 2012 is insignificant. Loan commitments on which the committed interest rate is less than the current market rate are also insignificant at December 31, 2013 and December 31, 2012.

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2013, 2012 and 2011

NOTE 3 - Cash and Due from Banks

The Bank is required to maintain vault cash and reserve balances with the FRB based upon a percentage of deposits. These requirements approximated \$13,596,000 at December 31, 2012. There was no reserve required as of December 31, 2013.

NOTE 4 - Held to Maturity and Available for Sale Securities

Amortized costs and fair values of held to maturity securities as of December 31, 2013 and 2012 are summarized as follows:

	December 31, 2013			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Obligations of:				
States and political subdivisions	\$ 55,281,869	\$ 829,413	\$ (771,695)	\$ 55,339,587
U.S. government sponsored entities	150,199,687	-	(6,349,322)	143,850,365
Collateralized mortgage obligations	36,062,991	179,281	(752,602)	35,489,670
Mortgage-backed securities	57,360,380	2,575,352	-	59,935,732
Totals	<u>\$ 298,904,927</u>	<u>\$ 3,584,046</u>	<u>\$ (7,873,619)</u>	<u>\$ 294,615,354</u>

	December 31, 2012			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Obligations of:				
States and political subdivisions	\$ 60,517,328	\$ 1,719,818	\$ (23,164)	\$ 62,213,982
U.S. government sponsored entities	151,781,160	119,198	(34,378)	151,865,980
Collateralized mortgage obligations	43,811,778	889,223	(21,931)	44,679,070
Mortgage-backed securities	95,412,884	1,816,032	-	97,228,916
Totals	<u>\$ 351,523,150</u>	<u>\$ 4,544,271</u>	<u>\$ (79,473)</u>	<u>\$ 355,987,948</u>

The amortized cost and fair value of held to maturity securities at December 31, 2013, by contractual maturity are shown below. Expected maturities will differ from contractual maturities because borrowers or issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	December 31, 2013	
	Amortized Cost	Fair Value
Due in one year or less	\$ 6,974,449	\$ 7,022,199
Due after one year less than 5 years	113,652,218	116,336,998
Due after 5 years less than 10 years	169,445,502	163,089,050
Due over 10 years	8,832,758	8,167,107
Totals	<u>\$ 298,904,927</u>	<u>\$ 294,615,354</u>

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2013, 2012 and 2011

NOTE 4 - Held to Maturity and Available for Sale Securities (cont.)

Held to maturity securities with an amortized cost of \$132,969,749 and \$130,560,317 at December 31, 2013 and 2012, respectively, were pledged as collateral on public deposits and for other purposes as required or permitted by law.

The following tables summarize the portion of the Bank's held to maturity securities portfolio which has gross unrealized losses, reflecting the length of time that individual securities have been in a continuous unrealized loss position at December 31, 2013 and 2012.

	December 31, 2013					
	Continuous unrealized losses existing for less than 12 Months		Continuous unrealized losses existing for greater than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Obligations of:						
States and political subdivisions	\$ 19,588,793	\$ 771,695	\$ -	\$ -	\$ 19,588,793	\$ 771,695
U.S. government sponsored entities	150,199,687	6,349,322	-	-	150,199,687	6,349,322
Collateralized mortgage obligations	22,461,319	752,602	-	-	22,461,319	752,602
Totals	<u>\$ 192,249,799</u>	<u>\$ 7,873,619</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 192,249,799</u>	<u>\$ 7,873,619</u>

	December 31, 2012					
	Continuous unrealized losses existing for less than 12 Months		Continuous unrealized losses existing for greater than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Obligations of:						
States and political subdivisions	\$ 4,053,173	\$ 23,164	\$ -	\$ -	\$ 4,053,173	\$ 23,164
U.S. government sponsored entities	17,993,200	34,378	-	-	17,993,200	34,378
Collateralized mortgage obligations	4,570,727	21,931	-	-	4,570,727	21,931
Totals	<u>\$ 26,617,100</u>	<u>\$ 79,473</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 26,617,100</u>	<u>\$ 79,473</u>

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2013, 2012 and 2011

NOTE 4 - Held to Maturity and Available for Sale Securities (cont.)

Management does not believe any individual unrealized loss as of December 31, 2013 and 2012 represents other than temporary impairment. The Bank held no investment securities at December 31, 2013 that had unrealized losses existing for greater than 12 months.

The Bank did not own any securities designated as available for sale in 2012. Amortized costs and fair values of available for sale securities as of December 31, 2013 are summarized as follows:

	December 31, 2013			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Obligations of:				
Collateralized mortgage obligations	\$ 5,310,619	\$ -	\$ (33,271)	\$ 5,277,348
Mortgage-backed securities	<u>27,097,652</u>	<u>74,545</u>	<u>(177,474)</u>	<u>26,994,723</u>
Totals	<u>\$ 32,408,271</u>	<u>\$ 74,545</u>	<u>\$ (210,745)</u>	<u>\$ 32,272,071</u>

The amortized cost and fair value of available for sale securities at December 31, 2013, by contractual maturity are shown below. Expected maturities will differ from contractual maturities because borrowers or issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	December 31, 2013	
	Amortized Cost	Fair Value
Due after one year less than 5 years	\$ 21,627,616	\$ 21,557,477
Due after 5 years less than 10 years	<u>10,780,654</u>	<u>10,714,594</u>
Totals	<u>\$ 32,408,270</u>	<u>\$ 32,272,071</u>

The following table presents the portion of the Bank's available for sale maturities portfolio which has gross unrealized losses, reflecting the length of time that individual securities have been in a continuous unrealized loss position at December 31, 2013.

	December 31, 2013					
	Continuous unrealized losses existing for less than 12 months		Continuous unrealized losses existing for greater than 12 months		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Obligations of:						
Collateralized mortgage obligations	\$ 5,310,619	\$ 33,271	\$ -	\$ -	\$ 5,310,619	\$ 33,271
Mortgage-backed securities	<u>17,746,263</u>	<u>177,474</u>	<u>-</u>	<u>-</u>	<u>17,746,263</u>	<u>177,474</u>
Totals	<u>\$ 23,056,882</u>	<u>\$ 210,745</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 23,056,882</u>	<u>\$ 210,745</u>

Management does not believe any individual unrealized loss as of December 31, 2013 represents other than temporary impairment. The Bank held no investment securities at December 31, 2013 that had unrealized losses existing for greater than 12 months. Management believes the temporary impairment in fair value was caused by market fluctuations in interest rates.

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2013, 2012 and 2011

NOTE 5 - Loans

Major classifications of loans are as follows at December 31:

	<u>2013</u>	<u>2012</u>
Commercial	\$ 20,576,973	\$ 20,286,468
Real Estate		
Construction	29,492,647	40,790,486
Commercial	346,972,401	325,335,181
Residential	229,564,938	258,548,191
Multifamily	45,610,330	47,525,720
Installment and other	10,792,423	12,150,634
	<u>683,009,712</u>	<u>704,636,680</u>
Less: Allowance for loan losses	(12,370,590)	(12,197,012)
Net Loans	<u>\$ 670,639,122</u>	<u>\$ 692,439,668</u>

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2013, 2012 and 2011

NOTE 5 – Loans (cont.)

The following table presents the contractual aging of the recorded investment in loans as of December 31, 2013 and 2012:

	As of December 31, 2013					
	Current Loans	Days Past Due			Total	Total Loans
		30-59	60-89	Over 90		
Commercial	\$ 20,478,350	\$ 34,093	\$ 42,228	\$ 22,302	\$ 98,623	\$ 20,576,973
Real Estate						
Construction	28,346,729	-	1,145,918	-	1,145,918	29,492,647
Commercial	339,316,371	926,782	430,642	6,298,606	7,656,030	346,972,401
Residential	216,409,850	3,876,315	1,288,457	7,990,316	13,155,088	229,564,938
Multifamily	44,280,364	-	1,329,966	-	1,329,966	45,610,330
Installment and other	10,336,632	39,710	132,912	283,169	455,791	10,792,423
Total loans	659,168,296	4,876,900	4,370,123	14,594,393	23,841,416	683,009,712
Purchase credit- impaired loans	(14,733,545)	(717,940)	(63,595)	(1,707,309)	(2,488,844)	(17,222,389)
Total loans, excluding purchase credit-impaired loans	<u>\$ 644,434,751</u>	<u>\$ 4,158,960</u>	<u>\$ 4,306,528</u>	<u>\$ 12,887,084</u>	<u>\$ 21,352,572</u>	<u>\$ 665,787,323</u>
	As of December 31, 2012					
	Current Loans	Days Past Due			Total	Total Loans
		30-59	60-89	Over 90		
Commercial	\$ 20,059,355	\$ 9,474	\$ 13,156	\$ 204,483	\$ 227,113	\$ 20,286,468
Real Estate						
Construction	39,644,388	253,698	-	892,400	1,146,098	40,790,486
Commercial	313,517,308	2,496,491	2,174,469	7,146,913	11,817,873	325,335,181
Residential	237,609,453	4,845,595	1,441,073	14,652,070	20,938,738	258,548,191
Multifamily	46,048,825	-	1,344,570	132,325	1,476,895	47,525,720
Installment and other	11,532,810	33,641	294,914	289,269	617,824	12,150,634
Total loans	668,412,139	7,638,899	5,268,182	23,317,460	36,224,541	704,636,680
Purchase credit- impaired loans	(19,718,246)	(875,837)	(207,330)	(4,823,045)	(5,906,212)	(25,624,458)
Total loans, excluding purchase credit-impaired Loans	<u>\$ 648,693,893</u>	<u>\$ 6,763,062</u>	<u>\$ 5,060,852</u>	<u>\$ 18,494,415</u>	<u>\$ 30,318,329</u>	<u>\$ 679,012,222</u>

Commercial loans deemed to be inadequately collateralized and past due 90 days or more for principal or interest are placed in a non-accrual status. Residential real estate loans are not subject to these guidelines if well-secured, as deemed by the Senior Loan Committee, and in the process of collection.

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2013, 2012 and 2011

NOTE 5 – Loans (cont.)

The following table presents the recorded investment in nonaccrual loans and loans past due ninety days or more and still accruing by class of loans as of December 31, 2013 and 2012:

	December 31, 2013	
	Nonaccrual	Past due 90 days or more and accruing
Commercial	\$ 30,136	\$ -
Real estate		
Construction	-	-
Commercial	7,079,352	-
Residential	10,018,596	323,523
Multifamily	1,329,966	-
Installment and other	28,808	254,361
Total Loans	18,486,858	577,884
Purchase Credit Impaired Loans:		
Commercial	-	-
Real estate		
Construction	-	-
Commercial	(56,980)	-
Residential	(2,013,234)	-
Multifamily	-	-
Installment & Other	-	-
Total Purchased Credit-Impaired Loans	(2,070,214)	-
Total Loans, excluding Purchase Credit Impaired Loans	\$ 16,416,644	\$ 577,884
	December 31, 2012	
	Nonaccrual	Past due 90 days or more and accruing
Commercial	\$ 221,414	\$ -
Real estate		
Construction	1,940,043	593,182
Commercial	8,989,870	483,500
Residential	15,039,972	275,602
Multifamily	252,152	-
Installment and other	101,328	241,002
Total Loans	26,544,779	1,593,286
Purchase Credit Impaired Loans:		
Commercial	-	-
Real estate		
Construction	-	-
Commercial	(1,300,890)	-
Residential	(4,463,017)	-
Multifamily	-	-
Installment & Other	-	-
Total Purchased Credit-Impaired Loans	(5,763,907)	-
Total Loans, excluding Purchase Credit Impaired Loans	\$ 20,780,872	\$ 1,593,286

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2013, 2012 and 2011

NOTE 5 – Loans (cont.)

Management uses an internal asset classification system as a means of identifying problem and potential problem assets. At the quarterly meetings, the Board of Directors of the Bank reviews trends for loans classified as “Special Mention,” “Substandard” and “Doubtful” for the previous twelve months both as a total dollar volume in each classified category and as the percent of capital each classified category represents. A Special Mention loan has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan at a future date. An asset is classified Substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets include those characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Assets classified as Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. Assets classified as Loss are those considered uncollectible and viewed as non-bankable assets, worthy of charge-off. Assets that do not currently expose the Bank to sufficient risk to warrant classification in one of the aforementioned categories, but possess weaknesses that may or may not be within the control of the customer are classified as “Pass.” The following tables present the risk category of loans by class of loans based on the most recent analysis performed and the contractual aging as of December 31, 2013 and December 31, 2012:

December 31, 2013					
	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	\$ 19,606,705	\$ 739,767	\$ 222,820	\$ 7,681	\$ 20,576,973
Real estate					
Construction	27,863,822	-	1,628,825	-	29,492,647
Commercial	321,010,091	9,975,662	15,986,648	-	346,972,401
Multifamily	44,280,364	-	1,329,966	-	45,610,330
Total	\$ 412,760,982	\$ 10,715,429	\$ 19,168,259	\$ 7,681	\$ 442,652,351
Current	\$ 410,628,416	10,715,429	\$ 11,077,969	\$ -	\$ 432,421,814
30-59	884,653	-	76,222	-	960,875
60-89	1,247,913	-	1,700,841	-	2,948,754
Over 90	-	-	6,313,227	7,681	6,320,908
Total	\$ 412,760,982	\$ 10,715,429	\$ 19,168,259	\$ 7,681	\$ 442,652,351
December 31, 2012					
	Pass	Special Mention	Substandard	Doubtful	Total
Commercial	\$ 18,747,473	\$ 1,021,793	\$ 312,719	\$ 204,483	\$ 20,286,468
Real estate					
Construction	35,448,492	-	5,182,404	159,590	40,790,486
Commercial	296,182,011	7,530,468	21,567,077	55,625	325,335,181
Multifamily	45,766,290	162,708	1,480,274	116,448	47,525,720
Total	\$ 396,144,266	\$ 8,714,969	\$ 28,542,474	\$ 536,146	\$ 433,937,855
Current	\$ 394,025,565	\$ 7,946,799	\$ 17,137,923	\$ 159,590	\$ 419,269,877
30-59	908,822	-	1,850,841	-	2,759,663
60-89	726,379	768,170	2,037,646	-	3,532,195
Over 90	483,500	-	7,516,064	376,556	8,376,120
Total	\$ 396,144,266	\$ 8,714,969	\$ 28,542,474	\$ 536,146	\$ 433,937,855

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2013, 2012 and 2011

NOTE 5 – Loans (cont.)

For residential real estate and installment loan classes, the Bank also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in those loan classes based on payment activity as of December 31, 2013 and 2012:

	December 31, 2013		
	Performing	Nonperforming	Total
Residential Real Estate	\$ 219,222,819	\$ 10,342,119	\$ 229,564,938
Installment & Other	10,509,254	283,169	10,792,423
Total	\$ 229,732,073	\$ 10,625,288	\$ 240,357,361

	December 31, 2012		
	Performing	Nonperforming	Total
Residential Real Estate	\$ 243,232,617	\$ 15,315,574	\$ 258,548,191
Installment & Other	11,808,304	342,330	12,150,634
Total	\$ 255,040,921	\$ 15,657,904	\$ 270,698,825

At December 31, 2013, the Bank has identified \$36.3 million of loans as impaired, including \$17.8 million of performing TDRs. The Bank evaluates loans placed on the watch list for impairment. A loan is identified as impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. A performing TDR consists of loans that have been modified and are performing in accordance with the modified terms for a sufficient length of time, generally six months, or loans that were modified on a proactive basis. A summary of the details regarding impaired loans follows:

	December 31,		
	2013	2012	2011
Loans for which there was a related allowance for loan loss	\$ 23,728,748	\$ 25,375,279	\$ 24,368,902
Impaired loans with no related allowance	12,573,993	18,364,383	24,144,704
Total Impaired Loans	\$ 36,302,741	\$ 43,739,662	\$ 48,513,606
Average quarterly balance of impaired loans	\$ 37,110,435	\$ 49,102,343	\$ 46,524,919
Related allowance for loan losses	6,862,950	7,185,630	6,466,579
Interest income recognized while impaired	581,355	628,270	842,282

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2013, 2012 and 2011

NOTE 5 – Loans (cont.)

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2013 and 2012:

	December 31, 2013			
	Unpaid Principal Balance	Partial Charge- offs	Allowance For Loan Losses Allocation	Recorded Investment
Loans with no related allowance recorded:				
Commercial	\$ 8,191	\$ 355	\$ -	\$ 7,836
Real estate				
Construction	146,810	-	-	146,810
Commercial	4,997,099	141,566	-	4,855,533
Residential	7,808,304	261,918	-	7,546,386
Multifamily	-	-	-	-
Installment & Other	17,428	-	-	17,428
Total	<u>12,977,832</u>	<u>403,839</u>	<u>-</u>	<u>12,573,993</u>
Loans with a related allowance recorded:				
Commercial	32,904	10,602	22,302	-
Real estate				
Construction	1,075,166	-	120,859	954,307
Commercial	8,080,918	195,248	2,127,837	5,757,833
Residential	13,800,586	511,615	4,172,490	9,116,481
Multifamily	1,344,570	14,604	383,966	946,000
Installment & Other	128,303	1,630	35,496	91,177
Total	<u>24,462,447</u>	<u>733,699</u>	<u>6,862,950</u>	<u>16,865,798</u>
Total Impaired Loans	<u>\$ 37,440,279</u>	<u>\$ 1,137,538</u>	<u>\$ 6,862,950</u>	<u>\$ 29,439,791</u>
	December 31, 2012			
	Unpaid Principal Balance	Partial Charge- offs	Allowance For Loan Losses Allocation	Recorded Investment
Loans with no related allowance recorded:				
Commercial	\$ 22,662	\$ 5,730	\$ -	\$ 16,932
Real estate				
Construction	284,481	-	-	284,481
Commercial	7,775,104	1,147,712	-	6,627,392
Residential	11,152,571	110,510	-	11,042,061
Multifamily	263,204	11,052	-	252,152
Installment & Other	141,788	423	-	141,365
Total	<u>19,639,810</u>	<u>1,275,427</u>	<u>-</u>	<u>18,364,383</u>
Loans with a related allowance recorded:				
Commercial	204,952	469	204,483	-
Real estate				
Construction	1,729,124	43,319	183,104	1,502,701
Commercial	7,821,504	231,976	1,566,027	6,023,501
Residential	16,123,025	317,731	5,156,847	10,648,447
Multifamily	-	-	-	-
Installment & Other	92,245	2,076	75,169	15,000
Total	<u>25,970,850</u>	<u>595,571</u>	<u>7,185,630</u>	<u>18,189,649</u>
Total Impaired Loans	<u>\$ 45,610,660</u>	<u>\$ 1,870,998</u>	<u>\$ 7,185,630</u>	<u>\$ 36,554,032</u>

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2013, 2012 and 2011

NOTE 5 – Loans (cont.)

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio class and based on impairment method as of December 31, 2013 and 2012:

	December 31, 2013						
	Commercial	Construction	Commercial Real Estate	Residential Real Estate	Multifamily	Consumer	Total
Allowance for loan losses:							
Beginning balance	\$ 361,022	\$ 476,986	\$ 3,971,661	\$ 6,858,876	\$ 360,611	\$ 167,856	\$ 12,197,012
Charge-offs	(20,204)	(110,736)	(362,875)	(6,303,596)	(116,519)	(101,533)	(7,015,463)
Recoveries	11,183	43,780	89,178	364,559	181,350	16,991	707,041
Provision	9,269	68,798	281,228	6,077,313	(41,476)	86,868	6,482,000
Ending Balance	<u>\$ 361,270</u>	<u>\$ 478,828</u>	<u>\$ 3,979,192</u>	<u>\$ 6,997,152</u>	<u>\$ 383,966</u>	<u>\$ 170,182</u>	<u>\$ 12,370,590</u>
Loans:							
Ending balance	\$ 20,576,973	\$ 29,492,647	\$ 346,972,401	\$ 229,564,938	\$ 45,610,330	\$ 10,792,423	\$ 683,009,712
Allowance for loan losses;							
Individually evaluated for impairment	22,302	120,859	2,127,837	4,172,490	383,966	35,496	6,862,950
Collectively evaluated for impairment	338,968	357,969	1,851,355	2,824,662	-	134,686	5,507,640
Total allowance for loan losses	<u>361,270</u>	<u>478,828</u>	<u>3,979,192</u>	<u>6,997,152</u>	<u>383,966</u>	<u>170,182</u>	<u>12,370,590</u>
Recorded Investment	<u>\$ 20,215,703</u>	<u>\$ 29,013,819</u>	<u>\$ 342,993,209</u>	<u>\$ 222,567,786</u>	<u>\$ 45,226,364</u>	<u>\$ 10,622,241</u>	<u>\$ 670,639,122</u>
Ending Balance:							
Individually evaluated for impairment	\$ 30,136	\$ 1,221,976	\$ 12,741,203	\$ 20,835,359	\$ 1,329,966	\$ 144,101	\$ 36,302,741
Collectively evaluated for impairment	20,535,446	28,270,671	332,403,122	198,038,704	43,370,751	10,639,310	633,258,004
Acquired	11,391	-	1,828,076	10,690,875	909,613	9,012	13,448,967
Total ending balance	<u>\$ 20,576,973</u>	<u>\$ 29,492,647</u>	<u>\$ 346,972,401</u>	<u>\$ 229,564,938</u>	<u>\$ 45,610,330</u>	<u>\$ 10,792,423</u>	<u>\$ 683,009,712</u>

	December 31, 2012						
	Commercial	Construction	Commercial Real Estate	Residential Real Estate	Multifamily	Consumer	Total
Allowance for loan losses:							
Beginning balance	\$ 163,865	\$ 583,784	\$ 3,748,857	\$ 5,569,743	\$ 786,919	\$ 158,920	\$ 11,012,088
Charge-offs	(56,744)	(608,699)	(1,117,451)	(4,008,226)	(720,373)	(203,407)	(6,714,900)
Recoveries	43,933	41,873	210,199	349,285	31,929	22,605	699,824
Provision	209,968	460,028	1,130,056	4,948,074	262,136	189,738	7,200,000
Ending Balance	<u>\$ 361,022</u>	<u>\$ 476,986</u>	<u>\$ 3,971,661</u>	<u>\$ 6,858,876</u>	<u>\$ 360,611</u>	<u>\$ 167,856</u>	<u>\$ 12,197,012</u>
Loans:							
Ending balance	\$ 20,286,468	\$ 40,790,486	\$ 325,335,181	\$ 258,548,191	\$ 47,525,720	\$ 12,150,634	\$ 704,636,680
Allowance for loan losses;							
Individually evaluated for impairment	204,483	183,104	1,566,027	5,156,847	-	75,169	7,185,630
Collectively evaluated for impairment	156,539	293,882	2,405,634	1,702,029	360,611	92,687	5,011,382
Total allowance for loan losses	<u>361,022</u>	<u>476,986</u>	<u>3,971,661</u>	<u>6,858,876</u>	<u>360,611</u>	<u>167,856</u>	<u>12,197,012</u>
Recorded Investment	<u>\$ 19,925,446</u>	<u>\$ 40,313,500</u>	<u>\$ 321,363,520</u>	<u>\$ 251,689,315</u>	<u>\$ 47,165,109</u>	<u>\$ 11,982,778</u>	<u>\$ 692,439,668</u>
Ending Balance:							
Individually evaluated for impairment	\$ 221,414	\$ 1,970,287	\$ 14,216,920	\$ 26,847,354	\$ 252,152	\$ 231,535	\$ 43,739,662
Collectively evaluated for impairment	20,053,903	37,756,394	309,063,238	218,668,170	46,329,346	11,907,932	643,778,983
Acquired	11,151	1,063,805	2,055,023	13,032,667	944,222	11,167	17,118,035
Total ending balance	<u>\$ 20,286,468</u>	<u>\$ 40,790,486</u>	<u>\$ 325,335,181</u>	<u>\$ 258,548,191</u>	<u>\$ 47,525,720</u>	<u>\$ 12,150,634</u>	<u>\$ 704,636,680</u>

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2013, 2012 and 2011

NOTE 5 – Loans (cont.)

The Corporation continues to evaluate loans purchased for impairment in accordance with U.S. GAAP. The purchased loans were considered impaired at the acquisition date if there was evidence of deterioration since origination and if it was probable that not all contractually required principal and interest payments would be collected. The following table reflects the carrying value of all purchased loans as of December 31, 2013 and 2012.

	December 31, 2013		
	Contractually Required Payments Receivable		
	Credit Impaired	Non-Credit Impaired	Carrying Value of Purchased Loans
Commercial	\$ 24,067	\$ 12,809	\$ 14,421
Real Estate			
Construction	-	39,554	38,655
Commercial	2,789,024	196,797	2,001,907
Residential	26,722,489	38,348,858	49,044,826
Multifamily	1,208,591	-	909,613
Installment and Consumer	12,037	1,575,607	971,710
Total	<u>\$ 30,756,208</u>	<u>\$ 40,173,625</u>	<u>\$ 52,981,132</u>
	December 31, 2012		
	Contractually Required Payments Receivable		
	Credit Impaired	Non-Credit Impaired	Carrying Value of Purchased Loans
Commercial	\$ 65,751	\$ 564,174	\$ 462,520
Real Estate			
Construction	1,919,976	41,953	1,104,826
Commercial	7,252,950	3,023,479	6,190,892
Residential	36,990,826	46,380,930	62,174,180
Multifamily	1,243,200	-	944,222
Installment and Consumer	14,192	2,604,422	1,573,922
Total	<u>\$ 47,486,895</u>	<u>\$ 52,614,958</u>	<u>\$ 72,450,562</u>

As of December 31, 2013, the estimated contractually-required payments receivable on credit impaired and non-credit impaired loans was \$30.8 million and \$40.2 million, respectively. The cash flows expected to be collected related to principal as of December 31, 2013 on all purchased loans is \$53.0 million. As a result, there is \$18.0 million of remaining discount on the purchased loans. These amounts are based upon the estimated fair values of the underlying collateral or discounted cash flows at December 31, 2013. The difference between the contractually required payments at acquisition and the cash flow expected to be collected at acquisition is referred to as the non-accretable difference. Subsequent decreases to the expected cash flows will generally result in a provision for loan losses. Subsequent increases in cash flows will result in a reversal of the provision for loan losses charged to earnings to the extent of prior charges or a reclassification of the difference from non-accretable discount to accretable discount, with a positive impact on interest income. Further, any excess of cash flows expected over the estimated fair value is referred to as the accretable yield and is recognized in interest income over the remaining life of the loan when there is a reasonable expectation about the amount and timing of such cash flows.

The change in the carrying amount of accretable yield for purchased loans was as follows for the years ended December 31, 2013 and 2012.

	For Twelve Months Ended	
	December 31,	
	2013	2012
Beginning Balance	\$ 5,653,497	\$ 9,760,544
Additions	1,008,424	-
Accretion ⁽¹⁾	(2,459,958)	4,107,047
Ending Balance	<u>\$ 4,201,963</u>	<u>\$ 5,653,497</u>

⁽¹⁾ Accretable yield is recognized in interest income as the purchased loans pay down, mature, renew or pay off.

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2013, 2012 and 2011

NOTE 5 – Loans (cont.)

Contractual maturities of loans with accretable yield range from 1 year to 30 years. Actual maturities may differ from contractual maturities because borrowers have the right to prepay or renew their loan prior to maturity or the loan may be charged off.

Certain directors and executive officers of the Corporation, and their related interests, had loans outstanding in the aggregate amounts of \$6.8 million, \$6.9 million and \$8.3 million at December 31, 2013, 2012 and 2011, respectively. During 2013, 2012 and 2011, \$0.8 million, \$0.2 million and \$0.02 million of new loans were made and repayments totaled \$0.9 million, \$1.6 million and \$0.1 million, respectively. Management believes these loans were made on substantially the same terms, including interest rates and collateral, as those prevailing at the same time for comparable transactions with other persons and did not involve more than normal risks of collectability or present other unfavorable features.

Residential and commercial real estate loans approximating \$126.5 million, \$116.5 million and \$128.4 million at December 31, 2013, 2012 and 2011, respectively, were pledged as collateral on public deposits and for other purposes as required or permitted by law.

NOTE 6 – Allowance for Loan Losses

The allowance for loan losses reflected in the accompanying consolidated financial statements represents the allowance available to absorb loan losses that are probable and inherent in the portfolio. An analysis of changes in the allowance is presented in the following tabulation as of December 31:

	2013	2012	2011
Balance at beginning of year	\$ 12,197,012	\$ 11,012,088	\$ 9,526,592
Charge-offs	(7,015,463)	(6,714,900)	(7,127,898)
Recoveries	707,041	699,824	243,394
Provision charged to operation	6,482,000	7,200,000	8,370,000
Balance at end of year	<u>\$ 12,370,590</u>	<u>\$ 12,197,012</u>	<u>\$ 11,012,088</u>

NOTE 7 - Other Real Estate Owned

Real estate acquired by foreclosure or by deed in lieu of foreclosure is held for sale and is initially recorded at fair value at the date of foreclosure less estimated selling expenses, establishing a new cost basis. At the date of foreclosure, any write down to fair value less estimated selling costs is charged to the allowance for loan losses. Subsequent to foreclosure, an analysis of the valuation is performed and a valuation allowance is established as needed. Costs relating to the development and improvement of the property may be capitalized; holding period costs and subsequent changes to the valuation allowance are charged to expense.

The following is a summary of the activity in OREO for the years ended December 31, 2013 and 2012:

	2013	2012
Beginning Balance	\$ 8,544,665	\$ 7,350,678
Additions	10,007,782	10,166,719
Valuation Adjustments	-	-
Sales	(12,843,046)	(8,972,732)
Ending Balance	<u>\$ 5,709,401</u>	<u>\$ 8,544,665</u>

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NOTE 8 - Troubled Debt Restructuring

A TDR includes a loan modification where a borrower is experiencing financial difficulty and the Bank grants a concession to that borrower that the Bank would not otherwise consider except for the borrower's financial difficulties. Modifications include below market interest rates, interest-only terms, forgiveness of principal, or an exceptionally long amortization period. Most of the Bank's modifications are below market interest rate concessions. A TDR may be either on accrual or nonaccrual status based upon the performance of the borrower and management's assessment of collectability. If a TDR is placed on nonaccrual status, it remains there until it performs under the restructured terms for a sufficient period of time, generally six consecutive months at which time it is returned to accrual status.

A summary of TDRs as of December 31, 2013, 2012 and 2011 are noted in the table below. All TDRs are considered impaired loans and, as of December 31, 2013, the allowance associated with those loans was \$4.6 million.

	December 31, 2013			
	Number of Modifications	Total Trouble Debt Restructurings	Allowance For Loan Losses Allocation	Recorded Investment
Commercial	-	\$ -	\$ -	\$ -
Real estate				
Construction	2	1,221,976	120,859	1,101,117
Commercial	15	9,731,985	1,939,354	7,792,631
Residential	85	13,235,999	2,183,362	11,052,637
Multifamily	1	1,329,966	383,966	946,000
Installment & Other	3	115,293	17,498	97,795
Total Loans	106	\$ 25,635,219	\$ 4,645,039	\$ 20,990,180
	December 31, 2012			
	Number of Modifications	Total Trouble Debt Restructurings	Allowance For Loan Losses Allocation	Recorded Investment
Commercial	-	\$ -	\$ -	\$ -
Real estate				
Construction	2	189,833	38,043	151,790
Commercial	21	10,440,652	1,013,782	9,426,870
Residential	101	16,320,585	1,949,960	14,370,625
Multifamily	1	119,828	-	119,828
Installment & Other	6	155,506	10,299	145,207
Total Loans	131	\$ 27,226,404	\$ 3,012,084	\$ 24,214,320
	December 31, 2011			
	Number of Modifications	Total Trouble Debt Restructurings	Allowance For Loan Losses Allocation	Recorded Investment
Commercial	-	\$ -	\$ -	\$ -
Real estate				
Construction	4	1,291,616	46,081	1,245,535
Commercial	13	7,360,189	790,410	6,569,779
Residential	86	15,950,281	923,937	15,026,344
Multifamily	2	541,192	170,295	370,897
Installment & Other	9	127,437	11,844	115,593
Total Loans	114	\$ 25,270,715	\$ 1,942,567	\$ 23,328,148

TRI CITY BANKSHARES CORPORATION
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NOTE 8 - Troubled Debt Restructuring (cont.)

The following is a summary of TDR's as of December 31, 2013, 2012 and 2011 that were in default. TDR's in default are past due 90 days or more at the end of the period.

	2013		2012		2011	
	Number of Modifications	Total in Default	Number of Modifications	Total in Default	Number of Modifications	Total in Default
Commercial	-	\$ -	-	\$ -	-	\$ -
Real Estate						
Construction	-	-	-	-	-	-
Commercial	2	3,927,773	2	4,073,472	-	-
Residential	9	1,735,152	23	4,532,899	18	2,860,627
Multifamily	-	-	-	-	-	-
Installment and other	-	-	1	25,299	-	-
Total Loans	11	\$ 5,662,925	26	\$ 8,631,670	18	\$ 2,860,627

A summary of the type of modifications made on TDR's that occurred during 2013, 2012 and 2011 are noted in the table below.

For the Year Ended December 31, 2013

	Modification of Terms		Reduction of Interest Rate		Modification to Interest-only Payments		Forgiveness of Debt		Total	
	Count	Balance	Count	Balance	Count	Balance	Count	Balance	Count	Balance
Commercial	-	\$ -	-	\$ -	-	\$ -	2	\$ 85,000	2	\$ 85,000
Real estate										
Construction	-	-	1	165,032	-	-	3	3,518,007	4	3,683,039
Commercial	-	-	-	-	4	801,112	1	427,300	5	1,228,412
Residential	4	439,326	47	6,678,519	5	2,486,920	2	2,717,078	58	12,321,843
Multifamily	-	-	1	415,821	-	-	-	-	1	415,821
Installment & Other	2	31,526	7	104,885	-	-	-	-	9	136,411
Total Loans	6	\$ 470,852	56	\$ 7,364,257	9	\$ 3,288,032	8	\$ 6,747,385	79	\$ 17,870,526

For the Year Ended December 31, 2012

	Modification of Terms		Reduction of Interest Rate		Modification to Interest-only Payments		Forgiveness of Debt		Total	
	Count	Balance	Count	Balance	Count	Balance	Count	Balance	Count	Balance
Commercial	-	\$ -	-	\$ -	-	\$ -	-	\$ -	-	\$ -
Real estate										
Construction	-	-	-	-	-	-	-	-	-	-
Commercial	2	414,129	5	2,472,278	6	2,184,220	-	-	13	5,070,627
Residential	6	1,029,130	31	3,239,121	1	14,023	-	-	38	4,282,274
Multifamily	-	-	-	-	-	-	-	-	-	-
Installment & Other	-	-	2	74,823	-	-	-	-	2	74,823
Total Loans	8	\$ 1,443,259	38	\$ 5,786,222	7	\$ 2,198,243	-	\$ -	53	\$ 9,427,724

For the Year Ended December 31, 2011

	Modification of Terms		Reduction of Interest Rate		Modification to Interest-only Payments		Forgiveness of Debt		Total	
	Count	Balance	Count	Balance	Count	Balance	Count	Balance	Count	Balance
Commercial	-	\$ -	-	\$ -	-	\$ -	2	\$ 85,000	2	\$ 85,000
Real estate										
Construction	-	-	1	165,032	-	-	3	3,518,007	4	3,683,039
Commercial	-	-	-	-	4	801,112	1	427,300	5	1,228,412
Residential	4	439,326	47	6,678,519	5	2,486,920	2	2,717,078	58	12,321,843
Multifamily	-	-	1	415,821	-	-	-	-	1	415,821
Installment & Other	2	31,526	7	104,885	-	-	-	-	9	136,411
Total Loans	6	\$ 470,852	56	\$ 7,364,257	9	\$ 3,288,032	8	\$ 6,747,385	79	\$ 17,870,526

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 9 - Core Deposit Intangible Asset

Estimated future amortization expense as of December 31, 2013 by year is as follows:

2014	\$	172,613
2015		130,381
2016		98,275
2017		63,272
Total	\$	<u>464,541</u>

NOTE 10 - Mortgage Servicing Rights

The following is an analysis of the mortgage servicing rights activity for the years ended December 31:

	2013	2012	2011
Balance at beginning of year	\$ 1,685,893	\$ 1,598,802	\$ 1,702,696
Additions of mortgage servicing rights	458,342	725,850	389,597
Amortization	<u>(392,586)</u>	<u>(638,759)</u>	<u>(493,491)</u>
Balance at end of year	<u>\$ 1,751,649</u>	<u>\$ 1,685,893</u>	<u>\$ 1,598,802</u>

The carrying value of MSR's is determined in accordance with relevant accounting guidance. This guidance permits capitalized MSR's to be amortized in proportion to and over the period of estimated net servicing income and to be assessed for impairment. The Bank relies on industry data to estimate the initial fair value of MSR's to be capitalized as a percentage of the principal balance of the loans sold. The Bank adjusts the carrying value monthly for reductions due to normal amortization and actual prepayments, including defaults. The Bank assesses its MSR's for impairment each reporting period by using a third party source. At December 31, 2013 and 2012, the weighted average coupon rates of mortgage loans underlying the MSR's were 3.74% and 4.04%, respectively, and the weighted average remaining maturity of the mortgage loans underlying the MSR's were 209 months and 208 months, respectively. The estimated fair values of MSR's were \$2,608,349 and \$1,750,724 at December 31, 2013 and 2012, respectively. As the carrying value of the Bank's MSR's was less than the estimated fair value at December 31, 2013 and 2012, no impairment existed.

The carrying value of MSR's was \$1,751,649 or 0.60% of loans serviced for others at December 31, 2013 compared with \$1,685,893, or 0.55% of loans serviced at December 31, 2012.

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2013, 2012 and 2011

NOTE 10 - Mortgage Servicing Rights (cont.)

The projections of amortization expense shown below for mortgage servicing rights are based on existing asset balances and the existing interest rate environment at December 31, 2013. Future amortization may be significantly different depending upon changes in the mortgage servicing portfolio, mortgage interest rates and market conditions.

Estimated future amortization by year is as follows:

2014	\$	164,673
2015		159,143
2016		130,295
2017		102,794
2018		88,178
Thereafter		<u>1,106,566</u>
	\$	<u><u>1,751,649</u></u>

The unpaid principal balance of mortgage loans serviced for others, which is not included in the accompanying consolidated balance sheets, was \$294,313,925 and \$307,314,943 at December 31, 2013 and 2012, respectively.

Custodial escrow balances maintained in connection with the foregoing loan servicing and included in demand deposits were \$682,285 and \$1,002,136 at December 31, 2013 and 2012, respectively.

NOTE 11 - Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation at December 31 and are summarized as follows:

	<u>2013</u>	<u>2012</u>
Land	\$ 5,997,024	\$ 6,244,202
Buildings and leasehold improvements	29,172,179	30,730,534
Furniture and equipment	<u>13,579,656</u>	<u>13,766,524</u>
Total	48,748,859	50,741,260
Less: Accumulated depreciation	<u>(32,853,646)</u>	<u>(32,735,993)</u>
Net Premises and Equipment	<u><u>\$ 15,895,213</u></u>	<u><u>\$ 18,005,267</u></u>

Depreciation expense amounted to \$1,905,020 and \$2,059,240, in 2013 and 2012, respectively.

NOTE 12 – Accrued Interest Receivable and Other Assets

A summary of accrued interest receivable and other assets at December 31 is as follows:

	<u>2013</u>	<u>2012</u>
Accrued interest receivable	\$ 3,262,918	\$ 4,164,716
Federal Reserve Stock	322,100	322,100
Prepaid expenses and other assets	<u>4,575,881</u>	<u>3,263,696</u>
Total	<u><u>\$ 8,160,899</u></u>	<u><u>\$ 7,750,512</u></u>

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 13 - Deposits

The aggregate amount of time deposits, each with a minimum denomination of \$100,000, was \$55,021,251 and \$75,517,308 at December 31, 2013 and 2012, respectively.

Scheduled maturities of time deposits at December 31 are:

	2013	2012
Due within one year	\$ 88,247,508	\$ 120,606,068
After one year but within two years	27,423,012	24,923,474
After two years but within three years	8,398,930	9,769,026
After three years but within four years	7,479,680	6,700,012
After four years but within five years	3,925,708	7,824,267
	<u>\$ 135,474,838</u>	<u>\$ 169,822,847</u>

The Bank had no customers with a deposit balance in excess of 5% of total deposits at December 31, 2013 and 2012, respectively.

NOTE 14 - Other Borrowings

The Bank has the ability to borrow (purchase) federal funds of up to \$70,000,000 under a revolving line-of-credit. Such borrowings bear interest at the lender bank's announced daily federal funds rate and mature daily. There were no federal funds purchased outstanding at December 31, 2013 or 2012.

At December 31, 2013, the Bank could pledge up to \$141,049,452 of additional securities as collateral to obtain additional borrowings. The Bank may be required to provide additional collateral based on the fair value of the underlying securities. The Bank may also borrow through the FRB Discount Window short term funds up to the amount of \$27,630,000 and \$33,520,500 as of December 31, 2013 and 2012, respectively. These funds are secured by U.S. government sponsored entity securities or qualified municipal securities totaling \$30,700,000 and \$37,245,000 as of December 31, 2013 and 2012, respectively.

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2013, 2012 and 2011

NOTE 15 - Income Taxes

The provision for income taxes included in the accompanying consolidated financial statements consists of the following components for the year ending December 31:

	2013	2012	2011
Current tax expense			
Federal	\$ 4,027,397	\$ 4,379,530	\$ 4,691,821
State	1,095,520	1,198,914	1,171,394
Total current expense	5,122,917	5,578,444	5,863,215
Deferred income taxes benefit			
Federal	(569,607)	(1,212,727)	(885,799)
State	(109,727)	(347,560)	(284,815)
Total deferred benefit	(679,334)	(1,560,287)	(1,170,614)
Total income tax expense	\$ 4,443,583	\$ 4,018,157	\$ 4,692,601

The net deferred income tax assets in the accompanying consolidated balance sheets include the following amounts of deferred income tax assets and liabilities at December 31:

	2013	2012
Deferred income tax assets:		
Allowance for loan losses	\$ 4,966,577	\$ 4,896,911
Other real estate owned	68,705	-
Depreciation	352,061	70,425
Non-accrual interest	536,223	916,395
Loss carryforwards	38,965	41,130
Unrealized losses on securities available for sale	54,664	-
Other	189,866	216,694
Net deferred income tax assets	6,207,061	6,141,555
Deferred income tax liabilities		
Loan acquisition fair market valuation	(1,640,020)	(2,223,162)
Other real estate owned	-	(34,840)
Core deposit intangible asset	(186,444)	(278,907)
Deferred loan fees	(249,042)	(239,892)
Mortgage servicing rights	(699,681)	(673,290)
Reserve for health plan	(75,162)	(38,055)
Other	(53,813)	(84,508)
Total deferred income tax liabilities	(2,904,162)	(3,572,653)
Net deferred income tax asset	\$ 3,302,899	\$ 2,568,901

The Corporation has state net business loss carryforwards of approximately \$759,000 and \$801,000 as of December 31, 2013 and 2012, respectively. The net business loss carryforwards expire in 2031.

Realization of the deferred income tax asset over time is dependent upon the existence of taxable income in carryback periods or the Corporation generating sufficient taxable income in future periods. In determining that realization of the deferred income tax asset recorded was more likely than not, the Corporation gave consideration to a number of factors including its recent earnings history, its expectations for earnings in the future, and where applicable, the expiration dates associated with tax carryforwards.

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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NOTE 15 - Income Taxes (cont.)

Due to a change in law, the Corporation has released the valuation allowance established against state deferred income taxes for those entities which have state net business loss carryforwards in which management believes that it is now more likely than not that the state deferred income tax assets will be realized. As a result, there is no valuation allowance at December 31, 2013, and December 31, 2012 compared to \$43,294 at December 31, 2011.

A reconciliation of statutory federal income taxes based upon income before taxes to the provision for federal and state income taxes is as follows:

	2013		2012		2011	
	Amount	% of Pretax Income	Amount	% of Pretax Income	Amount	% of Pretax Income
Federal income taxes at statutory rate	\$ 4,674,754	35.00	\$ 4,259,549	35.00%	\$ 4,973,083	35.00%
Adjustments for:						
Tax exempt interest on municipal obligations	(386,748)	(2.90)	(458,264)	(3.77)	(485,449)	(3.41)
Increase in taxes resulting from state income taxes, net of federal tax benefit	640,766	4.80	596,675	4.90	709,205	4.99
Increase in cash surrender value of life insurance	(353,674)	(2.65)	(293,021)	(2.41)	(163,610)	(1.15)
Permanent items prior years	-	-	-	-	(238,071)	(1.68)
Other – net	(58,390)	(0.43)	(86,782)	(0.70)	(102,557)	(0.72)
Income tax expense	\$ 4,520,675	33.85%	\$ 4,018,157	33.02%	\$ 4,692,601	33.03%

As of December 31, 2013, 2012 and 2011, the Corporation had no uncertain tax positions. The Corporation's policy is to record interest and penalties related to income tax liabilities in income tax expense. The Corporation, along with its subsidiaries, files U.S. Federal and Wisconsin income tax returns. The Corporation's federal tax returns for 2009 and prior and its 2008 and prior year Wisconsin tax returns are no longer subject to examination by tax authorities.

NOTE 16 - Employee Benefit Plans

The Bank has a contributory defined-contribution 401(k) retirement plan. This plan covers substantially all employees who have attained the age of 21 and completed one year of service. Participants may contribute a portion of their compensation (up to IRS limits) to the plan. The Bank may make regular and matching contributions to the plan each year. In 2013, 2012 and 2011, the Bank provided a dollar-for-dollar match of employee contributions up to 5% of their compensation. Participants direct the investment of their contributions into one or more investment options. The Bank recorded contribution expense of \$530,726, \$549,502, and \$629,577 in 2013, 2012 and 2011, respectively.

The Bank purchased paid-up life insurance as owner and beneficiary on certain officers and executives to provide the Bank with funds in the event of the death of such individuals and to help recover the cost of employee benefits. Included in the consolidated financial statements is \$29,339,423 and \$28,328,926 of related cash surrender value as of December 31, 2013 and 2012, respectively.

TRI CITY BANKSHARES CORPORATION
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NOTE 17 - Operating Leases

The Corporation leases various banking facilities under operating lease agreements from various companies. Three of these facilities are leased from companies held by a director and major shareholder of the Corporation. All of the agreements include renewal options and one agreement requires the subsidiary Bank to pay insurance, real estate taxes and maintenance costs associated with the lease. Rental amounts are subject to annual escalation based upon increases in the Consumer Price Index. Aggregate rental expense under all leases amounted to \$1,191,574, \$1,184,661 and \$1,357,715 in 2013, 2012 and 2011 respectively, including \$485,603, \$470,874 and \$449,474, respectively, on facilities leased from companies held by a director and major shareholder of the Corporation.

At December 31, 2013, the future minimum lease payments for each of the five succeeding years and in the aggregate are as follows:

2014	\$	1,149,966
2015		809,375
2016		418,302
2017		254,666
2018		157,143
Thereafter		<u>245,155</u>
	\$	<u><u>3,034,608</u></u>

Office space at certain facilities is leased to outside parties. Rental income included in net occupancy costs was \$923,308, \$964,132 and \$933,267 for the years ended December 31, 2013, 2012 and 2011, respectively.

NOTE 18 - Commitments and Contingencies

The Corporation and Bank are party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, financial guarantees and standby letters of credit. They involve, to varying degrees, elements of credit and interest rate risk in excess of amounts recognized on the consolidated balance sheets.

TRI CITY BANKSHARES CORPORATION
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NOTE 18 - Commitments and Contingencies (cont.)

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. The Bank uses the same credit policies in making commitments and issuing letters of credit as they do for on-balance-sheet instruments.

A summary of the contract or notional amount of the Bank's exposure to off-balance-sheet risk as of December 31, 2013 and 2012 is as follows:

	2013	2012
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	\$ 95,102,668	\$ 98,549,862
Standby letters of credit	2,942,872	2,943,530
Forward commitment to sell mortgage loans	209,800	2,669,915

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. Standby letters of credit are conditional commitments issued to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties. The Bank also enters into forward commitments to sell mortgage loans to a secondary market agency.

NOTE 19 - Stockholders' Equity

Cumulative Preferred Stock

The Corporation's articles of incorporation authorize the issuance of up to 200,000 shares of \$1 par value cumulative preferred stock. The Board of Directors is authorized to divide the stock into series and fix and determine the relative rights and preferences of each series. No shares have been issued.

Retained Earnings

The principal source of income and funds of the Corporation are dividends from the Bank. Dividends declared by the Bank that exceed the retained net income for the most current year plus retained net income for the preceding two years must be approved by federal regulatory agencies.

In December of 2012, the Corporation paid a special dividend of \$1.70 per share. The dividend was a prepayment of future dividends in anticipation of potential changes in the tax code related to dividend income. As a result, no dividend payment was made during 2013. The special dividend payment resulted in the Corporation paying more dividends than net income generated during 2012 and the preceding two years combined. Thus, the Corporation did ask for and receive regulatory approval to pay the special dividend.

Under Federal Reserve regulations, the Bank is limited as to the amount it may lend to its affiliates, including the Corporation. Such loans are required to be collateralized by investments defined in the regulations. In addition, the maximum amount available for transfer from the Bank to the Corporation in the form of loans is limited to 10% of the Bank's stockholders' equity in the case of any one affiliate or 20% in the case of all affiliates.

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2013, 2012 and 2011

NOTE 20 - Regulatory Capital Requirements

The Corporation (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by 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 Corporation's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.

Quantitative measures established by regulation to ensure capital adequacy require the Corporation and the Bank to maintain minimum amounts and ratios (set forth in the table that follows) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined) and Tier 1 capital (as defined) to average assets (as defined). As of December 31, 2013 and 2012, the Corporation and the Bank met all capital adequacy requirements to which they were subject.

As of December 31, 2013, the Bank as well-capitalized under the regulatory framework for prompt corrective action. To be categorized as well-capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since these notifications that management believes have changed the institution's category.

Listed below is a comparison of the Corporation's and the Bank's actual capital amounts with the minimum requirements for well-capitalized and adequately capitalized banks, as defined by the federal regulatory agencies' Prompt Corrective Action Rules, as of December 31, 2013 and 2012.

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provision	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2013						
Total capital (to risk weighted assets)						
Tri City Bankshares Corporation	\$ 127,107,000	17.2%	\$ 59,186,000	8.0%	\$ n/a	n/a
Tri City National Bank	\$ 125,340,000	17.0%	\$ 59,122,000	8.0%	\$ 73,902,000	10.0%
Tier 1 capital (to risk weighted assets)						
Tri City Bankshares Corporation	\$ 117,831,000	15.9%	\$ 29,593,000	4.0%	\$ n/a	n/a
Tri City National Bank	\$ 116,064,000	15.7%	\$ 29,561,000	4.0%	\$ 44,341,000	6.0%
Tier 1 capital (to average assets)						
Tri City Bankshares Corporation	\$ 117,831,000	10.0%	\$ 47,212,000	4.0%	\$ n/a	n/a
Tri City National Bank	\$ 116,064,000	9.8%	\$ 47,176,000	4.0%	\$ 58,970,000	5.0%
As of December 31, 2012						
Total capital (to risk weighted assets)						
Tri City Bankshares Corporation	\$ 118,312,000	15.4%	\$ 61,427,000	8.0%	\$ n/a	n/a
Tri City National Bank	\$ 116,536,000	15.2%	\$ 61,382,000	8.0%	\$ 76,728,000	10.0%
Tier 1 capital (to risk weighted assets)						
Tri City Bankshares Corporation	\$ 108,689,000	14.2%	\$ 30,713,000	4.0%	\$ n/a	n/a
Tri City National Bank	\$ 106,913,000	13.9%	\$ 30,691,000	4.0%	\$ 46,037,000	6.0%
Tier 1 capital (to average assets)						
Tri City Bankshares Corporation	\$ 108,689,000	9.1%	\$ 47,765,000	4.0%	\$ n/a	n/a
Tri City National Bank	\$ 106,913,000	9.0%	\$ 47,815,000	4.0%	\$ 59,768,000	5.0%

TRI CITY BANKSHARES CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 21 - Concentration of Credit Risk

Practically all of the Bank's loans, commitments, and commercial and standby letters of credit have been granted to customers in the Bank's market area of Southeastern Wisconsin. Although the Bank has a diversified loan portfolio, the ability of its debtors to honor its contracts is dependent on the economic conditions of the counties surrounding the Bank. The concentration of credit by type of loan is set forth in Note 5.