

# Fentura Financial, Inc.

Years Ended  
December 31,  
2013 and 2012

Consolidated  
Financial  
Statements

# FENTURA FINANCIAL, INC.

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**INDEPENDENT AUDITORS' REPORT**

March 7, 2014

Shareholders and Board of Directors  
Fentura Financial, Inc.  
Fenton, Michigan

We have audited the accompanying consolidated financial statements of *Fentura Financial, Inc.* (the "Corporation"), which comprise the consolidated balance sheets as of December 31, 2013 and 2012, and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

***Management's Responsibility for the Consolidated Financial Statements***

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

***Independent Auditors' Responsibility***

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of 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 auditor judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Corporation's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

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

***Opinion***

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Fentura Financial, Inc. as of December 31, 2013 and 2012, and the consolidated results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

***Emphasis of Matter***

As more fully described in Note 9 to the accompanying consolidated financial statements, the reversal of a large portion of a deferred income tax asset valuation allowance in 2013 had a significant impact on net income for the year.



# FENTURA FINANCIAL, INC.

## CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

	December 31	
	2013	2012
<b>ASSETS</b>		
Cash and cash equivalents	\$ 12,856	\$ 45,712
Securities, available for sale	33,293	44,530
Securities, held to maturity	2,620	3,058
<b>Total securities</b>	<b>35,913</b>	<b>47,588</b>
Loans held for sale	1,004	782
Loans	262,974	199,744
Less allowance for loan losses	4,900	4,962
<b>Net loans</b>	<b>258,074</b>	<b>194,782</b>
Bank owned life insurance	6,198	6,052
Premises and equipment, net	10,023	10,235
Federal Home Loan Bank ("FHLB") stock	661	661
Accrued interest receivable	983	902
Other real estate owned	2,594	2,579
Other assets	1,990	1,429
Deferred tax asset, net	4,929	-
<b>Total assets</b>	<b>\$ 335,225</b>	<b>\$ 310,722</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>Deposits</b>		
Noninterest-bearing	\$ 82,585	\$ 80,550
Interest-bearing	200,756	195,289
<b>Total deposits</b>	<b>283,341</b>	<b>275,839</b>
FHLB advances	10,855	891
Subordinated debentures	14,000	14,000
Accrued interest payable and other liabilities	2,267	3,789
<b>Total liabilities</b>	<b>310,463</b>	<b>294,519</b>
<b>Shareholders' equity</b>		
Common stock, no par value: 5,000,000 shares authorized, 2,482,431 (2,444,161 in 2012) shares issued and outstanding	43,502	43,310
Accumulated deficit	(18,804)	(27,290)
Accumulated other comprehensive income	64	183
<b>Total shareholders' equity</b>	<b>24,762</b>	<b>16,203</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$ 335,225</b>	<b>\$ 310,722</b>

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

# FENTURA FINANCIAL, INC.

## CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except share data)

	Year Ended December 31	
	2013	2012
<b>Interest and dividend income</b>		
Loans, including fees	\$ 11,746	\$ 10,970
Investments		
Taxable	560	1,081
Tax-exempt	169	119
Federal funds sold	6	23
<b>Total interest and dividend income</b>	<b>12,481</b>	<b>12,193</b>
<b>Interest expense</b>		
Deposits	865	1,499
Borrowings	589	446
<b>Total interest expense</b>	<b>1,454</b>	<b>1,945</b>
<b>Net interest income</b>	<b>11,027</b>	<b>10,248</b>
Provision for (reduction of) loan losses	7	(508)
<b>Net interest income, after loan losses</b>	<b>11,020</b>	<b>10,756</b>
<b>Noninterest income</b>		
Service charges on deposit accounts	897	1,030
Net gain on sale of mortgage loans	1,613	961
Trust and investment services	996	1,071
Net gain on sale of securities	-	25
Other income and fees	2,077	1,755
<b>Total noninterest income</b>	<b>5,583</b>	<b>4,842</b>
<b>Noninterest expenses</b>		
Salaries and employee benefits	6,925	6,775
Occupancy	1,084	1,079
Furniture and equipment	1,068	1,076
Loan and collection	688	944
Advertising and promotional	314	164
Telephone and communication services	134	167
Other professional services	877	1,049
Other general and administrative	2,145	3,007
<b>Total noninterest expenses</b>	<b>13,235</b>	<b>14,261</b>
<b>Income before income tax</b>	<b>3,368</b>	<b>1,337</b>
Federal income tax (benefit) expense	(5,118)	73
<b>Net income</b>	<b>\$ 8,486</b>	<b>\$ 1,264</b>
<b>Net income per share</b>		
Basic and diluted	<b>\$ 3.44</b>	<b>\$ 0.52</b>

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

# FENTURA FINANCIAL, INC.

## ■ CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

	Year Ended December 31	
	2013	2012
Net income	\$ 8,486	\$ 1,264
Other comprehensive (loss) income		
Unrealized holding (losses) gains on available for sale investment securities arising during the year	(119)	185
Reclassification adjustment for net realized gains included in income	-	(25)
Other comprehensive (loss) income	(119)	160
Comprehensive income	\$ 8,367	\$ 1,424

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

## FENTURA FINANCIAL, INC.

### CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(In thousands, except share data)

	Common Stock	Accumulated Deficit	Accumulated Other Comprehensive Income	Total
Balances, January 1, 2012	\$ 43,191	\$ (28,554)	\$ 23	\$ 14,660
Issuance of common shares under stock purchase and dividend reinvestment plans (55,936 shares)	119	-	-	119
Comprehensive income	-	1,264	160	1,424
Balances, December 31, 2012	43,310	(27,290)	183	16,203
Issuance of common shares under stock purchase and dividend reinvestment plans (38,270 shares)	192	-	-	192
Comprehensive income	-	8,486	(119)	8,367
Balances, December 31, 2013	<u>\$ 43,502</u>	<u>\$ (18,804)</u>	<u>\$ 64</u>	<u>\$ 24,762</u>

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

# FENTURA FINANCIAL, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Year Ended December 31	
	2013	2012
<b>Cash flows from operating activities</b>		
Net income	\$ 8,486	\$ 1,264
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	709	677
Amortization and accretion on securities, net	(540)	(695)
Provision for loan losses	7	(508)
Loans originated for sale	(56,585)	(45,011)
Proceeds from sale of loans	57,976	45,313
Net gain on sales of loans	(1,613)	(961)
Net gain on sales of securities	-	(25)
Net (gain) loss on sale of other real estate owned	(239)	6
Provision for other real estate owned losses	223	159
Deferred income taxes	(4,929)	-
Net earnings from bank owned life insurance	(146)	(111)
Net increase in interest receivable and other assets	(640)	(233)
Net (decrease) increase in interest payable and other liabilities	(1,522)	392
<b>Net cash provided by operating activities</b>	<b>1,187</b>	<b>267</b>
<b>Cash flows from investing activities</b>		
Proceeds from maturities of securities - HTM	413	-
Proceeds from maturities of securities - AFS	13,548	13,431
Proceeds from calls of securities - HTM	25	-
Proceeds from calls of securities - AFS	2,008	6,150
Proceeds from sales of securities - AFS	-	13,991
Purchases of securities - AFS	(3,898)	(18,535)
Purchase of securities - HTM	-	(95)
Origination of loans, net of principal payments	(64,843)	11,459
Purchases of loans	-	(10,530)
Proceeds from sales of other real estate owned	1,543	1,605
Purchase of premises and equipment, net	(497)	(710)
<b>Net cash (used in) provided by investing activities</b>	<b>(51,701)</b>	<b>16,766</b>
<b>Cash flows from financing activities</b>		
Net increase in deposits	7,502	9,958
Advances (repayments of advances) from FHLB	9,964	(32)
Net proceeds from common stock issuance	192	119
<b>Net cash provided by financing activities</b>	<b>17,658</b>	<b>10,045</b>
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>(32,856)</b>	<b>27,078</b>
Cash and cash equivalents, beginning of year	45,712	18,634
<b>Cash and cash equivalents, end of year</b>	<b>\$ 12,856</b>	<b>\$ 45,712</b>
<b>Supplemental cash flows information</b>		
Cash paid for interest	\$ 3,278	\$ 1,597
Cash paid for income taxes	\$ -	\$ 198
Transfers from loans to other real estate	\$ 2,538	\$ 2,400
Loans provided for sales of other real estate owned	\$ 996	\$ 239

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



# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 1. NATURE OF OPERATIONS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### Nature of Operations and Principles of Consolidation

The consolidated financial statements include *Fentura Financial, Inc.* (the "Corporation") and its wholly owned subsidiaries *Fentura Holdings LLC* ("FHLLC") and *The State Bank* ("the Bank") in Fenton, Michigan. Intercompany transactions and balances are eliminated in consolidation.

The Corporation provides banking and trust services principally to individuals, small businesses and governmental entities through its eight community banking offices in Genesee, Livingston, and Oakland Counties in southeastern Michigan. Its primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are residential mortgage, commercial, and installment loans. Commercial real estate loans were 50.1% and 51.7% of gross loans, and other commercial loans were 17.1% and 21.7% of gross loans at December 31, 2013 and 2012, respectively. Substantially all loans are secured by specific items of collateral including business assets, consumer assets, and real estate. Commercial loans are expected to be repaid from cash flow from operations of businesses. Real estate loans are secured by both residential and commercial real estate. The Corporation's exposure to credit risk is substantially affected by the economy in the Corporation's market area and by changes in commercial real estate values. While the loan portfolio is substantially commercial based, the Corporation is not dependent on any single borrower. Other financial instruments which potentially represent concentrations of credit risk in the normal course of business include deposit accounts in other financial institutions and federal funds sold.

The Bank's primary sources of liquidity are time deposits and non-maturity deposits. At December 31, 2013 retail time deposits equal 21.2% of total deposits. This is compared to December 31, 2012 when retail time deposits consisted of 22.8% of total deposits. Details regarding deposits are further described in Note 7 of the consolidated financial statements.

#### Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the consolidated financial statements and the disclosures provided, and future results could differ. The allowance for loan losses, the fair values of securities and other financial instruments, other than temporary impairment of securities, the carrying value of other real estate owned, the valuation of share appreciation rights and deferred taxes are particularly subject to change.

#### Summary of Significant Accounting Policies

##### *Cash and Cash Equivalents*

Cash and cash equivalents, includes cash, deposits with other financial institutions under 90 days, and federal funds sold. Net cash flows are reported for customer loan and deposit transactions and short-term borrowings.

##### *Investment Securities*

Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Securities are classified as available for sale when they might be sold before maturity. Securities

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income (loss).

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage-backed securities, where prepayments are anticipated. Premiums are amortized to call date whereby discounts are amortized to maturity. Gains and losses on sales are based on the amortized cost of the security sold.

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation.

In determining OTTI management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Corporation has the intent to sell the debt security or it is more likely than not it will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

When OTTI occurs, the amount of the OTTI recognized in earnings depends on whether the Corporation intends to sell the security or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss. If the Corporation intends to sell or it is more likely than not it will be required to sell the security before recovery of its amortized cost basis, less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If the Corporation does not intend to sell the security and it is not more likely than not that the Corporation will not be required to sell the security before recovery of its amortized cost basis less any current-period loss, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors is recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings becomes the new amortized cost basis of the investment.

### *Loans*

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoffs are reported at the principal balance outstanding, net of unearned interest, deferred loan fees and costs, and an allowance for loan losses. Loans held for sale are reported at the lower of cost or fair value, on an aggregate basis and are sold with servicing rights released.

Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level-yield method without anticipating prepayments. Interest income is not reported when full loan repayment is in doubt, typically when the loan is impaired or payments are past due over 90 days (180 days for residential mortgages).

All interest accrued in the current year but not received for loans placed on non-accrual are reversed against current interest income. Interest received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

### *Allowance for Loan Losses*

The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and decreased by charge-offs less recoveries. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Consumer loans are typically charged off no later than 120 days past due.

The allowance consists of specific, general, and unallocated components. The specific component relates to loans that are individually classified as impaired or loans otherwise classified as substandard or doubtful. The general component covers non-classified loans and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segments and is based on the actual weighted average loss history experienced by the Corporation over a range of the most recent 4 quarters to the most recent 20 quarters. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified: commercial, commercial real estate, residential mortgage, installment loans, and home equity loans.

A loan is impaired when full payment under the loan terms is not expected. Commercial and commercial real estate loans are individually evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures.

### *Troubled Debt Restructurings*

Under certain circumstances, the Bank will provide borrowers relief through loan restructurings and modifications. A loan restructuring constitutes a troubled debt restructuring ("TDR") if for economic or legal reasons related to the borrower's financial difficulties the Corporation grants a concession to the borrower that it would not otherwise consider. Restructured loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and are measured for impairment.

### *Loans Held for Sale*

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or fair value in the aggregate. Net unrealized losses, if any, are recognized through a valuation allowance of which the provision is accounted for in the consolidated statements of income.

### *Transfers of Financial Assets*

Transfers of financial assets, including mortgage loans held-for-sale, as described above, 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 legally 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. The Bank has no substantive continuing involvement related to these loans.

### *Other Real Estate Owned and Foreclosed Assets*

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less estimated selling costs when acquired, establishing a new cost basis. If fair value declines, a valuation allowance is recorded through expense. Costs after acquisition are expensed.

### *Bank Premises and Equipment*

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives ranging from 15 to 40 years. Furniture, fixtures, and equipment are depreciated using the straight-line method with useful lives ranging from 3 to 7 years. Premises and equipment and other assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value, if lower than carrying amount.

### *Federal Home Loan Bank (FHLB) stock*

The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### *Bank Owned Life Insurance*

The Corporation holds life insurance policies purchased on the lives of key members of management. In the event of death of one of these individuals, the Corporation, as beneficiary of the policies, would receive a specified cash payment equal to the face value of the policy. Such policies are recorded at their cash surrender value, or the amount that can be currently realized as of the balance sheet date. The change in cash surrender value is an adjustment of premiums paid in determining the net expense or income recognized under the contracts for the year and is included in noninterest expenses.

### *Stock Based Compensation*

Compensation cost is recognized for stock options and stock appreciation rights based on the fair value of these awards at the date of grant. A valuation model is utilized to estimate the fair value of stock options and stock appreciation rights. Compensation cost is recognized over the requisite service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

### *Income Taxes*

Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. If determined necessary, a valuation allowance reduces deferred tax assets to the amount expected to be realized.

A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that has a greater than 50% likelihood of being realized on examination including the appeals process. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded.

The Corporation recognizes interest and/or penalties related to income tax matters in income tax expense. Such interest or penalties recorded in 2013 or 2012 were not significant. As more fully described in Note 9, a reversal of a large portion of a deferred income tax asset valuation allowance in 2013 had a significant impact on net income for the year.

### *Loan Commitments and Financial Instruments*

Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and standby letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

### *Earnings Per Common Share*

Basic earnings per common share is calculated as net income divided by the weighted average number of common shares outstanding during the period. Employee Stock Ownership Plan (ESOP) shares are considered outstanding for this calculation unless unearned. Stock options were not considered in computing diluted earnings per common share because they were antidilutive.

### *Comprehensive Income*

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale, which are also recognized as separate components of equity.

### *Loss Contingencies*

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated.

### *Restrictions on Cash*

Cash on hand or on deposit with the Federal Reserve Bank of \$25,000 was required to meet regulatory reserve and clearing requirements at December 31, 2013 and 2012.

### *Dividend Restrictions*

The Holding Company is under restrictions by the Federal Reserve regarding the declaration or payment of any dividends to shareholders and the receipt of dividends from the Bank.

### *Fair Value of Financial Instruments*

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 12. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

### *Reclassifications*

Certain items in the prior year consolidated financial statements were reclassified to conform to the current year presentation.

### *Subsequent Events*

In preparing these consolidated financial statements, the Corporation has evaluated, for potential recognition or disclosure, significant events or transactions that occurred during the period subsequent to December 31, 2013, the most recent balance sheet presented herein, through March 7, 2014, the date these consolidated financial statements were available to be issued. No significant such events or transactions were identified.

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 2. EARNINGS PER SHARE

The components in the earnings per share computation follow:

(000s omitted except share and per share data)	2013	2012
<b>Basic</b>		
Net income	\$ <u>8,486</u>	\$ <u>1,264</u>
Weighted average common shares outstanding	<u>2,469,176</u>	<u>2,422,261</u>
<b>Basic income per common share</b>	\$ <u>3.44</u>	\$ <u>0.52</u>
<b>Diluted</b>		
Net income	\$ <u>8,486</u>	\$ <u>1,264</u>
Weighted average common shares outstanding for basic earnings per common share	2,469,176	2,422,261
Add dilutive effects of assumed exercises of stock options	<u>-</u>	<u>-</u>
Average shares and dilutive potential common shares	<u>2,469,176</u>	<u>2,422,261</u>
<b>Diluted income per common share</b>	\$ <u>3.44</u>	\$ <u>0.52</u>

Options for the purchase of 3,355 and 9,301 shares of common stock were not considered in computing diluted earnings per common share for 2013 and 2012 respectively, because they were antidilutive.

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 3. INVESTMENT SECURITIES

Year-end securities were as follows:

2013 (000s omitted)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Available-for-sale</b>				
U.S. government and federal agency	\$ 2,993	\$ -	\$ (276)	\$ 2,717
State and municipal	6,396	1	(197)	6,200
Mortgage backed residential Collateralized mortgage obligations - agencies	8,202	87	(17)	8,272
Equity securities	13,485	176	(36)	13,625
	<u>2,155</u>	<u>414</u>	<u>(90)</u>	<u>2,479</u>
	<u>\$ 33,231</u>	<u>\$ 678</u>	<u>\$ (616)</u>	<u>\$ 33,293</u>
<b>Held to Maturity</b>				
State and municipal	<u>\$ 2,620</u>	<u>\$ 29</u>	<u>\$ (22)</u>	<u>\$ 2,627</u>
<b>2012</b>				
2012 (000s omitted)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Available-for-sale</b>				
U.S. government and federal agency	\$ 4,992	\$ 19	\$ -	\$ 5,011
State and municipal	2,520	-	(14)	2,506
Mortgage backed residential Collateralized mortgage obligations - agencies	11,374	197	-	11,571
Equity securities	23,306	198	(121)	23,383
	<u>2,155</u>	<u>93</u>	<u>(189)</u>	<u>2,059</u>
	<u>\$ 44,347</u>	<u>\$ 507</u>	<u>\$ (324)</u>	<u>\$ 44,530</u>
<b>Held to Maturity</b>				
State and municipal	<u>\$ 3,058</u>	<u>\$ 64</u>	<u>\$ (6)</u>	<u>\$ 3,116</u>

Contractual maturities of securities at December 31, 2013 were as follows. Securities not due at a single maturity date, consisting of mortgage backed, collateralized mortgage obligations, and equity securities are shown separately.



# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(000s omitted)	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
U.S. government and federal agency				
Due in one year or less	\$ -	\$ -	\$ 525	\$ 531
Due from one to five years	5,171	5,051	1,154	1,163
Due from five to ten years	1,225	1,150	941	933
Due after ten years	2,993	2,716	-	-
Mortgage backed residential	8,202	8,272	-	-
Collateralized mortgage obligations - agencies	13,485	13,625	-	-
Equity securities	2,155	2,479	-	-
	<u>\$ 33,231</u>	<u>\$ 33,293</u>	<u>\$ 2,620</u>	<u>\$ 2,627</u>

Securities pledged at December 31, 2013 and 2012 had a carrying amount of \$23,307,000 and \$5,419,000 and were pledged to secure public deposits and borrowings.

Securities with unrealized losses at December 31, 2013 and 2012, including both available for sale and held to maturity securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position are as follows:

2013 (000s omitted)	Less Than 12 Months		Over 12 Months		Fair Value	Total Gross Unrealized Losses
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss		
State and municipal	\$ 5,594	\$ (196)	\$ 355	\$ (23)	\$ 5,949	\$ (219)
Mortgage backed residential	4,037	(17)	-	-	4,037	(17)
Collateralized mortgage obligations - agencies	2,593	(36)	-	-	2,593	(36)
U.S. Government and federal agency	2,717	(276)	-	-	2,717	(276)
Equity securities	-	-	563	(90)	563	(90)
<b>Total</b>	<b>\$ 14,941</b>	<b>\$ (525)</b>	<b>\$ 918</b>	<b>\$ (113)</b>	<b>\$ 15,859</b>	<b>\$ (638)</b>

2012 (000s omitted)	Less Than 12 Months		Over 12 Months		Fair Value	Total Gross Unrealized Losses
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss		
State and municipal	\$ 2,520	\$ (14)	\$ 491	\$ (6)	\$ 3,011	\$ (20)
Collateralized mortgage obligations - agencies	12,597	(121)	-	-	12,597	(121)
Equity securities	-	-	916	(189)	916	(189)
<b>Total</b>	<b>\$ 15,117</b>	<b>\$ (135)</b>	<b>\$ 1,407</b>	<b>\$ (195)</b>	<b>\$ 16,524</b>	<b>\$ (330)</b>

As of December 31, 2013, the Corporation's security portfolio consisted of 83 securities, 24 of which were in an unrealized loss position.

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### Other-Than-Temporary-Impairment

Management evaluates securities for other-than-temporary impairment (“OTTI”) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. In evaluating OTTI, management additionally considers the factors presented in Note 1. No OTTI was indicated following analysis in 2013 or 2012.

### 4. LOANS AND ALLOWANCE FOR LOAN LOSSES

The Bank originates primarily residential and commercial real estate loans, commercial, and installment loans. The Corporation estimates that the majority of their loan portfolio is based in Genesee, Oakland and Livingston counties within southeast Michigan. The ability of the Corporation's debtors to honor their contracts is dependent upon the real estate and general economic conditions in these areas.

Activity in the allowance for loan losses, by loan portfolio segment, for the year ended December 31, 2013 is as follows:

(000s omitted)	Commercial	Commercial Real Estate	Residential Real Estate	Installment Loan	Home Equity	Unallocated	Total
Balance, January 1, 2013	\$ 520	\$ 3,394	\$ 399	\$ 106	\$ 184	\$ 359	\$ 4,962
Provision for (reduction of) loan losses	96	(197)	338	(71)	25	(184)	7
Loans charged off	(154)	(630)	(73)	(12)	(33)	-	(902)
Loan recoveries	145	580	19	33	56	-	833
Balance, December 31, 2013	<u>\$ 607</u>	<u>\$ 3,147</u>	<u>\$ 683</u>	<u>\$ 56</u>	<u>\$ 232</u>	<u>\$ 175</u>	<u>\$ 4,900</u>

Activity in the allowance for loan losses, by loan portfolio segment, for the year ended December 31, 2012 is as follows:

(000s omitted)	Commercial	Commercial Real Estate	Residential Real Estate	Installment Loan	Home Equity	Unallocated	Total
Balance, January 1, 2012	\$ 892	\$ 5,993	\$ 501	\$ 214	\$ 475	\$ 89	\$ 8,164
Provision for (reduction of) loan losses	342	(1,326)	319	(92)	(21)	270	(508)
Loans charged off	(785)	(2,249)	(424)	(37)	(291)	-	(3,786)
Loan recoveries	71	976	3	21	21	-	1,092
Balance, December 31, 2012	<u>\$ 520</u>	<u>\$ 3,394</u>	<u>\$ 399</u>	<u>\$ 106</u>	<u>\$ 184</u>	<u>\$ 359</u>	<u>\$ 4,962</u>

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by loan portfolio segment, and impairment evaluation method at December 31, 2013:

(000s omitted)	Commercial	Commercial Real Estate	Residential Real Estate	Installment Loan	Home Equity	Unallocated	Total
Allowance for loan losses							
Ending allowance balance attributable to loans							
Individually evaluated for impairment	\$ 136	\$ 949	\$ 120	\$ -	\$ 5	\$ -	\$ 1,210
Collectively evaluated for impairment	<u>471</u>	<u>2,198</u>	<u>563</u>	<u>56</u>	<u>227</u>	<u>175</u>	<u>3,690</u>
<b>Total ending allowance balance</b>	<b><u>\$ 607</u></b>	<b><u>\$ 3,147</u></b>	<b><u>\$ 683</u></b>	<b><u>\$ 56</u></b>	<b><u>\$ 232</u></b>	<b><u>\$ 175</u></b>	<b><u>\$ 4,900</u></b>

(000s omitted)	Commercial	Commercial Real Estate	Residential Real Estate	Installment Loan	Home Equity	Unallocated	Total
Loans							
Loans individually evaluated for impairment	\$ 520	\$ 7,182	\$ 689	\$ 2	\$ 264		\$ 8,657
Loans collectively evaluated for impairment	<u>44,550</u>	<u>124,544</u>	<u>60,153</u>	<u>3,824</u>	<u>21,246</u>		<u>254,317</u>
<b>Total ending loan balance</b>	<b>45,070</b>	<b>131,726</b>	<b>60,842</b>	<b>3,826</b>	<b>21,510</b>		<b>262,974</b>
Accrued interest receivable	<u>162</u>	<u>287</u>	<u>158</u>	<u>14</u>	<u>77</u>		<u>698</u>
<b>Total recorded investment in loans</b>	<b><u>\$ 45,232</u></b>	<b><u>\$ 132,013</u></b>	<b><u>\$ 61,000</u></b>	<b><u>\$ 3,840</u></b>	<b><u>\$ 21,587</u></b>		<b><u>\$ 263,672</u></b>

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by loan portfolio segment, and based on impairment evaluation method at December 31, 2012:

(000s omitted)	Commercial	Commercial Real Estate	Residential Real Estate	Installment Loan	Home Equity	Unallocated	Total
<b>Allowance for loan losses</b>							
<b>Ending allowance balance attributable to loans</b>							
Individually evaluated for impairment	\$ 91	\$ 1,631	\$ 116	\$ 36	\$ 23	\$ -	\$ 1,897
Collectively evaluated for impairment	<u>429</u>	<u>1,763</u>	<u>283</u>	<u>70</u>	<u>161</u>	<u>359</u>	<u>3,065</u>
<b>Total ending allowance balance</b>	<b><u>\$ 520</u></b>	<b><u>\$ 3,394</u></b>	<b><u>\$ 399</u></b>	<b><u>\$ 106</u></b>	<b><u>\$ 184</u></b>	<b><u>\$ 359</u></b>	<b><u>\$ 4,962</u></b>
<b>Loans</b>							
Loans individually evaluated for impairment	\$ 1,476	\$ 13,534	\$ 1,126	\$ 52	\$ 340		\$ 16,528
Loans collectively evaluated for impairment	<u>41,829</u>	<u>89,645</u>	<u>28,712</u>	<u>4,751</u>	<u>18,279</u>		<u>183,216</u>
<b>Total ending loan balance</b>	<b>43,305</b>	<b>103,179</b>	<b>29,838</b>	<b>4,803</b>	<b>18,619</b>		<b>199,744</b>
Accrued interest receivable	<u>131</u>	<u>305</u>	<u>68</u>	<u>13</u>	<u>58</u>		<u>575</u>
<b>Total recorded investment in loans</b>	<b><u>\$ 43,436</u></b>	<b><u>\$ 103,484</u></b>	<b><u>\$ 29,906</u></b>	<b><u>\$ 4,816</u></b>	<b><u>\$ 18,677</u></b>		<b><u>\$ 200,319</u></b>

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

(000s omitted)	Unpaid Principal Balance	Recorded Investment	Allowance For Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized
<b>With no related allowances recorded</b>					
Commercial	\$ 724	\$ 281	\$ -	\$ 540	\$ 11
Commercial real estate	6,762	2,058	-	3,828	202
Residential real estate	523	107	-	171	6
Consumer					
Installment loans	43	2	-	3	3
Home equity	235	234	-	245	15
<b>With an allowance recorded</b>					
Commercial	246	240	136	332	13
Commercial real estate	5,515	5,396	949	4,352	246
Residential real estate	629	584	120	476	30
Consumer					
Installment loans	-	-	-	10	-
Home equity	30	31	5	64	2
<b>Total</b>	<b>\$ 14,707</b>	<b>\$ 8,933</b>	<b>\$ 1,210</b>	<b>\$ 10,021</b>	<b>\$ 528</b>

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

(000s omitted)	Unpaid Principal Balance	Recorded Investment	Allowance For Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized
<b>With no related allowances recorded</b>					
Commercial	\$ 2,022	\$ 1,183	\$ -	\$ 1,193	\$ 51
Commercial real estate	12,693	7,316	-	9,552	569
Residential real estate	263	215	-	144	23
Consumer					
Installment loans	30	5	-	10	3
Home equity	367	258	-	204	24
<b>With an allowance recorded</b>					
Commercial	295	295	91	1,168	11
Commercial real estate	6,263	6,257	1,631	9,894	233
Residential real estate	1,300	913	116	283	34
Consumer					
Installment loans	48	48	36	35	3
Home equity	82	83	23	245	5
<b>Total</b>	<b>\$ 23,363</b>	<b>\$ 16,573</b>	<b>\$ 1,897</b>	<b>\$ 22,728</b>	<b>\$ 956</b>

Non-accrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of December 31, 2013:

(000s omitted)	Nonaccrual	Loans Past Due Over 90 Days Still Accruing
Commercial	\$ 369	\$ -
Commercial real estate	1,392	-
Home equity	27	-
Installment loans	2	-
Residential real estate	<u>190</u>	<u>-</u>
<b>Total</b>	<b><u>\$ 1,980</u></b>	<b><u>\$ -</u></b>

The following table presents the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of December 31, 2012:

(000s omitted)	Nonaccrual	Loans Past Due Over 90 Days Still Accruing <sup>(1)</sup>
Commercial	\$ 1,771	\$ -
Commercial real estate	3,182	-
Home equity	-	-
Installment loans	5	-
Residential real estate	<u>625</u>	<u>102</u>
<b>Total</b>	<b><u>\$ 5,583</u></b>	<b><u>\$ 102</u></b>

<sup>(1)</sup>Includes accrued interest receivable of \$2

The following table presents the aging of the recorded investment in past due loans by class of loans as of December 31, 2013:

(000s omitted)	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due	Total Past Due
Commercial	\$ -	\$ -	\$ 369	\$ 369
Commercial real estate	-	-	161	161
Installment loans	-	-	2	2
Residential real estate	<u>228</u>	<u>-</u>	<u>83</u>	<u>311</u>
<b>Total</b>	<b><u>\$ 228</u></b>	<b><u>\$ -</u></b>	<b><u>\$ 615</u></b>	<b><u>\$ 843</u></b>

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the aging of the recorded investment in past due loans by class of loans as of December 31, 2012:

(000s omitted)	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due <sup>(1)</sup>	Total Past Due
Commercial	\$ 83	\$ -	\$ 1,073	\$ 1,156
Commercial real estate	215	-	1,028	1,243
Installment loans	-	-	5	5
Home equity	30	-	-	30
Residential real estate	-	-	688	688
<b>Total</b>	<b><u>\$ 328</u></b>	<b><u>\$ -</u></b>	<b><u>\$ 2,794</u></b>	<b><u>\$ 3,122</u></b>

<sup>(1)</sup>Includes accrued interest receivable of \$2

### Modifications

A modification of a loan constitutes a troubled debt restructuring ("TDR") when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Corporation offers various types of concessions when modifying a loan or lease, however, forgiveness of principal is rarely granted. Commercial loans modified in a TDR often involve temporary interest-only payments, term extensions, and converting revolving credit lines to term loans. Additional collateral, a co-borrower, or a guarantor is often requested. Commercial real estate loans modified in a TDR often involve reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, or substituting or adding a new borrower or guarantor. Residential real estate loans modified in a TDR are primarily comprised of loans where monthly payments are lowered to accommodate the borrowers' financial needs through a reduction of interest rate and/or extension of the maturity date. Installment loans modified in a TDR are primarily comprised of loans where the Corporation has lowered monthly payments by extending the term.

Loans modified in a TDR are typically already on non-accrual status and partial charge-offs have in some cases been taken against the outstanding loan balance. As a result, loans modified in a TDR for the Corporation may have the financial effect of increasing the specific allowance associated with the loan.

The Corporation allocated \$893,000 and \$1,690,000 of specific reserves to customers whose loan terms have been modified in TDRs as of December 31, 2013 and December 31, 2012. The Corporation does not have material commitments to lend additional funds to borrowers with loans whose terms have been modified in troubled debt restructurings or whose loans are on nonaccrual as of December 31, 2013.

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following presents by class, information related to loans modified in a TDR during the years ended December 31, 2013 and 2012:

(000s omitted)	Loans Modified as TDR for the Year Ended December 31, 2013		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial	3	\$ 92	\$ 92
Commercial real estate	1	481	481
<b>Total</b>	<b>4</b>	<b>\$ 573</b>	<b>\$ 573</b>

(000s omitted)	Loans Modified as TDR for the Year Ended December 31, 2012		
	Number of Loans	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Commercial real estate	10	\$ 4,211	\$ 4,211
Residential real estate	2	187	187
Home equity	1	36	36
<b>Total</b>	<b>13</b>	<b>\$ 4,434</b>	<b>\$ 4,434</b>

The following presents information on TDRs for which there was a payment default, (i.e. 30 days or more past due following a modification) that had been modified during the 12-month period prior to the default.

(000s omitted)	Loans with Payment Defaults December 31, 2013	
	Number of Contracts	Recorded Investment (as of Period End) <sup>(1)</sup>
Commercial	1	\$ 4
Installment loans	1	3
<b>Total</b>	<b>2</b>	<b>\$ 7</b>



# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(000s omitted)	Loans with Payment Defaults December 31, 2012	
	Number of Contracts	Recorded Investment (as of Period End) <sup>(1)</sup>
Commercial	5	\$ 1,123
Commercial real estate	5	2,241
Installment loans	<u>1</u>	<u>5</u>
<b>Total</b>	<b><u>11</u></b>	<b><u>\$ 3,369</u></b>

<sup>(1)</sup> The period-end balances are inclusive of all partial paydowns and charge-offs since the modifications date, if any. Loans modified in a TDR that were fully paid down, charged off, or foreclosed upon by period end are not reported.

Based on the Corporation's historical loss experience, losses associated with TDRs are not significantly different than other impaired loans within the same loan segment. As such, TDRs are analyzed in the same manner as other impaired loans within their respective loan segment.

The following presents by portfolio loan class, the type of modification made in a TDR:

(000s omitted)	Loans Modified Through Reduction of Interest Rate or Payment December 31, 2013		Loans Modified Through Extension of Term December 31, 2013	
	Number of Loans	Recorded Investment (as of Period End) <sup>(1)</sup>	Number of Loans	Recorded Investment (as of Period End) <sup>(1)</sup>
Commercial	2	\$ 74	-	\$ -
Commercial real estate	<u>1</u>	<u>481</u>	<u>1</u>	<u>18</u>
<b>Total</b>	<b><u>3</u></b>	<b><u>\$ 555</u></b>	<b><u>1</u></b>	<b><u>\$ 18</u></b>

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(000s omitted)	Loans Modified Through Reduction of Interest Rate or Payment December 31, 2013		Loans Modified Through Extension of Term December 31, 2012	
	Number of Loans	Recorded Investment (as of Period End) <sup>(1)</sup>	Number of Loans	Recorded Investment (as of Period End) <sup>(1)</sup>
Commercial real estate	7	\$ 3,755	3	\$ 456
Residential real estate	1	101	1	86
Home equity	1	36	-	-
<b>Total</b>	<b>9</b>	<b>\$ 3,892</b>	<b>4</b>	<b>\$ 542</b>

<sup>(1)</sup> The period end balances are inclusive of all partial paydowns and charge-offs since the modification date, if any. Loans modified in a TDR that were fully paid down, charged-off, or foreclosed upon by period end are not reported.

### Credit Quality Indicators

The Corporation categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debts such as: current financial information, historical payment experience; credit documentation, public information, and current economic trends, among other factors. The Corporation analyzes loans individually by classifying the loans as to credit risk. This analysis includes non-homogeneous loans, such as commercial and commercial real estate loans. This analysis is performed on a quarterly basis. The Corporation uses the following definitions for classified risk ratings:

**Prime.** Loans classified as prime are well seasoned borrowers displaying strong financial condition, consistently superior earnings performance, and access to a range of financing alternatives. The borrower's trends and outlook, as well as those of its industry are positive.

**Pass.** Loans classified as pass have a moderate to average risk to established borrowers that display sound financial condition and operating results. The capacity to service debt is stable and demonstrated at a level consistent with or above the industry norms. Borrower and industry trends and outlook are considered good.

**Watch.** Loans classified as watch have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

**Substandard.** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**Doubtful.** Loans classified as doubtful have all the weaknesses inherent in those classified as 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. The Corporation does not classify loans as doubtful. Loans that approach this status are charged-off.

Based on the most recent analysis performed, the recorded investment by risk category of loans by portfolio class is as follows at December 31:

2013 (000s omitted)	Prime	Pass	Watch	Substandard	Total
Commercial	\$ 5,028	\$ 38,699	\$ 805	\$ 700	\$ 45,232
Commercial real estate	4,582	117,208	8,260	1,963	132,013
<b>Total</b>	<b>\$ 9,610</b>	<b>\$ 155,907</b>	<b>\$ 9,065</b>	<b>\$ 2,663</b>	<b>\$ 177,245</b>

2012 (000s omitted)	Prime	Pass	Watch	Substandard	Total
Commercial	\$ 6,216	\$ 33,737	\$ 1,779	\$ 1,704	\$ 43,436
Commercial real estate	469	83,580	11,491	7,944	103,484
<b>Total</b>	<b>\$ 6,685</b>	<b>\$ 117,317</b>	<b>\$ 13,270</b>	<b>\$ 9,648</b>	<b>\$ 146,920</b>

The Corporation considers the performance of the loan portfolio and its impact on the allowance for loan losses. For residential and consumer loan classes, the Corporation 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 residential and consumer loans based on payment activity as of December 31:

2013 (000s omitted)	Home Equity	Installment	Residential Real Estate	Total
Performing	\$ 21,560	\$ 3,838	\$ 60,727	\$ 86,125
Non-performing	27	2	273	302
<b>Total</b>	<b>\$ 21,587</b>	<b>\$ 3,840</b>	<b>\$ 61,000</b>	<b>\$ 86,427</b>

2012 (000s omitted)	Home Equity	Installment	Residential Real Estate	Total
Performing	\$ 18,326	\$ 4,763	\$ 28,788	\$ 51,877
Non-performing	351	53	1,118	1,522
<b>Total</b>	<b>\$ 18,677</b>	<b>\$ 4,816</b>	<b>\$ 29,906</b>	<b>\$ 53,399</b>

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Loans to principal officers, directors, and affiliates at December 31, 2013 and 2012 were \$2,640,000 and \$2,750,000, respectively.

### 5. OTHER REAL ESTATE OWNED

Activity in other real estate owned for the years ended December 31 was:

(000s omitted)	2013	2012
Beginning balance, January 1	\$ 2,579	\$ 1,949
Transfers into other real estate	2,538	2,400
Sales of other real estate owned	(2,300)	(1,611)
Write downs of other real estate owned	<u>(223)</u>	<u>(159)</u>
Ending balance	<u>\$ 2,594</u>	<u>\$ 2,579</u>

Net gains (losses) on sales of other real estate owned were \$239,000 in 2013 and (\$6,000) in 2012. Due primarily to declining real estate values, the Corporation experienced write-downs of other real estate owned of \$223,000 in 2013 and \$159,000 in 2012. Carrying costs associated with other real estate owned totaled \$75,000 in 2013 and \$353,000 in 2012.

### 6. PREMISES AND EQUIPMENT, NET

Bank premises and equipment, net, is comprised of the following at December 31:

(000s omitted)	2013	2012
Land and land improvements	\$ 2,455	\$ 2,452
Building and building improvements	11,200	11,107
Furniture and equipment	5,437	5,054
Construction in progress	<u>99</u>	<u>81</u>
	19,191	18,694
Less accumulated depreciation	<u>9,168</u>	<u>8,459</u>
Ending balance	<u>\$ 10,023</u>	<u>\$ 10,235</u>

Depreciation expense was \$709,000 and \$677,000 for 2013 and 2012.

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The Corporation leases property for certain branches and ATM locations. Rent expense was \$60,000 for both 2013 and 2012. Rent commitments under non-cancelable operating leases were as follows, before considering renewal options that generally are present at December 31, 2013 (000s omitted):

2014	\$	57
2015		46
2016		23
2017		-
2018		-
		<u>          </u>
	\$	<u>126</u>

## 7. DEPOSITS

The following is a summary of deposits of at December 31:

(000s omitted)	2013	2012
<b>Non-interest bearing</b>		
Demand	\$ <u>82,585</u>	\$ <u>80,550</u>
<b>Interest-bearing</b>		
Savings	82,303	76,227
Money market demand	58,495	56,194
Time, \$100,000 and over	20,897	20,394
Time, \$100,000 and under	<u>39,061</u>	<u>42,474</u>
Total interest bearing	<u>200,756</u>	<u>195,289</u>
<b>Total deposits</b>	<b><u>\$ 283,341</u></b>	<b><u>\$ 275,839</u></b>

Scheduled maturities of time deposits for years succeeding December 31, 2013 were as follows (000s omitted):

2014	\$	27,966
2015		13,678
2016		6,328
2017		6,067
2018		5,572
Thereafter		<u>347</u>
	\$	<u>59,958</u>

The Corporation held no brokered deposits at December 31, 2013 or 2012.

Deposits from principal officers, directors, and affiliates at December 31, 2013 and 2012 were \$3,663,000 and \$3,468,000, respectively.

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 8. BORROWINGS

#### Federal Home Loan Bank Advances

At year-end, advances from the FHLB were as follows:

Principal Term (000s omitted)	Advance Amount	Maturity Date
<u>December 31, 2013</u> Fixed rate advance With rate of 1.66%	\$ 10,000	November 2018
Fixed rate advance With rate of 7.34%	<u>855</u>	May 2016
	<u>\$ 10,855</u>	
<u>December 31, 2012</u> Fixed rate advance With rate of 7.34%	\$ <u>891</u>	May 2016

The advances are payable at their maturity date; a prepayment penalty is assessed with early payoffs of advances. The advances are collateralized by securities totaling \$23,173,000 and \$4,743,000 at December 31, 2013 and 2012, respectively.

Maturities over each of the next five years are (000s omitted):

2014	\$ 39
2015	42
2016	774
2017	-
2018	<u>10,000</u>
	<u>\$ 10,855</u>

#### Subordinated Debentures and Trust Preferred Securities

A trust formed by the Corporation issued \$12,000,000 of trust preferred securities in 2003 as part of a pooled offering of such securities. The interest rate is a floating rate (3 month LIBOR plus 3.00%) and the current rate at December 31, 2013 is 3.31%. The Corporation issued subordinated debentures at the same terms as the trust preferred securities to the trust in exchange for the proceeds of the offering; the debentures and related debt issuance costs represent the sole assets of the trust. The Corporation may redeem the subordinated debentures, in whole but not in part, any time after 2008 at a price of 100% of face value. The subordinated debentures must be redeemed no later than 2033.

A trust formed by the Corporation issued \$2,000,000 of trust preferred securities in 2005 as part of a pooled offering of such securities. The interest rate is a floating rate (3 month LIBOR plus 1.60%) and the current rate at December 31, 2013 is 1.91%. The Corporation issued subordinated debentures at the same terms as the trust preferred securities to the trust in exchange for the proceeds of the offering; the debentures and related debt issuance costs

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

represent the sole assets of the trust. The Corporation may redeem the subordinated debentures, in whole but not in part, any time after 2010 at a price of 100% of face value. The subordinated debentures must be redeemed no later than 2035.

The Corporation is not considered the primary beneficiary of these trusts, therefore the trusts are not consolidated in the Corporations' financial statements but rather the subordinated debentures are shown as a liability.

In the normal course of the interest rate risk management processes, management identified a possible risk to its interest rate risk profile that exposed the Corporation to a possible rise in funding costs. Specifically, during management's review of its Trust Preferred ("Trups") facilities referred to above, it noted that the interest rate currently maintains a floating rate based upon LIBOR. Management determined that the continuation of the Trups facilities at a floating rate may adversely affect the Corporation's net interest margin in a possible rising rate environment, exposing the Corporation to increased interest rate costs.

In the second quarter of 2013, the Corporation entered into an interest rate cap with Wells Fargo. An interest-rate cap is an over-the-counter derivative that protects the holder from rises in interest rates by making a payment to the holder when an underlying interest rate (the "index" interest rate) exceeds a specified strike rate (the "cap rate"). The interest rate cap is intended to effectively fix the maximum interest rate paid on the Corporation's trust preferred securities.

The interest rate cap has a notional amount of \$12,000,000 and expires on June 15, 2020. During the term of the interest rate cap the Corporation will receive quarterly payments from Wells Fargo, calculated as the excess (if any) of LIBOR over the strike rate of 2.00%.

As of December 31, 2013 the interest rate cap is included in other assets at an amortized cost of approximately \$520,000. Management estimates that the fair value of the interest rate cap as of December 31, 2013 approximates its amortized cost. The Corporation assessed the significance of the impact of any credit valuation adjustment (counterparty credit risk) on the overall valuation of its derivative position, and determined that the credit valuation adjustment was not significant to the overall valuation of its derivative.

## 9. INCOME TAXES

The provision (benefit) for income taxes reflected in the consolidated statements of income for the years ended December 31 consists of the following:

(000s omitted)	2013	2012
Current (benefit) expense	\$ (189)	\$ 73
Deferred benefit	<u>(4,929)</u>	<u>-</u>
Income tax (benefit) expense	<u>\$ (5,118)</u>	<u>\$ 73</u>

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Income tax (benefit) expense was less than the amount computed by applying the statutory federal income tax rate to income before income taxes. The reasons for the difference are as follows:

(000s omitted)	2013	2012
Income tax at statutory rate	\$ 1,130	\$ 435
Tax exempt status	(75)	(60)
IRS audit settlement (recoveries)	(230)	228
Reduction in valuation allowance	(5,943)	(61)
Other	-	(469)
	<u>\$ (5,118)</u>	<u>\$ 73</u>

The net deferred tax asset recorded includes the following amounts of deferred tax assets and liabilities:

(000s omitted)	2013	2012
<b>Deferred tax assets</b>		
Allowance for loan losses	\$ 1,666	\$ 1,687
Alternative minimum tax credit	301	258
Compensation	271	293
Net operating loss carryforwards	2,872	3,562
Non-accrual interest	16	137
Capital loss	1,149	1,149
ORE write downs	191	440
Other	<u>365</u>	<u>295</u>
	<u>6,831</u>	<u>7,821</u>
<b>Deferred tax liabilities</b>		
Depreciation	(715)	(689)
Other	<u>(38)</u>	<u>(40)</u>
	<u>(753)</u>	<u>(729)</u>
Valuation allowance	<u>(1,149)</u>	<u>(7,092)</u>
<b>Net deferred taxes</b>	<u>\$ 4,929</u>	<u>\$ -</u>

In assessing whether or not some or all of the deferred tax assets are more likely than not to be realized in the future, management considers all available positive and negative evidence, including projected future taxable income, tax planning strategies, and recent financial performance. Based on an evaluation of the then-available positive and negative evidence, management determined it was appropriate to establish a full valuation allowance against its deferred tax asset as of June 30, 2009. At that time, and in subsequent periods, negative evidence, including a recent cumulative history of operating losses, outweighed the positive evidence.



## FENTURA FINANCIAL, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

However, as of December 31, 2013, management's assessment concluded that the positive evidence outweighed the negative evidence and management determined that a full deferred tax asset valuation allowance was no longer necessary. The significant positive evidence in management's analysis included: consecutive quarters of profitability, termination of the consent agreement with primary regulators, improved capital levels, solid and improving credit metrics, strong deposit mix, reduced regulatory risk, and a stabilizing economy. The federal net operating loss carryforwards of approximately \$8,447,000 will expire beginning in 2030 if not previously utilized.

A valuation allowance of \$1,149,000 and \$7,092,000 was determined to be necessary as December 31, 2013 and 2012 respectively. A partial valuation allowance as of December 31, 2013 was maintained for tax assets associated with previously generated capital losses for which management determined it is more likely than not will expire prior to being realized.

The deferred tax assets will continue to be analyzed at each reporting period for changes affecting realizability, and the valuation allowance may be adjusted in future periods accordingly. The ultimate realization of these deferred tax assets is primarily dependent on the generation of future taxable income during the periods in which those temporary differences become deductible. Changes in existing tax laws could also affect actual tax results and the valuation of deferred tax assets over time. The accounting for deferred taxes is based on an estimate of future results. Differences between anticipated and actual outcomes of these future tax consequences could have an impact on the Corporation's consolidated statement of income and balance sheet.

The Corporation concluded that there are no significant uncertain tax positions requiring recognition in the Corporation's consolidated financial statements based on the evaluation performed for the years 2010 through 2013, the years which remain subject to examination by major tax jurisdictions as of December 31, 2013. The Corporation does not expect the total amount of unrecognized tax benefits ("UTB") (e.g. tax deductions, exclusions, or credits claimed or expected to be claimed) to significantly change in the next 12 months.

At December 31, 2012, amounts accrued for uncertain tax positions under examination by the IRS were \$230,000. The amount recorded was for tax positions previously taken and was the result of the Corporation's IRS examination covering the 2009 tax year. During 2013 the Corporation was successful in discussions with the IRS, and as such, these amounts are no longer uncertain. Therefore, this liability was reversed when this determination was made. The Corporation does not expect the total amount of unrecognized or recognized tax benefits to significantly change within the next twelve months.

The Corporation and its subsidiaries are subject to U.S. federal income taxes as well as income tax of the state of Michigan. The Corporation is no longer subject to examination by taxing authorities for years before 2010.

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 10. BENEFIT PLANS

The Corporation has a noncontributory discretionary employee stock ownership plan covering substantially all of its employees. It is a requirement of the plan to invest principally in the Corporation's common stock. No contributions were made to the plan in 2013 or 2012.

The Corporation has also established a 401(k) Plan in which 100% of the employees' contribution can be matched up to 3% of their gross pay and 50% can be matched on the next 2% of their gross pay with a discretionary contribution by the Corporation. Contributions to the plan were \$41,000 in 2013 and \$0 in 2012.

The Corporation entered into Supplemental Executive Retirement Agreements ("SERP") with certain executives. The SERP Agreements are designed to encourage executives to remain long term employees of the Corporation, and to provide specified benefits to certain key executives who contribute materially to the continued growth, development, and future business success of the Corporation. The retirement benefits are an unsecured obligation of the Corporation. At year end 2013 and 2012, the accumulated liability for these agreements totaled \$796,000 and \$861,000, respectively. The Corporation has also established other Non-Qualified Deferred Compensation arrangements for employees not covered under the SERP. The arrangements are designed to encourage certain officers to remain long-term employees of the Corporation and the Bank, and to provide the officers with supplemental retirement income. The Corporation's contributions to the plans in 2013 and 2012 were \$64,000 and \$172,000, respectively.

### 11. COMMON STOCK PURCHASE AND OPTION PLANS

#### Director and Employee Plans

The Stock Purchase Plan permits directors and employees of the Corporation to purchase shares of common stock made available for purchase under the plan at the average fair market value of the shares over the most recent five days prior to the issuance date. The total number of shares issuable under this plan is limited to 330,000 shares.

The Retainer Stock Plan allows directors to elect to receive shares of common stock in full or partial payment of the director's retainer fees and fees for attending meetings. The number of shares is determined by dividing the dollar amount of fees to be paid in shares by the market value of the stock on the first business day prior to the payment date.

The Executive Stock Bonus Plan permits the administrator of the plan to grant shares of the Corporation's common stock to eligible employees. Any executive or managerial level employee is eligible to receive grants under the plan. The Board of Directors administers the plan and the numbers of shares issued are at the sole discretion of the Board of Directors. No shares were granted under this plan during 2013 or 2012.

#### Dividend Investment Plan

The Automatic Dividend Reinvestment Plan ("DRIP") permits enrolled shareholders to automatically use dividends paid on common stock to purchase additional shares of the Corporation's common stock at the fair market value on the investment date. Any shareholder who is the beneficial or record owner of not more than 9.9% of the issued and outstanding shares of the Corporation's common stock is eligible to participate in the plan.

## FENTURA FINANCIAL, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Pursuant to a separate agreement with a family who collectively holds more than 9.9% of the Corporation's stock on or prior to January 31 of each year beginning January 31, 1997, the Corporation is to advise the family, in a written notice, of the number of shares sold under the DRIP. Each family member will have the option, until February 28 of the same year, to purchase from the Corporation one-third of the total number of shares that would be sufficient to prevent the dilution to all family members as a group that result from the DRIP shares. The purchase price under this agreement is the fair market value on December 31 of the year immediately preceding the year in which the written notice is given. Similarly, a reverse agreement exists which allows the Corporation to redeem family shares to maintain the family ownership percentage in the event that stock repurchase activity more than offsets the shares available because of the DRIP.

The following summarizes shares issued under the various plans:

(000s omitted)	2013	2012
Automatic dividend reinvestment plan	\$ -	\$ -
Director stock purchase and retainer stock	37,142	54,146
Stock options	-	-
Other issuance of stock	<u>1,129</u>	<u>1,790</u>
	<u>\$ 38,271</u>	<u>\$ 55,936</u>

#### Stock Option Plans

The Nonemployee Director Stock Option Plan provides for granting options to nonemployee directors to purchase the Corporation's common stock. The purchase price of the shares is the estimated fair value at the date of the grant, and there is a three-year vesting period before options may be exercised. Options to acquire no more than 8,131 shares of stock may be granted under the plan in any calendar year and options to acquire not more than 73,967 shares in the aggregate may be outstanding at any one time. No options were granted in 2013 or 2012.

The Employee Stock Option Plan grants options to eligible employees to purchase the Corporation's common stock at or above, the fair market value of the stock at the date of the grant. Awards granted under this plan are limited to an aggregate of 86,936 shares. The administrator of the plan is a committee of directors. The administrator has the power to determine the number of options to be granted, the exercise price of the options and other terms of the options, subject to consistency with the terms of the plan. No options were granted in 2013 or 2012.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model. Expected volatilities are based on historical volatilities of the Corporation's common stock. The Corporation uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. Shares that are issued upon option exercise come from authorized but unissued shares.

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following table summarizes stock option activity:

(000s omitted)	Number of Options	Weighted Average Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Options outstanding at January 1, 2013	9,301	\$ 30.89		
Options forfeited during 2013	<u>(5,946)</u>	<u>22.81</u>		
<b>Options outstanding and exercisable at December 31, 2013</b>	<b><u>3,355</u></b>	<b><u>\$ 35.45</u></b>	<b><u>1.00</u></b>	<b><u>-</u></b>

  

(000s omitted)	Number of Options	Weighted Average Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Options outstanding at January 1, 2012	13,786	\$ 29.60		
Options forfeited during 2012	<u>(4,485)</u>	<u>26.92</u>		
<b>Options outstanding and exercisable at December 31, 2012</b>	<b><u>9,301</u></b>	<b><u>\$ 30.89</u></b>	<b><u>0.90</u></b>	<b><u>-</u></b>

No options were exercised during 2013 or 2012. As of December 31, 2013 and 2012, there was no unrecognized compensation cost related to non-vested stock options granted under the Plan.

The Corporation has issued a total of 35,000 stock appreciation rights ("SARs") to the executive management team, using a price of \$2.00 per share. The terms of the SARs provide that any appreciation in stock price will be paid in cash on two fixed dates which were subject to certain performance conditions, which management has determined have been met during 2013. SAR payment dates vary by individual agreement and range from February 2014 through May 2017. Initial measurement of the SAR's resulted in recording expense of \$120,000 for the year ended December 31, 2013, which is reflective of vesting through December 31, 2013 and is recorded in accrued interest payable and other liabilities on the consolidated balance sheet. Approximately \$184,000 of additional estimated liability has yet to be reflected in the consolidated financial statements as vesting conditions have not yet been met. The liability will continue to be re-measured each reporting period with changes recorded on a prospective ratable basis in salaries and employee benefits expense as further vesting transpires over the remaining SAR terms. The SAR's vest immediately upon a change in ownership control.

### 12. FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values.

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

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

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

#### Securities Available for Sale

The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). The remaining fair values of securities (Level 3 inputs) are based on the reporting entity's own assumptions and basic knowledge of market conditions and individual investment performance. The Corporation reviews the performance of the securities that comprise level 3 on a quarterly basis.

#### Impaired Loans

The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

#### Other Real Estate Owned

Non-recurring adjustments to certain commercial and residential real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available, which results in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### Assets Measured on a Recurring Basis

Assets measured at fair value on a recurring basis are summarized below:

2013 (000s omitted)	Fair Value Measurements Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)

#### Available-for-sale securities

U.S. government and federal agency	\$ 2,717	\$ -	\$ 2,717	\$ -
State and municipal	6,200	-	6,200	-
Mortgage backed residential	8,272	-	8,272	-
Collateralized mortgage obligations - agencies	13,625	-	13,625	-
Equity securities	2,479	-	1,377	1,102
	<u>\$ 33,293</u>	<u>\$ -</u>	<u>\$ 32,191</u>	<u>\$ 1,102</u>

2012 (000s omitted)	Fair Value Measurements Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)

#### Available-for-sale securities

U.S. government and federal agency	\$ 5,011	\$ -	\$ 5,011	\$ -
State and municipal	2,506	-	2,506	-
Mortgage backed residential	11,571	-	11,571	-
Collateralized mortgage obligations - agencies	23,383	-	23,383	-
Equity securities	2,059	-	1,394	665
	<u>\$ 44,530</u>	<u>\$ -</u>	<u>\$ 43,865</u>	<u>\$ 665</u>

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The table below presents a reconciliation and income statement classification of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3).

(000s omitted)	Equity Securities	
	2013	2012
Beginning balance, January 1	\$ 665	\$ 1,072
Included in other comprehensive income	437	(63)
Transfers in and/or out of Level 3	-	(344)
<b>Ending balance, December 31</b>	<b>\$ 1,102</b>	<b>\$ 665</b>

During 2012, \$344,000 of equity securities were transferred from level 3 to level 2 due to observable trades during the year.

### Assets Measured on a Non-Recurring Basis

Assets measured at fair value on a non-recurring basis are summarized below:

2013 (000s omitted)	Fair Value Measurements Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Impaired loans</b>				
Commercial	\$ 103	\$ -	\$ -	\$ 103
Commercial real estate	2,759	-	-	2,759
Residential real estate	462	-	-	462
Installment	-	-	-	-
Home equity	26	-	-	26
<b>Total impaired loans</b>	<b>\$ 3,350</b>	<b>\$ -</b>	<b>\$ -</b>	<b>\$ 3,350</b>
<b>Other real estate owned</b>				
Commercial real estate	\$ 535	\$ -	\$ -	\$ 535

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2012 (000s omitted)	Fair Value Measurements Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Impaired loans</b>				
Commercial	\$ 203	\$ -	\$ -	\$ 203
Commercial real estate	1,193	-	-	1,193
Residential real estate	796	-	-	796
Installment	12	-	-	12
Home equity	27	-	-	27
<b>Total impaired loans</b>	<b><u>\$ 2,231</u></b>	<b><u>\$ -</u></b>	<b><u>\$ -</u></b>	<b><u>\$ 2,231</u></b>
<b>Other real estate owned</b>				
Commercial real estate	<u>\$ 229</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 229</u>

The following represent impairment charges recognized during the year:

Impaired loans that are measured for impairment using the fair value of the collateral had a carrying amount of \$4,124,000, with a valuation allowance of \$774,000 at December 31, 2013. Impaired loans that are measured for impairment using the fair value of the collateral had a carrying amount of \$3,101,000, with a valuation allowance of \$870,000 at December 31, 2012.

Other real estate owned which is measured at the lower of carrying value or fair value less costs to sell, had a net carrying amount of \$2,594,000, of which \$535,000 was at fair value at December 31, 2013, which resulted from write-downs totaling \$117,000. Other real estate owned which is measured at the lower of carrying value or fair value less costs to sell, had a net carrying amount of \$2,579,000, of which \$229,000 was at fair value at December 31, 2012, which resulted from write-downs totaling \$48,000.

Qualitative information about level 3 fair value instruments is as follows as of December 31:

2013 (000's omitted)	Level 3 Instruments			
	Fair Value	Valuation Technique	Unobservable Input	Weighted Average
Equity securities	\$ 1,102	Market comparable	Price to book ratio	92%
Impaired loans	\$ 3,350	Appraisal value - real estate	Discount applied to appraisal	11.4%
Other real estate	\$ 535	Appraisal value	Discount applied to appraisal	0%



# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2012 (000's omitted)	Level 3 Instruments			
	Instrument	Fair Value	Valuation Technique	Unobservable Input
Equity securities	\$ 665	Market comparable	Price to book ratio	63%
Impaired loans	\$ 2,231	Appraisal value - real estate	Discount applied to appraisal	3%
Other real estate	\$ 229	Appraisal value	Discount applied	0%

Carrying amount and estimated fair value of financial instruments, not previously presented, at year-end were as follows:

(000s omitted)	2013		2012	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Assets</b>				
Cash and cash equivalents	\$ 12,856	\$ 12,856	\$ 45,712	\$ 45,712
Securities held to maturity	2,620	2,627	3,058	3,116
Loans held for sale	1,004	1,004	782	782
Net loans (including impaired loans)	258,074	247,305	194,782	198,737
FHLB stock	661	661	661	661
Accrued interest receivable	983	983	902	902
<b>Liabilities</b>				
Deposits	\$ 283,341	\$ 283,570	\$ 275,839	\$ 276,291
FHLB advances	10,855	10,873	891	1,072
Subordinated debentures	14,000	14,015	14,000	13,999
Accrued interest payable	96	96	1,920	1,920

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

### Cash and Cash Equivalents

The carrying amounts reported in the consolidated balance sheets for cash and short-term instruments approximate their fair values.

### Securities Held to Maturity

Fair values for securities held to maturity are based on similar information previously presented for securities available for sale.

### Loans Held for Sale

The fair values of these loans are determined in the aggregate on the basis of existing forward commitments or fair values attributable to similar loans.

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### FHLB Stock

It was not practical to determine the fair value of FHLB stock due to restrictions placed on its transferability.

### Loans

For variable rate loans that re-price frequently and with no significant change in credit risk, fair values are based on carrying values. The fair value of other loans is estimated using discounted cash flow analysis.

### Accrued Interest

The carrying amount of accrued interest approximates its fair value.

### Off-Balance-Sheet Instruments

The fair value of off-balance sheet items is not considered material.

### Deposits

The fair values disclosed for demand deposits are, by definition equal to the amount payable on demand at the reporting date. The carrying amounts for variable rate, fixed term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on similar certificates.

### FHLB Advances

Rates currently available for FHLB advances with similar terms and remaining maturities are used to estimate the fair value of the existing obligations.

### Subordinated Debentures

The estimated fair value of the existing subordinated debentures is calculated by comparing a current market rate for the instrument compared to the book rate. The difference between these rates computes the fair value.

### Limitations

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

## 13. REGULATORY MATTERS

The Corporation (on a consolidated basis) and its Bank subsidiary are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Corporation. Under capital adequacy guidelines and the regulatory framework for

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

prompt corrective action, the Corporation and the Bank must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance-sheet items that are calculated under regulatory accounting practices. The capital amounts and classifications 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 Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). As of December 31, 2013 and 2012, the most recent notifications from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. Management believes, as of December 31, 2013 and 2012, that the Corporation and the Bank met all capital adequacy requirements to which they are subject.

In January 2010, The State Bank entered into a Consent Order with federal and state banking regulators that contained provisions to foster improvement in The State Bank's earnings, lower nonperforming loan levels, increase capital, and require revisions to various policies. This order was lifted in March 2013 and was replaced with an informal action requiring continuation of certain reporting as well as continued maintenance of an 8.0% leverage capital ratio.

Effective in November 2010, the Corporation received a notice from the Federal Reserve which defined restrictions being placed upon the holding company. This order was lifted in August 2013 and was replaced with an informal action requiring permission be requested before paying or declaring a dividend, incurring debt, or purchasing or redeeming shares of the Corporation's common stock and restriction of dividend payments without prior regulatory approval.

The Corporation's principal source of funds for dividend payments is dividends received from the Bank. Banking regulations limit the amount of dividends that may be paid without prior approval of regulatory agencies.

The tables below illustrate the regulatory capital amounts and ratios as of December 31:

2013 (000s omitted)	Actual		For Capital Adequacy Purposes		To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to Risk Weighed Assets)						
The State Bank	33,487	12.3%	21,783	8.0%	27,228	10.0%
Tier 1 Capital (to Risk Weighed Assets)						
The State Bank	30,065	11.0%	10,891	4.0%	16,337	6.0%
Tier 1 Capital (to Average Assets)						
The State Bank	30,065	9.5%	12,705	4.0%	15,881	5.0%

# FENTURA FINANCIAL, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

2012 (000s omitted)	Actual		For Capital Adequacy Purposes		Regulatory Agreement Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to Risk Weighed Assets)						
The State Bank	28,829	13.3%	17,291	8.0%	25,937	12.0%
Tier 1 Capital (to Risk Weighed Assets)						
The State Bank	26,071	12.1%	8,646	4.0%	N/A	N/A
Tier 1 Capital (to Average Assets)						
The State Bank	26,071	8.7%	11,944	4.0%	23,888	8.0%

### 14. LOAN COMMITMENTS AND OTHER RELATED ACTIVITIES

#### Off-balance-Sheet Risk

Some financial instruments, such as loan commitments, credit lines, letters of credit, and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance-sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

The contractual amount of financial instruments with off-balance-sheet risk was as follows at year-end:

(000s omitted)	2013	2012
Commitments to make loans (at market rate)	\$ 33,977	\$ 20,653
Unused lines of credit and letters of credit	39,000	31,994

Commitments to make loans are generally made for periods of 90 days or less. At December 31, 2013, loan commitments and unused lines of credit had interest rates ranging from 2.99% to 6.00% and maturities ranging from 1 month to 30 years.

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## ■ NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### ■ 15. CONTINGENCIES

#### Litigation

The Corporation is party to litigation arising during the normal course of business. In the opinion of management, based on consultation with legal counsel, the resolution of such litigation is not expected to have a material effect on the consolidated financial statements.

#### Environmental Issues

As a result of acquiring real estate from foreclosure proceedings, the Corporation is subject to potential claims and possible legal proceedings involving environmental matters. No such claims have been asserted as of December 31, 2013.

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