

# 2005 Financial Report

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## Analysis Of Earning Assets And Interest Bearing Liabilities

In Thousands of Dollars

	2005			2004		
	Avg. Balance	Interest	Yield/Rate	Avg. Balance	Interest	Yield/Rate
<b>ASSETS</b>						
<b>Loans</b>						
Commercial (1)	\$ 10,775	\$ 798	7.41%	\$ 11,959	\$ 679	5.68%
Real Estate	222,005	15,332	6.91%	200,979	13,211	6.57%
Installment (2)	11,551	956	8.28%	13,254	1,475	11.13%
Total Loans	\$ 244,331	\$ 17,086	6.99%	\$ 226,192	\$ 15,365	6.79%
Securities (3)						
Taxable	134,735	4,929	3.66%	139,648	4,679	3.35%
Tax-Exempt (4)	5,154	393	7.62%	3,868	295	7.63%
Total Securities	\$ 139,889	\$ 5,322	3.80%	\$ 143,516	\$ 4,974	3.47%
Federal Funds Sold	54,638	1,680	3.07%	75,213	953	1.27%
<b>Total Earning Assets</b>	\$ 438,858	\$ 24,088	5.49%	\$ 444,921	\$ 21,292	4.97%
Cash and Due from Banks	19,972			23,562		
Premises and Equipment, Net	972			1,003		
Other Assets	3,343			3,518		
Allowance for Loan Losses	(4,111)			(4,119)		
<b>Total Assets</b>	\$ 459,034			\$ 468,885		
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>						
<b>Interest Bearing Deposits</b>						
Super NOW and MMDA	\$ 111,675	\$ 1,265	1.13%	\$ 121,664	\$ 1,226	1.01%
Savings	21,745	217	1.00%	21,438	214	1.00%
Time	221,867	6,213	2.80%	231,317	5,170	2.24%
<b>Total Interest Bearing Deposits</b>	\$ 355,287	\$ 7,695	2.17%	\$ 374,419	\$ 6,610	1.77%
Long-Term Borrowings	0	0	0	0	0	0
<b>Total Interest Bearing Liabilities</b>	\$ 355,287	\$ 7,695	2.17%	\$ 374,419	\$ 6,610	1.77%
Noninterest Bearing Deposits	47,594			42,175		
Accrued Expenses and Other Liabilities	1,392			2,355		
<b>Equity</b>	54,761			49,936		
<b>Total Liabilities and Equity</b>	\$ 459,034			\$ 468,885		
Net Interest Margin	\$ 438,858	\$ 16,393	3.74%	\$ 444,921	\$ 14,682	3.30%

(1) Includes loans on nonaccrual status.

(2) Net of unearned interest.

(3) Represents amortized value.

(4) Tax-exempt income converted to a fully tax-equivalent basis assuming a tax rate of 34%.

**Rate Sensitivity Analysis As Of December 31, 2005**

In Thousands of Dollars

<b>REPRICING INTERVAL</b>	<b>Three Months Or Less</b>	<b>Three To Twelve Months</b>	<b>One To Three Years</b>	<b>Three To Five Years</b>	<b>Five To Fifteen Years</b>	<b>Over Fifteen Years</b>
<b>ASSETS</b>						
Total Loans (1)	\$ 46,203	\$ 4,803	\$ 29,927	\$ 53,982	\$ 72,335	\$ 56,192
Investment Securities (2)	30,884	18,469	35,234	30,156	2,610	2,480
Federal Funds Sold	<u>52,000</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total Selected Assets	\$129,087	\$ 23,272	\$ 65,161	\$ 84,138	\$ 74,945	\$ 58,672
<b>LIABILITIES</b>						
Interest Bearing Deposits (3)	\$134,497	\$ 69,942	\$ 17,538	\$ 198	\$ 0	\$ 0
Borrowed Funds	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Total Selected Liabilities	\$134,497	\$ 69,942	\$ 17,538	\$ 198	\$ 0	\$ 0
Differences	<u>-5,410</u>	<u>-46,670</u>	<u>47,623</u>	<u>83,940</u>	<u>74,945</u>	<u>58,672</u>
Cumulative Differences	<u>\$ -5,410</u>	<u>\$ -52,080</u>	<u>\$ -4,457</u>	<u>\$ 79,483</u>	<u>\$154,428</u>	<u>\$ 213,100</u>

(1) Does not include loans on nonaccrual status.

(2) Does not include Federal Reserve Stock or securities on nonaccrual status. Reported HTM securities at amortized cost and AFS securities at fair value.

(3) Does not include Super NOW, Money Market Deposit Accounts or traditional savings deposits.

## Management's Discussion and Analysis of Financial Condition and Results of Operation

### Summary

The national banking industry recognized its fifth year of record profits in 2005. This is significant given a year of unprecedented bankruptcy filings due to more stringent rules, one of the worst natural disasters in the history of the United States, a continuing war overseas and a rising interest rate environment. In an attempt to curb inflation, the Federal Reserve increased interest rates eight consecutive times for a total of 200 basis points (1 basis point equals 1/100 percentage) as opposed to 130 basis points for 2004. For the first time since its inception in 1933, the FDIC reported no failures for insured financial institutions for the entire 2005 calendar year. The national seasonably adjusted unemployment rate for 2005 was 4.9% compared to 2004's 5.3%.

There were also some significant areas of progress for the State of West Virginia in 2005. The State's slogan "Open for Business" was proven true as seen through various changes in our state. There was a complete transformation of Workers' Compensation, an approval to reduce the sales tax on groceries one percent, a reduction of car and homeowners' premiums as a result of ongoing dialogues with the insurance industry, a surge in the fight against methamphetamine manufacture and usage, and the dedication of government to run the state more like a responsible business and thus reducing the State's dependence on debt as a means of financing. West Virginia continues to be recognized for its available development real estate, an abundance of natural resources and a good quality, dependable workforce. West Virginia's seasonably adjusted unemployment rate was 4.7% for December 2005 which placed the state as 28th in national ranking.

Location, location, location. While a lot of Putnam Bancshares' success can be attributed to the hard work and dedication of its employees and the loyalty of its many customers, the fact cannot be ignored that Putnam County Bank is located in the heart of one of the most prosperous counties in the state of West Virginia, Putnam County. Easy access to a major interstate highway and the close proximity of West Virginia's two largest cities has definitely been a benefit to the Putnam County economy. U.S. Bureau of the Census, Population Estimates Program (PEP) estimated that the population of Putnam County was 54,443 as of July 2005. The per capita personal income for 2003 was \$27,759 compared to a State average of \$24,542. The only county to surpass Putnam was Ohio County whose per capita income was \$30,349 for the same time period. The

Putnam County unemployment rate for December 2005 was 3.6% compared to the state average of 4.2%. Out of 55 counties, seven counties fared better than Putnam in regards to unemployment.

The bottom line is, regardless of where the source of the Company's success may be derived—national, state or county—Putnam Bancshares will continue to make improvements from within to insure that our success will continue for generations to come. The quality, stability and flexibility of our workforce, the loyalty of our customers, and the support and dedication of our shareholders and directors are all an integral part of the Company's success story.

The following description of the operating outcome and financial condition of Putnam Bancshares, Inc. (referred throughout as "the Company") should be read in conjunction with the Consolidated Balance Sheets, Statements of Income, Changes in Shareholders' Equity, Statements of Cash Flows, and Notes to Consolidated Financial Statements (beginning on page F11 and ending on page F28). References also will be made to Putnam Bancshares' wholly-owned subsidiary, Putnam County Bank ("the Bank"). In addition, various graphs, charts and analyses have been provided throughout the Annual Report to support the Management's Discussion and Analysis.

The Bank's "peer group" consists of all commercial banks having assets between \$300 million to \$1 billion. The Financial Institutions Examination Council (FFIEC) is a governmental organization represented by the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency. The federal regulatory bodies gather financial data from commercial banks quarterly Call Reports and compile the statistics on the banks and their related peer group culminating in a quarterly Uniform Bank Performance Report (UBPR). As of December 31, 2005, there were 1,076 banks in Putnam County Bank's peer group. This was an increase of 62 banks since December 2004. When analyzing the peer group in comparison to the Bank it is fundamentally necessary to analyze each bank and the particular components of its assets, liabilities, and owners equity along with their operating philosophy in conjunction with other available reports—10-K and/or external auditors' reports—which can affect their financial information and thus cause their ratios to be above or below that of their peer group. A UBPR report can be obtained on almost any bank through the FFIEC website at [www.ffiec.gov](http://www.ffiec.gov).

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### Net Interest Margin

The net interest margin is the difference between tax equivalent interest income and interest expense divided by average earning assets and is used to gauge the Company's profitability. A small change in margin may result in a significant impact on profitability. The net interest margin increased from 3.30% in 2004 to 3.74% in 2005, or 44 basis points. While margins improved, the Bank still fared lower than the peer net interest margin of 4.14 for 2004 and 4.24 for 2005. The ability to control funding costs in a rising rate environment helped to improve margins. The Bank's cost of funds increased from 1.77% in 2004 to 2.15% in 2005. The cost of funds is calculated by dividing the tax equivalent of interest expense from deposit accounts by the year-to-date average of deposit account balances. The peer banks' average costs of funds were 1.62% in 2004 and 2.26% in 2005 for the fourth quarter of 2005. Also contributing to margins was a 13% increase in loan balances.

### Interest Income

Interest income increased \$2.8 million or 13% from year-end 2004 to year-end 2005. The Federal Open Market Committee (FOMC) raised the overnight fed funds rates eight separate times during 2005 with a 25 basis increase each time. The Bank has slightly less than 20% of its loan portfolio tied to the Wall Street Journal prime rate, which was increased each time the fed funds overnight rate was increased. There was a total increase in average outstanding loans of \$18 million or 8% for 2005 during a rising interest rate environment. Interest income from loans represented the greatest portion of the increase in interest income which contributed 62% or \$1.7 million of the total increase between 2004 and 2005. The volume of average earning assets actually declined \$4.8 million or 1% between 2004 and 2005.

Within the category of loan income, income from real estate secured lending increased \$2.1 million or 16% between year-end 2004 and 2005. A rising interest rate environment and an increase in origination fee collections jointly helped fuel the upsurge of interest on real estate secured lending for 2005. Competition for real estate secured lending is keen. Consumers have a wide array of mortgage financing options and are increasing more astute. Even Wal-Mart, the nation's largest retailer, is seeking permission from the FDIC to

establish its own brand of bank. In order to compete, the Bank has increased its lending staff and educational resources our employees with the required knowledge to keep the Bank competitive. The average total of real estate secured loans increased \$21.0 million or 11% between 2004 and 2005. While the Bank always looks for ways to increase its loans, it does so in a way that does not compromise the Bank's underwriting standards to ensure that loan quality does not deteriorate as a result.

Income on commercial lending increased \$119 thousand or 18% between 2004 and 2005. Income on installment lending declined \$519 thousand or 35% during 2005. The average total of commercial loans declined \$1.1 million or 10% between 2004 and 2005 and the average total of installment loans declined \$1.7 million or 13% in the same period.

The average total of the investment portfolio decreased \$5.4 million or 4% between 2004 and 2005. The decrease helped to fund increases in lending. Income on securities increased \$304 thousand or 6% during 2005. The average tax equivalent yield on securities increased from 3.47% in 2004 to 3.80% in 2005. Purchases of investment securities in 2005, aside from regular purchases of U. S. Treasury bills, consisted of U. S. Treasury Notes and U. S. Government Agencies, which are generally viewed as very safe investments. In addition, securities of in-state municipal issues, which are rated, were also purchased during 2005. Income on securities increased largely as a result of the increase in interest rates as a whole. The Bank purchases Treasury Bills in three- and six-month maturities on a weekly basis at the Treasury's auction. The average balance of federal funds sold decreased \$20.6 million or 27% between 2004 and 2005. Even with such a large reduction in federal funds sold, the Bank still maintains a considerably higher ratio of federal funds as a percent of total average funds than that of our peer grouping, placing us in the ninety-eight percentile for the past three years. As with the investment portfolio, the decrease with federal funds sold was used to fund the increase within lending. Due to an increase of 180 basis points on the average yield for federal funds sold, income increased from the sale of federal funds by \$727 thousand or 76% between 2004 and 2005. Federal funds sold represent excess liquidity and are sold to correspondent banks at an interest rate which changes daily. As of year-end 2005, all municipal securities are West Virginia issues which are investment quality and rated A+ or better by Standard and Poors and A1 or better by Moody's.

## Management's Discussion and Analysis of Financial Condition and Results of Operation

Of these municipal securities, 28% are general obligations while the remaining issues are revenue obligations.

### Interest Expense

Interest expense on deposit accounts increased \$1.1 million or 16% from year-end 2004 to 2005. The average cost of deposits increased from 1.77% to 2.17%, or 40 basis points, in the same period. Almost 96% of the increase in interest expense was a result of increases in interest rates on certificates of deposit and individual retirement accounts. The yield on time deposits increased 56 basis points from 2.24% for 2004 up to 2.80% for 2005. The average balance of time deposits decreased 4% during 2005. The interest expense on MMDA and Super NOW accounts combined increased \$39 thousand whereas the average balance on the respective combined accounts decreased 8% or \$10 million for 2005. Passbook savings expense increased only \$3 thousand and the average yield remained the same at 1%. The average balance for the passbook accounts, unlike the other interest bearing deposit accounts, increased \$307 thousand or 1%. The Bank's cost of funds was 11 basis points less than our peers for 2005 (2.26% for the Peer). The Bank does not actively advertise for deposits in its marketing area and does not solicit deposits from brokers.

The Bank did not require borrowings to fund its operations in 2005. This has been due to ample liquidity in federal funds sales and in the investment portfolio. As of year-end 2005, the Company has no outstanding debt and there are no plans to incur debt in the immediate future.

### Asset and Liability Management (Interest Rate Sensitivity and Liquidity)

It is management's responsibility to monitor, measure, and control the Bank's asset and liability mix in order to set the interest rate sensitivity and liquidity basis for the Bank. To properly understand and interpret the Bank's financial asset and liability management, management has to comprehend the character of the Bank's assets and liabilities, its economic environment and customer base. Putnam County Bank's Asset/Liability Committee (ALCO), which meets monthly, is provided with historical, current, and anticipated trends analyses generated internally and externally in order to provide the most reliable information for the Committee to make decisions affecting the Bank's interest rate sensitivity and liquidity. The expertise and different backgrounds of the non-bank directors is used to obtain a fresh understanding of

how the customers might react based on decisions made by the Committee and/or management. Some of the items generally on the agenda for discussion include anticipated loan and deposit growth (or shrinkage), the impact of raising or lowering rates, how much liquidity should be maintained, strongest competition, trends in the economy, and etc.

As an effort to monitor the interest rate sensitivity, management has to gauge the inherent interest rate risk and the effects upon the financial statements. The variables include the maturity of instruments, repricing characteristics, and the "imprecise" knowledge of prepayments on loans and/or withdrawals from interest bearing deposits. The Rate Sensitivity Chart provided earlier provides for the maturity of instruments and takes into consideration the repricing characteristics, but not the possible prepayments or withdrawal scenarios. While not reflected within the chart, the analysis and assumptions used in regards to prepayments/withdrawals are discussed within the monthly ALCO meetings.

Liquidity levels in the Bank decreased in 2005 as evidenced by an increase of 8% of total average loans and a decrease of 11% in short-term investments, available for sale securities, and federal funds sold. The Bank's loan-to-deposit ratio increased from 56% at year-end 2004 to 65% at year-end 2005. The peer ratio was 85% for both periods. The decline in total deposits has enhanced the Bank's loan-to-deposit ratio as well as slowing asset growth to enhance capital ratios. The Bank appears to have ample liquidity within federal funds sold and investments to provide for this difference. The Bank has the ability to diversify its funding sources in order to avoid large concentrations and thereby decreasing its liquidity risk. The Bank has also been very conservative in regards to investments in U. S. Government securities, U. S. Government Agency securities and rated in-state municipal securities. The Bank does not purchase derivative contracts or foreign exchange contracts. The Bank also does not solicit brokered deposits.

Another common measure of liquidity involves the Bank's net non-core funding dependence ratio. The significance of this ratio is that it measures how much of our long-term assets are funded with non-core funds. Non-core funds consists of time deposits of \$100 thousand or greater and are usually considered more volatile than core deposits. The composition for the peer group can be a little more complex and include additional items such as borrowed money, foreign office deposits, and brokered deposits. As of year-end 2005, the Bank had a ratio of 6.06 compared to a

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negative 1.67 for year-end 2004. While the trend for the Bank has been increasing for the last three years, the ratio is still considerably lower than that of our peers, which was 22.27 for 2005 and 21.28 for 2004.

### Nonperforming Assets

Nonperforming assets includes all loans which are past due ninety days or more and any loans in nonaccrual status. Loans are required to be reported in nonaccrual status when principal and interest has been in default for ninety days or longer unless the loan is both well secured and in process of collection. Loans in nonaccrual status are generally those where payment of principal and interest is in question due to the deterioration of the financial condition of the borrower and any payments are reflected on a cash basis. The total of nonperforming loans at the end of 2005 was \$107 thousand or .04% compared to \$1.1 million or .46% in 2004. This compares with peer bank ratios of .49% at year-end 2005 and .53% at year-end 2004. There was a decrease in the nonaccrual balance from \$1 million in 2004 and none reported for 2005. Much of the improvement with the Bank's nonperforming assets can be attributed to an increasing emphasis on maintaining good underwriting standards in lending. Another reason for the improved balances can be credited to improved economic conditions in general. The nonperforming loan ratios have improved dramatically during the last three years. The Bank's percentile ranking with that of its peers improved from the 51st percentile for 2004 to the 13th percentile for 2005.

The Bank had no amounts representing other real estate owned at the end of 2005 as a result of debts previously contracted. The 2004 balance of \$95 thousand represented a one-to-four family residential property located in Winfield, WV. The property was shown at the lower of book or fair market value. The property was liquidated during February 2005.

### Provision and Allowance for Loan Losses

The Bank did not make any provisions to the allowance for loan loss in 2005. In fact, after careful consideration of history analysis, current trends and asset quality, management chose to reduce the allowance for loan losses by \$1.3 million for 2005. The Bank did not make any provisions for 2004 to the allowance for loan loss. The Bank had a much lower rate of recovery on previously written off loans in 2005 than in 2004. The recoveries for 2005

totaled \$115 thousand and in 2004 totaled \$909 thousand. In addition, the Bank had substantially less charge-offs in 2005 versus 2004. The charge-offs accounted for in 2005 were \$233 thousand and in 2004 the amount was \$703 thousand.

Net loan losses were \$118 thousand during 2005 compared to net loan recoveries of \$206 thousand in 2004. The Bank's ratio of .05% of net losses to average total loans stood in contrast with the peer ratio of .13% placing the Bank in the 38% of all banks in our peer group. In 2004, the Bank ranked in the lower 2% of the peer group. As of December 31, 2005, the allowance for loan loss stood at \$2.7 million or 1.02% of total loans. This compares to \$4.2 million or 1.80% of total loans on December 31, 2004. Peer banks show ratios of 1.22% in 2005 and 1.27% in 2004. It is management's responsibility to see that the allowance for loan losses is at a level which is sufficient to cover losses in the loan portfolio. The analysis of the allowance includes the evaluation of problem loans, historical trends in loan losses as well as local economic trends and their possible effects. The adequacy of the allowance is subject to review by the Company's internal auditors, external auditors, Federal Reserve Bank and the West Virginia Division of Banking.

### Noninterest Income

Total noninterest sources of income totaled \$281 thousand in 2005 (excluding gross gains on securities transactions) compared with \$252 thousand in 2004, an 11.9% increase. The largest increase came from Visa CheckCard fees which were up \$25 thousand or 72% between 2004 and 2005. This increase reflects the popularity and convenience of the product in light of the industry's reduction in the interchange rate paid to the Bank.

The Bank has historically been a low-cost provider of banking services. The percentage of noninterest income to average assets at the end of 2005 was .06% compared with 0.88% for peer institutions. Greater emphasis to increase revenue other than interest income has caused many institutions to place increasing emphasis on generating revenue through service charges and other noninterest sources.

The Company reported a net loss of \$700 thousand on the sale of securities held as available for sale in 2005 compared with a \$42 thousand gain 2004. Approximately 72% of the total losses recognized in 2005 were recorded in

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the last quarter. This was performed given the amount of market depreciation in those bonds sold in addition to the adjustment in the provision (see Provision And Allowance For Loan Loss section). Gains and losses are derived from the sale of transactions on investments classified as "available for sale". These securities are reflected on the financial statements at their fair market value and may be sold at any time at the discretion of management. Management must consider several points before the decision to sell, such as changing interest rates, liquidity, availability and alternative investments with the projected change on the Bank's asset/liability structure. All sales are carefully reviewed by management and reviewed by the Board. The Company does not speculate by "trading" in the portfolio and does not utilize any interest rate hedging or derivative products in its investment strategies.

### Noninterest Expense

Total noninterest expense (excluding gross securities losses) increased \$316 thousand or 5% between 2004 and 2005. This compares with an increase of \$667 thousand or 11% between 2003 and 2004. Noninterest expenses primarily relate to personnel, occupancy and other miscellaneous operating expenses.

Total personnel expenses increased \$105 thousand or 3% from 2004 to 2005. Officer and employee salary expense increased \$195 thousand or 7% between 2004 and 2005. The increase reflects the traditional annual salary increases for Bank personnel. Offsetting salary increases was a \$93 thousand, or 34%, decrease in retirement funding during 2005. This was favorable considering retirement funding increased \$192 thousand during 2004. Most of the reduction came after further re-evaluations of our current plan, market conditions, group experience and projected payouts. The retirement plan is administered through the West Virginia Bankers Association as a noncontributory plan whereby the plan's actuary assigns the value of contribution to be made by its members. The Bank's group health insurance plan for 2005 was a preferred provider option which provided flexibility in utilization of providers. The dollar increase of \$22 thousand in 2005 represented a modest increase of 5.8% compared to the \$53 thousand increase, or 16.6%, which the Bank incurred during 2004. Through contract negotiations and a bidding process, the Bank was able to reduce the percentage increase at a time when research companies were predicting a 12 to 13% increase in group health insurance. At year-end 2005 and 2004, the Bank employed 75 people.

Total occupancy expense increased \$4 thousand or less than 1% from 2004 to 2005. This compared to an increase of \$41 thousand during 2004. Surprisingly, fuel/maintenance on bank vehicles decreased 18% or less than \$2 thousand for 2005. Depreciation on furniture and fixtures increased almost \$16 thousand as a result of taking advantage of a provision in the tax code which allows the Bank to fully expense certain machines, equipment, various vehicle purchases, and furniture up to \$105 thousand for 2005. The allowance for 2004 was \$102 thousand. During 2005, the Bank purchased printers, personal computers, ATM upgrades, and various other equipment to replace damaged or obsolete equipment. Countering the increase was a decrease in depreciation on vehicles of less than \$22 thousand or a 57% reduction compared to 2004 balances. Much of the difference stems from complex IRS rules for deducting depreciation on certain vehicles and their classifications as SUVs and/or luxury vehicles. The Bank continues to operate three locations: 2761 Main Street in Hurricane; 300 Hurricane Creek Road in Hurricane; and 3058 Mount Vernon Road in Hurricane.

Other operating expenses increased \$203 thousand or slightly less than 9% from 2004 to 2005. Those categories largely responsible for the increase include data processing (\$207 thousand); Federal Reserve Bank services (\$62 thousand); fees to attorneys (\$35 thousand); computer supplies/software licenses (\$29 thousand) and fees to accountants (\$27 thousand). During 2005, data processing expenses increased 40% due largely to increases in services provided by Computer Services Inc (CSI). Imaging products introduced in the latter part of 2004 in response to Check 21 increased the monthly expenses incurred and this trend continued throughout 2005. In addition, the use of automated account opening services through CSI helped to reduce reliance on printed forms. While the amount of the increase was substantial, office supplies decreased \$52 thousand (22%) and postage expense declined over \$18 thousand (9%) during this same period. While not as easily measurable in terms of dollars, we have also been able to utilize our personnel in other areas by not having to file checks and prepare and process as many statements for mailing. Another non-monetary bonus (at least not directly) is the reduction of human error. Federal Reserve Bank services increased significantly. Services that were performed by a correspondent bank during 2004 and earlier were extremely low cost, if not free, if the Bank maintained a minimal balance with them. However, those services were assumed by the Federal Reserve during the last part of 2004 and as such, were no longer "free". Our monthly expense



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increased from approximately \$400 to over \$5 thousand. Fees to attorneys increased (39%) partially as a result of booking some large, however very complex, loans requiring the expertise of legal consultations and for legal advice in regards to bankruptcy filings and reorganizations of a few corporate loan customers. The returns on the loans will more than offset the legal fees but the results are not immediate. Not surprisingly, fees to accountants increased (40%) due to the increasing complexity of accounting rules.

Notable decreases within the other operating expense classification were in the in the following areas: FDIC insurance assessment (\$130 thousand), other real estate expense (\$47 thousand), office equipment and computers (\$31 thousand), and regulatory assessments (\$15 thousand). The Bank's quarterly assessment rates were increased in 2004 as a result of a written agreement entered into by Putnam County Bank and the Federal Reserve Bank of Richmond on November 19, 2003. This six-page written agreement can be viewed at [www.federalreserve.gov](http://www.federalreserve.gov) under the Enforcement Actions section. The FDIC uses a risk-based rating system to base a bank's quarterly assessments and as a part of this analysis, the FDIC will review and use the results of examinations, written agreements, offsite statistical analysis, and etc. While the Bank is still operating under the Written Agreement, the FDIC rating increased from "1B" to a "1A" between 2004 and 2005. A "1A" risk-based bank is considered to be a well capitalized, financially sound institution with only a few minor weaknesses as opposed to a "1B" which is a well capitalized institution that "demonstrates weaknesses which, if not corrected, could result in significant deterioration of the institution and increased risk of loss to the Bank Insurance Fund". The FDIC rules and regulations can be viewed at [www.fdic.gov](http://www.fdic.gov). Another piece of good news from the FDIC was the increase of coverage for individual retirement accounts from \$100 thousand to \$250 thousand effective April 2006. Other deposit accounts will remain at the \$100 thousand level of coverage.

The Bank's overhead expense as a percentage of average assets has seen a trend of continual increases for the past four years. Even still, compared with our peer grouping, the Bank still manages to rank in the three percentile. During 2005, the Bank's overhead expense ratio was 1.53% compared to the peer group rating of 2.86%. As discussed above, the biggest reason for the increase came as a result of the net increase in other operating expenses. The ratio is up from year-end 2004 when the ratio was 1.43% for the Bank and 2.90% for peer banks and the Bank was in the two percentile.

Another common measure of the Bank's ability to generate income from carefully managing its expenses and income is the calculation of its efficiency ratio. The efficiency ratio is derived from using the noninterest expense and dividing it by net interest income and noninterest income (excluding gains or losses on the sale of securities). Putnam County Bank's efficiency ratio for 2005 was 42.20% compared to the peer ratio of 58.57%. The ratios for 2004 were 44.96% and 59.86%, respectfully.

### Taxes

Putnam County Bank's Federal and State income tax provision increased \$718 thousand from year-end 2004 to year-end 2005 or a 24% increase. Income taxes for year-end 2003 to year-end 2004 increased only 5%, or \$149 thousand. The current year's increase was derived from an increase in net income, caused mainly by a large reversal of prior years' provisions to the allowance for loan loss of \$1.3 million and an increase in net interest income of \$1.6 million during 2005. The Bank reported a net overpayment of taxes of \$332 thousand on the 2005 consolidated federal and state tax returns. The Bank's related deferred tax benefit, excluding the deferred taxes on the unrealized gains/losses on available-for-sale securities, decreased \$509 thousand from 2004 to 2005.

The Company invests in municipal securities issued in West Virginia, which are "bank qualified" investments and, as such, are exempt from federal taxation.

Please refer to "Note 7 – Income Taxes" in the Consolidated Financial Statements for further discussion.

### Equity and Capital Ratios

Shareholders' equity increased \$4.4 million or 8% between 2004 and 2005 for a balance of \$57.3 million. This was the result of net income of \$6.5 million, a decrease in other comprehensive income of \$1.2 million, and payment of dividends of \$900 thousand. The book value of Putnam Bancshares, Inc. common stock at the end of 2005 based on 600,000 shares outstanding was \$95.51 compared to \$88.15 at year end 2004, representing an 8.3% increase. The Company's return on average equity for 2005 was 11.36%.

Banking regulatory bodies mandate the risk-weighting assets and off-balance sheet items to more accurately assess capital adequacy. Tier 1 capital (equity capital less the tax

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equivalent of unrealized gains or losses on available for sale securities) and total risk-based capital (Tier 1 plus the allowable portion of the allowance for loan losses) comprise two vital measures of capital adequacy. As of year-end 2005, the Bank's tier one risk-based-capital to risk-weighted-assets was 24.32% compared to 24.49% at year-end 2004. The peer banks' ratios were 11.81% in 2005 and 11.86% in 2004. In addition, the Bank's total risk-based-capital to risk-weighted-assets was 25.47% in 2005 and 25.75% in 2004. This compares with peer bank ratios of 12.96% in 2005 and 13.06% in 2004. Using the federal guidelines, the Bank is considered well capitalized which explains the Bank's ranking in the 97th percentile with its peers based on numbers used for the December 2005 Uniform Bank Performance Report (UBPR).

### Dividends

Bancshares paid dividends totaling \$900 thousand in 2005 compared with \$840 thousand in 2004. This equates to a cash dividends to net operating income payout ratio of 13.86% in 2005 and 16.19% in 2004. This conservative dividend policy has enhanced retained earnings. Regular dividends to shareholders are paid on a semi-annual basis: June and December.

For further discussion of dividend, please refer to "Note 13 – Dividend and Capital Restrictions" and the Consolidated Statements of Changes in Shareholders' Equity in the Consolidated Financial Statements.

### Statement of Management Responsibility

The financial statements, related financial data and other information found in this report are the responsibility of the management of Putnam Bancshares, Inc and its sole subsidiary, Putnam County Bank. The financial statements have been prepared in conformance with generally accepted accounting principles appropriate for the circumstances to mirror, in all material respects, reportable events and transactions.

The accounting systems of Putnam Bancshares, Inc. and its wholly-owned subsidiary, Putnam County Bank, record, summarize and report financial data. The Bank uses internal controls and procedures to provide reasonable assurance (the cost involved should not exceed related benefits) to the reliability of the financial records. Reliance on the accounting systems and internal controls by management is enhanced with written policies, internal audits and continuous training of accounting personnel in order to present fair and accurate statements.

The Audit Committee of Putnam County Bank, composed solely of outside directors, meets on a monthly basis to review various issues relating to audit, including coverage, findings and responses. The selection of Rollins, Cleavenger and Rollins as the Company's external auditors is recommended by the Board of Directors and ratified by the shareholders of Putnam Bancshares, Inc.

## Independent Auditors' Report

To the Board of Directors and Shareholders  
Putnam Bancshares, Inc. and Subsidiary  
Hurricane, West Virginia

We have audited the accompanying consolidated balance sheets of Putnam Bancshares, Inc. and Subsidiary (a West Virginia corporation) as of December 31, 2005 and 2004, and the related consolidated statements of income, changes in shareholders' equity, and cash flows for the three years in the period ended December 31, 2005. These consolidated financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Putnam Bancshares, Inc. and Subsidiary as of December 31, 2005 and 2004, and the results of its operations and its cash flows for the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

A handwritten signature in blue ink that reads "Rollins, Cleaver and Rollins". The signature is written in a cursive, flowing style.

Certified Public Accountants

January 12, 2006

**Consolidated Balance Sheets****DECEMBER 31, 2005 AND 2004**

	<b>2005</b>	<b>2004</b>
<b>ASSETS</b>		
Cash and Due from Banks	\$ 21,435,000	\$ 24,074,647
Federal Funds Sold	51,000,000	72,000,000
Available for Sale Securities	81,161,918	97,907,911
Held to Maturity Securities	38,670,652	38,819,674
Loans - Less Allowance for Credit Losses of \$2,700,000 and \$ 4,206,248, Respectively	260,743,261	229,814,160
Bank Premises and Equipment	960,791	1,002,161
Federal Reserve Bank Stock, at Cost	39,000	39,000
Other Assets	3,275,109	2,877,707
Total Assets	<u>\$457,285,731</u>	<u>\$466,535,260</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
<b>LIABILITIES:</b>		
Deposits:		
Noninterest Bearing	\$ 48,549,087	\$ 43,628,493
Interest Bearing	350,184,726	369,013,647
Total Deposits	\$398,733,813	\$412,642,140
Other Liabilities	1,241,454	1,000,027
Total Liabilities	<u>\$399,975,267</u>	<u>\$413,642,167</u>
Commitments and Contingent Liabilities (Note 11)		
<b>SHAREHOLDERS' EQUITY:</b>		
Common Stock, \$.50 Par Value, 1,200,000 Shares Authorized, 600,000 Shares Issued and Outstanding	\$ 300,000	\$ 300,000
Surplus	1,000,000	1,000,000
Retained Earnings	56,236,627	50,642,401
Accumulated Other Comprehensive Income	(226,163)	950,692
Total Shareholders' Equity	<u>\$ 57,310,464</u>	<u>\$ 52,893,093</u>
Total Liabilities and Shareholders' Equity	<u>\$457,285,731</u>	<u>\$466,535,260</u>

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

**Consolidated Statements Of Income****FOR YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003**

	2005	2004	2003
<b>INTEREST INCOME:</b>			
Interest and Fees on Loans	\$17,086,628	\$15,365,450	\$16,731,385
Interest on Available for Sale Securities	3,991,334	4,345,682	4,238,959
Interest on Held to Maturity Securities	1,160,325	501,653	444,646
Interest on Federal Funds Sold	<u>1,679,516</u>	<u>952,805</u>	<u>822,360</u>
Total Interest Income	<u>\$23,917,803</u>	<u>\$21,165,590</u>	<u>\$22,237,350</u>
<b>INTEREST EXPENSE:</b>			
Interest on Deposits	<u>\$ 7,695,093</u>	<u>\$ 6,610,483</u>	<u>\$ 7,782,843</u>
Net Interest Income	\$16,222,710	\$14,555,107	\$14,454,507
Provision for Possible Credit Losses	<u>(1,388,519)</u>	<u>-0-</u>	<u>867,965</u>
Net Interest Income after Provision for Possible Credit Losses	<u>\$17,611,229</u>	<u>\$14,555,107</u>	<u>\$13,586,542</u>
<b>OTHER INCOME:</b>			
Service Charges and Commissions	\$ 262,370	\$ 236,754	\$ 211,080
Net Realized Gains on Sales of Available for Sale Securities	289,506	534,000	-0-
Other Operating Income	<u>13,614</u>	<u>14,781</u>	<u>17,474</u>
Total Other Income	<u>\$ 565,490</u>	<u>\$ 785,535</u>	<u>\$ 228,554</u>
<b>OTHER EXPENSES:</b>			
Salaries and Employee Benefits	\$ 3,911,762	\$ 3,811,700	\$ 3,275,012
Expenses of Premises and Equipment	533,864	532,257	490,544
Net Realized Losses on Sales of Available for Sale Securities	990,188	492,009	-0-
Other Operating Expenses	<u>2,589,736</u>	<u>2,376,987</u>	<u>2,314,850</u>
Total Other Expenses	<u>\$ 8,025,550</u>	<u>\$ 7,212,953</u>	<u>\$ 6,080,406</u>
Income before Income Taxes	\$10,151,169	\$ 8,127,689	\$ 7,734,690
Provision for Income Taxes	<u>3,656,943</u>	<u>2,939,433</u>	<u>2,781,893</u>
Net Income	<u>\$ 6,494,226</u>	<u>\$ 5,188,256</u>	<u>\$ 4,952,797</u>

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

## Consolidated Statements Of Changes In Shareholders' Equity

FOR YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003

	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income	Total Shareholders' Equity
BALANCES—					
January 1, 2003	\$ 300,000	\$ 1,000,000	\$42,181,348	\$ 3,750,578	\$47,231,926
COMPREHENSIVE INCOME					
Net Income			4,952,797		4,952,797
Other Comprehensive Income - Net of Tax:					
Change in Unrealized Gain (Loss) on Securities Available for Sale, Net of Deferred Income Tax (Benefit) of (\$556,014)				(961,492)	(961,492)
Add: Reclassification Adjustment				-0-	-0-
Total Comprehensive Income					3,991,305
Cash Dividends (\$1.40 Per Share)			(840,000)		(840,000)
BALANCES—					
December 31, 2003	\$ 300,000	\$ 1,000,000	\$46,294,145	\$ 2,789,086	\$50,383,231
COMPREHENSIVE INCOME					
Net Income			5,188,256		5,188,256
Other Comprehensive Income - Net of Tax:					
Change in Unrealized Gain (Loss) on Securities Available for Sale, Net of Deferred Income Tax (Benefit) of (\$1,047,726)				(1,811,789)	(1,811,789)
Less: Reclassification Adjustment, Net of Income Taxes of \$15,386				(26,605)	(26,605)
Total Comprehensive Income					3,349,862
Cash Dividends (\$1.40 Per Share)			(840,000)		(840,000)
BALANCES—					
December 31, 2004	\$ 300,000	\$ 1,000,000	\$50,642,401	\$ 950,692	\$52,893,093
COMPREHENSIVE INCOME					
Net Income			6,494,226		6,494,226
Other Comprehensive Income - Net of Tax:					
Change in Unrealized Gain (Loss) on Securities Available for Sale, Net of Deferred Income Tax (Benefit) of (\$937,285)				(1,620,807)	(1,620,807)
Add: Reclassification Adjustment, Net of Income Tax Benefits of \$256,730				443,952	443,952
Total Comprehensive Income					5,317,371
Cash Dividends (\$1.50 Per Share)			(900,000)		(900,000)
BALANCES -					
December 31, 2005	\$ 300,000	\$ 1,000,000	\$56,236,627	(\$ 226,163)	\$57,310,464

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

## Consolidated Statements Of Cash Flows

FOR YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003

	2005	2004	2003
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net Income	\$ 6,494,226	\$ 5,188,256	\$ 4,952,797
Adjustments to Reconcile Net			
Income to Net Cash Provided by Operating Activities:			
Depreciation	188,532	195,699	155,268
Provision for Credit Losses	(1,388,518)	-0-	867,965
Provision for Deferred Taxes	508,775	11	(264,205)
Net (Gain) Loss on Sale of Fixed Assets	5,476	-0-	-0-
Net Realized (Gains) Losses on			
Available for Sale Securities	700,682	(41,992)	-0-
Net (Gains) Losses on Sale of Other			
Real Estate	-0-	127,610	118,979
Increase in Cash Value - Life Insurance	(12,673)	(7,698)	( 10,383)
Amortization of Premiums			
and (Accretion) of Discounts on			
Available for Sale Securities - Net	425,416	982,761	911,877
(Increase) Decrease in Interest Receivable	(42,598)	73,468	199,922
(Increase) Decrease in Prepaid Expenses	(283,501)	13,496	(54,964)
(Increase) Decrease in Repossessions	18,210	(18,221)	-0-
Increase (Decrease) in Accrued Interest	273,317	(73,219)	(230,479)
Increase (Decrease) in Other Liabilities	<u>(31,891)</u>	<u>39,858</u>	<u>(11,687)</u>
Net Cash Provided by			
Operating Activities	<u>\$ 6,855,453</u>	<u>\$ 6,480,029</u>	<u>\$ 6,635,090</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Net (Increase) Decrease in Federal Funds Sold	\$ 21,000,000	\$ 3,000,000	\$ 3,000,000
Proceeds from Sales and Maturities			
of Available for Sale Securities	74,746,879	45,802,929	255,000
Proceeds from Maturities of			
Held to Maturity Securities	102,839,675	105,498,350	103,555,354
Proceeds from Sales of Other Real Estate	94,941	280,000	663,268
Purchases of Available for Sale Securities	(60,984,395)	(37,340,030)	(20,583,744)
Purchases of Held to Maturity Securities	(102,690,653)	(105,395,547)	(103,588,380)
Purchase of Bank Premises and Equipment	(152,639)	(166,051)	(94,911)
Net (Increase) Decrease in Loans	<u>(29,540,582)</u>	<u>(10,715,428)</u>	<u>25,700,239</u>
Net Cash Provided by			
Investing Activities	<u>\$ 5,313,226</u>	<u>\$ 964,223</u>	<u>\$ 8,906,826</u>

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

**Consolidated Statements Of Cash Flows****FOR YEARS ENDED DECEMBER 31, 2005, 2004, AND 2003 (Continued)**

	2005	2004	2003
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net Increase (Decrease) in Demand and Savings Deposits	(\$ 7,152,540)	\$ 131,691	(\$ 7,920,950)
Net Increase (Decrease) in Certificates of Deposit	(6,755,786)	(5,939,803)	(4,896,254)
Dividends Paid	<u>(900,000)</u>	<u>(840,000)</u>	<u>(840,000)</u>
Net Cash Used in Financing Activities	<u>(\$ 14,808,326)</u>	<u>(\$ 6,648,112)</u>	<u>(\$ 13,657,204)</u>
Net Increase (Decrease) in Cash and Cash Equivalents	(\$ 2,639,647)	\$ 796,140	\$ 1,884,712
Cash and Cash Equivalents at Beginning of Year	<u>24,074,647</u>	<u>23,278,507</u>	<u>21,393,795</u>
Cash and Cash Equivalents at End of Year	<u>\$ 21,435,000</u>	<u>\$ 24,074,647</u>	<u>\$ 23,278,507</u>
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>			
Cash Paid During the Year for:			
Interest	<u>\$ 7,421,775</u>	<u>\$ 6,683,702</u>	<u>\$ 8,013,323</u>
Income Taxes	<u>\$ 3,447,000</u>	<u>\$ 2,900,000</u>	<u>\$ 3,196,062</u>
<b>SUPPLEMENTAL SCHEDULE OF SIGNIFICANT NONCASH ACTIVITIES:</b>			
Transfer from Loans to Other Real Estate Owned	<u>\$ -0-</u>	<u>\$ 122,610</u>	<u>\$ 839,830</u>

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



## Notes To Consolidated Financial Statements For Years Ended December 31, 2005, 2004, And 2003

### Note 1 Summary of Significant Accounting Policies:

The accounting and reporting policies of Putnam Bancshares, Inc. and its wholly-owned subsidiary conform to generally accepted accounting principles and general practices within the banking industry. Following is a summary of the more significant accounting policies:

#### Nature of Operations

Putnam County Bank operates under a state bank charter and provides full banking services, with the exception of trust services. As a state bank, the Bank is subject to regulation of the West Virginia Division of Banking, the Federal Reserve System, and the Federal Deposit Insurance Corporation. The area served by Putnam County Bank is Putnam County and its neighboring counties with services provided by the main office and two branch offices.

#### Principles of Consolidation

The consolidated statements include the accounts of Putnam Bancshares, Inc. and its wholly-owned subsidiary, Putnam County Bank. All significant intercompany balances and transactions have been eliminated.

#### Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

#### Investment Securities

Securities that management has both the positive intent and ability to hold to maturity are classified as securities held to maturity and are carried at cost, adjusted for amortization of premium or accretion of discount using the interest method. Securities that may be sold prior to maturity for asset/liability management purposes, or that may be sold in response to changes in interest rates, changes in prepayment risk, to increase regulatory capital or other similar factors, are classified as securities available for sale and carried at fair value with any adjustments to fair value, after tax, reported as a separate component of shareholders' equity.

Interest and dividends on securities, including the amortization of premiums and the accretion of discounts, are reported in interest and dividends on securities using the interest method. Gains and losses on securities are determined using specific-identification method.

Declines in the fair value of individual held to maturity and available for sale securities below their cost that are other than temporary result in write-downs of the individual securities to their fair value. The related write-downs are included in earnings as realized losses. The Bank had no such losses for the years ended December 31, 2005, 2004, and 2003.

#### Revenue Recognition

Interest on loans is accrued and credited to operations based upon the principal amount outstanding. The accrual of interest income generally is discontinued when a loan becomes 90 days past due as to principal or interest. When interest accruals are discontinued, unpaid interest credited to income in the current year is reversed, and interest accrued in prior years is charged to the allowance for credit losses. Management may elect to continue the accrual of interest when the estimated net realizable value of collateral is sufficient to cover the principal balance and accrued interest, and the loan is in the process of collection.

Credit life insurance commissions on loans (principally short-term installment loans) are being recognized as collected. The use of this method of recognition does not produce results which are materially different from that which would have been produced if such commissions were deferred and amortized as an adjustment of loan yield over the life of the related loan.

#### Comprehensive Income

Effective January 1, 1999, the Bank adopted Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income." Pursuant to this rule, the Consolidated Statements of Changes in Shareholders' Equity now include a new measure called "Comprehensive Income," which includes net income as well as certain items that are reported within a separate component of shareholders' equity that bypass net income. Currently, the Bank's only component of other comprehensive income is its unrealized gains (losses) on securities available for sale.

## Notes To Consolidated Financial Statements For Years Ended December 31, 2005, 2004, And 2003 (Continued)

### Allowance for Credit Losses

The allowance for credit losses is maintained at a level considered adequate to provide for potential credit losses. The allowance is increased by provisions charged to operating expense and reduced by net charge offs. The level of the allowance is based on management's evaluation of potential losses in the loan portfolio, as well as prevailing and anticipated economic conditions.

Effective January 1, 1995, the Bank adopted Financial Accounting Standards (FAS) No. 114 (as amended by FAS 118), "Accounting by Creditors for Impairment of a Loan." Under this standard, a loan is considered impaired, based on current information and events, if it is probable that the Bank will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. The reserve for possible credit losses related to loans that are identified for evaluation, in accordance with FAS 114, is based on discounted cash flows using the loan's initial effective interest rate or the fair value of the collateral for certain collateral dependent loans. If the valuation is less than the recorded value of the loan, an impairment reserve must be established for the difference. The adoption of this standard did not have, and is not expected to have, a material effect on the Bank's financial position, results of operations, accounting policies or the determination of the adequacy of the allowance for credit losses.

### Bank Premises and Equipment

Bank premises and equipment are carried at original cost, less accumulated depreciation computed primarily on the modified accelerated cost recovery system over the estimated useful lives of the assets. Maintenance and repairs and minor improvements are charged to expense. Gains and losses on premises and equipment retired or sold are recognized currently in the statements of income.

### Other Real Estate

Real estate acquired through foreclosure is carried at the lower of cost or market value determined at the date of acquisition. Any excess of the loan balance over the fair market value is charged to the allowance for credit losses. Expenses incurred in connection with other real estate subsequent to acquisition are charged to operating expense.

### Income Taxes

The Bank follows the practice of accruing federal income taxes based on income reported for financial statement purposes. In the event income or expenses are recognized in different periods for tax, as opposed to financial purposes, deferred taxes are provided on such timing differences.

### Pension Plan

The Bank accounts for its pension plan in accordance with Statement of Financial Accounting Standards No. 132, "Employer's Accounting for Pensions." Pension accounting information is disclosed in Note 8 to the consolidated financial statements.

### Cash and Cash Equivalents

For the purpose of presentation in the statements of cash flows, cash and cash equivalents are defined as those amounts included in the balance sheet caption "Cash and Due from Banks."

### Off-Balance Sheet Financial Instruments

In the ordinary course of business, the Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded in the financial statements when they become payable.

## Note 2 Restrictions on Cash and Due from Banks:

Federal Reserve regulations require depository institutions to maintain cash reserves with the Federal Reserve Bank. The average amounts of required reserve balances were approximately \$7,718,000 and \$8,577,000 for the years ended December 31, 2005 and 2004, respectively.

## Notes To Consolidated Financial Statements

### For Years Ended December 31, 2005, 2004, And 2003 (Continued)

#### Note 3 Investment Securities:

The carrying amounts and approximate market values of investment securities at December 31, 2005 and 2004, are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>December 31, 2005</b>				
Available for Sale Securities -				
U.S. Government and Agency Securities	\$ 75,242,593	\$ 252,274	(\$ 593,304)	\$ 74,901,563
State and Municipal Securities	6,276,274	36,179	(52,098)	6,260,355
Totals	<u>\$ 81,518,867</u>	<u>\$ 288,453</u>	<u>(\$ 645,402)</u>	<u>\$ 81,161,918</u>
Held to Maturity Securities -				
U.S. Government and Agency Securities	<u>\$ 38,670,652</u>	<u>\$ 8,475</u>	<u>(\$ 1,627)</u>	<u>\$ 38,677,500</u>
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>December 31, 2004</b>				
Available for Sale Securities -				
U.S. Government and Agency Securities	\$ 91,422,085	\$ 1,611,762	(\$ 174,472)	\$ 92,859,375
State and Municipal Securities	4,985,365	68,255	(5,084)	5,048,536
Totals	<u>\$ 96,407,450</u>	<u>\$ 1,680,017</u>	<u>(\$ 179,556)</u>	<u>\$ 97,907,911</u>
Held to Maturity Securities -				
U.S. Government and Agency Securities	<u>\$ 38,819,674</u>	<u>\$ 3,501</u>	<u>(\$ 8,799)</u>	<u>\$ 38,814,376</u>

Investment securities with carrying amounts of \$35,436,337 and \$34,108,099 and market values of \$35,616,723 and \$35,292,198, respectively, were pledged to secure public deposits and for other purposes as required or permitted by law at December 31, 2005 and 2004.

Gross realized gains and gross realized losses on sales of available for sale securities for the years ended December 31, 2005, 2004, and 2003, are as follows:

	2005	2004	2003
Gross Realized Gains:			
U.S. Government and Agency Securities	<u>\$ 289,506</u>	<u>\$ 534,000</u>	<u>\$ -0-</u>
Gross Realized Losses:			
U.S. Government and Agency Securities	<u>\$ 990,188</u>	<u>\$ 492,009</u>	<u>\$ -0-</u>

The amortized cost and estimated market value of debt securities at December 31, 2005, by contractual maturities, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or repayment penalties.

	Available for Sale Securities		Held to Maturity Securities	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in One Year or Less	\$ 12,076,656	\$ 12,103,959	\$ 38,670,652	\$ 38,677,500
Due from One Year to Five Years	66,286,697	65,922,247	-0-	-0-
Due from Five Years to Ten Years	3,155,514	3,135,712	-0-	-0-
Due after Ten Years	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>
Totals	<u>\$ 81,518,867</u>	<u>\$ 81,161,918</u>	<u>\$ 38,670,652</u>	<u>\$ 38,677,500</u>

## Notes To Consolidated Financial Statements

### For Years Ended December 31, 2005, 2004, And 2003 (Continued)

#### Note 4 Loans:

Total loans at December 31, 2005 and 2004, by major loan categories are summarized as follows:

	2005	2004
Commercial	\$ 13,426,993	\$ 10,433,547
Real Estate - Construction and Mortgage	238,340,256	211,036,890
Installment	<u>11,940,172</u>	<u>13,160,595</u>
Gross Loans	\$ 263,707,421	\$ 234,631,032
Unearned Discount	<u>(264,160)</u>	<u>(610,624)</u>
Total Loans	\$ 263,443,261	\$ 234,020,408
Allowance for Credit Losses	<u>(2,700,000)</u>	<u>(4,206,248)</u>
Loans, Net	<u>\$ 260,743,261</u>	<u>\$ 229,814,160</u>

An analysis of the change in the allowance for credit losses follows:

	2005	2004	2003
Beginning Balances - January 1,	\$ 4,206,248	\$ 4,000,000	\$ 3,600,000
Loans Charged Off	(233,329)	(703,437)	(1,297,614)
Recoveries of Loans			
Previously Charged Off	115,600	909,685	829,649
Provision to Expense for Credit Losses	<u>(1,388,519)</u>	<u>-0-</u>	<u>867,965</u>
Ending Balances - December 31,	<u>\$ 2,700,000</u>	<u>\$ 4,206,248</u>	<u>\$ 4,000,000</u>

The provision for credit losses charged to expense is based upon credit loss experience and an evaluation of potential losses in the current loan and lease portfolio, including the evaluation of impaired loans under SFAS No. 's 114 and 118 (collectively, SFAS 114), "Accounting by Creditors for Impairment of a Loan" and "Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures." All nonaccrual loans on which a specific reserve calculation is required and significant troubled debt restructurings are considered impaired. Impairment is primarily measured based on the fair value of the loan's collateral. Impairment losses are included in the provision for credit losses. Loans collectively evaluated for impairment include certain smaller balance commercial loans, consumer loans and residential real estate loans. SFAS 114 does not apply to large groups of smaller balance homogeneous loans that are collectively evaluated for impairment, except for those loans restructured under a troubled debt restructuring. A loan is considered restructured when certain concessions are made to a financially troubled debtor that are not normally considered.

The following summarizes impaired loan information at December 31, 2005, 2004, and 2003:

	2005	2004	2003
Impaired Loans with Related Allowance	\$ -0-	\$ 268,484	\$ -0-
Impaired Loans with no Related Allowance	<u>-0-</u>	<u>770,809</u>	<u>575,641</u>
Total Impaired Loans	<u>\$ -0-</u>	<u>\$ 1,039,293</u>	<u>\$ 575,641</u>
Allowance on Impaired Loans	<u>\$ -0-</u>	<u>\$ 109,306</u>	<u>\$ 86,346</u>
Average Impaired Loans	<u>\$ 504,467</u>	<u>\$ 867,123</u>	<u>\$ 1,520,789</u>
Interest Income Recognized on Impaired Loans	<u>\$ -0-</u>	<u>\$ 22,465</u>	<u>\$ 10,696</u>

## Notes To Consolidated Financial Statements

### For Years Ended December 31, 2005, 2004, And 2003 (Continued)

Interest payments on impaired loans are typically applied to principal unless collectibility of the principal amounts is fully assured, in which case interest is recognized on the cash basis. Interest may be recognized on the accrual basis for certain troubled debt restructurings which are included in the impaired loan data above.

In the normal course of business, the Bank makes loans to executive officers and directors and related business interests on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons and do not involve more than the normal risk of collectibility.

The following presents the activity with respect to loans to related parties for 2005 and 2004:

	2005	2004
Balances - January 1,	\$ 8,248,183	\$6,619,353
New Loans	6,657,598	2,800,333
Repayments	<u>(1,124,887)</u>	<u>(1,171,503)</u>
Balances - December 31,	<u>\$13,780,894</u>	<u>\$8,248,183</u>

## Note 5

### Bank Premises and Equipment:

Major classifications of bank premises and equipment at December 31, 2005 and 2004, are summarized as follows:

	2005	2004
Buildings and Improvements	\$ 1,856,588	\$1,856,589
Furniture and Fixtures	<u>1,195,420</u>	<u>1,346,522</u>
	\$ 3,052,008	\$3,203,111
Less: Accumulated Depreciation	<u>2,291,677</u>	<u>2,401,410</u>
	\$ 760,331	\$ 801,701
Land	<u>200,460</u>	<u>200,460</u>
Bank Premises and Equipment, Net	<u>\$ 960,791</u>	<u>\$1,002,161</u>

Depreciation expense for the years ended December 31, 2005, 2004, and 2003, was \$188,532, \$195,699, and \$155,268, respectively, and is included in expenses of premises and equipment on the statements of income.

Putnam County Bank has entered into a noncancelable lease agreement (operating lease) with a related party for its Teays Valley branch. The minimum annual rental commitment under this lease, exclusive of taxes and other charges payable by the lessee at December 31, 2005, is as follows:

Year	Amount
2006	\$ 50,548
2007	<u>47,767</u>
Total	<u>\$ 98,315</u>

## Notes To Consolidated Financial Statements

### For Years Ended December 31, 2005, 2004, And 2003 (Continued)

#### Note 6 Deposits:

The major categories of deposits at December 31, 2005 and 2004, are as follows:

	2005	2004
Noninterest Bearing	<u>\$ 48,549,087</u>	<u>\$ 43,628,493</u>
Interest Bearing:		
Money Market	\$107,276,660	\$118,494,626
Savings	20,733,045	21,584,071
Time and Certificates of Deposit	101,756,795	113,250,007
Certificates of Deposit over \$100,000	<u>120,418,226</u>	<u>115,684,943</u>
Total Interest Bearing Deposits	<u>\$350,184,726</u>	<u>\$369,013,647</u>
Total Deposits	<u>\$398,733,813</u>	<u>\$412,642,140</u>

Scheduled maturities of time and certificates of deposits at December 31, 2005, are as follows:

2006	\$204,439,466
2007	14,403,962
2008	3,134,030
2009 and Thereafter	<u>197,563</u>
Total	<u>\$222,175,021</u>

The Bank has received deposits in the normal course of business from directors and officers of the Bank and their associates. Such related party deposits were accepted on substantially the same terms including interest rates and maturities as those prevailing at the time for comparable transactions with unrelated parties. The aggregate dollar amount of these deposits was approximately \$37,308,905 and \$31,870,709 at December 31, 2005 and 2004, respectively.

#### Note 7 Income Taxes:

The income tax provisions (benefits) included in the consolidated statements of income are summarized as follows:

	2005	2004	2003
Currently Payable:			
Federal	\$ 2,790,662	\$ 2,597,055	\$ 2,676,895
State	<u>357,506</u>	<u>342,367</u>	<u>369,203</u>
Totals	<u>\$ 3,148,168</u>	<u>\$ 2,939,422</u>	<u>\$ 3,046,098</u>
Deferred (Benefit):			
Federal	\$ 453,232	\$ 10	(\$ 235,362)
State	<u>55,543</u>	<u>1</u>	<u>(28,843)</u>
Totals	<u>\$ 508,775</u>	<u>\$ 11</u>	<u>(\$ 264,205)</u>
Total Applicable Income Taxes	<u>\$ 3,656,943</u>	<u>\$ 2,939,433</u>	<u>\$ 2,781,893</u>

## Notes To Consolidated Financial Statements

### For Years Ended December 31, 2005, 2004, And 2003 (Continued)

Timing differences in the recognition of income and expenses for tax and financial reporting purposes created the following components of deferred income taxes (benefit):

	2005	2004	2003
Bad Debts	\$ 508,754	\$ -0-	(\$ 263,481)
Discount on Investment Securities	<u>21</u>	<u>11</u>	<u>(724)</u>
Totals	<u>\$ 508,775</u>	<u>\$ 11</u>	<u>(\$ 264,205)</u>

The following is a reconciliation of consolidated federal income tax to the amount computed at the statutory rate:

	2005		2004		2003	
	Amount	%	Amount	%	Amount	%
Tax on Income before Income Tax at the Top Statutory Income Tax Rate	\$3,451,398	34.00%	\$2,763,414	34.00%	\$2,629,794	34.00%
Increase (Decrease) Resulting from:						
State Income Tax, Net of Federal Benefit	272,611	2.69	225,963	2.78	224,638	2.90
Nontaxable Interest Income	(75,031)	(.74)	(59,756)	(.73)	(80,141)	(1.04)
Nondeductible Interest Expense	5,926	.06	3,895	.05	4,960	.06
Other Items	<u>2,039</u>	<u>.02</u>	<u>5,917</u>	<u>.07</u>	<u>2,642</u>	<u>.03</u>
Tax on Income	<u>\$3,656,943</u>	<u>36.03%</u>	<u>\$2,939,433</u>	<u>36.17%</u>	<u>\$2,781,893</u>	<u>35.95%</u>

The approximate tax (benefit) effects of the net investment securities gains (losses) were (\$256,730), \$15,386, and \$-0- for the years 2005, 2004, and 2003, respectively.

## Notes To Consolidated Financial Statements

### For Years Ended December 31, 2005, 2004, And 2003 (Continued)

#### Note 8

##### Pension Plan:

The Bank is a participant in a multiple employer non-contributory defined benefit pension plan covering the majority of employees. The retirement benefits are based on length of service and the employee's compensation during his/her time of service.

The following table shows the plan's funded status at December 31, 2005 and 2004:

	2005	2004
Accumulated Pension Benefit Obligation:	\$ 3,476,252	\$2,851,745
Value of Future Salary Projections	<u>349,495</u>	<u>327,838</u>
Total Projected Pension Benefit Obligation	\$ 3,825,747	\$ 3,179,583
Fair Value of Plan Assets	<u>2,358,137</u>	<u>2,081,758</u>
Plan Assets in Excess (Deficient) of Projected Benefit Obligation	(\$ 1,467,610)	(\$1,097,825)
Unrecognized Prior Service Cost	(6,965)	(11,960)
Unrecognized Net Loss or (Gain)	1,594,990	1,162,548
Unrecognized Net Transition Liability or (Asset)	-0-	(2,697)
Accumulated Other Comprehensive Income	<u>(1,238,530)</u>	<u>(820,053)</u>
Unfunded (Accrued) or Prepaid Pension Cost	<u>(\$ 1,118,115)</u>	<u>(\$ 769,987)</u>

The components of pension (expense) income for the years ended December 31, 2005, 2004, and 2003, are as follows:

	2005	2004	2003
Service Cost-Benefits Earned			
During Year	(\$ 137,972)	(\$ 119,931)	(\$ 107,009)
Interest Cost on Projected Benefit Obligation	(209,848)	(193,575)	(185,365)
Actual Return on Assets	206,583	190,912	185,358
Amortization of Net Gain (Loss)	(57,776)	(35,765)	(12,097)
Net Amortization and Deferral	<u>7,692</u>	<u>12,554</u>	<u>12,554</u>
Net Periodic Pension (Cost) Benefit	<u>(\$ 191,321)</u>	<u>(\$ 145,805)</u>	<u>(\$ 106,559)</u>
Actuarial Assumptions:			
Weighted Average Discount Rate for Projected Benefit Obligation	6.50%	6.50%	6.50%
Weighted Average Rate of Compensation Increase	3.50%	3.50%	3.50%
Expected Long-Term Rate of Return on Plan Assets	8.50%	8.50%	8.50%



**Notes To Consolidated Financial Statements**  
**For Years Ended December 31, 2005, 2004, And 2003 (Continued)**

**Note 9**  
**Parent Company Condensed Financial Information:**

	CONDENSED BALANCE SHEETS	
	December 31,	
	2005	2004
<b>ASSETS</b>		
Investment in Subsidiary	\$57,534,930	\$51,938,607
Cash	<u>1,697</u>	<u>3,794</u>
Total Assets	<u>\$57,536,627</u>	<u>\$51,942,401</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Total Liabilities	\$ <u>-0-</u>	\$ <u>-0-</u>
Shareholders' Equity	<u>\$57,536,627</u>	<u>\$51,942,401</u>
Total Liabilities and Shareholders' Equity	<u>\$57,536,627</u>	<u>\$51,942,401</u>

	CONDENSED STATEMENTS OF INCOME		
	For Years Ended December 31,		
	2005	2004	2003
<b>INCOME</b>	\$ <u>915,379</u>	\$ <u>854,794</u>	\$ <u>855,936</u>
<b>EXPENSES:</b>			
Operating Expenses	\$ <u>29,097</u>	\$ <u>26,640</u>	\$ <u>18,208</u>
Income before Income Tax Benefit and Equity in Undistributed Earnings of Subsidiary	\$ <u>886,282</u>	\$ <u>828,154</u>	\$ <u>837,728</u>
Applicable Income Taxes (Benefit)	<u>(11,621)</u>	<u>(10,640)</u>	<u>(7,272)</u>
Income before Equity in Undistributed Earnings of Subsidiary	\$ <u>897,903</u>	\$ <u>838,794</u>	\$ <u>845,000</u>
Equity in Undistributed Earnings of Subsidiary	<u>5,596,323</u>	<u>4,349,462</u>	<u>4,107,797</u>
Net Income	<u>\$6,494,226</u>	<u>\$ 5,188,256</u>	<u>\$ 4,952,797</u>

**Notes To Consolidated Financial Statements**  
**For Years Ended December 31, 2005, 2004, And 2003** (Continued)

**CONDENSED STATEMENTS OF CASH FLOWS**  
**For Years Ended December 31,**

	2005	2004	2003
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net Income	\$ 6,494,226	\$ 5,188,256	\$ 4,952,797
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:			
Equity in Undistributed Earnings of Subsidiary	<u>(5,596,323)</u>	<u>(4,349,462)</u>	<u>(4,107,797)</u>
Net Cash Provided by Operating Activities	<u>\$ 897,903</u>	<u>\$ 838,794</u>	<u>\$ 845,000</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Dividends Paid	<u>(\$ 900,000)</u>	<u>(\$ 840,000)</u>	<u>(\$ 840,000)</u>
Net Cash Used in Financing Activities	<u>(\$ 900,000)</u>	<u>(\$ 840,000)</u>	<u>(\$ 840,000)</u>
Net Change in Cash and Cash Equivalents	(\$ 2,097)	(\$ 1,206)	\$ 5,000
Cash and Cash Equivalents at Beginning of Year	<u>3,794</u>	<u>5,000</u>	<u>-0-</u>
Cash and Cash Equivalents at End of Year	<u>\$ 1,697</u>	<u>\$ 3,794</u>	<u>\$ 5,000</u>

**Note 10**  
**Related Party Transactions:**

Some officers and directors (including their affiliates, families and related entities) of Putnam Bancshares, Inc. and its subsidiary are customers of the subsidiary and have had, and are expected to have, transactions with the subsidiary in the ordinary course of business. In addition, some officers and directors are also officers and directors of corporations which are customers of the Bank and have had, and are expected to have, transactions with the Bank in the ordinary course of business. In the opinion of management, such transactions are consistent with prudent banking practices and are within applicable banking regulations.

## Notes To Consolidated Financial Statements For Years Ended December 31, 2005, 2004, And 2003 (Continued)

### Note 11 Commitments and Contingent Liabilities:

The Bank's consolidated financial statements do not reflect various commitments and contingent liabilities that arise in the normal course of business and that involve elements of credit risk, interest rate risk, and liquidity risk. These commitments and contingent liabilities are commitments to extend credit, commercial letters of credit, and standby letters of credit. A summary of the Bank's commitments and contingent liabilities at December 31, 2005, is as follows:

	Notional Amount
Commitments to Extend Credit	\$ 27,236,567
Commercial Letters of Credit	-0-
Standby Letters of Credit	670,888

Commitments to extend credit, commercial letters of credit, and standby letters of credit all include exposure to some credit loss in the event of nonperformance of the customer. The Bank's credit policies and procedures for credit commitments and financial guarantees are the same as those for extension of credit that are recorded on the consolidated balance sheets. Because these instruments generally have fixed maturity dates, they do not generally present any significant liquidity risk to the Bank.

In the ordinary course of business, Putnam Bancshares, Inc. and its subsidiary are sometimes parties to various legal proceedings and claims. While any litigation contains an element of uncertainty, management is unaware of any legal proceedings at December 31, 2005, of which the result would have a material adverse effect upon the consolidated financial statements.

### Note 12 Concentrations of Credit Risk:

Cash due from correspondent banks, based on bank balances, exceeded federally insured limits by approximately \$8,435,000 at December 31, 2005. Federal funds sold are generally unsecured by the correspondent banks.

The majority of the Bank's loans, commitments, and commercial and standby letters of credit have been granted to customers in the Bank's market area. The rest are to customers from the area that have since relocated to other areas. Most of such customers are depositors of the Bank. Investments in state and municipal securities and loans to governmental entities are within the Bank's home state. The concentrations of credit by type of loan are set forth in Note 4. The distribution of commitments to extend credit approximates the distribution of loans outstanding. Commercial and standby letters of credit were granted primarily to commercial borrowers.

### Note 13 Regulatory Matters:

Putnam Bancshares, Inc.'s principal source of funds for future dividend payments to shareholders will be from dividend payments received from its wholly-owned subsidiary, Putnam County Bank.

The Bank, as a state chartered member bank of the Federal Reserve System, is subject to the dividend restrictions set forth by the West Virginia Division of Banking as well as the Federal Reserve Board. Under such restrictions, the Bank may not, without the prior approval of the West Virginia Division of Banking and the Federal Reserve Board, declare dividends in excess of the sum of the current year's earnings (as defined) plus the retained net profits (as defined) from the prior two years. The Bank normally restricts dividends to a lesser amount. The dividends as of December 31, 2005, that the Bank could declare without the approval of the West Virginia Division of Banking and the Federal Reserve Board, amounted to approximately \$9,942,000.

The Bank is also subject to various regulatory capital requirements administered by federal and state banking agencies. Failure to meet the minimum capital requirements can initiate certain actions by regulators that, if undertaken, could have a material effect on the Bank and the consolidated financial statements. Capital adequacy guidelines require minimum ratios of 4.00% for Tier 1 risk-based capital, 8.00% for total risk-based capital, and 4.00% for Tier 1 leverage capital. To be considered well capitalized under the regulatory framework for prompt corrective actions, the ratios must be at least 6.00%, 10.00%, and 5.00%, respectively.

Capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk-weighting of assets and certain off-balance sheet items, and other factors. As of December 31, 2005 and 2004, the Bank has met all capital adequacy requirements and had regulatory capital ratios in excess of the levels established for well capitalized institutions. There are no conditions or events since the most recent notification that management believes have changed the Bank's prompt corrective action category.

## Notes To Consolidated Financial Statements For Years Ended December 31, 2005, 2004, And 2003 (Continued)

The Bank's actual ratios as well as a comparison of the period-end capital balances with the related amounts established by the regulatory agencies are as follows:

	Ratios	Capital Amounts		
		Actual	Minimum	Well Capitalized
<b>As of December 31, 2005:</b>				
Tier 1 Risk-Based Capital	24.32%	\$57,537,000	\$ 9,462,000	\$ 14,192,000
Total Risk-Based Capital	25.47	60,237,000	18,923,000	23,654,000
Tier 1 Leverage Capital	12.56	57,537,000	18,324,000	22,905,000
<b>As of December 31, 2004:</b>				
Tier 1 Risk-Based Capital	24.49%	\$51,942,000	\$ 8,483,120	\$ 12,724,680
Total Risk-Based Capital	25.75	54,612,000	16,966,240	21,207,800
Tier 1 Leverage Capital	11.12	51,942,000	18,687,680	23,359,600

The Bank executed a written agreement on November 19, 2003, with the Federal Reserve Bank of Richmond and the West Virginia Division of Banking to take corrective measures to enhance and improve its programs and procedures for complying with the Bank Secrecy Act of the U.S. Department of the Treasury and with the anti-money laundering provisions of the Board of Governors of the Federal Reserve System.

### Note 14 Disclosures about Fair Value of Financial Instruments:

At December 31, 1995, the Bank adopted Financial Accounting Standards Board Statement 107, which requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent market settlement of the instruments. Statement 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Bank.

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

**Cash and Due from Banks:** The carrying amount reported in the balance sheet for cash and due from banks approximates that asset's fair value.

**Federal Funds Sold:** The carrying amount reported in the balance sheet for federal funds sold approximates that asset's fair value.

**Investment Securities:** Fair values for investment securities are based on quoted market prices where available. If quoted market prices are not available, fair values are based on quoted market prices of similar instruments.

**Loans:** The fair values of fixed rate commercial, real estate, and consumer loans are estimated using discounted cash flow analysis, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

**Deposits:** The estimated fair values of demand deposits (i.e. interest and noninterest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to their carrying amounts. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates, currently being offered on certificates, to a schedule of aggregated expected monthly maturities on time deposits.

**Notes To Consolidated Financial Statements**  
**For Years Ended December 31, 2005, 2004, And 2003 (Continued)**

The estimated fair values of the Bank's financial instruments at December 31, 2005 and 2004, are as follows:

	2005		2004	
	Carrying Amounts	Fair Value	Carrying Amounts	Fair Value
<b>Financial Assets:</b>				
Cash and Due from Banks	\$ 21,435,000	\$ 21,435,000	\$ 24,074,646	\$ 24,074,646
Federal Funds Sold	51,000,000	51,000,000	72,000,000	72,000,000
Investment Securities	119,832,570	119,839,418	136,727,585	136,722,286
Loans	263,443,261	268,712,126	234,133,569	238,816,240
<b>Financial Liabilities:</b>				
Deposits	398,733,813	398,892,784	412,642,140	412,806,656

**Note 15**  
**Reclassifications:**

Certain accounts from 2004 and 2003 have been reclassified so as to make the statements more comparable.