

Independent Auditor's Report

Board of Directors
Friendship BanCorp
Friendship, Indiana

We have audited the accompanying consolidated financial statements of Friendship BanCorp and its subsidiary, which comprise the consolidated balance sheet as of December 31, 2013, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for the year then ended, and the related notes to the 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.

Auditor's Responsibility

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

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

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

Opinion

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

Prior Year Audited by Other Auditors

The 2012 consolidated financial statements were audited by other auditors and their report thereon, dated April 2, 2013, expressed an unmodified opinion.

BKD, LLP

Indianapolis, Indiana
April 3, 2014

Friendship BanCorp
Consolidated Balance Sheets
December 31, 2013 and 2012

Assets

	<u>2013</u>	<u>2012</u>
Cash and due from banks	\$ 10,153,241	\$ 12,743,193
Federal funds sold	484,000	1,732,019
Cash and cash equivalents	10,637,241	14,475,212
Interest-bearing time deposits	1,953,590	200,000
Available-for-sale securities	40,579,633	42,235,642
Held to maturity securities (fair value of \$14,028,147 and \$15,305,227, respectively)	13,828,879	14,582,519
Loans held for sale	287,500	768,167
Loans	233,821,453	227,929,221
Allowance for loan losses	(2,274,480)	(2,309,465)
Loans, net	231,546,973	225,619,756
Premises and equipment, net	6,698,032	6,881,992
Restricted equity investments, at cost	2,352,450	2,352,450
Cash surrender value of life insurance policies	3,224,759	3,136,309
Goodwill	1,457,953	1,457,953
Other real estate	469,788	575,027
Other assets	2,594,445	3,047,674
	<u>\$ 315,631,243</u>	<u>\$ 315,332,701</u>

Liabilities and Shareholders' Equity

Liabilities

Deposits		
Noninterest-bearing	\$ 16,785,498	\$ 15,313,720
Interest-bearing	264,191,631	265,935,724
Total deposits	280,977,129	281,249,444
Federal Home Loan Bank advances	3,000,000	3,000,000
Notes payable	-	1,555,375
Accrued interest payable and other liabilities	2,046,526	2,441,519
Total liabilities	<u>286,023,655</u>	<u>288,246,338</u>

Shareholders' Equity

Common stock, no par value		
2,000,000 shares authorized; 880,999 (2013) and 870,655 (2012) shares issued and outstanding	3,628,632	3,276,936
Additional paid-in capital	567,709	510,962
Retained earnings	25,681,750	23,171,513
Accumulated other comprehensive income (loss)	(270,503)	260,827
Unearned ESOP	-	(133,875)
Total shareholders' equity	<u>29,607,588</u>	<u>27,086,363</u>
	<u>\$ 315,631,243</u>	<u>\$ 315,332,701</u>

Friendship BanCorp
Consolidated Statements of Income
Years Ended December 31, 2013 and 2012

	<u>2013</u>	<u>2012</u>
Interest Income		
Loans	\$ 13,686,181	\$ 14,327,470
Securities		
Taxable	524,679	601,881
Nontaxable	416,427	424,383
Other	122,258	107,808
Total interest income	<u>14,749,545</u>	<u>15,461,542</u>
Interest Expense		
Deposits	2,333,437	2,879,244
Federal Home Loan Bank advances and other debt	145,812	237,009
Total interest expense	<u>2,479,249</u>	<u>3,116,253</u>
Net Interest Income	12,270,296	12,345,289
Provision for Loan Losses	<u>470,000</u>	<u>600,000</u>
Net Interest Income After Provision for Loan Losses	<u>11,800,296</u>	<u>11,745,289</u>
Noninterest Income		
Service charges and fees	1,033,199	1,071,114
Insurance revenues	1,406,797	1,271,101
Net gain on sale of loans	230,193	489,731
Net gain (loss) on sales and calls of securities	(1,105)	7,961
Trust and investment product fees	149,046	138,843
Other	600,359	557,950
Total noninterest income	<u>3,418,489</u>	<u>3,536,700</u>
Noninterest Expense		
Salaries and employee benefits	6,185,520	5,962,615
Net occupancy and equipment expense	1,233,460	1,290,123
Data processing	188,811	290,935
Advertising	174,388	225,683
Professional services	183,880	184,203
Supplies	78,457	99,125
Postage	100,037	96,589
Telephone	73,483	74,331
FDIC insurance	178,000	173,200
Loss on extinguishment of debt	-	531,140
Other	1,610,476	1,499,331
Total noninterest expense	<u>10,006,512</u>	<u>10,427,275</u>
Income Before Income Tax	5,212,273	4,854,714
Provision for Income Taxes	<u>1,828,645</u>	<u>1,679,701</u>
Net Income	<u>\$ 3,383,628</u>	<u>\$ 3,175,013</u>

Friendship BanCorp
Consolidated Statements of Comprehensive Income
Years Ended December 31, 2013 and 2012

	2013	2012
Net Income	\$ 3,383,628	\$ 3,175,013
Other Comprehensive Income (Loss)		
Change in net unrealized appreciation (depreciation) on securities	(884,930)	79,106
Reclassification adjustment for realized (gains) losses included in net income	1,507	(6,911)
	(883,423)	72,195
Tax Effect	352,093	(28,597)
Total other comprehensive income (loss)	(531,330)	43,598
Comprehensive Income	\$ 2,852,298	\$ 3,218,611

Friendship BanCorp

Consolidated Statements of Changes in Shareholders' Equity

Years Ended December 31, 2013 and 2012

	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Unearned ESOP	Total
Balance, January 1, 2012	\$ 3,171,936	\$ 496,777	\$ 20,866,405	\$ 217,229	\$ (312,375)	\$ 24,439,972
Net income			3,175,013			3,175,013
Other comprehensive income				43,598		43,598
Stock-based compensation expense		14,185				14,185
Exercise of stock options (4,500 shares)	105,000					105,000
Compensation expense related to release of ESOP shares					178,500	178,500
Cash dividend (\$1.00 per share)			(869,905)			(869,905)
Balance, December 31, 2012	3,276,936	510,962	23,171,513	260,827	(133,875)	27,086,363
Net income			3,383,628			3,383,628
Other comprehensive loss				(531,330)		(531,330)
Stock-based compensation expense		14,247				14,247
Exercise of stock options (344 shares)	11,696					11,696
Compensation expense related to release of ESOP shares					133,875	133,875
Proceeds from sale of stock (10,000 shares)	340,000	42,500				382,500
Cash dividend (\$1.00 per share)			(873,391)			(873,391)
Balance, December 31, 2013	<u>\$ 3,628,632</u>	<u>\$ 567,709</u>	<u>\$ 25,681,750</u>	<u>\$ (270,503)</u>	<u>\$ -</u>	<u>\$ 29,607,588</u>

Friendship BanCorp

Consolidated Statements of Cash Flows

Years Ended December 31, 2013 and 2012

	2013	2012
Operating Activities		
Net income	\$ 3,383,628	\$ 3,175,013
Items not requiring (providing) cash		
Provision for loan losses	470,000	600,000
Depreciation and amortization	520,382	588,496
Net amortization and accretion of securities	433,754	362,428
Net realized (gain) loss on available-for-sale securities	1,507	(6,911)
Net realized gain on held-to-maturity securities	(402)	(1,050)
Net realized loss on sale of other real estate	13,127	17,898
Earnings on life insurance	(88,450)	(82,786)
Gain on sale of loans	(230,193)	(489,731)
(Gain) loss on sale of disposals of fixed assets	25,917	(8,427)
Loss on retirement of debt	-	531,140
Stock-based compensation	14,247	14,185
ESOP compensation expense	133,875	178,500
Changes in		
Loans held for sale	480,667	33,564
Accrued interest and other assets	805,321	403,877
Accrued expenses and other liabilities	(394,993)	(25,460)
Net cash provided by operating activities	<u>5,568,387</u>	<u>5,290,736</u>
Investing Activities		
Available-for-sale securities:		
Sales	2,056,600	-
Maturities, prepayments and calls	7,854,187	23,387,990
Purchases	(9,541,663)	(32,326,989)
Held-to-maturity securities:		
Maturities, prepayments and calls	1,002,279	995,505
Purchases	(280,035)	(2,354,393)
Loan originations and payments, net	(7,471,954)	(11,945,439)
Net change in interest-bearing deposits	(1,753,590)	300,000
Additions to premises and equipment, net	(362,339)	(386,686)
Proceeds from sale of other real estate	1,397,042	1,281,495
Purchase of bank owned life insurance	-	(1,000,000)
Net cash used in investing activities	<u>(7,099,473)</u>	<u>(22,048,517)</u>
Financing Activities		
Net change in deposits	(272,315)	22,539,428
Repayments on Federal Home Loan Bank advances	-	(9,531,140)
Repayments of note payable	(1,555,375)	(600,000)
Cash dividends paid	(873,391)	(869,905)
Proceeds from sale of stock	382,500	-
Proceeds from exercise of stock options	11,696	105,000
Net cash provided by (used in) financing activities	<u>(2,306,885)</u>	<u>11,643,383</u>
Net Change in Cash and Cash Equivalents	(3,837,971)	(5,114,398)
Cash and Cash Equivalents, Beginning of Year	14,475,212	19,589,610
Cash and Cash Equivalents, End of Year	\$ 10,637,241	\$ 14,475,212
Supplemental Cash Flows Information		
Interest paid	\$ 2,487,404	\$ 3,129,581
Income taxes paid	1,995,000	2,035,000
Noncash Supplemental Information		
Loans transferred to other real estate	\$ 1,304,930	\$ 1,150,874

Friendship BanCorp

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

Note 1: Nature of Operations and Summary of Significant Accounting Policies

Principles of Consolidation

The consolidated financial statements include Friendship BanCorp (Company) and its wholly owned subsidiary, The Friendship State Bank, with its wholly owned subsidiary, Friendship Financial Services, LLC, together referred to as “the Bank.” Intercompany transactions and balances are eliminated upon consolidation.

Nature of Operations

The Bank is primarily engaged in providing a variety of deposit and lending services to individual customers in southeastern Indiana. Its primary deposit products are checking, savings, and term certificate accounts, and its primary lending products are residential mortgage, commercial, and installment loans. 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. There are no significant concentrations of loans to any one industry or customer. However, the customers’ ability to repay their loans is dependent on the real estate and general economic conditions in the area. Friendship Financial Services is a full service insurance agency and sells those products, as agent, to its customers.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect 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.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, valuation of real estate acquired in connection with foreclosures or in satisfaction of loans, other-than temporary impairments (OTTI) and fair value of financial instruments. In connection with the determination of the allowance for loan losses and valuation of foreclosed assets held for sale, management obtains independent appraisals for significant properties.

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

Friendship BanCorp
Notes to Consolidated Financial Statements
December 31, 2013 and 2012

Cash and Cash Equivalents

Cash and cash equivalents consist of cash on hand and in other institutions and interest-bearing demand deposits.

Interest-Bearing Time Deposits

Interest bearing time deposits mature within five years and are carried at cost.

Investment Securities

Debt securities are classified as held to maturity when the Company has the positive intent and ability to hold the securities to maturity. Securities held to maturity are carried at amortized cost. Debt securities not classified as held to maturity are classified as available for sale. Securities available for sale are carried at fair value with unrealized gains and losses reported separately in accumulated other comprehensive income (loss), net of tax.

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. Gains and losses on sales are recorded on the trade date and are based on the amortized cost of the individual security sold.

When the Company does not intend to sell a debt security, and it is more likely than not, the Company will not have to sell the security before recovery of its cost basis, it recognizes the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income (loss). For held-to-maturity debt securities, the amount of an other-than-temporary impairment recorded in other comprehensive income (loss) for the noncredit portion of a previous other-than-temporary impairment is amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security.

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 by charges to noninterest income. Gains and losses on loan sales are recorded in noninterest income, and direct loan origination costs and fees are deferred at origination of the loan and are recognized in noninterest income upon sale of the loan.

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoffs are reported at their outstanding principal balances adjusted for unearned income, charge-offs, the allowance for loan losses, any unamortized deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans.

Friendship BanCorp

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

For loans amortized at cost, interest income is accrued based on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, as well as premiums and discounts, are deferred and amortized as a level yield adjustment over the respective term of the loan.

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

All interest accrued but not collected for loans that are placed on nonaccrual or charged off are reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. Discounts and premiums on purchased residential real estate loans are amortized to income using the interest method over the remaining period to contractual maturity, adjusted for anticipated prepayments. Discounts and premiums on purchased consumer loans are recognized over the expected lives of the loans using methods that approximate the interest method.

Concentration of Credit Risk

Most of the Company's business activity is with customers located within Ripley, Dearborn, Ohio, and Switzerland counties. Therefore, the Company's exposure to credit risk is significantly affected by changes in the economy in the area.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to income. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of allocated and general components. The allocated component relates to loans that are classified as impaired. For those loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers nonclassified loans and is based on historical charge-off experience and expected loss given default derived from the Bank's internal risk rating process. Other adjustments may be made to the allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected in the historical loss or risk rating data.

Friendship BanCorp

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

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

Groups of loans with similar risk characteristics are collectively evaluated for impairment based on the group's historical loss experience adjusted for changes in trends, conditions and other relevant factors that affect repayment of the loans. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment measurements, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower.

Premises and Equipment

Land is carried at cost. Depreciable assets are stated at cost, less accumulated depreciation. Depreciation is charged to expense using the straight-line method over the estimated useful lives of the assets.

The Bank evaluates the recoverability of the carrying value of long-lived assets whenever events or circumstances indicate the carrying amount may not be recoverable. If a long-lived asset is tested for recoverability and the undiscounted estimated future cash flows expected to result from the use and eventual disposition of the asset is less than the carrying amount of the asset, the asset cost is adjusted to fair value and an impairment loss is recognized as the amount by which the carrying amount of a long-lived asset exceeds its fair value. No asset impairment was recognized during the years ended December 31, 2013 and 2012.

Restricted Equity Investments

Restricted equity investments include Federal Home Loan Bank (FHLB) of Indianapolis stock, Federal Reserve Bank (FRB) stock, and Bankers' Bank of Kentucky stock. This restricted stock is carried at cost and periodically evaluated for impairment. Because this stock is viewed as a long-term investment, impairment is based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

Friendship BanCorp

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

Cash Surrender Value of Life Insurance Policies

The Bank has purchased life insurance policies on certain key executives. Bank-owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Goodwill and Other Intangible Assets

Goodwill resulting from business combinations prior to January 1, 2009 represents the excess of the purchase price over the fair value of the net assets of businesses acquired. Goodwill resulting from business combinations after January 1, 2009, is generally determined as the excess of the fair value of the consideration transferred, plus the fair value of any noncontrolling interests in the acquired business, over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimate residual values. Goodwill is the only intangible asset with an indefinite life on the balance sheet.

Intangible assets are amortized on an accelerated method over their estimated useful lives, which range from 2 to 7 years. The current balance of intangible assets is \$119,583 and \$154,583 at December 31, 2013 and 2012, respectively. Amortization expense is \$35,000 and \$73,298 for 2013 and 2012, respectively.

Other Real Estate

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

Servicing Assets

Servicing assets are recognized separately when they are acquired through sales of loans. When mortgage loans are sold, servicing assets are initially recorded at fair value with the income statement effect recorded in gain on sale of loans. Fair value is based on market prices for comparable mortgage servicing contracts. The Company uses the amortization method, which requires servicing rights to be amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans. Servicing assets are included in other assets.

Friendship BanCorp

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

Servicing assets are evaluated for impairment based upon the fair value of the assets as compared to carrying amount. Impairment is determined by stratifying assets into groupings based on predominant risk characteristics, such as loan type and investor type. Impairment is recognized through a valuation allowance for an individual grouping, to the extent that fair value is less than the carrying amount. If the Company later determines that all or a portion of the impairment no longer exists for a particular grouping, a reduction of the allowance may be recorded as an increase to income. Changes in valuation allowances are reported with other income on the income statement. The fair values of servicing assets are subject to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses.

The fair values of servicing rights are subject to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses.

Servicing fee income which is reported on the income statement as other income is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal; or a fixed amount per loan and are recorded as income when earned. The amortization of servicing assets is netted against loan servicing fee income.

Stock-Based Compensation

Compensation cost is recognized for stock options issued to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options. Compensation cost is recognized over the required 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

The Bank accounts for income taxes in accordance with income tax accounting guidance (ASC 740, *Income Taxes*). The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Bank determines deferred income taxes using the liability method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Friendship BanCorp

Notes to Consolidated Financial Statements

December 31, 2013 and 2012

Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term “more-likely-than-not” means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances and information available at the reporting date and is subject to the management’s judgment. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

The Bank would recognize interest and penalties on income taxes as a component of income tax expense, if applicable.

Employee Stock Ownership Plan

The cost of shares issued to the ESOP, but not yet allocated to participants, is shown as a reduction of shareholders’ equity. Compensation expense is based on the market price of shares as they are committed to be released to participant accounts. Dividends on allocated ESOP shares reduce retained earnings; dividends on unearned ESOP shares reduce debt and accrued interest.

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. Management does not believe there now are such matters that will have a material effect on the consolidated financial statements.

Off-Balance Sheet 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.

Comprehensive Income (Loss)

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

Friendship BanCorp
Notes to Consolidated Financial Statements
December 31, 2013 and 2012

Dividend Restriction

Banking regulations require maintaining certain capital levels and may limit the dividends paid by the bank to the holding company or by the holding company to shareholders.

Fair Value of Financial Instruments

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. 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.

Subsequent Events

Subsequent events have been evaluated through the date of the Independent Auditor's Report, which is the date of the consolidated financial statements were available to be issued.

Note 2: Restriction on Cash and Due from Banks

Cash and cash equivalents consist of cash on hand and in other institutions and interest-bearing demand deposits.

At December 31, 2013, the Company's cash accounts exceeded federally insured limits by approximately \$6,261,000. Additionally, the Company has approximately \$170,000 on deposit with the Federal Reserve Bank and Federal Home Loan Bank of Indianapolis as of December 31, 2013, which are not federally insured.

The Company is required to maintain reserve funds in cash on deposit with the Federal Reserve Bank. The reserve required at December 31, 2013 was \$5,944,000.

Friendship BanCorp
Notes to Consolidated Financial Statements
December 31, 2013 and 2012

Note 3: Securities

The following table summarizes the amortized cost and fair value of the available-for-sale securities portfolio at December 31, 2013 and 2012 and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive income were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale Securities				
December 31, 2013				
U.S. Treasury and government agency	\$ 32,426,083	\$ 71,397	\$ (715,594)	\$ 31,781,886
Mortgage-backed securities - residential	5,605,619	97,468	(13,027)	5,690,060
Corporate debt	2,999,449	109,401	(1,163)	3,107,687
	<u>\$ 41,031,151</u>	<u>\$ 278,266</u>	<u>\$ (729,784)</u>	<u>\$ 40,579,633</u>
December 31, 2012				
U.S. Treasury and government agency	\$ 29,640,790	\$ 139,077	\$ (21,081)	\$ 29,758,786
Mortgage-backed securities - residential	9,163,207	163,938	-	9,327,145
Corporate debt	2,999,741	154,135	(4,165)	3,149,711
	<u>\$ 41,803,738</u>	<u>\$ 457,150</u>	<u>\$ (25,246)</u>	<u>\$ 42,235,642</u>

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The amortized cost, unrecognized gains and losses, and fair value of securities held to maturity were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Approximate Fair Value
Held-to-Maturity Securities				
December 31, 2013				
State and political subdivisions	<u>\$ 13,828,879</u>	<u>\$ 384,212</u>	<u>\$ (184,944)</u>	<u>\$ 14,028,147</u>
December 31, 2012				
State and political subdivisions	<u>\$ 14,582,519</u>	<u>\$ 807,149</u>	<u>\$ (84,441)</u>	<u>\$ 15,305,227</u>

During 2013, the Company recognized gross losses of approximately \$2,000 on the sale of available-for-sale securities.

Certain investment securities at December 31, 2013 were reported in the financial statements at an amount less than their historical cost. Total fair value of these investments at December 31, 2013 was \$20,708,000, which is approximately 38% of the Company's investment portfolio.

Based on evaluation of available evidence, including recent changes in market interest rates, credit rating information and information obtained from regulatory filings, management believes the declines in fair value for the Company's securities are temporary.

Should the impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period the other-than-temporary impairment is identified.

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Notes to Consolidated Financial Statements

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The following tables show the Company's investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2013 and 2012:

Description of Securities	2013					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available for sale						
U.S. Treasury and government agency	\$ 14,387,754	\$ (627,775)	\$ 912,181	\$ (87,819)	\$ 15,299,935	\$ (715,594)
Corporate debt	498,463	(1,163)	-	-	498,463	(1,163)
Mortgage-backed securities - residential	1,097,662	(13,027)	-	-	1,097,662	(13,027)
Held to maturity						
States and political subdivisions	2,820,708	(91,276)	991,332	(93,668)	3,812,040	(184,944)
Total temporarily impaired	<u>\$ 18,804,587</u>	<u>\$ (733,241)</u>	<u>\$ 1,903,513</u>	<u>\$ (181,487)</u>	<u>\$ 20,708,100</u>	<u>\$ (914,728)</u>

Description of Securities	2012					
	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Available for sale						
U.S. Treasury and government agency	\$ -	\$ -	\$ 8,242,994	\$ (21,081)	\$ 8,242,994	\$ (21,081)
Corporate debt	-	-	495,835	(4,165)	495,835	(4,165)
Held to maturity						
States and political subdivisions	134,886	(114)	2,610,488	(84,327)	2,745,374	(84,441)
Total temporarily impaired	<u>\$ 134,886</u>	<u>\$ (114)</u>	<u>\$ 11,349,317</u>	<u>\$ (109,573)</u>	<u>\$ 11,484,203</u>	<u>\$ (109,687)</u>

U.S. Treasury and Government Agencies

The unrealized losses on the Company's investments in direct obligations of U.S. government agencies were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2013.

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State and Political Subdivisions

The unrealized losses on the Company's investments in securities of state and political subdivisions were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2013.

The amortized cost and fair value of the investment securities portfolio by contractual maturity are shown below. Expected maturities may differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Securities, not due at a single maturity date, primarily mortgage-backed securities are shown separately.

	Available-for-Sale	
	Amortized Cost	Fair Value
Within one year	\$ 16,780,101	\$ 16,785,279
One to five years	7,430,016	7,434,365
Five to ten years	10,715,790	10,164,468
After ten years	499,625	505,461
	<u>35,425,532</u>	<u>34,889,573</u>
Mortgage-backed securities - residential	5,605,619	5,690,060
Total	<u>\$ 41,031,151</u>	<u>\$ 40,579,633</u>

	Held-to-Maturity	
	Amortized Cost	Fair Value
Within one year	\$ 750,240	\$ 755,457
One to five years	5,832,306	5,998,409
Five to ten years	5,493,992	5,566,112
After ten years	1,752,341	1,708,169
	<u>13,828,879</u>	<u>14,028,147</u>
Total	<u>\$ 13,828,879</u>	<u>\$ 14,028,147</u>

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Notes to Consolidated Financial Statements
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Note 4: Loans and Allowance for Loan Losses

Total loans are comprised at December 31, 2013 and 2012 include:

	2013	2012
Commercial	\$ 8,597,618	\$ 7,222,399
Agricultural	14,775,916	16,318,199
Real estate	198,485,170	192,916,549
Municipal	805,220	709,608
Consumer	11,157,529	10,762,466
	<u>\$ 233,821,453</u>	<u>\$ 227,929,221</u>

Certain directors and executive officers of the Bank, including their families and companies in which they are the principal owners, were customers of and had other transactions with the Bank. Total loans to these persons were \$5,252,552 and \$6,849,793 at December 31, 2013 and 2012.

Mortgage loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of these loans at December 31, 2013 and 2012 were \$47,458,085 and \$46,448,347. At December 31, 2013, the fair value of servicing rights was approximately \$299,000.

Activity for capitalized mortgage-servicing rights was as follows.

	2013	2012
Beginning of year	\$ 249,486	\$ 216,553
Additions	75,937	138,955
Amortized to expense	<u>(114,191)</u>	<u>(106,022)</u>
End of year	<u>\$ 211,232</u>	<u>\$ 249,486</u>

There was no valuation allowance activity for 2013 and 2012.

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Notes to Consolidated Financial Statements

December 31, 2013 and 2012

The following tables present the activity in the allowance for loan losses by portfolio segment for the years ended December 31, 2013 and 2012.

	2013						
	Commercial	Agricultural	Real Estate	Municipal	Consumer	Unallocated	Total
Beginning Balance	\$ 77,160	\$ 40,795	\$ 1,685,943	\$ 1,774	\$ 214,827	\$ 288,966	\$ 2,309,465
Provision	(14,275)	99,193	668,715	777	4,556	(288,966)	470,000
Loans charged off	-	(82,681)	(559,872)	-	(80,843)	-	(723,396)
Recoveries	5,197	-	172,666	-	40,348	-	218,211
Ending Balance	<u>\$ 68,082</u>	<u>\$ 57,307</u>	<u>\$ 1,967,452</u>	<u>\$ 2,551</u>	<u>\$ 178,888</u>	<u>\$ -</u>	<u>\$ 2,274,280</u>

	2012						
	Commercial	Agricultural	Real Estate	Municipal	Consumer	Unallocated	Total
Beginning Balance	\$ 115,544	\$ 42,420	\$ 1,698,051	\$ 2,642	\$ 188,029	\$ 144,502	\$ 2,191,188
Provision	(42,917)	(1,625)	424,510	(868)	76,436	144,464	600,000
Loans charged off	-	-	(439,781)	-	(70,533)	-	(510,314)
Recoveries	4,533	-	3,163	-	20,895	-	28,591
Ending Balance	<u>\$ 77,160</u>	<u>\$ 40,795</u>	<u>\$ 1,685,943</u>	<u>\$ 1,774</u>	<u>\$ 214,827</u>	<u>\$ 288,966</u>	<u>\$ 2,309,465</u>

The following tables present the balance in the allowance for loan losses and the recorded investment in loans based on the portfolio segment and impairment method as of December 31, 2013 and 2012:

	December 31, 2013						
	Commercial	Agricultural	Real Estate	Municipal	Consumer	Unallocated	Total
Allowance Balances:							
Ending allowance balance attributable to loans:							
Individually evaluated for impairment	\$ 19,623	\$ 10,617	\$ 744,881	\$ -	\$ 47,936	\$ -	\$ 823,057
Collectively evaluated for impairment	48,459	46,690	1,222,571	2,551	130,952	-	1,451,223
Total allowance for loan losses	<u>\$ 68,082</u>	<u>\$ 57,307</u>	<u>\$ 1,967,452</u>	<u>\$ 2,551</u>	<u>\$ 178,888</u>	<u>\$ -</u>	<u>\$ 2,274,280</u>
Loan Balances:							
Individually evaluated for impairment	\$ 55,189	\$ 50,082	\$ 4,302,894	\$ -	\$ 68,363	\$ -	\$ 4,476,528
Collectively evaluated for impairment	8,542,429	14,725,834	194,182,276	805,220	11,089,166	-	229,344,925
Total loan balances	<u>\$ 8,597,618</u>	<u>\$ 14,775,916</u>	<u>\$ 198,485,170</u>	<u>\$ 805,220</u>	<u>\$ 11,157,529</u>	<u>\$ -</u>	<u>\$ 233,821,453</u>

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Notes to Consolidated Financial Statements

December 31, 2013 and 2012

	December 31, 2012						
	Commercial	Agricultural	Real Estate	Municipal	Consumer	Unallocated	Total
Allowance Balances:							
Ending allowance balance attributable to loans:							
Individually evaluated for impairment	\$ -	\$ -	\$ 240,183	\$ -	\$ -	\$ -	\$ 240,183
Collectively evaluated for impairment	<u>77,160</u>	<u>40,795</u>	<u>1,445,760</u>	<u>1,774</u>	<u>214,827</u>	<u>288,966</u>	<u>2,069,282</u>
Total allowance for loan losses	<u>\$ 77,160</u>	<u>\$ 40,795</u>	<u>\$ 1,685,943</u>	<u>\$ 1,774</u>	<u>\$ 214,827</u>	<u>\$ 288,966</u>	<u>\$ 2,309,465</u>
Loan Balances:							
Individually evaluated for impairment	\$ 340,928	\$ -	\$ 2,235,539	\$ -	\$ -	\$ -	\$ 2,576,467
Collectively evaluated for impairment	<u>6,881,471</u>	<u>16,318,199</u>	<u>190,681,010</u>	<u>709,608</u>	<u>10,762,466</u>	<u>-</u>	<u>225,352,754</u>
Total loan balances	<u>\$ 7,222,399</u>	<u>\$ 16,318,199</u>	<u>\$ 192,916,549</u>	<u>\$ 709,608</u>	<u>\$ 10,762,466</u>	<u>\$ -</u>	<u>\$ 227,929,221</u>

The risk characteristics of each loan portfolio segment are as follows:

Commercial

Commercial loans are primarily based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. Borrowers may be subject to adverse economic conditions that can lead to decreases in product demand; increasing material or other production costs; interest rate increase that could have an adverse impact on profitability; non-payment of credit that has been extended under normal vendor terms for goods sold or services extended; interruption related to the importing or exporting of production materials or sold products.

Agricultural

Agricultural loans are typically secured by crops or other farm equipment. These loans are subject to risks which could cause poor operating performance of the borrower, such as adverse weather conditions; fluctuation of price of agricultural commodities; and the general economy.

Real Estate

Real estate loans are generally secured by 1-4 family residences, multifamily residences, or farm real estate, and are generally owner occupied. Home equity loans are typically secured by a subordinate interest in 1-4 family residences. These loans are subject to adverse employment conditions in the local economy leading to increased default rate; decreased market values from oversupply in a geographic area; impact to borrowers' ability to maintain payments in the event of incremental rate increases on adjustable rate mortgages.

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Notes to Consolidated Financial Statements

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Municipal

Municipal obligations are generally secured by specific assets or the taxing power of the municipality. These loans are subject to adverse employment conditions in the local economy and lower real estate values, which can reduce the municipality's tax base.

Consumer

Consumer loans generally consist of loans secured by personal property or unsecured loans such as credit cards. Repayment of these loans is primarily dependent on the personal income of the borrowers, who are subject to adverse employment conditions in the local economy, which may lead to higher unemployment.

Internal Risk Categories

Loan grades are numbered 1 through 8. Grades 1 through 4 are considered satisfactory grades. The grade of 5, Special Mention, represents loans of lower quality and is considered criticized. The grades of 6, or Substandard, and 7, or Doubtful, refer to assets that are classified. The use and application of these grades by the bank will be uniform and shall conform to the bank's policy.

Pass (1-4) Loans of reasonable credit strength and repayment ability proving an average credit risk due to one or more underlying weaknesses.

Special Mention (5) A special mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification. Ordinarily, special mention credits have characteristics which corrective management action would remedy.

Substandard (6) Loans in this category are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Substandard loans have a high probability of payment default, or they have other well-defined weaknesses. Such loans have a distinct potential for loss; however, an individual loan's potential for loss does not have to be distinct for the loan to be rated substandard.

The following are examples of situations that might cause a loan to be graded a "6":

- Cash flow deficiencies (losses) jeopardize future loan payments.
- Sale of noncollateral assets has become a primary source of loan repayment.
- The relationship has deteriorated to the point that sale of collateral is now the Company's primary source of repayment, unless this was the original source of loan repayment.
- The borrower is bankrupt or for any other reason future repayment is dependent on court action.

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Doubtful (7) A loan classified as doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of current existing facts, conditions, and values, highly questionable and improbable. A doubtful loan has a high probability of total or substantial loss. Doubtful borrowers are usually in default, lack adequate liquidity or capital, and lack the resources necessary to remain an operating entity. Because of high probability of loss, nonaccrual accounting treatment will be required for doubtful loans.

Loss (8) Loans classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off the loan even though partial recovery may be affected in the future.

The following tables present the credit risk profile of the Company's loan portfolio based on rating category and payment activity as of December 31, 2013 and 2012:

December 31, 2013						
	Pass	Special Mention	Substandard	Doubtful	Not Rated	Total
Commercial	\$ 8,519,116	\$ 12,703	\$ 65,799	\$ -	\$ -	\$ 8,597,618
Agricultural	14,152,503	265,754	357,659	-	-	14,775,916
Real estate						
Construction	9,234,369	-	261,961	-	-	9,496,330
Commercial	29,638,979	280,678	660,081	-	-	30,579,738
Residential	157,289,479	-	1,119,623	-	-	158,409,102
Municipal	-	-	-	-	805,220	805,220
Consumer	-	-	-	-	11,157,529	11,157,529
Total	<u>\$ 218,834,446</u>	<u>\$ 559,135</u>	<u>\$ 2,465,123</u>	<u>\$ -</u>	<u>\$ 11,962,749</u>	<u>\$ 233,821,453</u>

December 31, 2012						
	Pass	Special Mention	Substandard	Doubtful	Not Rated	Total
Commercial	\$ 6,217,298	\$ 342,829	\$ 662,272	\$ -	\$ -	\$ 7,222,399
Agricultural	16,234,152	-	84,047	-	-	16,318,199
Real estate						
Construction	10,091,483	-	189,915	-	-	10,281,398
Commercial	29,446,357	50,744	532,007	-	-	30,029,108
Residential	151,004,084	-	1,601,959	-	-	152,606,043
Municipal	-	-	-	-	709,608	709,608
Consumer	-	-	-	-	10,762,466	10,762,466
Total	<u>\$ 212,993,374</u>	<u>\$ 393,573</u>	<u>\$ 3,070,200</u>	<u>\$ -</u>	<u>\$ 11,472,074</u>	<u>\$ 227,929,221</u>

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The following tables present the Company's loan portfolio aging analysis of the recorded investment in loans as of December 31, 2013 and 2012:

December 31, 2013						
	30-59 Past Due	60-89 Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans
Commercial	\$ 117,611	\$ -	\$ -	\$ 117,611	\$ 8,480,007	\$ 8,597,618
Agricultural	-	-	-	-	14,775,916	14,775,916
Real Estate						
Construction	-	-	-	-	9,496,330	9,496,330
Commercial	319,775	-	42,906	362,681	30,217,057	30,579,738
Residential	4,599,370	258,334	463,300	5,321,004	153,088,098	158,409,102
Municipal	-	-	-	-	805,220	805,220
Consumer	296,248	4,433	7,765	308,446	10,849,083	11,157,529
Total loans	\$ 5,333,004	\$ 262,767	\$ 513,971	\$ 6,109,742	\$ 227,711,711	\$ 233,821,453

December 31, 2012						
	30-59 Past Due	60-89 Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans
Commercial	\$ 147,431	\$ -	\$ -	\$ 147,431	\$ 7,074,968	\$ 7,222,399
Agricultural	2,040	-	-	2,040	16,316,159	16,318,199
Real Estate						
Construction	-	-	-	-	10,281,398	10,281,398
Commercial	255,841	201,433	25,084	482,358	29,546,750	30,029,108
Residential	3,778,531	1,013,139	1,601,539	6,393,209	146,212,834	152,606,043
Municipal	-	-	-	-	709,608	709,608
Consumer	144,822	4,573	-	149,395	10,613,071	10,762,466
Total loans	\$ 4,328,665	\$ 1,219,145	\$ 1,626,623	\$ 7,174,433	\$ 220,754,788	\$ 227,929,221

As of December 31, 2013, the Company had one consumer loan greater than 90 days past due and accruing for \$7,765.

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The following table presents the Company's nonaccrual loans at December 31, 2013 and 2012:

	2013	2012
Commercial	\$ -	\$ -
Agricultural	-	-
Real estate		
Construction	261,961	-
Commercial	42,906	25,084
Residential	463,300	1,601,539
Municipal	-	-
Consumer	-	-
	<u> </u>	<u> </u>
Total nonaccrual loans	<u>\$ 768,167</u>	<u>\$ 1,626,623</u>

The following tables present impaired loans for the years ended December 31, 2013 and 2012:

	December 31, 2013					
	Recorded Balance	Unpaid Principal Balance	Specific Allowance	Average Investment in Impaired Loans	Interest Income Recognized	Cash Basis Interest Recognized
Impaired loans without a specific valuation allowance:						
Commercial	-	-	-	-	-	-
Agricultural	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Real estate						
Construction	-	-	-	-	-	-
Commercial	-	-	-	-	-	-
Residential	415,365	415,365	-	489,522	36,481	-
Municipal	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total	<u>415,365</u>	<u>415,365</u>	<u>-</u>	<u>489,522</u>	<u>36,481</u>	<u>-</u>
Impaired loans with a specific valuation allowance:						
Commercial	55,189	55,189	19,623	44,051	2,209	-
Agricultural	50,082	50,082	10,617	44,531	3,288	-
Real estate						
Construction	261,961	261,961	52,438	65,490	-	-
Commercial	1,073,809	1,073,809	211,304	1,088,728	66,754	-
Residential	2,551,759	2,551,759	481,139	2,568,025	130,316	-
Municipal	-	-	-	-	-	-
Consumer	68,363	68,363	47,936	63,743	7,902	-
Total	<u>4,061,163</u>	<u>4,061,163</u>	<u>823,057</u>	<u>3,874,568</u>	<u>210,469</u>	<u>-</u>
Total impaired loans	<u>\$ 4,476,528</u>	<u>\$ 4,476,528</u>	<u>\$ 823,057</u>	<u>\$ 4,364,090</u>	<u>\$ 246,950</u>	<u>\$ -</u>

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December 31, 2012						
	Recorded Balance	Unpaid Principal Balance	Specific Allowance	Average Investment in Impaired Loans	Interest Income Recognized	Cash Basis Interest Recognized
Impaired loans without a specific valuation allowance:						
Commercial	\$ 340,928	\$ 340,928	\$ -	\$ 424,913	\$ 27,700	\$ 27,324
Agricultural	-	-	-	5,114	-	694
Real estate	-	-	-	-	-	-
Construction	-	-	-	-	-	-
Commercial	608,916	608,916	-	713,475	46,772	46,252
Residential	-	-	-	68,894	-	-
Municipal	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total	949,844	949,844	-	1,212,396	74,472	74,270
Impaired loans with a specific valuation allowance:						
Commercial	-	-	-	-	-	-
Agricultural	-	-	-	-	-	-
Real estate	-	-	-	-	-	-
Construction	-	-	-	-	-	-
Commercial	25,084	25,084	25,084	26,081	1,759	809
Residential	1,601,539	1,601,539	215,099	1,582,405	60,938	2,992
Municipal	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total	1,626,623	1,626,623	240,183	1,608,486	62,697	3,801
Total impaired loans	\$ 2,576,467	\$ 2,576,467	\$ 240,183	\$ 2,820,882	\$ 137,169	\$ 78,071

The following table presents information regarding troubled debt restructurings by class for the year ended December 31, 2013.

	2013		
	Number of Loans	Pre- Modification Recorded Balance	Post- Modification Recorded Balance
Real Estate			
Construction	1	\$ 261,961	\$ 261,961
	1	\$ 261,961	\$ 261,961

The troubled debt restructurings noted above generally consisted of interest rate and maturity date concessions and had an immaterial impact on the allowance for loan losses during the year ended December 31, 2013.

The Company has not had any current year troubled debt restructurings that subsequently defaulted in the current year. Default occurs when a loan is 90 days or more past due or transferred to nonaccrual within 12 months of restructuring.

There were no newly classified troubled debt restructured loans for the year 2012.

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Note 5: Premises and Equipment

Major classifications of premises and equipment, stated at cost, are as follows:

	2013	2012
Land	\$ 1,913,220	\$ 1,913,220
Buildings and improvements	6,033,673	6,021,639
Furniture and equipment	4,006,231	3,965,354
Construction in process	29,090	25,001
	<u>11,982,214</u>	<u>11,925,214</u>
Less accumulated depreciation	<u>(5,284,182)</u>	<u>(5,043,222)</u>
Net premises and equipment	<u>\$ 6,698,032</u>	<u>\$ 6,881,992</u>

Note 6: Income Taxes

The provision for income taxes includes these components:

	2013	2012
Taxes currently payable	\$ 1,958,074	\$ 1,717,603
Deferred income benefit	<u>(129,429)</u>	<u>(37,902)</u>
Income tax expense	<u>\$ 1,828,645</u>	<u>\$ 1,679,701</u>

	2013	2012
Computed at the statutory rate (34%)	\$ 1,772,173	\$ 1,650,603
Tax-exempt interest	(149,369)	(142,646)
State income taxes, net	281,509	261,600
Income tax credits	(84,560)	(55,810)
Other	<u>8,892</u>	<u>(34,046)</u>
Actual tax expense	<u>\$ 1,828,645</u>	<u>\$ 1,679,701</u>

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A reconciliation of income tax expense (benefit) at the statutory rate to the Bank's actual income tax expense is shown below:

	2013	2012
Deferred tax assets		
Allowance for loan losses	\$ 687,109	\$ 676,842
Deferred compensation	445,658	394,040
Other real estate owned write-downs	-	55,883
State capital loss carryforward	48,654	48,654
Net unrealized loss on securities available for sale	177,424	-
Other	55,212	47,472
Total assets	<u>1,414,057</u>	<u>1,222,891</u>
Deferred tax liabilities		
Depreciation	(272,164)	(278,455)
Goodwill	(530,684)	(474,021)
Net unrealized gain on securities available for sale	-	(171,077)
Mortgage servicing rights	(84,549)	(97,525)
Prepaid expenses	(79,108)	(73,216)
Deferred FHLB stock dividends	(39,985)	(39,050)
Other	(24,528)	(184,438)
Total liabilities	<u>(1,031,018)</u>	<u>(1,317,782)</u>
Valuation allowance	<u>(48,654)</u>	<u>(48,654)</u>
	<u>\$ 334,385</u>	<u>\$ (143,545)</u>

The Company has an Indiana state tax capital loss carryforward of \$955,733, which expires in 2014. The Company maintains a valuation allowance as it does not anticipate generating capital gains in Indiana to utilize this carryforward prior to its expiration.

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax of the state of Indiana. The Company is no longer subject to examination by taxing authorities for years before 2010. The Company does not expect the total amount of unrecognized tax benefits to significantly change in the next 12 months.

The Company recognizes interest and/or penalties related to income tax matters in income tax expenses. The Company did not have any amounts accrued for interest and penalties at December 31, 2013.

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Note 7: Deposits

Time deposits in denominations of \$100,000 or more were \$43,180,613 and \$46,670,503 at December 31, 2013 and 2012, respectively.

At December 31, 2013, the scheduled maturities of certificates and time deposits are as follows:

2014	\$ 49,139,162
2015	14,529,377
2016	12,034,150
2017	9,497,824
2018	4,778,164
	<u>\$ 89,978,677</u>

Deposits from related parties totaled approximately \$4,571,000 at December 31, 2013.

Note 8: Federal Home Loan Advances

Federal Home Loan Advances at December 31, 2013 and 2012 consisted of the following:

	<u>2013</u>	<u>2012</u>
Federal Home Loan Bank advances	<u>\$ 3,000,000</u>	<u>\$ 3,000,000</u>

Each advance is payable at its maturity date, with a prepayment penalty for fixed rate advances. During the year ended December 31, 2012, the Bank paid off a portion of its FHLB advances early, which resulted in prepayment penalty fees of \$531,140. This is separately disclosed on the income statement as loss on extinguishment of debt. The Federal Home Loan Bank advances are secured by first mortgage loans totaling approximately \$72,431,000 December 31, 2013.

The future maturities of borrowings at December 31, 2013 were as follows:

2014	\$ -
2015	2,000,000
2016	-
2017	-
2018	1,000,000
	<u>\$ 3,000,000</u>

Notes payable at December 31, 2012 consists of a line of credit with Bankers Bank of Kentucky with an interest rate of prime rate less 0.25%; however, the interest rate shall not drop below 4.50%. The principal was repaid on March 3, 2013 at maturity and was collateralized by 100% of the common stock of the Company.

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Note 9: Commitments and Contingencies

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet financing needs of its customers. These financial instruments include commitments to extend loans and unused credit lines to customers. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument is represented by the contractual amount of those instruments. The Bank uses the same credit policy to make such commitments as it uses for on-balance-sheet items.

Off-balance-sheet commitments are as follows at December 31, 2013 and 2012

	2013	2012
Commitments to extend credit	\$ 2,189,000	\$ -
Unused lines of credit	12,414,000	5,965,564
Standby letters of credit	340,000	230,000

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include accounts receivable, inventory, property and equipment, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party.

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

As of December 31, 2013, the Bank had line of credit agreements with the Federal Home Loan Bank, which allow the Bank to borrow up to the \$6,000,000. There were no outstanding balances on these lines of credit as of December 31, 2013.

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Note 10: Benefit Plans

The Bank sponsors a defined-contribution 401(k) plan with ESOP provisions, which covers substantially all employees. Eligible employees can elect to defer up to 15 percent of their salary, not to exceed \$17,500. The Bank matches one half of employee contributions, up to six percent of their salaries. Employer's contributions are 100% vested after five years of service. The Plan includes an employee stock ownership option. Employees can direct all or a portion of their contributions to purchase stock of the Company. The Bank's total 401(k) contributions charged to expense in 2013 and 2012 were \$139,151 and \$169,029.

Participants receive distributions from the plan of their vested shares of Company common stock subsequent to the end of their employment. The Company is required to redeem the shares of Company common stock that have been distributed from the plan at current market value, upon request of the participants receiving such distributions. An independent appraisal is obtained annually to determine the market value of Company stock. As of December 31, 2013 and 2012, there were 22,833 and 22,506 allocated shares with a fair value of \$890,485 and \$810,212 subject to repurchase obligation.

Under the ESOP provisions of the Plan, the Plan entered into a loan with the Company in connection with the repurchase of 10,500 shares from an unrelated shareholder. The amount of the loan at inception was \$357,000 and accordingly, this amount was shown as a reduction of shareholders' equity. These unallocated shares are released to participants proportionately as the loan is repaid. Dividends on allocated shares are recorded as dividends and charged to retained earnings. Dividends on unallocated shares are used to repay the loan and are treated as compensation expense. Compensation expense recorded is equal to the fair market value of the shares released for allocation.

The ESOP shares as of December 31, 2013 and 2012 were as follows:

	<u>2013</u>	<u>2012</u>
Allocated shares, beginning of year	143,455	129,914
Shares released during the year for allocation	3,938	5,250
Unreleased shares, end of year	<u>-</u>	<u>3,938</u>
Total ESOP shares	<u>147,393</u>	<u>139,102</u>
Fair value of unreleased shares	<u>-</u>	<u>141,750</u>

The Bank is obligated at the option of each beneficiary to repurchase shares of the ESOP upon the beneficiary's termination or after retirement. At December 31, 2013, the fair value, as estimated by independent third party, of the 147,393 allocated shares held by the ESOP is \$5,895,720. In addition, there are 188 outstanding shares held by former employees that are subject to an ESOP-related repurchase option. The fair value of all shares subject to the repurchase obligation is \$7,332.

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In addition, the Bank has entered into deferred compensation, salary continuation agreements that provide benefits to certain directors and officers or their beneficiaries. The benefits expected to be paid are being accrued to date of full eligibility. Benefit payments under the agreements may be accelerated upon death, disability or termination by the Bank prior to full eligibility. The salary continuation plan was frozen in 2007. The expense incurred for the deferred compensation plan in 2013 and 2012 was \$120,099 and \$148,189.

Note 11: Stock Options

Options to buy stock are granted to directors, officers and employees under the Employee Stock Option Plan, which provides for issue of up to 100,000 options. The maximum option term is ten years. At December 31, 2013, options to purchase 85,728 shares of stock remain for future grant under this plan.

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 Company's common stock. The Company 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. The risk-free rate of interest for the expected life of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. There were no grants in 2013 or 2012.

A summary of the activity in the plan is as follows.

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding, beginning of year	12,172	34.00	8.03	\$ 24,344
Granted	-			
Exercised	(344)	34.00		
Forfeited or expired	-			
	<u>11,828</u>	<u>34.00</u>	<u>7.03</u>	<u>\$ 59,140</u>
Outstanding, end of year	<u>11,828</u>	<u>34.00</u>	<u>7.03</u>	<u>\$ 59,140</u>
Exercisable, end of year	<u>11,828</u>	<u>34.00</u>	<u>7.03</u>	<u>\$ 59,140</u>

The total intrinsic value of options exercised during the years ending December 31, 2013 and 2012 was \$688 and \$22,415, respectively. Cash received from option exercises for the years ended December 31, 2013 and 2012 was \$11,696 and \$105,000. The actual tax benefit realized for the tax deductions from stock option exercises totaled \$0 and \$14,423 for the years ended December 31, 2013 and 2012.

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Note 12: Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies and is assigned to a capital category. The assigned capital category is largely determined by three ratios that are calculated according to the regulations: total risk adjusted capital, Tier 1 capital and Tier 1 leverage ratios. The ratios are intended to measure capital relative to assets and credit risk associated with those assets and off-balance sheet exposures of the entity. The capital category assigned to the Bank can also be affected by qualitative judgments made by regulatory agencies about the risk inherent in the entity's activities that are not part of the calculated ratios. Furthermore, the Bank's regulators could require adjustments to regulatory capital not reflected in these consolidated financial statements.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined) and of Tier I capital to average assets (as defined). Management believes, as of December 31, 2013 and 2012, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2013, the most recent notification from the regulators categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the table. There are no conditions or events since December 31, 2013 that management believes have changed the Bank's classification.

The Bank's actual and required capital amounts and ratios are as follows:

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2013						
Total capital						
(to risk-weighted assets)	\$ 30,684	16.1%	\$ 15,274	8.0%	\$ 19,093	10.0%
Tier I capital						
(to risk-weighted assets)	28,410	14.9%	7,637	4.0%	11,456	6.0%
Tier I capital						
(to average assets)	28,410	8.9%	12,809	4.0%	16,011	5.0%
As of December 31, 2012						
Total capital						
(to risk-weighted assets)	\$ 28,919	15.4%	\$ 15,044	8.0%	\$ 18,804	10.0%
Tier I capital						
(to risk-weighted assets)	26,610	14.2%	7,522	4.0%	11,283	6.0%
Tier I capital						
(to average assets)	26,610	8.4%	12,653	4.0%	15,816	5.0%

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Without prior approval, current regulations allow the Bank to pay dividends not exceeding net profits (as defined) for the current year, plus those for the previous two years. The Bank normally restricts dividends to a lesser amount because of the need to maintain an adequate capital structure.

Note 13: Disclosures About Fair Values of Financial Instruments

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements must maximize the use of observable inputs and minimize the use of unobservable inputs. There is a hierarchy of three levels of inputs that may be used to measure fair value:

- Level 1** Quoted prices in active markets for identical assets or liabilities.
- Level 2** 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 for substantially the full term of the assets or liabilities
- Level 3** Unobservable inputs supported by little or no market activity and are significant to the fair value of the assets or liabilities

Following is a description of the valuation methodologies and inputs used for instruments measured at fair value on a nonrecurring basis and recognized in the accompanying consolidated balance sheets, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Available-for-Sale Securities

Where quoted market prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics or discounted cash flows. Matrix pricing is a mathematical technique widely used in the banking industry to value investment securities without relying exclusively on quoted prices for specific investment securities but rather relying on the investment securities relationship to other benchmark quoted investment securities.

Level 2 securities include U.S. Government-sponsored agencies and mortgage-backed securities. Matrix pricing is a mathematical technique widely used in the banking industry to value investment securities without relying exclusively on quoted prices for specific investment securities but rather relying on the investment securities' relationship to other benchmark quoted investment securities.

In certain cases where Level 1 or Level 2 inputs are not available, securities are classified within Level 3 of the hierarchy.

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Assets Measured on a Recurring Basis

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

	Fair Value	2013 Fair Value Measurements Using		
		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. Treasury and government agency	\$ 31,781,886	\$ 7,086,289	\$ 24,695,597	\$ -
Mortgage-backed securities - residential	5,690,060	-	5,690,060	-
Corporate debt	3,107,687	-	3,107,687	-
 Total investment securities available-for-sale	 \$ 40,579,633	 \$ 7,086,289	 \$ 33,493,344	 \$ -

	Fair Value	2012 Fair Value Measurements Using		
		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. Treasury and government agency	\$ 29,758,786	\$ 9,241,408	\$ 20,517,378	\$ -
Mortgage-backed - residential	9,327,145	-	9,327,145	-
Corporate debt	3,349,711	-	3,349,711	-
 Total investment securities available-for-sale	 \$ 42,435,642	 \$ 9,241,408	 \$ 33,194,234	 \$ -

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Following is a description of the valuation methodologies and inputs used for assets and liabilities measured at fair value on a nonrecurring basis and recognized in the accompanying consolidated balance sheets, as well as the general classification of such assets and liabilities pursuant to the valuation hierarchy.

Impaired Loans (Collateral Dependent)

The estimated fair value of collateral-dependent impaired loans is based on the appraised fair value of the collateral, less estimated cost to sell. Collateral-dependent impaired loans are classified within Level 3 of the fair value hierarchy.

The Company considers the appraisal or evaluation as the starting point for determining fair value and then considers other factors and events in the environment that may affect the fair value. Appraisals of the collateral underlying collateral-dependent loans are obtained when the loan is determined to be collateral-dependent and subsequently as deemed necessary by management. Appraisals are reviewed for accuracy and consistency by management. Appraisers are selected from the list of approved appraisers maintained by management. The appraised values are reduced by discounts to consider lack of marketability and estimated cost to sell if repayment or satisfaction of the loan is dependent on the sale of the collateral. These discounts and estimates are developed by management by comparison to historical results.

Other Real Estate Owned

Other real estate owned (OREO) is carried at the lower of fair value at acquisition date or current estimated fair value, less estimated cost to sell when the real estate is acquired. Estimated fair value of OREO is based on appraisals or evaluations. OREO is classified within Level 3 of the fair value hierarchy.

Appraisals of OREO are obtained when the real estate is acquired and subsequently as deemed necessary by management. Appraisals are reviewed for accuracy and consistency by management. Appraisers are selected from the list of approved appraisers maintained by management.

The following tables present the fair value measurement of assets measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fall at December 31, 2013 and 2012:

	2013			
	Fair Value Measurements Using			
Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Impaired loans	\$ 525,832	\$ -	\$ -	\$ 525,832

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	Fair Value	2012 Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	\$ 1,386,440	\$ -	\$ -	\$ 1,386,440
Other real estate				
Commercial	\$ 288,922	\$ -	\$ -	\$ 288,922
Residential	286,105	-	-	286,105
	<u>\$ 575,027</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 575,027</u>

Unobservable (Level 3) Inputs

The following tables present quantitative information about unobservable inputs used in nonrecurring Level 3 fair value measurements.

	Fair Value at December 31, 2013	Valuation Technique	Unobservable Inputs	Range
Impaired loans - collateral dependent	\$ 525,832	Sales comparison approach	Marketability discount	0-43%

	Fair Value at December 31, 2012	Valuation Technique	Unobservable Inputs	Range
Impaired loans - collateral dependent	\$ 1,386,440	Sales comparison approach	Marketability discount	10-35%
Other real estate owned	575,027	Sales comparison approach	Marketability discount	10-20%

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The following tables present the fair value measurement of assets recognized in the accompanying consolidated balance sheets measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fall at December 31, 2013 and 2012:

	2013		2012	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(Table in '000's)		(Table in '000's)	
Financial Assets				
Cash and due from banks	\$ 10,153	\$ 10,153	\$ 12,743	\$ 12,743
Federal funds sold	484	484	1,732	1,732
Interest bearing time deposits	1,954	1,954	200	200
Securities held to maturity	13,829	14,028	14,583	15,305
Loans held for sale	288	288	768	768
Loans, net	231,547	235,315	225,620	239,398
Restricted equity investments	2,352	N/A	2,352	N/A
Accrued interest receivable	1,367	1,367	1,374	1,374
Financial liabilities				
Deposits	280,977	282,159	281,249	283,514
Federal Home Loan Bank advances	3,000	3,168	3,000	3,193
Notes payable	-	-	1,555	1,555
Accrued interest payable	103	103	112	122

The following methods were used to estimate the fair value of all other financial instruments recognized in the accompanying consolidated balance sheets at amounts other than fair value.

Cash and Cash Equivalents, and Interest-Bearing Time Deposits

The carrying amount approximates fair value.

Loans Held For Sale

The carrying amount approximates fair value due to the insignificant time between origination and date of sale. The carrying amount is the amount funded and accrued interest.

Loans

Fair value is estimated by discounting the future cash flows using the market rates at which similar notes would be made to borrowers with similar credit ratings and for the same remaining maturities. The market rates used are based on current rates the Banks would impose for similar loans and reflect a market participant assumption about risks associated with nonperformance, illiquidity, and the structure and term of the loans along with local economic and market conditions.

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Restricted Equity Investments

Fair value is estimated at book value due to restrictions that limit the sale or transfer of such securities.

Accrued Interest Receivable and Payable

The carrying amount approximates fair value. The carrying amount is determined using the interest rate, balance and last payment date.

Deposits

Fair value of term deposits is estimated by discounting the future cash flows using rates of similar deposits with similar maturities. The market rates used were obtained from a knowledgeable independent third party and reviewed by the Company. The rates were the average of current rates offered by local competitors of the bank subsidiaries.

The estimated fair value of demand, NOW, savings and money market deposits is the book value since rates are regularly adjusted to market rates and amounts are payable on demand at the reporting date.

Federal Home Loan Bank Advances and Notes Payable

Fair value is estimated by discounting the future cash flows using rates of similar advances with similar maturities. These rates were obtained from current rates offered by FHLB.